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The Limits of Federal Arbitrage Replacement Theories

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I. Introduction

The use of tax-exempt obligations in municipal financing has recently seen tremendous growth.[1] The attraction, for purchasers and municipal issuers, is the tax-exempt nature of the interest earned and paid on municipal obligations; the purchaser earns tax-free income and, because of this, a municipality can issue obligations which pay interest rates lower than obligations whose interest is not tax-exempt.[2] However, not all municipal obligations earn tax-exempt interest for their purchasers: section 103(b)[3] of the Internal Revenue Code disqualifies industrial development bonds; section 103(c)[4] disqualifies the subject of this Article, arbitrage bonds.

An arbitrage bond, in general, is a municipal obligation which is used to make an arbitrage profit;[5] such a profit is made when municipalities exploit the difference between taxable and tax-exempt interest rates. For example, by issuing an obligation which pays interest to its purchaser at the rate of seven percent,

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1. *See* The Bond Buyer, Apr. 4, 1983, at 1.

2. *See* I.R.C. § 103(a) (1976), which provides in part, that gross income does not include interest on the obligations of a state, territory, or possession of the United States or any subdivision of the above. The effect of this section is to benefit states and localities by lowering their borrowing costs.

3. I.R.C. § 103(b) (1976). An industrial development bond is a bond issued by a municipality on behalf of a private business which is secured only by such business' credit. The issuer lends the borrowed funds to the business directly, or leases or sells, on an installment basis, property financed with such funds. Industrial development bonds suffer from the same defects as arbitrage bonds. See *infra* notes 72-74 and accompanying text for a discussion of the defects of arbitrage bonds.

4. I.R.C. § 103(c) (1976).

5. Arbitrage, generally, is "[t]he simultaneous purchase in one market and sale in another of a security or commodity in hope of making a profit on price differences in the different markets." BLACK'S LAW DICTIONARY 95 (rev. 5th ed. 1979).

and reinvesting the proceeds obtained from such obligations in other high grade taxable investments which yield nine percent per year, a municipality gains a material financial advantage to the extent that the interest rates differ. For reasons discussed in full later in this Article,[6] Congress, in 1969,[7] delegated broad authority to the Treasury Department to keep arbitrage bonds out of the municipal bond market.

Clearly, an arbitrage bond exists if a municipality takes proceeds from a bond issuance and directly invests them in materially higher yielding obligations.[8] However, and unfortunately for unwary municipal bond financiers, arbitrage bonds also exist when it is found that the proceeds of a bond issuance *replace* funds invested in materially higher yielding obligations. This replacement concept, created with the original statutory section in 1969,[9] has emerged, since 1978,[10] as the Treasury Department's major weapon in its war against arbitrage bonds.

Section 103(c)(2) provides:

> [T]he term "arbitrage bond" means any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly —
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> (A) to acquire securities . . . or obligations . . . which may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue which is materially higher . . . than the yield on obligations of such issue, or
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> (B) to *replace* funds which were used directly or indirectly to acquire securities or obligations described in subparagraph (A).[11]

The problem with section 103(c)(2)(B) is how to determine when such a "replacement" occurs. Simply stated, there must be a sufficiently direct relationship between the note proceeds and

6. *See infra* notes 72-75 and accompanying text.

7. Tax Reform Act of 1969, Pub. L. No. 91-172, § 601(a), 83 Stat. 487, 656. *See infra* notes 84-88 and accompanying text.

8. Generally, a "materially higher yielding" obligation is determined, by regulation, in two different calculations. First, the "yield" of an obligation is computed. Treas. Reg. § 1.103-13(c)-(d) (1979). Second, "materially higher" is computed. *Id.* at § 1.103-13(b)(5) (1976). A "materially higher" yield is normally that which exceeds ⅛ % of the yield on the bond.

9. *See infra* note 87.

10. *See infra* notes 91-93 and accompanying text.

11. I.R.C. § 103(c)(2)(A)-(B) (1976) (emphasis added).

the higher yielding obligations.[12] This Article, by drawing upon the legislative history and regulations of section 103(c), the rulings interpreting section 103(c)(2)(B) and a closely related code section, section 265(2),[13] will explore the nature of this "sufficiently direct relationship" and thereby illustrate the limits of the arbitrage replacement concept.

Any discussion of section 103 must be preceded by an analysis of section 265 which provides the exception to the general rule that interest paid or accrued within the taxable year is tax deductible. This Article will begin by presenting the legislative development and interpretive case law relating to section 265(2). This review will include the concept of a "sufficiently direct relationship" which has evolved from revenue rulings and case law to become a requirement under section 265(2). This term, as will become clearer later,[14] is extremely helpful in formulating a replacement model. This overview will be followed by a similar review of section 103(c)'s legislative history and the development of the requisite "sufficiently direct relationship," with appropriate references to its counterpart under section 265(2). The Article will then conclude with a model illustrating the limits of the arbitrage replacement concept.

II. The Evolution of Section 265(2)

A. *Legislative Development*

Section 163 of the Internal Revenue Code allows deductions for "all interest paid or accrued within the taxable year on indebtedness."[15] Section 265(2),[16] which provides an exception to this general rule, disallows deductions for "[i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from"[17] federal income tax.

12. *See* Rev. Rul. 78-348, 1978-2 C.B. 95.

13. I.R.C. § 265(2) (1981). Note that any discussion of § 265(2) necessarily revolves around its application to corporations. Discussions of other § 265(2) applications are beyond the scope of this Article.

14. *See infra* text accompanying notes 67-70.

15. I.R.C. § 163(a) (1976).

16. I.R.C. § 265(2) (1981).

17. *Id.*

The legislative history of this section indicates that interest deductions should not be allowed if there is a purpose to use borrowed funds to purchase or carry tax-exempt securities.[18] This "purpose" requirement has been part of the statute since 1917. The second paragraph of subdivision (a) of section five reads in part: "Second. All interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities . . . ."[19]

Section 265(2) was broadened to its present scope by section 214(a)(2) of the Revenue Act of 1918,[20] which allowed deductions for interest expense on indebtedness except for

> [a]ll interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer.[21]

Two unsuccessful attempts, in 1924 and 1925, to amend these sections solidified the "purpose" requirement in section 265(2)'s statutory scheme.[22]

B. *The Interpretive Case Law*

The first case to interpret section 265(2) was *R.B. George Machinery Co. v. Commissioner.*[23] The petitioner, having received non-negotiable, tax-exempt deficiency warrants[24] from

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18. *See infra* note 21.

19. Revenue Act of 1917, Pub. L. No. 50, § 1201(1), 40 Stat. 300, 330.

20. Revenue Act of 1918, Pub. L. No. 250, § 234(a)(2), 40 Stat. 1057, 1066-67.

21. This is a paraphrase of I.R.C. § 265(2) (1981). A broader statute, proposed and passed by the House of Representatives, would have eliminated any requirement of "purpose" or "direct relationship" and automatically offset tax-exempt income against deductible interest expenses without regard for any relationship between the two items. This version would have allowed deductions for interest paid or accrued within the taxable year on indebtedness in excess of interest received free from taxation under this title. *See* J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 910 (1938).

22. *See* 67 CONG. REC. 2964 (1926); 65 CONG. REC. 7541 (1924).

23. 26 B.T.A. 594 (1932). *See also* Sioux Falls Metal Culvert Co. v. Commissioner, 26 B.T.A. 1324 (1932).

24. A warrant is simply an order by which the drawer promises to pay one person a particular sum of money. *See* BLACK'S LAW DICTIONARY 1421 (rev. 5th ed. 1979). The deficiency warrants were debt instruments representing the money owed by the State of Texas to R.B. George Machinery Co.

the State of Texas and its political subdivisions in payment for machinery, used the warrants as security in obtaining a loan for normal business operations, since payment in the form of warrants had created a cash shortage for the company. The court identified the issue as whether "the interest here in controversy was interest paid on 'indebtedness incurred or continued . . . to *carry* obligations or securities . . . the interest upon which is wholly exempt from taxation.' "[25] Noting that the statute was designed to prevent the purchaser of tax-exempt obligations from deducting interest paid for borrowed money used to acquire such securities, the court held:

> [T]he exception in the statute should not be construed more broadly than to effect its obvious purpose. It was not intended to penalize legitimate business or to deny it the right to deduct interest paid for borrowed money, which money was used for the purpose of carrying on its regular functions. The warrants held by petitioner were received in payment for goods sold and they were apparently given because the state or its subdivisions could not at the time pay cash. They in no true sense of the word represented investments by petitioner, as it preferred at all times to get its cash out of them. The fact that in making the loan the petitioner hypothecated the warrants does not alter the fact as stipulated that the cash as borrowed was for the purpose of operating its business. It was not used to buy or secure the warrants in any sense of the word.[26]

Thus the interest paid on the loan was considered to be a deductible business expense. The court's reasoning revolved around legitimate business reasons: the company needed money to carry on its operations, borrowed money for such purpose, and therefore did not borrow money to "carry" the tax-exempt warrants.[27]

The term "sufficiently direct relationship" did not appear

25. R.B. George Mach. Co. v. Commissioner, 26 B.T.A. at 597 (quoting I.R.C. § 265(2) (1981) (emphasis added)).

26. *Id.* at 597-98. *See also* Denman v. Slayton, 282 U.S. 514 (1931). Holding § 265(2) to be constitutional, the Court stated: "The manifest purpose of the exception in paragraph 2, § 214 (a), was to prevent the escape from taxation of income properly subject thereto by the purchase of exempt securities with borrowed money. . . . It was proper to make provision to prevent such a possibility." *Id.* at 519-20.

27. R.B. George Mach. Co. v. Commissioner, 26 B.T.A. at 597-98.

until 1967, in *Illinois Terminal Railroad v. United States.*[28] Illinois Terminal, having obtained a large loan to purchase several assets, sold one of these assets to a municipality for cash and tax-exempt obligations. The cash was used to pay back some of the original debt; the tax-exempt obligations, however, were held and not liquidated to further reduce such debt.[29] The Internal Revenue Service argued that the indebtedness was "continued" to "carry" the bonds; the taxpayer argued that "the bonds were unrelated to the loan and instrumental to the successful long-term financing of its business."[30]

The court began its analysis by noting that the taxpayer erred in assuming that the loan funds must be traced to the cost of the bonds, because this approach fails to distinguish between loans "incurred . . . to purchase" and loans "continued . . . to carry" tax-exempt obligations.[31] "The real issue here is whether the remaining loan, regardless of its size or correlation with the cost basis of other assets, was continued for the purpose of enabling plaintiff to own the Series 'B' bonds of the City of Venice."[32]

The resolution of this issue, noted the court, requires the

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28. 375 F.2d 1016, 1021 (Ct. Cl. 1967).

29. *Id.* at 1018-19.

30. *Id.* at 1020. The court noted:

> Because the proceeds from the sale of the bridge were used in part to reduce the loan by more than the cost basis of the bridge, plaintiff argues, the remaining debt must be identified with the other assets and expenses which were acquired or incurred during the purchase and early operation of the business and the additional consideration in the form of municipal bonds represents appreciation in the value of the bridge and, hence, is unrelated to the debt.

Id.

31. *Id. See also* Bishop v. Commissioner, 41 T.C. 154, 160-61 (1963), *aff'd*, 342 F.2d 757 (6th Cir. 1965), where the court stated:

> She did not repay the loan but left it outstanding. This is the generally understood meaning of the word "continued" when used in connection with a loan. She continued the loan instead or repaying it with the proceeds of the sale of the non-tax-exempt securities, so that she would have the funds to purchase and hold tax-exempt securities. This, we consider to be continuing the loan to purchase and carry the tax-exempt securities. . . . The purpose of this section [265(2)] would be too easily frustrated if a borrower could avoid its impact by the simple expedient of buying non-tax-exempt securities with the borrowed funds, then selling those securities and using the proceeds of the sale to purchase tax-exempt securities instead of repaying the loan.

Id.

32. Illinois Terminal R.R. v. United States, 375 F.2d at 1020.

establishment of a sufficiently direct relationship between the continuance of the debt and the carrying of the tax-exempt obligations.[33] Citing *Denman v. Slayton*,[34] the court set the stage for this "sufficiently direct relationship" by stating that "a business cannot escape taxation of income by the device of purchasing or carrying tax exempt securities with borrowed money not required to carry on its regular functions."[35] If the loan in question was necessary to sustain the taxpayer's business operations rather than to sustain the ownership of tax-exempt securities, section 265(2) would not apply.[36] Here the court found, however, that the taxpayer could have reduced the outstanding debt by liquidating the bonds without damaging the corporation's activities;[37] the taxpayer had a choice, and chose to hold the bonds and maintain the outstanding debt.[38] Therefore, there was an obvious relationship between the debt and the tax-exempt bonds: despite the taxpayer's legitimate business reasons[39] for holding the bonds, it was apparent that the dominant reason for continuing the indebtedness was the unwillingness to relinquish

33. *Id.* at 1021. The court further noted that this is a slightly different inquiry from one used in situations where the issue is whether indebtedness was incurred to purchase tax-exempt bonds. *Id.*

34. 282 U.S. 514 (1931).

35. Illinois Terminal R.R. v. United States, 375 F.2d at 1021.

36. *Id. See also supra* notes 23-26 and accompanying text.

37. The taxpayer, citing R.B. George Mach. Co. v. Commissioner, 26 B.T.A. 594 (1932), argued, correctly, that 265(2) does not disallow interest on debts incurred in carrying on business functions. The court, however, distinguished *R.B. George Mach. Co.*: "[T]here the state securities could not be liquidated and, hence, the taxpayers had no alternative for supplying their cash needs but to borrow money." Illinois Terminal R.R. v. United States, 375 F.2d at 1021. *See supra* notes 23-26 and accompanying text. *See also* Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420, 422 (7th Cir. 1968).

38. Illinois Terminal R.R. v. United States, 375 F.2d at 1021.

> Thus, a loan was not the only source of funds and was not required by the dictates of successful corporate finance, but rather it was chosen by plaintiff as a more desirable source of funds than the municipal bonds. Plaintiff's argument fails for lack of purity of purpose in maintaining the loan, because it was continued out of a concern for preserving the bondholdings, which could be accomplished only if the debt financed the plaintiff's operations.

Id.

39. The taxpayer argued that the bonds were valuable as security for another bond issue; the court countered by stating that "the issue is whether the indebtedness was continued in order to carry the bonds and the beneficial use of those bonds (absent a showing of essentiality) says little about this central issue." *Id.* at 1022. Further, "to say that a large part of the debt was needed because it enabled an asset to be security for the refinancing of that debt is circular, to say the least." *Id.*

the bonds. Since "the total impression given by the evidence led to the conclusion that the taxpayer had the forbidden purpose,"[40] and that the requisite relationship between the bonds and the debt existed, the court disallowed the taxpayer's interest deduction.[41]

Wisconsin Cheeseman, Inc. v. United States,[42] following *Illinois Terminal Railroad*, developed further this requisite "sufficiently direct relationship." Wisconsin Cheeseman, which ran a seasonal business, incurred cash shortages at specific times of the year which it alleviated with short term loans. These loans were repaid with receipts from each year's sales; the balance was used to purchase municipal bonds and treasury bills. The treasury bills were reduced to cash every July, while the municipal bonds were used as collateral for the short-term loans. Eventually, Wisconsin Cheeseman accumulated over $200,000 in municipal bond holdings.[43]

The Government argued that Wisconsin Cheeseman could have sold its municipals, instead of using them as collateral for short-term loans, to meet its high cost seasonal business needs; Wisconsin Cheeseman argued that the loans were obtained to meet its financing needs.[44] The court began its analysis by stating that an interest deduction is not forbidden whenever a taxpayer has the alternative of liquidating tax-exempts in lieu of borrowing.[45] Rather, there must be a nexus, or a sufficiently direct relationship, between the debt and the tax-exempt bonds; here the requisite nexus existed because the tax-exempt bonds were used as collateral for the seasonal loans.[46] The court stated:

> Applying the rule that the substance of the transaction is controlling in determining the tax liability, the same result should follow when the tax-exempt securities are used as collateral for a loan. Surely one who borrows to buy tax-exempts and one who borrows

40. *Id.* at 1022-23. *See supra* text accompanying note 18.
41. *Id.* at 1023.
42. 388 F.2d 420 (7th Cir. 1968).
43. *Id.* at 421.
44. *Id.* at 421-22.
45. *Id.* at 422. "The Government has not convinced us that interest deduction can be allowed only where the taxpayer shows that he wanted to sell the tax-exempt securities but could not." *Id.* at 422.
46. *Id.*

against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them.[47]

The court added an additional test which disallowed the interest deduction even if the municipals were not used as collateral for the short-term loans: the deduction "will not be allowed if the taxpayer could reasonably have foreseen at the time of purchasing the tax-exempts that a loan would be required to meet future economic needs of an ordinary, recurrent variety."[48] This test applied to Wisconsin Cheeseman: "Its regular business pattern showed that it would have to go into debt each fall if it bought or kept municipals as a long-term investment."[49] This conduct, the court noted, clearly indicated that the underlying reason for the recurring loans was to carry the municipal bonds. The requisite nexus between the debt and the tax-exempts existed, and the court accordingly disallowed Wisconsin Cheeseman's interest deduction.[50]

In 1972, the Internal Revenue Service attempted to summarize the development of section 265 in one statement: Revenue Procedure 72-18.[51] The procedure classified section 265(2) inquiries into two categories: the requisite "sufficiently direct relationship" may be established either by direct evidence of a purpose to carry or purchase tax-exempt obligations or, in its absence, circumstantial evidence of such purpose.[52] Direct evidence of a purpose to purchase tax-exempts exists when the loan

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47. *Id.*

48. *Id.*

49. *Id.* at 422-23.

50. *Id.* Also in contention was the interest deduction for payments on a mortgage; the court found only an "insufficient relationship" here: "We cannot say that a reasonable person would sacrifice liquidity and security by selling municipals in lieu of incurring mortgage debt to finance a new plant. Business reasons dominated the mortgaging of the property." *Id.* at 423. If Wisconsin Cheeseman "had sold municipal bonds to pay for the plant, it would have had fewer liquid assets to meet seasonal needs and would have had difficulty in borrowing to meet those needs. Plant construction is undeniably a major, non-recurrent expenditure and is usually financed over a long term." *Id.*

51. Rev. Proc. 72-18, 1972-1 C.B. 740. Similarly, § 265(2) will not apply to an individual taxpayer's "mortgage incurred to purchase or improve a residence or other real property . . . held for personal use . . . , because the *purpose* to purchase or carry tax-exempt obligations cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt obligations ordinarily dominates the transaction." *Id.* at 741.

52. *Id.* at 740.

proceeds are directly traced to such purchase; direct evidence of a purpose to carry tax-exempts exists where such tax-exempts are used as collateral for the loan.[53]

The circumstantial evidence test is that, in the absence of direct evidence, section 265(2) will only apply if the totality of the facts and circumstances supports a *reasonable inference* that the forbidden purpose exists.[54] "Stated alternatively, section 265(2) will apply only where the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations."[55]

In effect, this test may be set forth as follows: the forbidden purpose will be *inferred* if the facts and circumstances establish a sufficiently direct relationship between the debt and the tax-exempts. Further, the purpose to carry tax-exempts can be a rebuttable presumption, such as when the taxpayer could have reasonably foreseen, at the time of purchasing the tax-exempt obligations, that indebtedness would have to be incurred to meet future ordinary, recurrent economic needs of the business.[56] This presumption is rebutted by the demonstration of dominating business reasons, unrelated to the purchase or carrying of tax-exempts, for obtaining the loan.[57] "[T]he purpose to carry tax-exempt obligations [will also] be inferred [when the taxpayer] continues indebtedness which it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations without withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities."[58]

Handy Button Machine Co. v. Commissioner[59] reinforced Revenue Procedure 72-18's interpretation of section 265(2). The

53. *Id.* at 740-41 (citing Wisconsin Cheeseman, Inc. v. United States, 388 F.2d at 422).

54. Rev. Proc. 72-18, 1972-1 C.B. at 741.

55. *Id.*

56. *Id.* (citing Wisconsin Cheeseman, Inc. v. United States, 388 F.2d at 422).

57. *See* Rev. Proc. 72-18, 1972-1 C.B. at 743.

> For example, the purpose to carry tax-exempt obligations generally cannot be inferred where a mortgage debt is incurred to finance a new plant which is a nonrecurrent major expenditure. In such cases, a dominant business purpose, other than the purchase or carrying of tax exempt obligations will normally exist and, accordingly, any inference will be rebutted.

Id.

58. *Id.* (citing Illinois Terminal R.R. v. United States, 375 F.2d at 1022).

59. 61 T.C. 846 (1974).

taxpayers purchased shares of their own stock while simultaneously holding large amounts of tax-exempt obligations originally purchased to meet established business needs. The cash proceeds of some of the obligations were used to make the down payments for the stock; the balance of the purchase price was represented by six percent interest-bearing installment notes. Cash derived from subsequent earnings was used to purchase more tax-exempt obligations; further, such holdings were less than the amounts required to satisfy recognized business needs.[60] The issue was whether deductions for an allocable portion of the interest on the installment notes should be disallowed under section 265(2); alternatively, did the taxpayers, under these particular circumstances, incur or continue the installment note indebtedness in order to purchase or carry the tax-exempt obligations?

The court's analysis centered on the applicable legal principles: the purpose of the taxpayer in incurring or continuing the indebtedness is paramount; further, this purpose may be gleaned from evidence of subjective interest, inferences from the conduct of the taxpayer, and the circumstances surrounding the pertinent transaction.[61] If these inferences reveal a sufficiently direct relationship between the indebtedness and the tax-exempt obligations, section 265(2) will apply.

Applying these principles, the court summarily rejected the Commissioner's argument that "but-for" the borrowing, each taxpayer would have been required to sell, or liquidate, its pre-existing tax-exempt obligations; although the taxpayer made a "conscious choice" not to liquidate, and chose to borrow, that in itself is not enough. First, the taxpayer's holdings at the time of the redemption represented previously acquired tax-exempts: such tax-exempts were held as part of a long-established business purpose — providing funds to meet established business needs. Further, the income produced by these tax-exempts obviated the need to borrow to meet such needs.[62] Second, the court distinguished other "conscious choice" cases: in *Illinois Terminal Railroad,* the proscribed purpose to continue the indebted-

60. *Id.* at 847-51.
61. *Id.* at 851.
62. *Id.* at 852.

ness instead of liquidating tax-exempts to pay off such indebtedness existed when the taxpayer chose to extend or renew bank borrowings which otherwise would have become due and payable;[63] similarly, in *Wisconsin Cheeseman, Inc.*, the taxpayer consciously chose to buy tax-exempts when, at the time of such purchase, it was reasonably foreseeable that a loan would soon be required to meet its business needs.[64]

Therefore, based upon the total impression given by the evidence, the court's ultimate finding of fact revealed that the taxpayers did not have the proscribed purpose needed to invoke section 265(2).[65]

C. *Summary*

In order to apply section 265(2), one must find a "purpose" to incur or continue indebtedness in order to purchase or carry tax-exempt obligations.[66] This "purpose" will be found if there is a "sufficiently direct relationship" between the tax-exempt obligations and the loan proceeds. The collected principles, gleaned from the cited case law and Revenue Procedure 72-18, reveal the following analysis:

> (1) Section 265(2) is not invoked whenever a taxpayer has an alternative of liquidating the tax-exempt obligations in lieu of borrowing; similarly, the simultaneous holding of debt and tax-exempt obligations is not enough to invoke section 265(2). There must be a purpose to incur or continue indebtedness in order to hold the tax-exempts.[67]
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> (2) One finds this purpose by inferring that a "sufficiently direct relationship" exists between the debt and the tax-exempts.[68]
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> (3) These inferences can arise from:
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> (a) Direct evidence, such as when the tax-exempts are used as collateral for the loan, or such tax-exempts are purchased with loan proceeds;[69] or

63. 375 F.2d 1016 (Ct. Cl. 1967). *See supra* notes 28-41 and accompanying text.
64. 388 F.2d 420 (7th Cir. 1968). *See supra* notes 42-50 and accompanying text.
65. Handy Button Mach. Co. v. Commissioner, 61 T.C. at 851.
66. *See supra* notes 16-22 and accompanying text.
67. *See supra* notes 36-41 and accompanying text.
68. *See supra* notes 33-41, 45-46 and accompanying text.
69. *See supra* text accompanying note 53.

(b) Circumstantial evidence, such as when one could have liquidated the tax-exempts to finance what the loan proceeds financed without impairing working capital needed for regular business activities, or when one purchases tax-exempts with the foreseeability of the need to incur indebtedness in the future, and such indebtedness could have been obviated by not purchasing the tax-exempts.[70]

III. The Evolution of Section 103(c)(2)

A. *Legislative History*

In 1965, the Internal Revenue Service began to receive requests for private letter rulings regarding the tax status of arbitrage bonds.[71] The Treasury Department began to view such bonds with considerable concern: a large volume might be issued, increasing public borrowing costs,[72] crowding out weaker public borrowers,[73] and causing a loss of federal revenues.[74]

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70. *See supra* notes 56-58 and accompanying text.

71. *See* Surrey, *Tax Trends and Bond Financing*, 22 TAX LAW. 123, 124 (1968).

72. *Id.* Increasing the volume of tax-exempt obligations in the market generally has the effect of driving up the yield on such obligations. *See, e.g.*, H.R. REP. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 200, 308.

> In order to market an increasing volume of securities to finance these public projects in competition with a growing volume of private borrowers, State and local governments have been offering higher yields, and the differential between tax-exempt and taxable securities of comparable quality has been narrowing. Historically, the ratio of yields on tax-exempt issues to taxable issues has been as low as 60 percent but in recent years it has been close to 75 percent.

Id.

73. *See Tax Adjustment Act of 1968: Hearings on H.R. 15414 Before the Senate Comm. on Fin.*, 90th Cong., 2d Sess. 91, 96 (1968) (letter from Assistant Secretary Surrey to Sen. Long, Chairman, Senate Fin. Comm., testimony of S. Surrey) [hereinafter cited as *1968 Hearings*]; 113 CONG. REC. 31,612, 31,613 (daily ed. Nov. 8, 1967) (remarks of Sen. Ribicoff).

74. *See 1968 Hearings, supra* note 73, at 97; 113 CONG. REC. at 31,613. *See also* P.L.R. 8011094. "[I]f the interest exemption is viewed as a Federal subsidy, then affording interest exemption to arbitrage bonds represents a waste of federal funds, because the federal government would lose more tax revenues than the municipality would be able to realize from such transactions." *Id. See also* H.R. REP. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 200, 308: Some state and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from tax-exempt issues are employed to purchase higher yielding federal obligations whose interest is not taxed in their hands. The tax-exempt issue in these cases in general states that the interest on the federal bonds will be used to service the state and local securities. Someone who purchases a state or local security under such an arbitrage arrangement has the advantage of a tax-exempt security with the protection of a federal

Carefully analyzing ruling requests, the Internal Revenue Service, concluded that the tax-exempt status of arbitrage bonds was doubtful, and refused to issue a ruling.[75]

Consequently, the Internal Revenue Service issued Technical Information Release 840,[76] which announced that it would not issue advance ruling regarding the tax-exempt status of municipal or state bonds where

> a principal purpose is to invest the proceeds of tax exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield. The profit received by the governmental units on the difference between the interest paid on the tax exempt obligations is in the nature of arbitrage.[77]

Technical Information Release 840 described two categories of arbitrage bonds:

> 1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.
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> 2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded.[78]

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security. The federal government then finds itself in the position of being an unintended source of revenue for state and local governments while losing the possibility to tax the interest income from its own taxable bond issues.

75. *See* Surrey, *supra* note 71, at 124-25.

> [Arbitrage bonds] guaranteed the holders of the bonds that the proceeds would be kept invested in Federal securities, so that essentially a person buying the municipal bond was buying an interest in the Federal bonds. Now this is certainly a curious and roundabout way for one to buy a Federal bond. An analysis of the transaction thus showed that the bond issued by the local government was simply a conduit to investment in the Federal obligation. The Treasury thought that a bond serving such a conduit purpose, though issued by a local government, was not the kind of obligation granted a tax-exempt status under the Internal Revenue Code. Accordingly, it refused to rule on these requests.

Id. See also H.R. Rep. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 200, 308; S. Rep. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 423, 562.

76. T.I.R. No. 840 (Aug. 11, 1966).

77. *Id.*

78. *Id.*

Subsequently, bills were introduced in the House[79] and the Senate[80] to remove arbitrage bonds from section 103(a) exemption status. The Senate bill, introduced by Senator Abraham Ribicoff, was similar in both language and intent to the current section 103(c): it defined an arbitrage bond as an obligation the proceeds of which are, either directly or indirectly, invested in higher yielding taxable obligations; furthermore, the bill requires that such taxable obligations be held as security for the bonds.[81] The Treasury Department, in a letter dated January 23, 1968, vigorously supported the Ribicoff bill;[82] however, Congress deferred action on this bill and the House version while it struggled with the more immediate problem of industrial revenue bonds.[83]

Congress finally addressed the arbitrage bond issue in the Tax Reform Act of 1969.[84] The House version contained a provision which simply denied tax-exempt status to arbitrage bonds; further, it did not define the term "arbitrage bond" but gave broad authority to the Treasury Department to prescribe regulations defining such term.[85] The Treasury Department replied that this delegation of authority was too broad, and requested more legislative guidance.[86] The Senate version, adopting a pro-

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79. *See* H.R. 11757, 90th Cong., 1st Sess. (1967).

80. *See* S. 2636, 90th Cong., 1st Sess. (1967).

81. *Id.*

82. *See 1968 Hearings, supra* note 73, at 91. The letter noted that arbitrage is a profit from the interest differential between taxable securities and exempt securities; further, arbitrage bonds distort the basic purpose of the interest exemption provided by § 103, which is to permit state and local governments to finance their governmental functions at a reduced interest cost. *Id.*

83. *See* H.R. 11757, 90th Cong., 1st Sess. (1967); *see also* City of Tucson v. Commissioner, 78 T.C. 767, 775 (1982).

84. Tax Reform Act of 1969, Pub. L. No. 91-172, § 601(a), 83 Stat. 487.

85. *See* H.R. 13270, 91st Cong., 1st Sess. (1969) (as passed by the House).

86. *See* SENATE COMM. ON FIN., TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 13270, TAX REFORM ACT OF 1969, at 118, *reprinted in Hearings on H.R. 13270 Before the Senate Comm. on Fin.*, 91st Cong., 1st Sess. (pt. 1) (1969). Specifically, the Treasury Department proposed the following:

> Treasury proposes that an obligation be considered an "arbitrage obligation" if, under regulations prescribed by the Secretary or his delegate the circumstances (including but not limited to the terms of the obligation, the specified purpose of the issue, the nature of the security provided for the obligation, and all other relevant facts) demonstrate that the result of the issuance is the realization of an arbitrage profit from reinvestment of the proceeds in higher yield securities other than governmental obligations to which section 103(a) of the Code applies.

vision almost identical to the finally enacted section 103(c), provided the requested guidance, defining the term "arbitrage bond" generally and delegating to the Treasury Department a broad grant of regulatory authority to carry out the purposes of section 103(c).[87] Congress ultimately enacted section 103(c) as part of the Tax Reform Act of 1969.[88]

The primary congressional purpose, gleaned from this legislative history, was to eliminate the profit element which permeates the use of arbitrage bonds.[89]

B. *The Interpretive Regulations and Rulings Relating to Section 103(c)(2)(B)*

Section 103(c)(2) provides: the term arbitrage bond means any obligation that is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly. Part B continues: (B) to *replace* funds that were used directly or indirectly to acquire securities or obligations described in (A).[90]

This section 103(c)(2)(B) replacement theory was implemented by the Internal Revenue Service in 1978, in response to abusive devices designed by creative financial planners to circumvent the ambit of section 103(c).[91] The Internal Revenue Service, using the broad grant of authority delegated to it by Congress to keep arbitrage bonds off the market,[92] issued extensive regulations dealing with one of these abusive devices: the

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Id.

87. *See* H.R. 13270, 91st Cong., 1st Sess. (1969) (as passed by the Senate). Interestingly, the Senate explanation of the provision defined arbitrage bonds as including obligations issued to replace funds which were used to acquire (directly or indirectly) materially higher yielding obligations. S. REP. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 562. However, no explanation as to why arbitrage bonds were defined as such was given.

88. Tax Reform Act of 1969, Pub. L. No. 91-172, § 601(a), 83 Stat. 487, 656.

89. *See* H.R. REP. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 200, 307-09; S. REP. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 423, 561-62; *see also* City of Tucson v. Commissioner, 78 T.C. 767, 778 (1982); State of Washington v. Commissioner, 77 T.C. 656, 668-69 (1981); Fairfax County Econ. Dev. Auth. v. Commissioner, 77 T.C. 546, 558 (1981).

90. I.R.C. § 103(c)(2) (1976). *See supra* text accompanying note 11.

91. *See* 43 Fed. Reg. 39,822 (1978) (to be codified at 26 C.F.R. pt. 1) (proposed Sept. 7, 1978).

92. *See supra* note 87 and accompanying text.

invested sinking fund.[93]

The invested sinking fund generally involved the following pattern. Typically, municipal bonds had serial maturities: a city would sell $10 million of twenty-year bonds, using property taxes to pay off, each year, a portion of the principal. For the protection of the bond holders, the $10 million principal amount of the bonds would be paid off gradually over a twenty-year period. A city which employed an invested sinking fund would not pay any principal off until the bond due date twenty years hence; however, the city would continue to pay property taxes into a sinking fund, investing such funds in Treasury notes and profits. This resulted in a substantial investment profit for the city.[94] The Treasury Department noted two effects of this invested sinking fund: first, the purpose and effect of a sinking fund is to earn arbitrage. Issuers were able to gain a financial advantage from such funds because the arbitrage profit earned more than offset the additional interest payment that had to be made to holders of the term bonds.[95] Second, increased outstanding indebtedness resulted from the use of such funds because the bonds were not retired serially; this would eventually increase the cost of municipal borrowing used to fund traditional governmental projects and thereby frustrate the purpose of section 103, which is to enable governmental entities to more easily

93. *See* 43 Fed. Reg. 39,822 (1978). Advance refundings, beyond the scope of this Article, represent a more complicated form of arbitrage transaction simultaneously addressed by the Internal Revenue Service. In a typical case, a state or local government with bonds outstanding that are not presently callable would issue a new series of bonds to "refund" the old bonds by using the proceeds of the new issue to purchase Federal Government Securities which are then put in escrow for payment of the outstanding bonds or the new issue until the outstanding bonds are callable. In such cases the state or local government utilizes the profit from the differential between the interest on its new issue and the return on the Federal securities to decrease its debt service cost. *See, e.g.*, P.L.R. 7947117. The Treasury Department noted that advance refundings double the amount of tax-exempt bonds outstanding for any project, thereby increasing governmental borrowing costs; afford holders of the older bonds a double benefit by having them secured, in effect, by Treasury obligations held in escrow; and third, advance refundings have been the principal cause of difficulty with the arbitrage regulations causing frequent changes in such regulations and, consequently a disruption of the tax-exempt market. In view of the above, the 1978 Amendments to the regulations were designed to eliminate the need for future changes in this area. *See* 43 Fed. Reg. 39,822 (1978).

94. *See* Fed. Reg. 39,822 (1978).

95. *See, e.g.*, P.L.R. 8011094; *see also* 43 Fed. Reg. 39,822 (1978).

finance governmental projects by providing them with a lower borrowing cost.[96]

To combat this circumvention of section 103, the Internal Revenue Service promulgated regulation 1.103-13(g) which provides in part, that amounts contributed to a sinking fund[97] for an issue are treated as, or "replace," proceeds of the issue: such funds are therefore subject to arbitrage yield restrictions.[98]

Following the release of this proposed regulation, the Internal Revenue Service issued Revenue Rulings 78-348,[99] 78-349[100] and 80-13[101] which all aided in clarifying the arbitrage replacement concept.

Revenue Ruling 78-348, in providing the foundation for discerning the relationship between sections 265(2) and 103(c)(2)(B), introduced the "sufficiently direct relationship" concept under section 265(2) into the arbitrage replacement area. The ruling, in assessing whether certain securities pledged as collateral for municipal bonds were subject to arbitrage yield restrictions, reasoned that the replacement theory does not apply in every instance in which the higher-yielding securities could have been liquidated as an alternative to issuing the bonds: a requisite "nexus" or "sufficiently direct relationship" must exist between the bonds and the higher yielding securities.[102] The requisite "nexus" does exist when the higher yielding securities are pledged as collateral for the bonds.

> An issuer that borrows to invest in higher-yielding securities and one that borrows against such securities already owned are in virtually the same economic position. Compare Section 265(2) relating to interest paid to earn tax-exempt income, and see especially Section 3.03 of Rev. Pro. 72-18, 1972-1 C.B. 740, citing *Wisconsin*

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96. *See* P.L.R. 8011094; *see also supra* note 72.

97. Regulation 1.103-13(g)(2) provides that the term "sinking fund" includes a debt service fund, or any similar fund, to the extent that the issuer reasonably expects to use the fund to pay principal or interest on the issue. Treas. Reg. § 1.103-13(g)(2) (1979).

98. The Internal Revenue Service, in adopting the position that the sinking fund regulations implemented the replacement language of § 103(c)(2)(B), did not concede that the accumulation of moneys in a sinking fund is not an indirect use of bond proceeds under § 103(c)(2)(A). *See, e.g.,* Rev. Rul. 78-349, 1978-2 C.B. 96; P.L.R. 8011094.

99. Rev. Rul. 78-348, 1978-2 C.B. 95.

100. Rev. Rul. 78-349, 1978-2 C.B. 97.

101. Rev. Rul. 80-13, 1980-2 C.B. 53. *See infra* text accompanying note 117.

102. Rev. Rul. 78-348, 1978-2 C.B. 96.

Cheeseman v. United States, 388 F.2d 420 (7th Cir. 1968).[103]

Further, although the pledge need not be cast in any particular form, there must be a reasonable assurance that the collateral is available if needed to pay debt service.[104] The securities in question pledged as collateral were subject to arbitrage yield restrictions.[105]

Revenue Ruling 78-349[106] provided examples of how the sinking fund regulations of 1.103-13(g) would be applied: this regulation, which illustrates another expression of the replacement theory, provides that amounts held in such a fund, to the degree the issuer expects to pay principal or interest on the issue, are treated as proceeds. The nexus required by section 103(c)(2)(B) exists since the securities held in the sinking fund can be expected to be used to pay principal or interest on the bonds.[107]

In Revenue Ruling 80-13,[108] the Internal Revenue Service introduced a substance over form analysis to arbitrage replacement theory, placing particular emphasis upon the economic effect of the transaction. There, a political subdivision of a state proposed a fifty million dollar bond issuance to finance a feasibility study to determine whether a hydro-electric plant should be built. The indenture indicated that the bond proceeds could only be spent to the extent that the state legislature appropriated funds to be deposited in an escrow fund: such funds would be used to retire the bonds if there were a default or if the feasibility study concluded that the power plant should not be built. Both the bond proceeds and the escrow fund amounts were invested in materially higher yielding acquired obligations.[109]

Holding that the issue did not comply with the arbitrage yield restrictions of section 103(c), the ruling proceeded with the following analysis: first, during each year that the bonds were outstanding, only the original bond proceeds portion matched by investment proceeds and the legislatively appropriated funds de-

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103. *Id.*
104. *Id.*
105. *Id. See also* P.L.R. 8128057; P.L.R. 8028077.
106. Rev. Rul. 78-349, 1978-2 C.B. 97.
107. *Id. See also* P.L.R. 7912098.
108. Rev. Rul. 80-13, 1980-1 C.B. 27.
109. *Id.* at 27-28.

posited in the escrow fund could be cited to finance the annual cost of the feasibility study; therefore, the sum of the amounts held in the bond accounts and the escrow fund could never exceed the face amount of the bonds. Second, the bondholders would look to the escrow fund and the bond funds, and not to the state authority, for debt service because the political subdivision had neither assets nor revenues.

> Therefore, although the form of the transaction is that the bond proceeds will be used to fund the feasibility study, the substance of the transaction is that the feasibility study will be funded only by the earnings on the original bond proceeds and amounts appropriated by the legislature of M and the earnings thereon, and none of the original bond proceeds will be spent for the study. Thus the transaction is the equivalent of M issuing the bonds and placing the proceeds in escrow and financing the feasibility study on a year to year basis with the amounts appropriated by the legislature and the earnings on both the appropriations and the original bond proceeds.[110]

Consequently, the proposed bond proceeds replaced, under section 103(c)(2)(B), the amounts held in the escrow fund.

Two very closely related arbitrage concepts also turned the described issuance into an arbitrage bond: over-issuance and artifice or device. The Internal Revenue Service has set forth regulations and revenue rulings pertaining to these concepts. It is clear that if the state authority had issued the bonds in Revenue Ruling 80-13, placed the proceeds in escrow, and invested them to obtain arbitrage profits, such issuance would be considered to have no governmental purpose within the meaning of regulation 1.103-13(b)(5)(iv).[111] The form of the transaction, that the political subdivision is issuing the bonds, does not change its substance; since the bond proceeds are considered to have replaced the amounts held in the escrow fund, it follows that the issuance of these bonds is solely to derive an arbitrage profit which is not

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110. *Id.* at 29.

111. *Id. See also* Rev. Rul. 79-108, 1979-1 C.B. 75, where a city which obtained from a securities dealer a 60-day loan of 300x dollars, securing it with city-owned U.S. Treasury notes, invested the loan proceeds in an investing pool which earned a higher rate of interest than that paid by the city to the securities dealer, was considered to have issued bonds solely to obtain an arbitrage profit and thus overissued. *Id.*

for a governmental purpose.[112] This lack of governmental purpose demonstrates that the bonds have been "over-issued" and therefore subject to special yield restrictions. These bonds, having replaced funds invested in materially higher yielding securities, did not comply.[113]

Further, since the funds appropriated by the state legislature are sufficient to conduct the feasibility study, the bonds are not issued for a governmental purpose; therefore the issuance is unnecessary. In this regard, regulation 1.103-13(j) provides that the employment of an "artifice or device" in connection with an issuance of a governmental obligation will make such obligation an arbitrage bond. An artifice or device is

> a transaction or series of transactions that attempts to circumvent the provisions of section 103(c), this section, § 1.103-14, or § 1.103-15 —
>
> (1) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to gain a material financial advantage, and
>
> (2) Increasing the burden on the market for tax-exempt obligations.[114]

Under the above regulation, the unnecessary issuance of bonds creates a burden on the market for tax-exempt bonds;[115] further, since the bond proceeds, having replaced the escrow funds, will be invested in materially higher yielding securities, the political subdivision has exploited the difference between tax-exempt and taxable interest rates to gain a material financial advantage. Therefore, the political subdivision em-

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112. Rev. Rul. 80-91, 1980-1 C.B. 29.

113. *See* Treas. Reg. § 1.103-13(b)(5)(iv) (1979).

114. Treas. Reg. § 1.103-13(j) (1979).

> Examples of increased burdens on the market for tax-exempt obligations include selling obligations that would not otherwise be sold, selling more obligations than would otherwise be necessary, and issuing obligations sooner or allowing them to remain outstanding longer than would otherwise be necessary. In no case shall it be considered an artifice or device to invest bond proceeds (or amounts treated as bond proceeds) at a materially higher yield if specifically provided for in Section 103(c)(4).

Id.

115. See *supra* text following note 93 and notes 94-98 and accompanying text regarding discussion of same concept regarding the sinking fund and advance refunding regulations.

ployed an "artifice or device" in connection with this issuance, and the bond is an arbitrage bond.[116]

Revenue Ruling 80-328[117] described the arbitrage implications of a situation where a political subdivision contemporaneously issued short-term notes, paying interest at seven percent, and long-term bonds, paying interest at nine percent, to finance governmental projects. The short-term notes were used to finance the project; generally, the bond proceeds were invested and held as security for the bond holders until the project was completed. The Internal Revenue Service employed a comprehensive analysis in ruling that the interest on the notes was not tax-exempt, since the notes were arbitrage bonds.[118]

> First, when an issuer issues long-term bonds and short-term notes contemporaneously . . . for the same project, . . . the proceeds of the notes [being] used to finance the project while the bond proceeds are invested, the notes replace the bonds within the meaning of section 103(c)(2)(B). Thus the bond proceeds are replaced proceeds and have . . . the same yield restrictions as the note proceeds.[119]

Since the bond proceeds are invested in materially higher yielding securities, the note is an arbitrage bond.

Further, general business reasons dictate that short-term notes issued for a project usually provide interim financing until long-term financing is financially feasible; an issuer who expects to issue permanent financing in the form of long-term bonds at the commencement of the project demonstrates that interim financing in the form of short-term notes is unnecessary for the project. Therefore, the notes are over-issued within the meaning of regulation 1.103-13(b)(5)(iv), and subject to the special yield restrictions of that section.[120]

In addition, by issuing the seven percent notes contemporaneously with the nine percent bonds, the issuers have exploited the difference between the tax-exempt and taxable interest rates to gain a material financial advantage during the term of the

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116. Rev. Rul. 80-91, 1980-1 C.B. 29.
117. Rev. Rul. 80-328, 1980-2 C.B. 53.
118. *Id.* at 56.
119. *Id.* at 55.
120. *Id.* at 56.

notes. The overall borrowing cost to the issuers will be two percentage points lower then it would have been if only the bond proceeds had been used to finance the projects.

> In other words, the economic effect of the contemporaneous issuance of the notes and bonds is the same as if M and N had used the proceeds of the 9 percent bonds to provide the projects, invested the proceeds of the tax-exempt notes yielding 7 percent in taxable securities yielding 9 percent during the term of the notes, and used the arbitrage profits on this investment to lower the overall cost of borrowing during the term of the notes by 2 percentage points.[121]

Finally, in issuing both notes and bonds totalling more than twice the aggregate principal amount of the actual cost of the projects, the issuers have sold unnecessary obligations and allowed such obligations to remain outstanding longer than necessary.[122] The issuers, therefore, have employed an artifice or device in connection with the issuance of their notes.[123]

Revenue Ruling 82-101[124] employed the prior rulings "economic effect" analysis, coupled with a facts and circumstances analysis, in applying the arbitrage replacement concept. There, the state government established a perpetual fund with the proceeds from the sale of lands and invested the fund in taxable obligations. State officials anticipated that creation of the fund would enable the state to sell $100 million of general obligations without requiring increases in existing or future tax rates. On the same day, $100 million of general obligation bonds were issued.[125]

State law dictated that the fund's corpus could never be invaded or made subject to any lien for any purpose; income from the fund, $13.5 million annually, could only be appropriated by an affirmative act of the state legislature. Average annual debt service on the $100 million bond issuance was $13.5 million; further, the state's annual expenditures, including debt service on

121. *Id.* at 57 (citing Rev. Rul. 80-13, 1980-1 C.B. 27).

122. *Id.*

123. Rev. Rul. 80-328, 1980-2 C.B. 57. *See, e.g.*, P.L.R. 8107038; P.L.R. 8113030; P.L.R. 8240050; *see also supra* notes 114-16 and accompanying text.

124. Rev. Rul. 82-101, 1982-1 C.B. 21.

125. *Id.*

outstanding obligations, could not exceed the state's revenues. If revenues were insufficient to pay expenditures, such expenditures would have to be prorated except those for essential governmental services and debt service on outstanding obligations. The state government's operating account had an average annual surplus of $3 million accumulated over the preceding five years.[126]

The Internal Revenue Service supported its reasoning by citing the holding in Revenue Ruling 78-348[127] regarding materially higher yielding "collateral."[128] Listing the following facts, the Internal Revenue Service held that the state reasonably expects to pay debt service on the $100 million of general obligation bonds from the income generated by the fund invested in materially higher yielding securities. First, the creation of the fund and the issuance of the obligations, having been legislatively enacted on the same day, were closely-related. Second, the average annual debt service is four times the average annual surplus; the fund will earn $13.5 million per year, which alone is enough to pay debt service on the bonds. Third, the state government must pay the debt service on these obligations by law; therefore, "the bondholders are reasonably assured that the income from the fund will be available, directly or indirectly, if needed, to pay debt service."[129] Fourth, the fact that the operating account only receives money from the fund upon the affirmative act of the state legislature "does not prevent the application of section 103(c)(2)(B), because all the facts and circumstances indicate that . . . [the state] reasonably expects"[130] to pay debt service from the fund. Therefore, the substance of the transaction, as opposed to its form, "is that debt service will be paid from the income generated by the fund,"[131] which is invested in materially higher yielding securities; further, the bondholders are reasonably assured that this will occur. The *effect*, then, is that the state government has borrowed $100 million of general obligation bonds "against securities invested with the corpus of

126. *Id.*
127. Rev. Rul. 78-348, 1978-2 C.B. 95.
128. *See supra* notes 102-05 and accompanying text.
129. Rev. Rul. 82-101, 1982-1 C.B. 22.
130. *Id.*
131. *Id.*

the fund at a materially higher yield."[132] Therefore, the proceeds of the bonds replace the fund.[133]

In addition, the state has employed an artifice or device[134] in connection with this bond issuance for two reasons. First, the facts and circumstances indicate that the state created the fund to pay debt service on the bonds; in a series of transactions in which the state invested the fund in materially higher yielding securities and then issued bonds, it used the difference between tax-exempt and taxable interest rates to gain a material financial advantage.[135] Second, since the state expects to pay debt service on the bonds from the fund, it is clear that the state would not have sold the obligations if the income from the fund had not been available. Therefore, the state sold obligations that would not otherwise have been sold and issued them sooner than would otherwise have been necessary.[136] Consequently, the bonds are arbitrage bonds under regulation 1.103-13(j).

C. *Summary*

Section 103(c)(2)(B) does not apply in every case in which higher yielding securities could have been liquidated as an alternative to issuing the bonds.[137] A "sufficiently direct relationship" or "nexus" is required between the higher yielding securities and the bonds.[138] Such a nexus exists when:

> (1) the higher yielding securities are pledged as collateral for the bonds and there is reasonable assurance that such collateral is available to pay debt service;[139]
>
> (2) securities are held in a sinking fund and such securities are reasonably expected to be used to pay debt service;[140]
>
> (3) economic effect - substance of the transaction reveals that bond proceeds were not needed, and not in substance used, for

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132. *Id.* at 23.
133. *Id.*
134. *See supra* note 114 and accompanying text.
135. Rev. Rul. 82-101, 1982-1 C.B. 23.
136. *Id.* at 21, 23.
137. *See* Rev. Rul. 78-348, 1978-2 C.B. 95.
138. *Id.*
139. *See supra* notes 102-05 and accompanying text.
140. *See, e.g.,* Rev. Rul. 78-349, 1978-2 C.B. 97.

any governmental purpose;[141]

(4) facts and circumstances, as well as the substance, of a transaction, indicate that the issuer reasonably expects to pay debt service from fund containing securities invested at a materially higher yield.[142]

IV. The Limits of Federal Arbitrage Replacement Theories

Having reviewed the law regarding the two relevant sections, the limits of section 103(c)(2)(B)[143] will now be explored. First, an arbitrage replacement model intended to illustrate the extent of the coverage under section 103(c)(2)(B) will be proposed. Support will then be gathered from the previous discussion regarding the legislative history of section 103(c)(2)(B), its published rulings and regulations, and concepts developed under section 265(2)[144] to illustrate the viability of this model.

The proposed replacement model is based upon two simple premises. First, a section 103(c)(2)(B) replacement will occur, when section 103(c)(2)(A)[145] is not applicable, if the economic effect of the transaction, or series of transactions, results in the earning of an arbitrage profit. Second, an arbitrage profit will exist if there is a sufficiently direct relationship between the materially higher yielding securities and the bonds. These points will be presented and analyzed.

It is clear that section 103(c), and in particular section 103(c)(2)(B), is intended to eliminate arbitrage profits.[146] The legislative history[147] and interpretive case law[148] could not be clearer on this point. Further, because of the breadth of possible arbitrage transactions, each analysis of such transactions has looked to their *effect*, rather than to their purpose.[149] The reve-

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141. *See, e.g.*, Rev. Rul. 80-13, 1980-1 C.B. 27; Rev. Rul. 80-328, 1980-2 C.B. 53, 57.

142. *See, e.g.*, Rev. Rul. 82-101, 1982-1 C.B. 21.

143. I.R.C. § 103(c)(2)(B) (1976). *See supra* text accompanying note 11.

144. I.R.C. § 265(2) (1981). *See supra* text accompanying note 17.

145. I.R.C. § 103(c)(2)(A) (1976). *See supra* text accompanying note 11.

146. *See supra* note 89 and accompanying text.

147. *See* H.R. Rep. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 200, 307; S. Rep. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 423, 561.

148. *See, e.g.*, City of Tucson v. Commissioner, 78 T.C. 767 (1982).

149. *See* P.L.R. 8011094.

Section 103(c) is intended to apply to transactions that have the effect — as well as the purpose — of producing arbitrage. While some of the language and rhetoric

nue rulings, using a substance over form - economic effect analysis, support this view: each Internal Revenue Service section 103(c)(2)(B) pronouncement makes it clear that if the economic effect[150] of the transaction yields an arbitrage profit,[151] a replacement occurs.[152]

It is less clear, however, "when" an arbitrage profit is being made; here the definition of "sufficiently direct relationship" becomes critical. Again, the legislative history and the revenue rulings provide clarification.

First, the concept of when the "effect" of a transaction, or series of transactions, yields an arbitrage profit is extremely broad. The legislative history and the revenue rulings demonstrate that this is the focal point of the analysis. Therefore, the term "sufficiently direct relationship" which is employed in discerning "when" the "effect" of the transaction is to yield an arbitrage profit must be defined equally as broadly: a sufficiently direct relationship must exist each time an arbitrage profit is being made.

Further guidance may be obtained by, first, exploring the relationship between a "sufficiently direct relationship" under section 265(2) and the term as used under section 103(c)(2)(B); and, second, tracking a comparative analysis format for each section to see if the definitional limit of "sufficiently direct relationship" within section 265(2) can be used to shape the contours of the comparative term embodied in section 103(c)(2)(B).

Sections 265(2) and 103(c)(2)(B), although intended to eradicate slightly different evils, are very closely related. Section 265(2) is designed to eliminate the double tax benefit which arises when one incurs indebtedness to purchase or carry tax-

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> in the legislative history single out transactions whose sole or principal purpose is to produce arbitrage, the legislative history consistently recognizes the danger of transactions that have the effect of producing arbitrage, and every attempt to define arbitrage transactions has looked to the effect of the transaction rather than its purpose.

Id.

150. *See* Rev. Rul. 82-101, 1982-1 C.B. 21; *see supra* notes 124-36 and accompanying text; Rev. Rul. 80-13, 1980-1 C.B. 27, 29; *see supra* text accompanying note 121.

151. *See* Rev. Rul. 80-13, 1980-1 C.B. 27, 29; *see supra* text accompanying note 121; Rev. Rul. 80-328, 1980-2 C.B. 53, 57; *see supra* text accompanying note 119; Rev. Rul. 82-101, 1982-1 C.B. 21; *see supra* notes 124-36 and accompanying text.

152. *See supra* notes 150-51.

exempts: one may not receive tax-free income while deducting the interest expense attributable to obtaining that income.[153] Section 103(c)(2)(B) on the other hand is part of a statutory scheme designed to eliminate arbitrage profits.[154] The similarity between these two sections occurs in the method used to locate the existence of each section's proscribed evil. This similarity will be discussed point by point.

The legal touchstone[155] for applying section 265(2) is the discovery of a purpose to incur or carry indebtedness in order to purchase or carry tax-exempt obligations.[156] This purpose is inferred from the existence of a "purposive relationship," "sufficiently direct relationship," or a "nexus" between the debt and the tax-exempt obligations.[157]

Similarly, the legal touchstone for applying section 103(c), particularly section 103(c)(2)(B), is the discovery of an arbitrage profit.[158] This profit may be discovered from the existence of a "sufficiently direct relationship" or "nexus" between the materially higher yielding securities and the bond proceeds.[159]

The analysis used to determine the requisite "sufficiently direct relationship" under each section, appropriately simplified, is a mirror image of the other. Basically, it proceeds as follows:

(1) Section 265(2) is not invoked whenever the taxpayer has the alternative of liquidating tax-exempt obligations in lieu of borrowing; a sufficiently direct relationship must exist between the two.[160] Similarly, section 103(c)(2)(B) is not invoked whenever the issuer has the alternative of liquidating materially higher yielding securities in lieu of issuing tax-exempt bonds; a

153. *See, e.g.*, Illinois Terminal R.R. v. United States, 375 F.2d 1016 (Ct. Cl. 1967); *see supra* notes 31-41 and accompanying text; R.B. George Mach. Co. v. Commissioner, 26 B.T.A. 594 (1932); *see supra* notes 23-27 and accompanying text.

154. *See supra* note 89 and accompanying text.

155. Handy Button Mach. Co. v. Commissioner, 61 T.C. 846, 851 (1974).

156. *Id. See supra* notes 59-65 and accompanying text; *see also* Rev. Proc. 72-18, 1972-1 C.B. 740. *See supra* notes 51-65 and accompanying text.

157. *See, e.g.*, Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968); Handy Button Mach. Co. v. Commissioner, 61 T.C. 846 (1974); Rev. Proc. 72-18, 1972-1 C.B. 740.

158. *See supra* note 89 and accompanying text; *see also supra* text accompanying note 121.

159. *See, e.g.*, Rev. Rul. 78-348, 1978-2 C.B. 95.

160. *See* Wisconsin Cheeseman, Inc. v. United States, 388 F.2d 420 (7th Cir. 1968).

sufficiently direct relationship must exist between the two.[161]

(2) Direct evidence of this sufficiently direct relationship, under section 265(2), exists when the tax-exempt obligations are used as collateral for the loan; the *economic effect* of the transaction is the same as if the tax-exempt obligations were directly purchased with loan proceeds.[162] Similarly, direct evidence of section 103(c)(2)(B)'s sufficiently direct relationship exists when the materially higher yielding securities are used as collateral for the bond issuance; the *economic effect* is the same as if the bond proceeds have been used directly to purchase the materially higher yielding securities.[163]

(3) Circumstantial evidence of section 265(2)'s sufficiently direct relationship exists when the totality of the facts and circumstances reveals that the indebtedness was incurred or carried to purchase or carry tax-exempt obligations.[164] Such a sufficiently direct relationship exists when one could have liquidated the tax-exempt to finance what the loan proceeds financed without impairing working capital needed for regular business activities.[165] Similarly, circumstantial evidence of section 103(c)(2)(B)'s sufficiently direct relationship exists when the totality of the facts and circumstances reveals an arbitrage profit has been made.[166] Such a "sufficiently direct relationship" should exist when one could have liquidated the materially higher yielding securities to finance what the bond proceeds financed without impairing working capital needed for regular business activities. First, this definition of "sufficiently direct relationship" does not exceed the legislative intent of section 103(c): clearly, an arbitrage profit is being made, for under the replacement theory, this transaction would have the same effect if these securities were liquidated to finance the project, and then were *replaced* with bond proceeds. Second, the revenue rul-

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161. *See* Rev. Rul. 78-348, 1978-2 C.B. 95.

162. *See, e.g.*, Rev. Proc. 72-18, 1972-1 C.B. 740; *see also supra* text accompanying note 69.

163. *See* Rev. Rul. 78-348, 1978-2 C.B. 95; *see also supra* text accompanying note 139.

164. *See, e.g.*, Rev. Proc. 72-18, 1972-1 C.B. 740.

165. *Id. See* Illinois Terminal R.R. v. United States, 375 F.2d 1016 (Ct. Cl. 1967). *See supra* notes 34-36 and accompanying text.

166. *See, e.g.*, Rev. Rul. 82-101, 1982-1 C.B. 21.

ings support this definition: in every situation in which the collateral was held to *replace* the bond proceeds, such collateral could have been liquidated, without impairing needed working capital, to finance the project. In *effect*, the collateral was earning an arbitrage profit for the issuer.[167]

(4) Followed to its logical conclusion, then, the concept of a "sufficiently direct relationship" as set out in section 265(2) exists when it is apparent that contraction of the indebtedness was not necessary other than for the purpose of continuing to hold the tax-exempt obligations.[168] It should be equally clear, that the concept of a "sufficiently direct relationship" under section 103(c)(2)(B) exists when it is apparent that the bond issuance was not necessary other than for the purpose of earning an arbitrage profit.

Finally, two regulatory arbitrage concepts, "overissuance"[169] and "artifice or device,"[170] further support the proposed replacement model. A close reading of the revenue rulings reveals an interacting relationship between these concepts and section 103(c)(2)(B): simply, once a replacement occurs, an overissuance and an artifice or device will also be present.[171] The question is whether this relationship works in reverse: first, the concepts certainly are applicable every time an arbitrage profit is being made; second, it therefore follows that the replacement concept applies, in the absence of the applicability of section 103(c)(2)(A), every time an overissuance or artifice or device occurs, since the effect of those transactions is to yield an arbitrage profit. If a replacement has occurred, then a sufficiently direct relationship exists between the materially higher yielding securities and the bond proceeds. Therefore, the sufficiently direct relationship exists simultaneously with every overissuance or artifice or device. This reverse analysis will be explored.

The concept of "overissuance" applies in situations where the issuance, or a portion thereof, is not necessary for any governmental purpose.[172] Revenue Ruling 80-328[173] illustrates both

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167. *See, e.g.*, Rev. Rul. 78-348, 1978-2 C.B. 95; Rev. Rul. 80-13, 1980-1 C.B. 27.
168. *See* Illinois Terminal R.R. v. United States, 375 F.2d 1016 (Ct. Cl. 1967).
169. *See supra* notes 112-13 and accompanying text.
170. *See supra* note 114 and accompanying text.
171. *See, e.g.*, Rev. Rul. 82-101, 1982-1 C.B. 21.
172. *See* Treas. Reg. § 1.103-13(b)(5)(iv) (1979).

an overissuance and a replacement. There the simultaneous issuance of long-term notes and short-term bonds for the same project, effectively doubled the amount necessary for the project.[174] This overissuance yields an arbitrage profit: issuing notes not necessary for the project and investing such notes in materially higher yielding securities. Further, the economic effect is the same as if the long-term notes had been issued just to invest in materially higher yielding securities; therefore, a sufficiently direct relationship existed, and a section 103(c)(2)(B) replacement occurred.

The concept of "artifice or device"[175] may also be used to find a section 103(c)(2)(B) replacement. Revenue Ruling 80-328 again serves as an example. The simultaneous issuance of notes and bonds was an artifice or device, within the meaning of regulation 1.103-13(j), because an arbitrage profit was being made and the unnecessary issuance created a burden on the tax-exempt market.[176] Again, for the same reasons discussed above, a sufficiently direct relationship exists between such materially higher yielding securities and the bond issuance: the economic effect of the artifice or device is the same as if a portion of the issuance had been used for a legitimate governmental project, with the rest being invested in materially higher yielding securities. Again, a section 103(c)(2)(B) replacement has occurred.

It should be clear from the above analysis, that the application of the "overissuance" and "artifice or device" concepts further illustrates that, first, a section 103(c)(2)(B) replacement occurs when the "effect" of the transaction is to yield an arbitrage profit, and, second, since a replacement cannot occur without the existence of a sufficiently direct relationship between the profit yielding materially higher yielding securities and the note proceeds, its definition must be broad enough to cover such transactions.

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173. Rev. Rul. 80-328, 1980-2 C.B. 53.

174. *Id.*

175. *See* Treas. Reg. § 1.103-13(j) (1979); *see also supra* note 114 and accompanying text.

176. *See supra* note 114 and accompanying text.

V. Conclusion

The uncertain extent of section 103(c)(2)(B)'s[177] replacement coverage stems from the complicated nature of arbitrage transactions and the statute designed to combat them, section 103(c). Congress intended to eliminate all arbitrage profits, and legislatively gave the Treasury Department the authority to do so. As there are myriad ways to earn arbitrage, so must there be an applicable statute; hence, the replacement concept was conceived, enacted, and developed. It is hoped that the proposed replacement model introduces some certainty into this confusing, complicated area.

177. I.R.C. § 103(c)(2)(B) (1976). *See supra* text accompanying note 11.