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APPLICATION OF INTERNAL REVENUE CODE SECTION 103(c)* TO VARIABLE RATE DEMAND BONDS: PURGING THE PROFITEERING POTENTIAL

I. Introduction

In recent years, high and fluctuating interest rates in the bond market precipitated a creative surge in tax-exempt finance.¹ Investors were clamoring for shorter-term instruments and issuers were grumbling about exorbitantly high long-term interest costs.² Ingenious investment bankers responded by developing the variable rate demand bond (VRDB), a new form of long-term tax-exempt instruments that do not carry the fixed interest rates traditionally associated with long-term tax-exempt debt.³ One feature common to these instruments is a provision for varying the interest rates.⁴ In addition, the holders are given "put" rights⁵ designed to insure that they can dispose of the instruments at par value whenever the interest rate changes.⁶

As the variable rate demand bond market has grown,⁷ however, counsel involved in these financings have faced the need to interpret

* On October 22, 1986, as this Note was in its final stages before going to press, President Reagan signed into law legislation that comprehensively revised the tax laws of the United States. See Tax Reform Act of 1986, Pub. L. No. 99-514, (to be codified as amended in scattered sections of 26 U.S.C.). Because the substance of the prior law referred to in the Note is largely in keeping with the amendments, and the examination of the prior law may well facilitate an understanding of the new law, the author has based this Note almost entirely on the law prior to amendment by Pub. L. No. 99-514. See *infra* note 164 and accompanying text for a discussion of some of the more salient aspects of the Tax Reform Act of 1986 as it relates to this Note.

1. Andrews, *The Creative Surge in Tax-Exempt Finance*, INST. INVESTOR, Dec. 1984, at 211, col. 1 [hereinafter *Creative Surge*].

2. *Id.*

3. Winterer, "Reissuance" and Deemed Exchanges Generally, 37 TAX LAW. 509 (1984) [hereinafter *Reissuance*].

4. *Id.*

5. For a more detailed discussion of this put option and what it entails, see *infra* notes 27, 40-44 and accompanying text.

6. *Reissuance*, *supra* note 3, at 509.

7. A tremendous expansion has occurred during the past four years in the portion of the "new issue" tax-exempt bond market comprised of variable rate demand bonds. Roughly 40% of the tax-exempt debt issued in 1984 carried floating rates and put options, as compared to less than 5% in 1981. See *Creative Surge*, *supra* note 1, at col. 3. Variable rate demand bonds (VRDBs) were originally used for industrial development financings, but, since 1983, this financing technique has

provisions of the Internal Revenue Code (IRC) that were enacted before VRDBs were common.⁸ The IRC contains many requirements that must be satisfied in order for the interest on bonds to be exempt from federal income taxes.⁹ In particular, IRC section 103(c) restricts the extent to which an issuer or beneficiary¹⁰ of an exempt bond may profit by investing the proceeds of the bond in higher yielding, taxable obligations.¹¹ Currently, some question has arisen over whether VRDBs satisfy the requirements of IRC section 103(c) concerning arbitrage bonds.¹²

This Note analyzes transactions involving VRDBs, to determine whether they comply with the strictures of IRC section 103(c) and, hence, qualify for the tax exemption.¹³ Initially, this Note provides an overview of the tax-exempt bond market by examining the factors

gained wide acceptance in municipal, multi-family rental housing, hospital and university financings. See Watterson, *Variable Rate Bonds: A Flexible Tool*, N.Y.L.J., Sept. 26, 1985, at 17, col. 1 (citing Bond Buyer, June 11, 1985, at 4) [hereinafter *Flexible Tool*].

8. *Flexible Tool*, *supra* note 7, at 17. Variable rate municipal debt with a put feature is a relatively new innovation in the tax-exempt market. Instruments combining these two features began to appear in the bond market sometime after 1981. See *Creative Surge*, *supra* note 1, at 211, col. 3. The relevant Internal Revenue Code (IRC) subsections were enacted well before this time. See *infra* note 66 and accompanying text.

9. The exemption for interest paid on municipal bonds is found in § 103(a), which provides that "[g]ross income does not include interest on—;(1) the obligations of a State . . . or any political subdivision of . . . the foregoing" I.R.C. § 103(a) (1985). Subsections (b)-(o), and their corresponding regulations, enumerate myriad requirements that the obligations must meet in order to qualify for the exemption. See generally I.R.C. § 103(b)-(o) (1985); Treas. Reg. § 1.103-7 (as amended in 1983); Treas. Reg. § 1.103-8 (as amended in 1983); Treas. Reg. § 1.103-9 (as amended in 1977); Treas. Reg. § 1.103-10 (as amended in 1986); Treas. Reg. § 1.103-11 (1972); Treas. Reg. § 1.103-12 (1972).

10. In an industrial development bond financing, it is a private entity—the underlying obligor (not the issuer)—who will ultimately benefit from a tax-exempt financing. See *infra* note 20.

11. See I.R.C. § 103(c) (1985); *infra* notes 66-68 and accompanying text.

12. See *Flexible Tool*, *supra* note 7, at cols. 1-2 (it has proven difficult to calculate the yield on VRDBs for purposes of arbitrage requirements). The determination of yield on variable rate obligations has been the subject of much confusion. For a general discussion of some of the interpretive problems that arise, see Rogers, *Public Comments on Proposed Regulations, Hawkins, Delafield & Wood Asks For Clarifications And Transitional Safe Harbor in Regulations (Sec. 103)* (available Apr. 30, 1985, on LEXIS, FTX library, 85 TNT 86-49) [hereinafter *Clarifications in Regulations*]; Section Of Taxation, American Bar Association, *ABA Comments On Investments In Nonpurpose Industrial Development Bonds Under The 1984 Tax Act* (available Jan. 31, 1985, on LEXIS, FTX library, 85 TNT 23-90) [hereinafter as *ABA Comments*].

13. See *infra* notes 20-174 and accompanying text. The analysis focuses primarily on the implications of IRC section 103(c)(2)(A). See *infra* notes 66-114 and accompanying text.

that led to the development of VRDBs.¹⁴ It then demonstrates how a reasonable interpretation of the language of IRC section 103(c), gleaned from its legislative history and Treasury promulgations,¹⁵ requires that almost all VRDBs lose their tax-exempt status.¹⁶ More specifically, this Note concludes that the inability to calculate the yield for VRDBs creates an impermissible potential to earn arbitrage profits.¹⁷ Based on this conclusion, this Note suggests that it is incumbent upon the Treasury Department to issue regulations that will limit the tax exemption for transactions involving VRDBs.¹⁸ Finally, this Note proposes measures that delineate the proper scope of the tax exemption for VRDBs and incorporates them in a model Treasury Regulation.¹⁹

II. The Development of VRDB Financing

From the outset, it is important to recognize that VRDBs are not a genre of debt obligations distinct from industrial development bonds²⁰ or bonds issued to finance activities associated with traditional municipal functions.²¹ Nor are VRDBs a species of either of these

14. See *infra* notes 20-49 and accompanying text.

15. See *infra* notes 50-77 and accompanying text for a detailed discussion of the concerns which led to the enactment of IRC § 103(c).

16. See *infra* notes 78-128 and accompanying text for a legal analysis of § 103(c) with respect to VRDBs.

17. See *infra* notes 78-90, 106-14 and accompanying text.

18. See *infra* notes 129-31 and accompanying text.

19. For a discussion of measures that virtually abrogate the tax-exemption for VRDBs and a suggested Internal Revenue Service regulation, see *infra* notes 132-73.

20. Generally, an industrial development bond (IDB) is a bond that a local government agency (with an elected body or an appointed authority) issues on behalf of a private entity for the purpose of acquiring, constructing, or rehabilitating a capital facility. See Note, *Industrial Development Bond Financing After the Deficit Reduction Act of 1984: The Final Chapter?* 13 *FORDHAM URB. L.J.* 443, 444 (1985) [hereinafter *IDB Financing*]; see also Scholl & Jimenez, *The Florida Industrial Development Bond Financing Act: The Need For Judicial Consistency* 12 *FLA. ST. U.L. REV.* 31, 32 (1984) [hereinafter *Industrial Development Bonds*]. For a further explanation of the typical IDB financing relationship between the local authority and the private entity, see *infra* notes 108-09 and accompanying text.

Section 103(b)(2) of the IRC along with Treasury Regulation § 1.103-7 define the term "industrial development bond" for federal income tax purposes. See I.R.C. § 103(b)(2) (1985); Treas. Reg. § 1.103-7 (as amended in 1983). Section 103(b)(1) excludes industrial development bonds from the definition of state and local obligations in § 103(a) unless they meet certain requirements set forth in the remainder of § 103(b). See I.R.C. § 103(b) (1985).

21. Originally, the tax-exempt status of interest on municipal bonds was limited to the financing of essential or legitimate governmental functions, e.g., jails, public utilities, private housing, college dormitories, roads, and hospitals. See *IDB Financing*, *supra* note 20, at 446-47. Many states constitutionally prohibited lending

genres distinct from general obligation bonds²² or revenue bonds.²³

the public credit for the benefit of a private enterprise. *See id.* at 446. Prior to 1938, state courts, following the "public purpose" doctrine, precluded their states from issuing bonds for a private purpose. *Id.* at 447 n.24.

Since this time, however, the definition of an essential function (public purpose) has expanded to enable states and municipalities to shift to private corporations part of their burden of providing traditional services by assisting private corporations with their financing of projects (through IDBs). *See id.* at 448. For instance, the interest from IDBs is exempt when the proceeds of the IDBs are used for certain activities, such as low income residential rental property; sports facilities; convention or trade show facilities; airports; docks; wharves; mass commuting facilities, including parking facilities; sewage and solid waste disposal facilities; facilities for the local furnishing of water; qualified mass commuting vehicles; or local district heating or cooling facilities. *See* I.R.C. § 103(b)(4) (1985) (these purposes are specifically authorized by Congress). Thus, "whether the bonds are issued for purposes of pollution control, to expand a small manufacturing facility, or for any other purpose specifically authorized by Congress, the bonds are at that point *legally indistinguishable* under federal law from bonds issued by political subdivisions for schools, roads, water and sewerage systems, or any other traditional public purpose." *ABA Comments, supra* note 12, at 4-5 (emphasis in original). The rationale underlying the exemption, in part, is that the activities exempted are the type that state or local governments have traditionally undertaken. *See IDB Financing, supra* note 20, at 455.

Currently, many realize that a public- versus private-purpose bond distinction is unmanageable as a basis for a tax exemption. *See* Hawthorne, *Planning for Armageddon*, INST. INVESTOR, Apr. 1985 at 119, col. 1 [hereinafter *Armageddon*]; *see also* Gillette, *Fiscal Federalism And The Use Of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1035-39 (1983) (concept of public purpose largely irrelevant to issue of whether bond issue ought to carry federal tax exemption) [hereinafter *Gillette*]. This basis is unmanageable because the definition of a public-purpose bond has been stretched a bit beyond reason, and because everyone seems to draw the line at a different point. *See Armageddon, supra*, at 119, col. 1. The movement is toward defining public purposes or governmental projects according to who operates the facilities, not the purpose of the facility or whether the project is built with municipal bonds. *See* N.Y. Times, Mar. 13, 1986, at B24, col. 4. *See infra* note 164 and accompanying text for a discussion of the recently enacted federal tax legislation that significantly limits the availability of tax-exempt industrial development bonds to meet infrastructure needs with private development, by restricting the ownership and operation of facilities by private persons.

22. A general obligation bond is a bond backed by the issuer's full faith and credit and taxing power. *See* 15 E. McQUILLIN, MUNICIPAL CORPORATIONS § 43.05, at 479 (3d ed. 1970). An unlimited general ad valorem tax on all taxable property is the most common source of revenue pledged for repayment of general obligation bonds. *See id.*; *see also* Ramsey v. Cameron, 245 S.C. 189, 197, 139 S.E.2d 765, 769 (1965).

23. A revenue bond is a bond secured by specifically dedicated income, usually revenues generated by the project, but sometimes supplemented by a collateral revenue source. *See, e.g.,* Flushing Nat'l Bank v. Municipal Assistance Corp., 40 N.Y.2d 731, 735, 358 N.E.2d 848, 851 (1976). The people benefiting from the service financed with revenue bonds pay for it. *See IDB Financing, supra* note 20, at 443 n.1. A revenue bond may also be secured by the property acquired with the bond proceeds. *See id.* Since the total taxing power of an issuer is not pledged as security for payment of the bonds, revenue bonds typically bear slightly higher

Rather, VRDBs are an innovative financing technique that may be used in conjunction with any form of state or local bonds.²⁴

The following is a model of a VRDB:

The instruments have a fixed term [typically a nominal maturity of twenty to thirty years].²⁵ Holders have the right to "put" them [at intervals ranging anywhere from five years to one day] on short notice²⁶ to a remarketing agent who will then try to resell them.²⁷ If they cannot be resold, a letter of credit will be drawn upon to pay them off.²⁸ The interest rate floats throughout the term, within a band of any number of basis points above or below a stated index, at whatever rate the remarketing agent periodically determines would be necessary to sell the instruments at par.²⁹

interest rates than would the equivalent general obligation bonds. See Eddy, *The Referendum Requirement: A Constitutional Limitation on Local Government Debt in Florida*, 38 U. MIAMI L. REV. 677, 684 (1984) [hereinafter *The Referendum Requirement*].

Although IDBs are most commonly revenue bonds, all IDBs need not be. Industrial development bonds can come in the form of either general obligations or revenue bonds. The same is true for bonds issued for traditional public purposes. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, INDUSTRIAL DEVELOPMENT BOND FINANCING 37 (Report A-18 1963); see also PUBLIC SECURITIES ASS'N, FUNDAMENTALS OF MUNICIPAL BONDS 19 (rev. ed. 1982).

24. See *supra* note 7.

25. See *Flexible Tool*, *supra* note 7, at 17, col. 1; *Creative Surge*, *supra* note 1, at 212, col. 1.

26. For a brief discussion of notice requirements, see *Flexible Tool*, *supra* note 7, at 20 n.3.

27.

[T]he bondholder has the option periodically (at least as often as the interest rate is adjusted) to tender the bonds to the issuer for repurchase at par ("tender options"). The "remarketing agent" for the bonds (which is usually one of the underwriters for the bonds) will attempt to sell to the public any bonds which have been tendered for repurchase by the current bondholders.

Flexible Tool, *supra* note 7, at 17, col. 1. See *Creative Surge*, *supra* note 1, at 211, col. 3. For simplicity, reference is often made to tender to the issuer, while in fact tender is made to a tender agent. See *Flexible Tool*, *supra* note 7, at 20 n.3. For a discussion concerning the substance of this relationship among the issuer, remarketing agent and the bondholder, see *infra* notes 120-22 and accompanying text.

28. See *Flexible Tool*, *supra* note 7, at 17, col. 1. What makes the tender option possible is an underlying liquidity facility, normally a bank letter of credit or other third-party security arrangement, whereby a commercial bank on behalf of the issuer or the beneficiary agrees to advance funds to the remarketing agent to purchase any bonds tendered for repurchase. *Id.*; see *Creative Surge*, *supra* note 1, at 212, col. 2. However, the first obligation of the remarketing agent is to find a new buyer, and, therefore, the letter of credit is not expected to be drawn upon in a smoothly working transaction.

29. Various approaches are used to fix interest rates on these instruments. In

VRDBs are mainly an outgrowth of three seemingly negative economic forces that have emerged over the past few years.³⁰ First, a turbulent economy has produced volatile interest rates and an ever-steeper municipal yield curve.³¹ Second, governmental fiscal crises³² and the stingy attitude that Congress has shown toward the tax-exempt market³³ have severely undermined the confidence of tax-exempt investors. Third, reduced profits of banks and property and casualty insurers, the traditional consumers of municipal instru-

some cases, the rate is adjusted by the issuer periodically in accordance with a formula, an index, or some other objective standard set forth in the bond indenture—the formula approach. See *Flexible Tool*, *supra* note 7, at 18, col. 1. For example, the indenture may provide for the rate to be set in accordance with one of several tax-exempt commercial paper indices, a percentage of an index of short-term Treasury securities, or a percentage of the prime rate of a particular bank. See *Reissuance*, *supra* note 3, at 509; *Flexible Tool*, *supra* note 7, at 18, col. 1. In other cases, a remarketing agent or other independent third party has authority to fix the rate at whatever level is required to resell the instruments at par—the delegation approach. See *Flexible Tool*, *supra* note 7, at 17, col. 3 to 18, col. 1.

Having an independent third party make the decisions regarding changes in the interest rate may be preferable to having the issuer or the beneficiary of the financing make such decisions. See *id.* at 18, col. 1. The independent third party has the necessary expertise to determine, based on prevailing market conditions, the interest rates on each interest adjustment date and, moreover, is free from influence of economic interests of the parties. See *id.* Sometimes the authority to fix rates is limited to a specified number of points above or below a specified index. *Reissuance*, *supra* note 3, at 509. The former formula approach may also be used in conjunction with the latter delegation approach. See *id.* For a discussion of the delegation problems under state law that the approach used to fix rates may raise, see *id.* at 17, col. 3 to 18, col. 2.

30. See *Creative Surge*, *supra* note 1, at 211, col. 1.

31. See *id.* at 211, col. 1; *id.* at 222, col. 3; *Reissuance*, *supra* note 3, at 509.

32. A municipal bond investor, like any prudent lender, takes into consideration the creditworthiness of an issuer before investing. An analysis of the creditworthiness of an issuer of general obligation bonds concentrates on the issuer's financial health and potential taxing power. See *The Referendum Requirement*, *supra* note 23, at 684. Cleveland's bond default, New York City's financial crisis, and the Washington Public Power Supply System debacle are a few examples of fiscal crises that have caused investors to be more wary. See *id.* at 677; *Creative Surge*, *supra* note 1, at 211, col. 1; see also Wall St. J., Feb. 28, 1980, at 1, col. 6.

33. See *Creative Surge*, *supra* note 1, at 211, col. 1; *id.* at 222, col. 3. At present, the only legal basis for the exemption of interest on state and local obligations from federal income tax is found in section 103(a) of the IRC. See H.R. REP. NO. 413, 91st Cong., 1st Sess. 172, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1825. A body of authority, however, stemming from the Supreme Court's opinion in *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895), holds that it would be unconstitutional for the federal government to tax interest earned on state and local obligations. See H.R. REP. NO. 413, 91st Cong., 1st Sess. 172, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1825-26. Proponents of this view contend that the tax exemption has a constitutional basis, both in the reciprocal immunity doctrine

and in the federal system of government under which the federal government does not interfere with powers and affairs of local governments. See SECURITIES INDUSTRY ASS'N, FUNDAMENTALS OF MUNICIPAL BONDS 115-19 (9th ed. 1972).

On the other hand, the United States Treasury has been challenging the principle of state and local governments' constitutional immunity from federal taxation for decades. See *Armageddon*, *supra* note 20, at 116, col. 1. The better reasoned view is that there are simply no constitutional underpinnings for the municipal bond interest tax exemption and, therefore, the federal government does have a constitutional right to tax the interest on state and local obligations.

In the first place, since 1913, Congress has repeatedly overlaid restrictions on the section 103(a) tax exemption afforded municipal bonds. See, e.g., Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.) (placing extirpative restrictions and limitations on the issuance of IDBs by placing cap on amount of bonds that can pay for student loans, waste disposal, docks and other projects serving a mixture of public and private interests); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.) (imposing restrictions that apply to all § 103 obligations and specific restrictions that apply solely to IDBs); Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107(a), 82 Stat. 251, 266-68 (codified as amended in scattered sections of 26 U.S.C.) (divesting IDBs of the general tax exemption accorded interest on state and local obligations). To give in anywhere is to give in on the basic principle of state and local governments' constitutional immunity from federal taxation. See *Armageddon*, *supra* note 21, at 119, col. 1.

In the second place, *Pollock* is no longer good law. For an excellent analysis leading to the inescapable conclusion that nothing remains of the intergovernmental burden theory established in *Pollock*, see *South Carolina v. Regan*, 104 S. Ct. 1107, 1128-36 (1984) (Stevens, J., concurring in part, dissenting in part). *But see IDB Financing*, *supra* note 20, at 468-70.

In the third place, Article I, section 8 of the United States Constitution specifically delegates to Congress the "[p]ower [t]o lay and collect [t]axes." U.S. CONST. art. I, § 8. The sixteenth amendment removes any possible ambiguity concerning the scope of the power to be exercised by Congress by conferring a federal power to tax "incomes, from whatever source derived." See U.S. CONST. amend. XVI. Therefore, any notion that the federal tax exemption for municipal bond interest is supported by the tenth amendment or any other constitutional basis is clearly inconsistent with the plain language of the Constitution. See *South Carolina*, 104 S. Ct. at 1129 (Stevens, J., concurring in part, dissenting in part).

In the final analysis, simply no considerations of a constitutional proportion underlie the present municipal bond interest exemptions. See B. BITTKER, L. STONE & W. KLEIN, FEDERAL INCOME TAXATION 282 (6th ed. 1984) (citing Comment, *Intergovernmental Tax Immunities: An Analysis and Suggested Approach to the Doctrine and Its Application to State and Municipal Bond Interest*, 15 VILL. L. REV. 414 (1970) (constitutional barrier now seems to be insubstantial)) [hereinafter BITTKER]. Rather, the exemptions are at best an act of legislative grace (*i.e.*, the exemption of interest on state and local government bonds from federal income taxation should be deemed a privilege) based on a number of policy reasons. See Note, *The Limited Tax-Exempt Status of Interest on Industrial Development Bonds Under Subsection 103(c) of the Internal Revenue Code*, 85 HARV. L. REV. 1649, 1652-53 n.24 (1972) [hereinafter *Exempt Status*]. It is upon this assumption that the Treasury Department, with the encouragement of President Reagan, has pursued with a renewed vigor its efforts to constrict the use of tax-exempt bonds. See *infra* note 164 for a discussion of the progress of these efforts and some of the cogent policy objections to the tax exemption for IDBs.

ments,³⁴ have decreased their demand for tax-exempt bonds.³⁵ Because VRDBs, however, enable issuers to take advantage of the municipal yield curve and to secure new sources of funds by providing greater liquidity to investors, the effects of these forces have been mitigated.³⁶

With the interest rate floating—that is, changing at frequent intervals—these instruments are the functional equivalent of short-term debt.³⁷ The bondholder, knowing that the interest rate will be adjusted periodically to a current market rate and that the bonds will maintain their value at or about par on each interest adjustment date, is willing to accept a substantially lower rate of interest than the bondholder would for fixed rate bonds with a comparable maturity.³⁸ Thus, the issuer gets the advantage of paying short-term rates while it retains the protection against tax law changes normally provided by long-term financing.³⁹

On the other side of the transaction, the investors get, in reality, a short-term instrument with the option of retaining it for twenty to thirty years.⁴⁰ The tender option provides investors, who are

34. It has been estimated that banks own 45 to 50% of all tax-exempt bonds; insurance companies account for another 10 to 15%. See G. BREAK & J. PECHMAN, *FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM?* 53 (1975). The beneficiaries of tax-exempt bonds are higher tax-bracket individuals and entities. See Surrey, *Tax Trends and Bond Financing* 22 TAX LAW. 123, 126 (1968) [hereinafter *Tax Trends*]. Tax-exempt bonds pay a lower rate of interest than do taxable bonds, because people buying tax-exempt bonds are willing to accept a lower rate in order to obtain the exemption. See BITTKER, *supra* note 33, at 274.

For example, suppose the taxable rate of interest is 10% and the tax-exempt rate of interest is 7%. For a person taxed at a marginal rate of 50% on an investment of \$100,000, the after-tax return on the taxable investment will be \$5,000, while the after-tax return on the tax-exempt investment will be \$7,000. Such an investor saves \$2,000 in taxes by buying the tax-exempt, whereas a taxpayer in a 30% marginal tax-bracket would come out the same on either alternative. See *id.* at 275.

35. *Creative Surge*, *supra* note 1, at 212, col. 1. Since 1981, a fundamental change in the profile of the municipal security buyer has occurred. See *id.*

36. See *id.* at 211.

37. *Reissuance*, *supra* note 3, at 509; see also 17 C.F.R. § 270.2a-7 (1985) (variable rate bonds, unlike fixed rate bonds, may be purchased by tax-exempt "money market" funds which, otherwise, would be restricted to the purchase of tax-exempt notes).

38. *Flexible Tool*, *supra* note 7, at 17, col. 1; see *Creative Surge*, *supra* note 1, at 212, col. 2 (Utah's Intermountain Power Agency was able to obtain nine and nine and one-half percent whereas had it been fixed rate bonds, rate would have been closer to eleven and three-quarters percent).

39. *Creative Surge*, *supra* note 1, at 212, cols. 1-2. Unlike long-term debt, short-term debt is susceptible to the dangers of IRC revisions. See *Reissuance*, *supra* note 3, at 511. What is eligible for tax-exempt financing today may not be eligible a few years or even months hence. See *id.*

40. *Creative Surge*, *supra* note 1, at 212, col. 2.

worried about the security of long-term bonds and unpredictable interest rates, with greater flexibility.⁴¹ This added liquidity is another reason VRDBs carry a lower interest rate.⁴² Finally, the features of VRDBs have enabled municipal issuers to tap new sources of funds.⁴³ VRDBs are appealing to retail buyers and large corporations, whose paramount objective as investors—after safety and yield—is liquidity.⁴⁴

Thus, from the standpoint of the municipal issuers, investors, and investment bankers, VRDBs are a welcome innovation in the tax-exempt market.⁴⁵ This is evidenced, in part, by the burgeoning volume of this type of debt.⁴⁶ Municipal issuers are able to take advantage of lower interest costs and new pockets of money,⁴⁷ investors are docked in the safe haven of greater liquidity,⁴⁸ and investment bankers naturally benefit from the increased need for bond issuance services.⁴⁹

III. Limitations: IRC Section 103(c)—Arbitrage Bonds

“Arbitrage is the practice of acquiring property in one market and simultaneously disposing of it in another, with a view to profiting from a difference in prices exceeding transaction costs.”⁵⁰ IRC section 103(a), which exempts interest on municipal obligations from federal income tax, has created a separate financial market in which state and local governments can borrow at an artificially low price, taking taxable yields as the norm.⁵¹ Since these governments also have access to taxable money markets as investors, the tax exemption places them in the unique position of being able to earn a form of arbitrage profit by borrowing at tax-exempt interest rates and investing the borrowed funds in taxable obligations or equity securities.⁵²

41. *See id.* at 212, cols. 1-2.

42. *See id.* at 212, cols. 2-3.

43. *See id.* at 211, col. 2 to 212, col. 1.

44. *See id.* at 212, cols. 1, 3.

45. *See id.* at 222, col. 3.

46. *See supra* note 7 and accompanying text.

47. *See supra* notes 37-39, 42-44 and accompanying text.

48. *See supra* notes 40-44 and accompanying text.

49. Investment bankers play a key role in the underwriting and remarketing of variable rate debt. *Creative Surge*, *supra* note 1, at 212, col. 2 (number of basis points goes to remarketing agent on put bonds, usually bank selling issue); *see supra* notes 27, 29 and accompanying text. Commercial banks also benefit from the increased demand for the underlying liquidity facility. *See Creative Surge*, *supra* note 1, at 212, col. 2; *supra* note 28 and accompanying text.

50. Peaslee, *The Limits of Section 103(c): Municipal Bond Arbitrage After the Invested Sinking Fund*, 34 TAX L. REV. 423 (1979) [hereinafter *Limits of Section 103(c)*].

51. *See id.*

52. *See id.*

As an illustration, suppose a city needs a \$10 million sewer improvement. A municipal officer plans a \$100 million thirty-year serial bond issue, at five percent. Ten million dollars of this issue will be used to build the sewers and \$90 million will be invested in 6% United States Treasury bonds. The city will pledge the federal bonds and the interest to be earned to secure the municipal issue. The higher interest rate available on the federal bonds will enable the city to pay the \$10 million cost of the sewers entirely with the interest earned on the federal bonds—"the arbitrage between the two interest rates is buying the sewers."⁵³

At first blush, this may seem to be a very sensible means of financing, and even one that ought to be encouraged. After all, a city would be able to provide valuable services and programs at no cost.⁵⁴ In turn, the city's savings would be passed on to its taxpayers. But what if the municipal officer decides not to stop there, and wants to issue another \$100 million bond issue, invest all of it in federal bonds, and use the interest differential to help defray operating expenses of the city? And why stop at \$100 million; why not issue as many municipal bonds and buy as many federal bonds as possible?

Herein lies the crucial distinction between arbitrage profit and interest saving. The principal intention of IRC section 103(a) is to benefit states and localities by reducing their borrowing costs—*i.e.*, interest savings.⁵⁵ Although arbitrage profit would arguably reduce the borrowing costs,⁵⁶ the difference is that arbitrage transactions are not self-limiting in terms of either size or frequency.⁵⁷ In other words, arbitrage transactions are purely financial transactions whose volume is not tied to the capital requirements of state or local governments.⁵⁸ The only limit on the amount of municipal arbitrage

53. See *Tax Trends*, *supra* note 34, at 124.

54. See *id.*

55. See *Tax Adjustment Act of 1968: Hearings on H.R. 15414 Before the Senate Comm. on Finance*, 90th Cong., 2d Sess. 91 (1968) (letter from Assistant Secretary Surrey to Sen. Long, Chairman, Senate Fin. Comm., testimony of S. Surrey) [hereinafter *1968 Hearings*]. The recognized purpose of the section 103(a) exemption has been to aid state and local governments by allowing them to issue marketable bonds at interest rates below those of corporate and federal securities. See 113 CONG. REC. S31,611 (daily ed. Nov. 8, 1967) (statement of Senator Abraham Ribicoff); see also Note, *Arbitrage Bonds: Reviving The Regulation Roundabout*, 3 VA. TAX REV. 369 (1984) [hereinafter *Regulation Roundabout*].

56. See *infra* notes 69-70 and accompanying text for a discussion of how issuing municipal bonds for the purpose of earning arbitrage profit might have the exact opposite effect.

57. *Limits of Section 103(c)*, *supra* note 50, at 424.

58. See *id.* at 428.

bonds that could be issued would be the amount of federal bonds or other securities or obligations available.⁵⁹

This problem was very real for the United States Treasury during the 1960's.⁶⁰ Indeed, some state and local governments had misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from tax-exempt issues were employed to purchase higher yielding federal obligations whose interest was not taxed in their hands.⁶¹ Typically, such bonds guaranteed their holders that the proceeds would be kept invested in federal securities.⁶² An analysis of these transactions indicates that the bonds issued by the local government were simply a conduit to investment in the federal obligations.⁶³ Therefore, an individual who purchased a state or local security under such an arbitrage arrangement had the advantage of a tax-exempt security with the safety of a federal security.⁶⁴ The federal government then found itself in the position of being an unintended source of revenue for state and local governments while having lost the opportunity to tax the interest income from its own taxable bond issues.⁶⁵

In 1969, in order to curb this abuse, Congress enacted IRC section 103(c),⁶⁶ which provides in its pertinent parts:

(c) Arbitrage.—

(1) Subsection (a)(1) or (2) not to apply to arbitrage bonds [*i.e.*, no tax exemption]—Except as provided in this subsection, any arbitrage bond shall be treated as an obligation not described in subsection (a)(1) or (2).

(2) Arbitrage Bond.⁶⁷—For purposes of this subsection, the term "arbitrage bond" means any obligation which is issued as

59. See *Tax Trends*, *supra* note 34, at 124.

60. See *id.*

61. See H.R. REP. NO. 413, 91st Cong., 1st Sess. 173, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1826; S. REP. NO. 552, 91st Cong., 1st Sess. 219, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2254. States and their political subdivisions are not subject to being taxed by the federal government. See I.R.C. § 115 (1985).

62. See *Tax Trends*, *supra* note 34, at 124.

63. See *id.*

64. See *supra* note 61.

65. See *id.*

66. Tax Reform Act of 1969, Pub. L. No. 91-172, § 601(a), 83 Stat. 487, 656 (codified as amended in scattered sections of 26 U.S.C.) (formerly designated subsection (d)).

67. "Arbitrage bonds are otherwise tax-exempt obligations." *Regulation Roundabout*, *supra* note 55, at 369.

part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly—

(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

(B) to replace funds which were used directly or indirectly to acquire securities or obligations described in subparagraph (A).⁶⁸

The reasons offered for the legislative action reflect the policies IRC section 103(c) embodies. First, it is believed that arbitrage bonds serve no useful governmental purpose and yet compete in the tax-exempt market with bonds issued to finance legitimate public needs.⁶⁹ The effect of these bonds is that they tend to increase public borrowing costs and crowd out weaker public borrowers.⁷⁰ Second, arbitrage bonds arguably are not, in substance, obligations of a state or locality, but merely represent participation interests in the pool of taxable securities underlying the bonds.⁷¹ Third, arbitrage bonds cause loss of federal revenue and therefore erode the federal tax base.⁷²

68. I.R.C. § 103(c)(1), (2)(A), (B) (1985).

69. See *Limits of Section 103(c)*, *supra* note 50, at 425; see also *1968 Hearings*, *supra* note 55, at 91 (arbitrage bonds represent clear distortion of basic purpose of interest exemption; therefore, Treasury Department is unable to perceive any conceivable justification for extending tax exemption to such bonds). Although arbitrage profits might be spent for equally legitimate public needs or might have a bearing on the needs of potential tax-exempt bond issuers, the long-term consequences will damage the bond market and run counter to the interest of municipalities. 43 Fed. Reg. 39,822 (1978).

70. See *Regulation Roundabout*, *supra* note 55, at 370-73; *supra* note 6.

71. See *Limits of Section 103(c)*, *supra* note 50, at 425. Arbitrage bonds can be fully secured with the investments they are used to acquire and, hence, the creditworthiness of the issuer is not a factor. As a result, questions have been raised about whether such bonds in reality are obligations of a state or local government. See *id.* at 424; 113 CONG. REC. S31,613 (daily ed. Nov. 8, 1967) (statement of Senator Abraham Ribicoff) ("profit [from arbitrage bonds] is claimed on the sole ground that the local government lends its name to a security—without assuming any risk, or responsibility, or work, or anything else"); *supra* notes 57-58 and accompanying text. But see *Limits of Section 103(c)*, *supra* note 50, at 425 (application of section 103(c) may not depend on whether the local governments' credit is on the line). In enacting IRC section 103(c), Congress was clearly concerned that states and municipalities might act as "conduits" to turn taxable investments into nontaxable ones. *State of Washington v. Commissioner*, 692 F.2d 128, 135 (D.C. Cir. 1982).

72. Arbitrage bonds cost the federal government more than they benefit state and local governments, which results in a net loss to the federal taxpayer. Statement of Donald Lubick, Assistant Secretary of Treasury (Tax Policy) on S.3370 (Aug.

Furthermore, several elements of the legislative history⁷³ shed light on the issue of whether to treat VRDBs as arbitrage obligations. In particular, it is important to recognize that the primary purpose of IRC section 103(c) is to eliminate the profit element that permeates the use of arbitrage bonds.⁷⁴ Moreover, the legislative history evinces a legislative purpose to broaden the scope of the provision beyond the relatively narrow categories specifically described in the agency release, which initially prompted congressional action.⁷⁵ The broad language of the section, when read in the context of its legislative history, reflects a purpose to prevent avoidance of the statute through

24, 1978) (*reprinted in* BNA Tax Management Portfolio); *see also Regulation Roundabout*, *supra* note 55, at 370. The House Report on the Tax Reform Act of 1969 pointed out that arbitrage bonds tend to cause a loss of federal revenue when municipalities invest their bond proceeds in taxable federal securities. *See* H.R. REP. NO. 413, 91st Cong., 1st Sess. 173, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1826-27; *see also supra* note 62 and accompanying text. A federal revenue loss is also attributable to the fact that income tax on the entire interest on a taxable obligation is lost when a tax-exempt bond is issued instead. *See Tax Trends*, *supra* note 34, at 126 n.*, 129 n.*. The buyer of the tax-exempt bond must forego a taxable investment to be able to buy the tax-exempt bond. *See id.*

73. For a thorough review of the congressional deliberations concerning the enactment of section 103(c), *see* *State of Washington v. Commissioner*, 77 T.C. 656, 666-68 (1981), *aff'd*, 692 F.2d 128 (D.C. Cir. 1982).

74. *See* H.R. REP. NO. 413, 91st Cong., 1st Sess. 172-74, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1825-28; S. REP. NO. 552, 91st Cong., 1st Sess. 219-20, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2254-55; *see also State of Washington*, 77 T.C. at 668 (Congress recognized that its primary objective should be to eliminate "profit" element which permeates use of arbitrage bonds), *aff'd*, 692 F.2d at 135 (curtailing arbitrage profits was *main concern* of section 103(c)'s sponsors). *See generally Regulation Roundabout*, *supra* note 55, at 369.

75. *City of Tucson, Ariz. v. Commissioner*, 78 T.C. 767, 777 (1982). In August of 1966, when the arbitrage bond problem was first officially addressed, the Treasury Department announced, in Technical Information Release 840, that it would decline to rule on certain municipal obligations when "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." Tech. Info. Rel. 840 (Aug. 11, 1966), *reprinted in* 7 Stand. Fed. Tax Rep. (CCH) ¶ 6701. More specifically, Technical Information Release 840 described two categories of arbitrage bonds to which the policy applied:

- (1) Where all or a substantial part of the proceeds of the issue (other than normal contingency reserve 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.
- (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.

Id.

manipulation of the form of municipal borrowing in such a way as to create arbitrage profits.⁷⁶ In order to implement the purposes of IRC section 103(c), the Treasury Department has been delegated a broad grant of regulatory authority.⁷⁷

IV. Application and Implications of IRC Section 103(c) With Respect to VRDBs

Whether an obligation is an arbitrage bond under IRC section 103(c) depends upon the issuer's reasonable expectations as of the date of issuance regarding the use of proceeds.⁷⁸ Generally, an obligation is not an arbitrage bond if, based on the issuer's reasonable expectations on the date of issuance, the proceeds will not be invested in a materially higher yielding security.⁷⁹ In this regard, the issuer

Congress' decision to deal with the problem of arbitrage bonds in terms of comparison of "yield" suggests that section 103(c) is not confined within a "conduit" frame of reference such as that expressed in Technical Information Release 840. *See State of Washington*, 77 T.C. at 668-69. Confining section 103(c) would dilute the accomplishment of the main objective of eliminating the profit element of arbitrage bonds. *See id.*

76. *See City of Tucson*, 78 T.C. at 778; *see also Regulation Roundabout*, *supra* note 56, at 379-83.

77. "The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection." I.R.C. § 103(c)(7) (1985). As originally passed by the House of Representatives, section 103(c) simply denied tax-exempt status to arbitrage bonds; it failed to define the term "arbitrage bond" but gave broad authority to the Treasury Department to prescribe regulations defining such term. *See H.R. 13270*, 91st Cong., 1st Sess. (1969) (as passed by the House). The Treasury Department replied that this delegation of authority was too broad, and recommended that the House bill be amended to provide a rule "which may be easily understood and applied and which furnishes a clearer standard to follow in the regulations." *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. 619 (1969) (statement of Assistant Secretary Cohen, Treasury Dep't). The Senate Finance Committee acceded to the Treasury's request by recommending a change in the proposed legislation so that "arbitrage bonds are defined." *See S. REP. NO. 552*, 91st Cong., 1st Sess. 219-20, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2254-55. The Senate ultimately adopted a provision almost identical to the finally enacted section 103(c). *See H.R. 13270*, 91st Cong., 1st Sess. (1969) (as passed by the Senate).

78. *See* Treas. Reg. § 1.103-13(a)(2) (1979).

79. *See id.* The regulations provide that the yield produced by the acquired obligations is materially higher than the yield produced by an issue of governmental obligations if the yield produced by the acquired obligations exceeds the yield produced by the issue of governmental obligations by more than one-eighth of one percentage point or, in a special instance, one-half of one percentage point. *See* Treas. Reg. § 1.103-13(b)(5) (1979). Also, the regulations define yield to be "that yield which when used in computing the present worth of all payments of principal and interest to be paid on the obligation produces an amount equal to the purchase price." Treas. Reg. § 1.103-13(c)(1)(ii) (1979). *See Regulation Roundabout*, *supra* note 55, for a discussion of the method for computing yield and the treatment of

must calculate the yield on its bonds and compare it with the yield on the securities or obligations that are to be or were purchased with the proceeds allocable to the bonds issued.⁸⁰ If the latter yield is materially higher than the former, the entire issuance by the municipality is taxable.⁸¹

This analysis is not easily adapted to the case of VRDBs because the interest rate on the bonds is constantly changing.⁸² Accordingly, the issuer can not predict the yield on its bonds with any degree of certainty until some time well into the term of the issue—probably closer to the time the issue is retired.⁸³ Thus, the VRDB issuer may well be precluded from having any reasonable expectations as of the date of issuance regarding the use of the proceeds.⁸⁴

Nevertheless, municipalities continue to issue VRDBs that pay short-term interest rates (e.g., four to seven percent) as opposed to the long-term rates (e.g., nine to twelve percent) usually associated with traditional fixed rate instruments, and yet use the nominal long-term rate for yield comparison purposes.⁸⁵ Furthermore, VRDB holders may either elect to retain the bonds for a short-term and exercise the put or, in the alternative, hold the bonds until maturity or somewhere in between.⁸⁶

Although Congress could not foresee all of the forms which

issuer discounts, administrative costs and other elements. At the very least, it should be noted that the yield is not merely equal to the rate of interest of the VRDBs as determined—there is a distinction between yield and interest rate.

80. See I.R.C. § 103(c)(2) (1985); Treas. Reg. § 1.103-13(a)(1) (1979).

81. See I.R.C. § 103(c)(1), (2) (1985); Treas. Reg. § 1.103-13(a)(1) (1979). An arbitrage obligation is not treated as a tax-exempt state or local government bond and all interest is taxable from the date of the issuance of the bond. See *id.* See *infra* notes 144-46 and accompanying text for a discussion of the new arbitrage rules that create an exception to the general rule by allowing such bonds to enjoy a tax-exempt status if a special tax or rebate is paid to the United States.

82. See Committee on Tax Exemption of Obligations, Neil P. Arkuss, Chairman, *New Federal Tax Legislation Affecting Tax-Exempt Obligations*, 16 URB. LAW. 805, 811 (1984) [hereinafter *Tax-Exempt Obligations*].

83. See *id.*; see also Thomas, *An Analysis Of The New Industrial Development Bond Rules*, at 24 (available Aug. 13, 1984, on LEXIS, FTX library, 24 TN 691) [hereinafter *New IDB Rules*].

84. See *id.*; Treas. Reg. § 1.103-13(a)(2)(i)-(v) (1979).

85. Telephone interview with Michael K. De Chiara, Esq., Associate with Brown & Wood, New York City (Oct. 15, 1985); see, e.g., Wall St. J., Oct. 1, 1986, at 51 (tombstone advertisement for Metropolitan Transportation Authority adjustable rate refunding obligations); see also *supra* notes 37-39 and accompanying text; *infra* notes 108-11 and accompanying text.

86. See *supra* notes 40-44 and accompanying text. This raises the question whether VRDBs should be treated or viewed as short-term obligations or as long-term obligations for tax purposes. See *infra* notes 115-28 and accompanying text for an attempted resolution of this problem.

arbitrage might take,⁸⁷ VRDBs should still fall squarely within the ambit of arbitrage bonds as defined by IRC section 103(c)(2).⁸⁸ Most significantly, the potential source of arbitrage profits created by VRDBs is exactly the profit element that the broad language of IRC section 103(c) was designed to curtail.⁸⁹ Therefore, this profit element should cause VRDBs to be characterized as arbitrage bonds under IRC section 103(c)(2).⁹⁰ In addition, VRDBs cannot fit conceptually into any of the exceptions to IRC section 103(c)(2).⁹¹ More specifically, neither the exercise of the put nor the interest adjustments should constitute a reissuance of the bond; to characterize them as such might cause VRDBs to fall within the purview of IRC section 103(c)(4)(A), which arguably excepts short short-term obligations from being treated as arbitrage bonds.⁹²

A. A VRDB is an Arbitrage Bond Under Section 103(c)(2)

As stated above, the conventional test for characterizing an obligation as an arbitrage bond under IRC section 103(c) turns on the

87. See *Commissioner v. Portland Cement Co.*, 450 U.S. 156, 169 (1981).

88. See *infra* notes 93-128 and accompanying text.

89. See *supra* notes 50-77 and accompanying text. See *infra* notes 106-14 and accompanying text for a discussion of the potential source of arbitrage profits inextricably intertwined with VRDB transactions.

90. See *infra* notes 96-97, 106-14 and accompanying text.

91. The breadth of the definition of arbitrage bonds is qualified by exceptions and special rules. I.R.C. § 103(c)(3), (4) (1985). In brief, these provisions define limited circumstances under which bond proceeds, moneys held for debt service, and amounts that are part of a reasonably required reserve or replacement fund may be invested at an unrestricted yield. See *generally* Treas. Reg. § 1.103-14 (1979). Apparently, however, these regulations did not contemplate VRDBs, but only fixed rate obligations. See *generally id.*

92. IRC section 103(c)(4) provides, in its pertinent parts:

[A]n obligation shall not be treated as an arbitrage bond solely by reason of the fact that—(A) the proceeds of the issue . . . may be invested for a temporary period in securities or other obligations until such proceeds are needed for the purpose for which such issue was issued

I.R.C. § 103(c)(4)(A) (1985).

This subparagraph essentially creates a temporary exemption from the arbitrage bond definition by permitting a state or local governmental unit to invest the proceeds of an issue at an unrestricted yield for a temporary period. See *id.* The special rules regarding the duration of the temporary period relating to a refunding issue are contained in Treasury Regulation § 1.103-14(e) (1979). One interpretation of these rules seems to suggest that the issuer is allowed as a minimum a 30-day period beginning on the date of issue for each refunding issue. See Treas. Reg. § 1.103-14(e)(3) (1979) (“the issuer shall be allowed the longer of the temporary periods determined under paragraph (e)(3)(ii)(A) [a 30-day period] or (B) or (at the issuer’s option) the temporary period determined under paragraph (c)(3)(ii)(C)”). Thus, if VRDBs can be viewed as a continuous rolling over of short-term debt

issuer's intent with regard to the use of the proceeds.⁹³ Also noted was the fact that such a test is inappropriate in the case of VRDBs because of the fluctuating interest rates and resulting uncertainty in computing the yield on the instruments.⁹⁴ Nonetheless, because the language of the statute itself is broad enough to encompass transactions involving VRDBs⁹⁵ and because of the enormous profit potential that is inherent in the instruments,⁹⁶ VRDBs violate the statutory policies of IRC section 103(c) and, therefore, should be considered arbitrage bonds.⁹⁷

The terms "proceeds" and "acquired obligations" both illustrate the breadth of IRC section 103(c). For example, the definition of "proceeds" is not limited to the net amounts received by the state or local governmental units as a result of the sale of the issue.⁹⁸ Proceeds also include amounts received by the issuer, namely interest and dividends, "resulting from the investment of any proceeds of an issue of obligations in acquired nonpurpose obligations."⁹⁹ In addition, arbitrage bonds exist when it is found that the proceeds of a bond issuance replace funds invested in materially higher yielding obligations.¹⁰⁰ Consequently, certain funds, which technically are not

(i.e., a refunding occurs every 30 days or less), then it may be possible to avoid the arbitrage problems altogether because the proceeds (or transferred proceeds) would be invested in materially higher yield acquired obligations for a permissible temporary period.

93. The arbitrage rules depend on reasonably expected yields. See *supra* notes 78-84 and accompanying text.

94. See *supra* notes 82-84 and accompanying text.

95. See *infra* notes 98-103 and accompanying text.

96. See *infra* notes 106-14 and accompanying text.

97. Telephone interview with Michael K. De Chiara, Esq., Associate with Brown & Wood, New York City (Oct. 15, 1985).

98. Treas. Reg. § 1.103-13(b)(2)(i) (1979). Temporary Regulations § 1.103-15AT(b)(6) extends the statute so that gross proceeds mean all of the following: (1) original proceeds (as defined in section 1.103-13(b)(2)(i)), (2) investment proceeds (as defined in section 1.103-13(b)(2)(ii)), (3) transferred proceeds (as defined in 1.103-14(e)(2)(ii)), (4) amounts treated as proceeds of the issue under section 1.103-13(g) (relating to invested sinking funds), (5) amounts invested in a reasonably required reserve or replacement fund (as defined in 1.103-14(d)), (6) securities or obligations pledged as security for payment of debt service on an issue by an ultimate obligor (or a related person), the issuer, or by a governmental unit of which the issuer is a part, (7) amounts received with respect to acquired purpose obligations (e.g., lease payments, repayments of principal), (8) other amounts used to pay debt service on the issue, and (9) other amounts received as a result of investing the amounts. See Temp. Treas. Reg. § 1.103-15AT(b)(6) (1985).

99. Treas. Reg. § 1.103-13(b)(2)(ii)(A) (1979).

100. I.R.C. § 103(c)(2)(B) (1985). For a discussion of what is needed for this replacement to occur, see Thornton, *The Limits of Federal Arbitrage Replacement Theories*, 4 PACE L. REV. 81 (1984) [hereinafter *Federal Arbitrage*].

proceeds, are deemed or treated as the proceeds of an issue for the purpose of determining whether there has been arbitrage.¹⁰¹

Furthermore, the term "acquired obligations," as used in IRC section 103(c), includes not only the purchase of "federal" obligations, but the purchase of any other type of taxable security or obligation as well.¹⁰² Thus, "acquired obligations," as defined in the statute, include: (1) transactions that the state or local governmental unit, for tax purposes, treated as a loan; (2) non-exempt industrial development bonds or arbitrage bonds issued by the state or local governmental unit; (3) time or demand deposits; and (4) contracts between the issuer and another person who is required personally to discharge any obligation of the issuer.¹⁰³

In view of the expansiveness of the terms "proceeds" and "acquired obligations," IRC section 103(c)(2) should be readily applicable to virtually any transaction employing VRDBs.¹⁰⁴ To confine the language of IRC section 103(c) solely to those situations that prompted Congress to enact the statute—arbitrage transactions involving fixed rate tax-exempt bonds—would be inconsistent with the underlying purposes of the statute.¹⁰⁵

Finally, given that IRC section 103(c) is applicable and that its primary objective is to eliminate the profit element in transactions involving tax-exempt municipal obligations,¹⁰⁶ VRDBs should be classified as arbitrage bonds under IRC section 103(c)(2) because of the large profit element that is inherent in such instruments.¹⁰⁷ Consider the following hypothetical: A state or local government issues VRDBs and makes the proceeds available to private business concerns located in the area so that they can build industrial plants.¹⁰⁸ Assume that the governmental issue is otherwise eligible for tax-exempt status.

101. *Federal Arbitrage*, *supra* note 100, at 95.

102. Treas. Reg. § 1.103-13(b)(4) (1979); *see* S. REP. NO. 552, 91st Cong., 1st Sess. 219-20, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2254-55; *see also* *City of Tucson*, 78 T.C. at 776-77.

103. Treas. Reg. § 1.103-13(b)(4)(iii) (1979).

104. *See Tax-Exempt Obligations*, *supra* note 82, at 811.

105. *See* *State of Washington v. Commissioner*, 77 T.C. 656, 668-69 (1981) (section 103(c) was designed to deal only with legislative concern that arbitrage profits should be eliminated); *supra* notes 50-77 and accompanying text.

106. *See supra* notes 50-77, 105 and accompanying text.

107. *See infra* notes 108-14 and accompanying text. Many bankers admit that a number of deals were done for the pure purpose to create arbitrage. *See Armageddon*, *supra* note 21, at 119, col. 1.

108. The issuer may simply lend the borrowed funds to the business directly, or may lease or sell on an installment basis property financed with such funds. *See Tax Trends*, *supra* note 34, at 125; *Industrial Development Bonds*, *supra* note 20, at 34.

The agreement between the issuer and the private business is ordinarily characterized for tax purposes as an obligation acquired with the proceeds of the bonds and, according to the arbitrage rules, the yield of such an obligation may not be materially higher than the yield of the VRDBs.¹⁰⁹ Under existing rules, however, the yield is simply not calculable on the governmental floating issue until it is retired.¹¹⁰ Undoubtedly though, absent a determinable yield on the governmental issue, the yield on the acquired obligation approximates the yield on an issue of traditional fixed rate instruments of a comparable maturity.¹¹¹ It is highly improbable that the interest actually paid on the VRDBs will produce a yield that is within the spread limitations.¹¹²

The net result is a governmental issue that was supposedly expected to produce a permitted yield actually produces an impermissible one. This is precisely the point at which VRDBs run afoul of section 103(c)(2).¹¹³ Even if the subjective purpose of a transaction is not solely to produce arbitrage profits, it is still an arbitrage transaction if the effect produces material amounts of arbitrage.¹¹⁴

B. A VRDB Does Not Result in a Reissuance

Essentially, one must ask "three questions in analyzing any reissuance problem: (1) has there been a change in terms?; (2) is the change material?; and (3) does the principle of the conversion rulings mean there is nevertheless no new issue?"¹¹⁵ If the answer to the

109. *Limits of Section 103(c)*, *supra* note 50, at 426 n.3; *see supra* note 103 and accompanying text. In other words, the yield produced by the rental or installment sale payments obtained from the operating revenues of these concerns is subject to the arbitrage bond yield limitations.

110. *See Tax-Exempt Obligations*, *supra* note 82, at 811; *see also supra* notes 82-84 and accompanying text.

111. *See supra* notes 85-86 and accompanying text. The theory is that the state or local government will want to arrange the rental or installment sale payment schedule to ensure repayment of the principal and interest—whatever it may be—with respect to the VRDB issue.

112. *See Tax-Exempt Obligations*, *supra* note 82, at 811.

113. *See supra* note 68 and accompanying text.

114. *See Regulation Roundabout*, *supra* note 55, at 379-83 (section 103(c) intended to apply to transactions having effect, as well as purpose, of producing arbitrage supported by principles of statutory construction); *see also* Treas. Reg. § 1.103-13(j) (1979) (transactions that attempt to circumvent provisions of section 103(c)—"artifice or device"—constitute arbitrage bond transactions); Note, *The IRS's Application of Arbitrage Provisions: Overregulation of Municipal Finance*, 10 *FORDHAM URB. L.J.* 659, 661 n.12 (1982) [hereinafter *Arbitrage Provisions*].

115. *See Reissuance*, *supra* note 3, at 527; *see also supra* notes 91-92 and accompanying text (explaining significance of this analysis).

first question is "no," the inquiry ends there; if not, one must address the remaining questions.¹¹⁶

In determining whether VRDBs result in a reissuance, the analysis must focus on the interest rate adjustment and the option to put the bonds.¹¹⁷ It is true that it might appear as though the remarketing agents were in substance retiring old paper and selling new paper each time an investor exercised a put or a remarketing agent reset an interest rate.¹¹⁸ Nevertheless, neither the exercise of the put nor the remarketing agent's authority to set the interest rate should result in a reissuance.¹¹⁹

With regard to the exercise of the put, the remarketing agent can be viewed as retiring old paper and selling new paper only if he is actually the agent of the issuer.¹²⁰ A properly structured transaction, however, avoids anything that hints at the issuer buying and re-selling.¹²¹ The put, then, is merely a mechanism for the holder to dispose of his investment to a third party, rather than a mechanism for redemption, unless, of course, the remarketing agent is unable to find a buyer.¹²² Thus, the put is basically irrelevant in deciding whether a reissuance has occurred and the question narrows to whether the remarketing agent's authority to set the interest rate creates a reissuance problem.¹²³

Almost instinctively, a person could reasonably conclude that a change in the rate of interest payable is not really a change in the terms of the instrument.¹²⁴ In the first place, there has been no physical exchange of the bonds.¹²⁵ Moreover, the "new rate" is not really new in the sense that a provision, embedded in the instrument, preauthorized the change to this rate from the outset.¹²⁶ In a simple situation such as this, a variation in the interest rate should not be a change in terms.¹²⁷ Accordingly, VRDBs do not qualify for the

116. See *Reissuance*, *supra* note 3, at 527.

117. See *id.*; *Flexible Tool*, *supra* note 7, at 18.

118. See *Reissuance*, *supra* note 3, at 531.

119. See *infra* notes 120-28 and accompanying text.

120. See *Reissuance*, *supra* note 3, at 531.

121. See *id.* at 532.

122. See *id.*

123. See *id.*

124. See *id.* at 527.

125. See *id.*

126. See *id.*

127. See *Tax Analysis of "Reissue" Questions Arising From Changes in Bond Terms 10* (undated) (unpublished memorandum available from National Association of Bond Lawyers, Committee on General Federal Tax Matters); see also *Reissuance*, *supra* note 3, at 532.

IRC section 103(c)(4)(A) exception because their operation does not result in a reissuance.¹²⁸

V. The Need for the Internal Revenue Service to Issue Rules

Municipal issuers currently believe that they have adapted their VRDBs to conform to the regulations.¹²⁹ Yet VRDBs exploit the interest differential between tax-exempt and taxable securities and obligations, to achieve a material financial advantage—increased arbitrage profits.¹³⁰ Accordingly, the Treasury Department should take steps to enforce the congressional view that municipal bond arbitrage via VRDBs is a serious abuse of the tax exemption.¹³¹

A. Alternative Resolutions

One approach that the Internal Revenue Service might take is to promulgate rules for forecasting the yield based on present assumptions.¹³² This approach, however, is so fatally flawed that it does not warrant elaboration on the mechanics to make it work. Axiomatically, there are no experts on the future. The potential source of arbitrage profit would still exist.¹³³ At best, the potential profit margin would be reduced slightly. Tolerance of any profit, no matter how slight, is clearly inconsistent with the legislative fiat to eliminate all profits.¹³⁴

Another approach that has been suggested requires a look-back to the yield actually produced over a prior period.¹³⁵ Presumably, the theory is that the yield actually produced over a prior period

128. See *supra* notes 91-92 and accompanying text.

129. See *Flexible Tool*, *supra* note 7, at 17, col. 2 (legal counsel have devised acceptable approaches to many problems).

130. See *supra* notes 108-14 and accompanying text.

131. See *supra* notes 69-77 and accompanying text.

132. See *Tax-Exempt Obligations*, *supra* note 82, at 811.

133. Absent a determinable yield on the VRDBs, the ceiling yield (*i.e.*, the maximum permissible yield of the acquired obligation) will still be an approximation, although some will be better than others. See *supra* notes 111-12 and accompanying text.

134. See *Regulation Roundabout*, *supra* note 55, at 376-83 (criticizing Tax Court's decision in *State of Washington*, holding primary intent of section 103(c) was not to eliminate all arbitrage from municipal bond offerings). The drafters did provide special rules and exceptions regarding temporary investments, minor proceed investments, and reserve fund investments which do permit some arbitrage effects. See *supra* note 91. The reference to "arbitrage profit" in the context of this discussion is intended to refer only to the overage of these permissible arbitrage effects.

135. *Tax-Exempt Obligations*, *supra* note 82, at 811.

could be used in any one of three ways.¹³⁶ One way would be to use this yield as a basis to predict the yield for the next period.¹³⁷ A second way would be to use this yield as the comparative yield for the acquired obligations in a future period of the same duration.¹³⁸ A third way to use the yield actually produced over a prior period is to use it as a sort of monitoring device.¹³⁹ Regardless of which method is used, however, this approach suffers from the same defects of the aforementioned approach.¹⁴⁰ This approach is in fact nothing more than a periodic review to check whether there is a potential non-compliance with the arbitrage rules.¹⁴¹ The potential for non-compliance is very real.¹⁴² The consequences of this non-compliance—loss of the tax exemption for the bond issue—could be catastrophic. An additional disadvantage common to each variation of this approach is that it requires an impracticable policing and continuous supervision by the municipal issuer and also the IRS.¹⁴³

A third approach is analogous to the 1984 amendment to the arbitrage rules in paragraph 6 of section 103(c).¹⁴⁴ This amendment provided that arbitrage profit earned on investments that are not acquired in order to carry out a government purpose must be paid

136. *See id.*

137. *See id.* For instance, assume that at the end of the first bond year the weighted average rate of interest for the first year is a rate of 7%. The yield could then be calculated assuming a rate of 7% over the life of the obligations. See *Clarifications in Regulations*, *supra* note 12, at 9-11, for other ways to use the weighted average rate and for the effects of the weighted average rate of interest in subsequent periods.

138. For example, the weighted average rate of interest for period year one would be used to establish the maximum permissible yield of the acquired obligations during period year two. In turn, the weighted average rate of interest for period year two would form the basis for the maximum permissible yield of the acquired obligations during period year three, so on and so forth. In addition to the problem with this method at the beginning of issuance (no weighted average rate of interest to use for period year one), see *infra* note 142 for another problem.

139. *See Tax-Exempt Obligations*, *supra* note 82, at 811-12; *infra* notes 141-42 and accompanying text.

140. *See supra* notes 132-34 and accompanying text.

141. *See id.*

142. It is inconceivable that a municipal issuer could invest and divest in acquired obligations in order to parallel the fluctuations of the weighted average rate of interest and the yield produced thereby from period to period.

143. For a discussion of the problems that the IRS currently faces in auditing municipal issuers, see *Limits of Section 103(c)*, *supra* note 50, at 429.

144. *See* I.R.C. § 103(c)(6) (1985). The requirements of section 103(c)(6) apply to IDBs other than obligations described in section 103(b)(4), relating to projects for residential rental property, and housing program obligations issued under section 11(b) of the Housing Act of 1937. *See* H.R. REP. NO. 432, 98th Cong., 2d Sess. 1696, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1319.

to the federal government.¹⁴⁵ At least every five years, an issuing authority must rebate ninety percent of the arbitrage earned to that date to the federal government with any remaining balance paid thirty days after the bonds are retired.¹⁴⁶ Similarly, an issuer might be permitted to prevent its VRDBs from becoming an arbitrage bond by rebating all of the arbitrage profit earned to the United States.¹⁴⁷

The beauty of this last method is its exactness and certainty—the municipal issuers can not make any arbitrage profit.¹⁴⁸ At least two major drawbacks, however, diminish the efficacy of this approach. First, the rebate merely shifts the impermissible profit to the federal government.¹⁴⁹ Second, after a rebate calculation is made, and the payment of the rebate is made to the United States, rates on the bonds may increase to the point at which, had the increase been known or predicted, less rebate would have been payable.¹⁵⁰ The question arises whether the United States would be required to rebate the rebate under such circumstances.¹⁵¹

B. Recommendations

From the foregoing analysis, one may perceive that any rule that

145. See I.R.C. § 103(c)(6)(D)(ii) (1985). Section 103(c)(6) supplements the general provisions of section 103(c)(4) and related regulations, which define the circumstances under which bond proceeds and moneys held for debt service may be invested at an unrestricted yield during various temporary periods or as part of reasonably required reserve funds. See *ABA Comments*, *supra* note 12, at 3; *supra* note 91. The new rules are supplemental to the existing arbitrage rules. Paragraph six does not allow issuers to earn arbitrage profit in addition to the permitted spreads as long as they do not retain any arbitrage earned. See *New IDB Rules*, *supra* note 83, at 25 (rule does not excuse violation of old rules limiting amount of arbitrage that may be earned and excess earnings still disqualify a bond, even if earnings rebated); H.R. REP. No. 861, 98th Cong., 2d Sess. 1205-06, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 1445, 1893-94; see also *supra* note 134. Rather, the issuers are no longer allowed to retain any arbitrage earned and the amendment does not prevent an IDB from becoming an arbitrage bond if the spread limitations are violated. See *New IDB Rules*, *supra* note 83, at 25 (new rule requires that certain arbitrage profits which previously could have been retained to be passed on to federal government and failure to comply results in bond losing exempt status); H.R. REP. No. 861, 98th Cong., 2d Sess. 1205-06, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 1445, 1893-94.

146. See I.R.C. § 103(c)(6)(E) (1985).

147. See *supra* notes 145-46 and accompanying text. Note that this approach is a departure from I.R.C. § 103(c)(6) in that, as long as the money is rebated, the IDBs would not lose their tax-exempt status even though the arbitrage exceeds the limits set by Congress.

148. See I.R.C. § 103(c)(6)(D), (E) (1985).

149. See *supra* note 147.

150. *Tax-Exempt Obligations*, *supra* note 82, at 811.

151. See *id.*

attempts to keep the tax exemption for VRDBs intact is potentially inequitable.¹⁵² This Note, therefore, proposes two changes in the current law concerning VRDBs.

The first change is to disallow the exemption from federal income tax for VRDBs when the bonds are issued by a state or local governmental unit to finance certain exempt activities,¹⁵³ to finance industrial parks,¹⁵⁴ or as part of an exempt small issue.¹⁵⁵ The justification for this disallowance is simple and logically sound. The purpose of the tax exemption is to benefit states and localities by reducing their borrowing costs.¹⁵⁶ The proposed change does not bar the use of VRDBs; it only abrogates their tax-exempt status.¹⁵⁷ Notwithstanding the taxability of VRDBs, municipal issuers would still be able to achieve lower borrowing costs than with traditional (fixed rate) long-term instruments that are without the tax exemption.¹⁵⁸ There is no compelling reason further to enhance municipal issuers' borrowing ability at the expense of creating the risk of contravening congressionally determined economic policies.¹⁵⁹

The second proposed change is to permit the tax exemption for VRDBs only when the acquired purpose obligations are analogous to acquired program obligations as specified in Treasury Regulation

152. See *id.*; see *supra* notes 132-51 and accompanying text.

153. See I.R.C. § 103(b)(4) (1985); Treas. Reg. § 1.103-8 (as amended in 1983).

154. See I.R.C. § 103(b)(5) (1985); Treas. Reg. § 1.103-9 (as amended in 1977).

155. See I.R.C. § 103(b)(6) (1985); Treas. Reg. § 1.103-10 (as amended in 1986). In short, VRDBs of the IDB variety would no longer be eligible for the tax exemption.

156. See *supra* note 55 and accompanying text.

157. These proposals affect only the tax consequences of VRDBs.

158. The general IRC section 103(a) tax exemption enables municipal issuers to borrow at two to four percentage points below market interest rates. See BITTKER, *supra* note 33, at 274-75. VRDBs enable municipal issuers to borrow at two to four percentage points below the municipal fixed rate market interest rates. See *supra* notes 37-39 and accompanying text. Therefore, loss of the tax exemption for VRDBs should still, theoretically, enable municipal issuers to borrow at two to four percentage points below market interest rates.

159. One could argue that since one of the underlying rationales of IDBs is to subsidize indirectly economic development, VRDB/IDB transactions qualify for the tax exemption as long as the private enterprises reap the full benefit of the subsidy effect produced by the arbitrage. See *Arbitrage Provisions*, *supra* note 114, at 661-63, 676-81. The arbitrage profit in the hands of the private enterprise would represent an additional reduction in the private enterprise's cost of financing and therefore would be consistent with the policy to subsidize. *Id.* There are at least two grounds for rejecting this argument. First, the private enterprise would still be making private profits at the expense of the public. See *Tax Trends*, *supra* note 34, at 128-29. Second, the continuation of the tax-exempt status of IDBs under any rationale is at best improbable. See *infra* note 164 and accompanying text.

section 1.103-13(h),¹⁶⁰ or when no securities or obligations,¹⁶¹ are acquired at all.¹⁶¹ It is only in these two instances that there will be no arbitrage profit. The governmental program exception is inherently self-limiting and, furthermore lessens the need to make additional issuances—*i.e.*, purely interest saving.¹⁶² The latter exception enables the municipal issuer to certify conclusively that the proceeds will definitively not be invested in materially higher yielding securities or obligations.¹⁶³

These proposed changes will not only comport better with the entire legislative scheme of tax-exempt bonds,¹⁶⁴ but will also drast-

160. Section 1.103-13(h) provides, in pertinent parts:

(2) Governmental programs. A governmental program is described in this subparagraph if—

(i) The program involves the acquisition of acquired purpose obligations;

(ii) At least 90 percent of all such obligations acquired under the program, by amount of cost outstanding, are evidences of loans to a substantial number of persons representing the general public, loans to exempt persons within the meaning of section 103(b)(3), loans to provide housing and related facilities, or any combination of the foregoing;

(iii) At least 90 percent of all of the amounts received by the governmental unit with respect to obligations acquired under the program shall be used for one or more of the following purposes: To pay the principal or interest or otherwise to service the debt on governmental obligations relating to the governmental program; to reimburse the governmental unit, or to pay, for administrative costs of issuing such governmental obligations; to reimburse the governmental unit, or to pay, for administrative and other costs and anticipated future losses directly related to the program financed by such governmental obligations; to make additional loans for the same general purposes specified in such program; or to redeem and retire governmental obligations at the next earliest possible date of redemption

Treas. Reg. § 1.103-13(h) (1979) (subparagraph (3) provides examples illustrating governmental programs).

161. This change would leave open the possibility that the municipal issuer may expend all the proceeds in such a way that no obligations are acquired. *See* Treas. Reg. § 1.103-13(b)(4) (1979).

162. *See* Treas. Reg. § 1.103-13(h)(2), (3) (1979). It is true, however, that bonds issued as part of an exempt small issue also possess a similar self-limiting quality. *See* I.R.C. § 103(b)(6) (1985). At any rate, this sunset legislation will generally expire in the near future. *See* I.R.C. § 103(b)(6)(N) (1985).

163. *See* Treas. Reg. § 1.103-13(a)(2) (1979).

164. *See Flexible Tool, supra* note 7, at 18, col. 4 (President has proposed, and Congress is considering, legislation that is part of plan to simplify tax laws, and if enacted would virtually eliminate tax-exempt financing of private purposes); *Armageddon, supra* note 21, at 119, col. 1 (tax-exempt market is facing threat to its very existence). The thrust of the proposals is to make municipal bonds taxable if more than a very small percentage (*e.g.*, one percent) of the proceeds is used by non-governmental persons. *See id.* at 116.

The position for depriving VRDBs of the tax exemption is quite in accord with the policy of narrowing the § 103(a) tax exemption. If the day were ever to come

ically simplify the law,¹⁶⁵ drain the intensive efforts to develop

when the § 103(a) tax exemption was done away with altogether, then the tax-exempt status of VRDBs would become a moot point. *See supra* note 67. Although the Tax Reform Act of 1986 has not yet abolished the § 103(a) tax exemption, it certainly can be seen as a step toward that inevitable destination. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 103, 141-150 (to be codified as amended in scattered sections of 26 U.S.C.); *see also infra*. In addition, the lower tax rates established by the 1986 Act are likely to sap much of the incentive for investing in tax-exempt bonds. *See id.* § 1; *see also* note 34.

Several considerations lend support to those favoring restrictions on IDBs and on the federal tax exemption for interest on state and municipal bonds in general. *See New IDB Rules, supra* note 83, at 2. *See generally* Gillette, *supra* note 21, at 1030-83 (restrictions on tax exemption are appropriate and criticism of restrictions is misplaced). IDBs are problematic because as their volume increases, the attractiveness of other exempt bonds diminishes, making the financing of public projects more expensive. *See* BITTKER, *supra* note 33, at 280. Furthermore, as a result of the complexity of IDB transactions, the costs of issuance render the subsidy to the funded projects inefficient—"between a quarter and a third of the subsidy goes to bondholders, underwriters, and bond counsel." *See id.* at 281.

With respect to the federal tax exemption in general, the subsidy is frequently criticized as inefficient and inequitable because the subsidy redistributes wealth from those who reside outside the locality to those who reside inside. *See* Gillette, *supra* note 21, at 1040-49. In addition, local governments have a tendency to enter the bond market without regard to their collective overuse of the market, and decisions to issue tax-exempt bonds are often made by officials who are not accountable to the local residents for the long-term consequences of their decisions. *See id.* at 1049-71.

Generally, the Tax Reform Act of 1986 continues to provide the basic framework for governmental bonds reorganized under ten additional sections, numbered from 141 to 150. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, (to be codified as amended in scattered sections of 26 U.S.C.). IRC §§ 141-150 impose a number of new limitations on the receipt of tax-exempt interest. *See id.*

More specifically, the 1986 Act substitutes "Private Activity Bond" for "Industrial Development Bond," and redefines the key amount of proceeds to be used in a business of a nongovernmental person by reducing it to ten percent from twenty-five percent. *See id.* §§ 103(b), 141(b). A "Qualified Bond" is exempted from the meaning of "Private Activity Bond" and therefore is tax-exempt. *See id.* §§ 103(b)(1), 141(d). Many of the exempt activities under the old IRC § 103(b)(4) are carried forward in the definition of "exempt facility bond," which is a "Qualified Bond" classification. *See id.* §§ 141(d), 142.

The arbitrage provisions have been transplanted to IRC § 148 in a slightly different form, and some new arbitrage restrictions have been added. *See id.* § 148. Judging by the House Committee Report, Congress has approved of and adopted substantial portions of the analysis in this Note. *See id.* § 148(a); [1987] 2 Stand. Fed. Tax Rep. (CCH) ¶ 1201, at 15,020-22, ¶ 1221.02 (1986). First, the reasonable expectations test is clarified so that an initial satisfaction of the reasonable expectations test will not provide an umbrella and protect existing tax-exempt bonds from being classified as arbitrage bonds. *See id.* ¶ 1201, at 15,021, ¶ 1221.02. If subsequent intentional acts are taken after the date of issue to earn arbitrage, then, however reasonable the expectations were, the bonds may be taxed. *See id.* Second, the House Committee Report explicitly refers to VRDBs as an example of a bond to which the arbitrage restrictions extend. *See id.* ¶ 1201, at 15,022.

165. *See Tax-Exempt Obligations, supra* note 82, at 811-12. *See* Temp. Treas. Reg. § 1.103-15AT(c)(4) (1985) for numerous unduly complex provisions and cal-

advances in arbitrage technology,¹⁶⁶ and resolve several other pressing problems associated with VRDBs.¹⁶⁷ These changes do not alter the statute, but rather fulfill it.¹⁶⁸ Accordingly, the Treasury can effectuate these proposed changes in a regulation.¹⁶⁹

The Regulation should of course apply prospectively to all issues not yet initiated.¹⁷⁰ It should also apply retroactively to the date on which municipal issuers and bond counsel are deemed to have notice of consideration of the Regulation by the Treasury.¹⁷¹ In regard to issues already outstanding, municipal issuers should be given a reasonable time to bring their issuances into compliance with the regulations (*e.g.*, by refunding the issue).¹⁷²

The following is a proposed Treasury Regulation:

Section 1.103-13 Arbitrage bonds

(k) Variable Rate Demand Bonds. Except as otherwise provided in this paragraph, a variable rate demand bond shall be treated as an arbitrage bond as described in section 1.103-13(a). A variable rate demand bond is defined as any instrument whose yield is unable to be calculated as of the date of issue due to an adjustable rate of interest and an option held by the holder to dispose of the bond at various intervals.¹⁷³

culations necessitated by an attempt to have VRDBs comply with the portion of the statute dealing with nonpurpose obligations. These complexities could all be obviated.

166. It is doubtful that regulations along the lines of forecasting the yield on VRDBs could now be issued without regenerating intensive efforts to promote arbitrage. See *Limits of Section 103(c)*, *supra* note 50, at 470.

167. See, *e.g.*, *supra* note 165. Furthermore, certain techniques have evolved in which fixed rate bonds are used in conjunction with floating rate bonds. See Shepard, *Attorney Asks For Treasury Release Opposing Fixed Rate/Floating Rate Refunding Issues* (available Apr. 9, 1985, on LEXIS, FTX library, 85 TNT 71-97). These transactions allegedly violate the arbitrage regulations. See *id.* (discussing various situations in which these violations occur). Because certain legal counsel are willing to approve these VRDB transactions, law firms that have advised that VRDBs violate the arbitrage regulations face the imminent prospect of losing clients. See *id.*

168. IRC § 103(c) and regulations accompanying this section remain satisfactory with respect to traditional fixed rate instruments. See *Matthew 5:17-18* (The Jerusalem Bible).

169. For a discussion of the specific congressional grant of regulatory power to the Treasury Department and the deference to be accorded to its promulgations, see *Arbitrage Provisions*, *supra* note 114, at 662 n.18, 679 n.110; see also *Regulation Roundabout*, *supra* note 55, at 372, 377; *supra* note 77 and accompanying text.

170. See *Limits of Section 103(c)*, *supra* note 50, at 427 n.6.

171. See *id.*

172. See *id.*

173. "The term 'variable rate obligation' means any obligation the yield on which, under the terms of the obligation, is adjusted periodically according to a

(1) A variable rate demand bond shall not be treated as an arbitrage bond when the proceeds are used directly to acquire program obligations as described in section 1.103-13(h).

(2) A variable rate demand bond is not an arbitrage bond if a major portion of the proceeds will not be used to acquire any obligations described in section 1.103-13(b)(4).

VI. Conclusion

Variable rate demand bonds represent the "never-to-be-underestimated fecundity of investment bankers' imagination."¹⁷⁴ These bonds are a sophisticated financing device which enable the municipal issuer to increase arbitrage profits without actually violating the letter of the current regulations. The federal interest in eliminating this practice, which undermines the enforceability of the federal tax system and laws, sufficiently outweighs the modest fiscal burdens such a measure imposes upon the state and local governments. By issuing regulations incorporating the above proposals, which abrogate the tax exemption for VRDBs in all but two select situations, the IRS can effectively safeguard against municipal profiteering and circumscribe the circumvention of section 103(c).

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prescribed formula such that the yield over the term of the obligation cannot be determined on the date of issue." Temp. Treas. Reg. § 1.103-15AT(b)(7) (1985).

174. See *Reissuance*, *supra* note 3, at 532.