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The IRS's Application of Arbitrage Provisions: Overregulation of Municipal Finance

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I. Introduction

The arbitrage practices engaged in by the issuers of municipal bonds have been scrutinized by the Treasury Department over the last fifteen years. Arbitrage traditionally is defined as the simultaneous purchase and sale of the same or equivalent securities in order to profit from the differences in their respective interest rates. Municipal arbitrage, however, involves the investment of municipal bond proceeds which are derived from the sale of tax exempt obligations in higher yielding taxable securities to generate a profit rather than to finance a project constituting a valid public purpose.

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1. Municipal bonds are evidences of indebtedness issued by local governments to raise money for municipal expenses, beyond the immediate resources of reasonable taxation. City of Stamford v. Town of Stamford, 107 Conn. 596, 610, 141 A. 891, 896 (1928). The distinguishing feature between a note and bond is that notes are issued generally with a shorter maturity. Alabama Power Co. v. City of Scottsboro, 238 Ala. 230, 236-37, 190 So. 412, 417 (1939); Muskingum County Comm'rs v. State, 78 Ohio St. 287, 301, 85 N.E. 562, 566 (1908).


3. Because the interest on municipal bonds is exempt from federal income tax, see note 12 infra, municipalities have been able to market bonds at a lower yield than issuers of taxable securities. See SECURITIES INDUSTRY ASSOCIATION, FUNDAMENTALS OF MUNICIPAL BONDS (9th ed. 1972).

4. Municipalities would invest their bond proceeds in Treasury notes. Such notes are highly secured obligations because they are backed by the taxing power of the federal government and, therefore, are the highest rated securities. By investing the bond proceeds in United States obligations, the municipality is assured that the bondholders' investments are backed indirectly by the federal government. See Comment, The Tax Exempt Status of Local Government Bonds Used in Arbitrary Transactions, 35 GEO. WASH. L. REV. 574, 577 (1966) [hereinafter cited as Tax Exempt Status].

5. 43 Fed. Reg. 3982 (1978); see also 113 CONG. REC. 31613 (1967); Technical Information Release No. 840, Aug. 11, 1966, 7 STAND. FED. TAX REP. (CCH) ¶ 6701 (1966). The drafters of the legislation and the Treasury both identified arbitrage bonds as obligations issued by local governments to make an investment profit. Municipal arbitrage was an easy and risk free source of revenue for local governments. According to Sen. Ribicoff, sponsor of the Senate arbitrage provisions, the profits of an arbitrage transaction were claimed by the municipalities "on the sole grounds that the local government [lends] its name to the security—without assuming any risk, or responsibility, or work, or anything else." 113 CONG. REC. 31613 (1967).

As an example of an arbitrage transaction, assume a city issues $100 million 30 year bonds for sewer improvements at a five percent yield. The city would use $10
The Treasury Department is concerned about the profits generated by municipal arbitrage\(^7\) for two reasons: first, it has determined these profits cost\(^8\) the federal government more than they benefit state and local governments\(^9\) resulting in a net loss to the federal taxpayer; \(^{10}\) and second, at the local level, arbitrage bonds crowd the bond mar-

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million for the sewer improvements and invest the remaining $90 million in federal securities yielding six percent. The return on the federal obligations would cover the cost of the entire $10 million spent on the sewer system. The sewers would be built, therefore, "without costing the city one cent—the arbitrage between the two interest rates is buying the sewers." Surrey, Tax Trends and Bond Financing, 22 Tax Law. 123, 124 (1968) [hereinafter cited as Tax Trends].


7. See Treasury Letter from Stanley S. Surrey, Assistant Secretary of Treasury to the Hon. Wilbur D. Mills, Jan. 23, 1968, 7 Stand. Fed. Tax Rep. (CCH) ¶ 6183A (1968). The Assistant Secretary stated that arbitrage practices represented a "clear distortion of the basic purpose of the interest exemption" and that such transactions "represent an intolerable waste of federal funds." Id.

8. When municipalities invest their bond proceeds in taxable federal securities, the federal government becomes "an unintended source of revenue for state and local governments while losing the opportunity to tax the interest income from its own taxable bond issues." S. Rep. No. 552, 91st Cong. 1st Sess. 219 (1969), reprinted in 1969 U.S. Code Cong. & Ad. News 2027, 2254. The federal government does not tax the interest earned by the municipality, a nontaxable government entity, or the municipal bondholder, whose bond is indirectly secured by federal obligations. Senate Comm. on Finance, Technical Memorandum of the Treasury Position, 91st Cong., 1st Sess. 117 (Comm. Print 1969).


ket, drive up municipal interest rates, and compete with those bonds issued pursuant to a valid public purpose.\textsuperscript{11}

The federal tax exemption afforded municipal bonds\textsuperscript{12} makes them an attractive investment and allows the bonds to compete with taxable securities which offer higher interest rates. The municipal tax exemption, however, has been described as "one of the costly preferences in the federal tax system,"\textsuperscript{13} and is estimated by the Treasury Department to have resulted in a $9.4 billion federal revenue loss in fiscal year 1981.\textsuperscript{14} As a result of this cost, legislation has been enacted

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  \item \textsuperscript{11} Id. Although the short term arbitrage profits may benefit local governments in terms of increased revenues, the long term consequences will damage the bond market and run counter to the interest of municipalities. 43 Fed. Reg. 39822 (1978); Tax Exempt Status, supra note 4, at 576-77.
  \item \textsuperscript{12} "Gross income does not include interest on (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia . . . ." I.R.C. § 103(a) (P-H 1981).
  \item Authorities are split, however, on the source of the federal tax exemption. The general view is 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 the powers and affairs of local governments. See Securities Industry Association, Fundamentals of Municipal Bonds 115-19 (9th ed. 1972). Opponents argue, id. at 116, that the federal government does have a right to tax municipal bonds under the sixteenth amendment: "The Congress shall have the power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." U.S. Const. amend. XVI (emphases added). From the time interest first became exempt from the federal income tax under the Revenue Act of 1913, numerous unsuccessful attempts have been made to introduce legislation abolishing the municipal tax exemption. Id. See also H.R. Rep. No. 413, 91st Cong., 1st Sess. 172 (1969), reprinted in 1969 U.S. Code Cong. & Ad. News 1645, 1825.

  \item \textsuperscript{13} Costing the Tax Exemption, supra note 9, at 796.
  \item \textsuperscript{14} Id. The federal government loses money on the municipal bond tax exemption because the tax savings realized by the holders of the municipal bonds is greater than the differential between the interest yields on the tax exempt and taxable securities. S. Rep. No. 552, 91st Cong., 1st Sess. 218 (1969), reprinted in 1969 U.S. Code Cong. & Ad. News 2253. The municipal tax exemption is an "inefficient" federal subsidy because it results in a "leakage" of federal revenues to the taxpayer (assuming the taxpayer would invest in taxable securities rather than in municipal securities). Gabinet, The Municipal Bond Interest Exemption: Comments on a Running Battle, 24 Case W. Res. 64, 66 (1972). For example, if a 50\% bracket taxpayer purchases a taxable security yielding $100.00 in interest, the federal government would collect $50.00 in taxes, and the taxpayer would net $50.00. If, however, the taxpayer purchased a municipal bond yielding only $75.00 in interest, the taxpayer nets $75.00 and the federal government collects nothing. The municipality gains $25.00,
to limit the use of the municipal tax exemption when issuers engage in arbitrage practices.

Section 103(c) of the Internal Revenue Code (Code)\textsuperscript{15} defines arbitrage bonds as municipal securities which are issued for the purpose of investing the majority of the bond proceeds in higher yielding securities, or to replace funds invested at a higher yield and disqualifies them from tax exemption.\textsuperscript{16} The Code, however, does not strictly prohibit all arbitrage practices. Instead, it outlines special municipal arbitrage rules and exceptions\textsuperscript{17} and empowers the Secretary of the Treasury to prescribe regulations “as may be necessary to carry out the purposes of the arbitrage restrictions.”\textsuperscript{18}

Since the introduction of the first arbitrage restrictions in the Tax Reform Act of 1969,\textsuperscript{19} the Internal Revenue Service (IRS) has established a series of regulations governing municipal arbitrage. Although the IRS has sought to prevent what it considers to be arbitrage abuses, municipal issuers have successfully adapted their financing techniques to conform to the periodic changes in the regulations.\textsuperscript{20}

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\textsuperscript{16} Id.

\textsuperscript{17} The special rules and exceptions provide that a bond will not be considered an arbitrage bond if the proceeds are invested for a temporary period pending expenditure of the proceeds, or if a part or all of the proceeds are invested in a reasonably required reserve or replacement fund. I.R.C. § 103(c)(4) (P-H 1981).

\textsuperscript{18} I.R.C. § 103(c)(6) (P-H 1981). I.R.C. § 7805 states that, “[e]xcept where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title . . . .” When Congress specifically grants the Treasury Department power to promulgate regulations for a part of the Code, these regulations are entitled to greater deference by the courts than the “interpretive” regulations issued under the general authority of the Treasury Department pursuant to § 7805. State of Washington v. Commissioner, 77 T.C. 656, 675 (1981). See also I.R.C. § 105(h)(9) (P-H 1981), for another example of a specific Congressional grant of regulatory power to the Treasury Department regarding the exclusion from gross income of amounts received under accident and health plans.

\textsuperscript{19} Pub. L. No. 91-172, § 301(a), 89 Stat. 1056 (1969).

\textsuperscript{20} See Ltr. Rul. 7947117, August 27, 1979. In a description of the administrative history of the arbitrage regulations, the IRS stated that shortly after the first arbitrage regulations were published in 1970, see note 32 infra and accompanying text, financial experts formulated a series of techniques to circumvent the regulations. Through the use of these techniques, local governments were able to comply with the literal terms of the regulations yet still obtain substantial economic benefits through arbitrage. The I.R.S. further stated that “while the regulations have been amended
This Note discusses IRS arbitrage regulations with an emphasis on those which are designed to control problems involved with advance refunding bonds—securities issued and invested for the purpose of retiring a prior, outstanding issue. It also considers the effects of a recently issued Revenue Ruling, 80-328, which prevents state housing authorities from simultaneously issuing notes and bonds to finance the same low cost housing projects. Finally, this Note examines the IRS's restrictive application of the arbitrage regulations in light of a recent Tax Court decision, State of Washington v. Commissioner, which invalidates an arbitrage regulation prohibiting the recovery of expenses incurred in the issuance of bonds. The effects of Revenue Ruling 80-328 on state housing construction, and the court's decision in State of Washington suggest that the IRS may have exceeded its authority in administering the arbitrage provisions of the Code.

II. The Development of Arbitrage Regulations

Prior to 1966 there were no federal statutes governing arbitrage. At one point, the Treasury Department even encouraged arbitrage as a source of federal capital. Excessive arbitrage profits, however, eventually attracted the attention of the Treasury Department, and in 1966, the IRS issued a Technical Information Release announcing that it would decline to rule whether the interest on certain government obligations was exempt from federal tax. The release stated repeatedly to prohibit these devices, they have not been fully effective in carrying out the purposes of section 103(e).” Id. (Private Letter rulings are cited for illustrative purposes only. I.R.C. § 6110(j) (P-H 1981)).


23. 77 T.C. 656 (1981).


25. One arbitrage scheme which prompted the Treasury Department to issue the News Release, see note 26 infra, was described in a ruling requested by the State of Ohio. The Ohio Development Finance Commission issued $100 million of bonds—$10 million of the bond proceeds were used for public purposes, and $90 million of the proceeds were invested in federal securities bearing a higher interest rate than the state bonds. The return on this investment provided adequate funds to retire all of the outstanding bonds, including the $10 million used by the Commission for public improvements. See Tax Exempt Status, supra note 4, at 575; for an analogous situation, see note 5 supra.


27. This release was the first indication that the federal government was aware that municipalities were practicing arbitrage and put issuers on notice that the Treasury Department was planning to implement arbitrage restrictions. See Mum-
that this policy would remain in effect until the conclusion of an examination of municipal obligations which the IRS suspected were issued for "the principal purpose of investing the proceeds of tax exempt obligations in taxable obligations... bearing a higher interest yield." In 1969, the Treasury Department recommended that Congress define the limits of arbitrage to provide a clear standard for the regulation of arbitrage bonds. In response to this recommendation, Congress defined arbitrage bonds as

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—

(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 (taking into account any discount or premium) 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 sub-paragraph (A).

The definition contains various ambiguities, including the meaning of terms such as "materially higher yield," "proceeds of an issue," and "temporary period." Thus, temporary arbitrage regulations were issued by the Treasury Department in 1970 in an effort to clarify the statutory rules and exceptions governing permissible arbitrage.

ford, Arbitrage and Advance Refundings, 1976 Duke L.J. 1239, 1246 [hereinafter cited as Advance Refundings].

28. Id. The release described two categories of transactions which the Treasury Department determined were issued for the purpose of generating arbitrage profit:

1. Where all or a substantial part of the proceeds of the issue... are only to be invested in taxable obligations which are, in turn, to be held as security for 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 issues to be refunded.

Id.


33. The temporary regulations, and later the proposed regulations, enabled the Treasury Department to experiment with arbitrage restrictions before finalizing
The temporary regulations were supplemented in 1972 and 1973 by proposed regulations which attempted to define the ambiguous statutory terms in section 103(c). The proposed regulations, however, were more restrictive than the temporary regulations; they not only reduced the permissible yield spread between exempt and taxable securities, but also limited the authorized methods of computing yield, thereby reducing the profit issuers could realize on invested

them. 5 U.S.C. § 553(b) (1976), requires that general notice of proposed rule making will be published in the Federal Register. After notice is given, the agency shall give interested parties, "an opportunity to participate in the rule making through submission of written data, views or arguments with or without opportunity for oral presentation." 5 U.S.C. § 553(c) (1976). The Treasury Department, however, did not issue notice of the temporary regulations or allow the public procedure described in § 553(c) because of the need for immediate guidance for § 103(c). T.D. 7072, 1970-2 C.B. 12, 15. In 1972, after following the necessary notice procedures, the Treasury Department replaced the temporary regulations with the proposed regulations. T.D. 7174, 1972-1 C.B. 31.

34. The temporary regulations defined "materially higher yield" as the adjusted yield produced by an acquired obligation which exceeds the adjusted yield by more than one half of a percentage point. For special government program obligations, such as student loan notes and housing mortgage notes, the permissible yield spread was one and one half percent. The proposed regulations also provided a means for calculating the adjusted yield of an issue, which in turn determines the yield at which issuers could invest their proceeds. This calculation permitted administrative costs to be taken into account when determining the bond's purchase price. The purchase price is a major component in the yield calculation and ultimately affects the yield. The issuer, therefore, was able to recover the issuance costs because by discounting the bonds' purchase prices, the issuer could raise the adjusted yield, allowing him a higher investment return. T.D. 7072 1972-2 C.B. 12.

35. The 1972 proposed regulations defined the "proceeds" of an issue as "the original proceeds of an issue plus gross repayment proceeds, reduced by the amount expended for which the bonds were issued, and by a reasonably required reserve or replacement fund." 37 Fed. Reg. 10946 (1972). The proposed regulations defined and distinguished between "original," "investment," and "repayment" proceeds. The proposed regulations also established a means for determining the "reasonable certainty" that an issuer must have at the time of issuance that the bonds will not be used for arbitrage purposes. See note 16 supra. When bonds are issued, they must be accompanied by either a covenant in the bond indenture assuring that the bonds were not issued for investment purposes, or an opinion of counsel stating that any investment of the bond proceeds will not violate the arbitrage restrictions. 37 Fed. Reg. 10946 (1972).

36. The 1972 proposed regulations reduced the permissible point spread used in determining a "materially higher yield" from one half of a percentage point, see note 34 supra, to one eighth of a percentage point. Prop. Reg. § 1.103-13(b)(5)(i), 37 Fed. Reg. 10949 (1972). If the bonds were used in an advance refunding, see notes 41-49 infra and accompanying text, the period of investment at the one eighth point spread is limited to three years immediately preceding the redemption of the first issue. Prop. Reg. §§ 1.103-(b)(5)(ii),(iii), 37 Fed. Reg. 10949 (1972). For a discussion of the differences between the temporary and proposed regulations see Ritter, An Analysis of the New Proposed Regs on Arbitrage Bonds Under Section 103(d), 37 J. Taxation 164 (1972).

37. The 1972 proposed regulations contained some highly controversial rules. Therefore, the Treasury Department withdrew them and issued a new set of regula-
municipal proceeds. The temporary and proposed regulations lacked the effect of law, but were regarded as effective constraints by municipal issuers because no municipality wanted to run the risk of having the IRS declare its issue taxable as a result of noncompliance with the temporary or proposed Treasury Regulations.

Throughout the 1970's the IRS amended the proposed regulations several times in order to prevent municipalities from engaging in financial practices which, in the view of the IRS, were aimed at circumventing the intent of section 103(c). One such practice involved techniques used with advance refundings. The classic advance refundings practiced prior to the enactment of section 103(c) enabled municipalities to profit from interest rate fluctuations by using the proceeds of the new issue to retire outstanding issues sold at higher interest rates or subject to other unfavorable terms. The
proceeds of the advance refunding issue, after a period of investment in Treasury obligations, are used to retire the prior outstanding issue. Municipalities could generate large arbitrage profits by issuing advance refunding bonds because considerable sums of money are invested in Treasury obligations for long periods of time.

The Treasury Department objected to these arbitrage profits on the theory that they double the amount of tax exempt bonds outstanding for any project, flood the bond market, and result in higher interest rates. As borrowing costs increase, local governments may not be able to issue debt as frequently as necessary to finance essential government services. The 1972 proposed regulations curtailed the profits which could be realized by limiting the interest spread between the refunding issue and the Treasury obligations to one eighth of one percent.

In 1975, the Treasury Department attempted to eliminate any arbitrage profits generated through advance refundings. The yield restrictions were amended to limit further the permissible difference between interest paid on advance refunding issues and on the interest

already had a series of revenue bonds outstanding and the bond resolution prohibited a second lien on the hospital’s revenues. The county issued an advance refunding to retire the first lien revenue bonds, and then issued another series of hospital revenue bonds which now had the status of first lien bonds rather than as second lien bonds. The county also benefited from lower interest rates in effect at the time the second series of bonds was issued and from investment profits earned while the advance refunding issue was invested.

43. If an issuer issues a $1,000,000 ten-year bond at 4.5% interest compounded semiannually, the issuer would have to pay the bondholder $1,560 by maturity. If, however, the issuer immediately invested the proceeds at 6% interest, the municipality would earn $1,906. The issuer’s revenues would then exceed his obligations, allowing him to begin reducing principal. In an advance refunding, the bonds are issued and invested in higher yielding securities before the first issue has matured. The second issue can, therefore, act as a revenue generating investment. Advance Refunding, supra note 27, at 1241.

44. National Association of Bond Lawyers—Arbitrage Outlines and Materials 6-1 (1981). The two outstanding issues often are necessary because the original issue may not be subject to repayment until after the refunding bonds are issued. If the outstanding issue was retired immediately with the proceeds of the new issue, the transaction was called a refunding issue. Id. at 6-2.


46. Id.

47. See note 36 supra. If the interest spread was any greater, the proceeds of the issue would be regarded as proceeds used to acquire securities producing a yield over the term of the issue which is “materially higher” than the yield on the issue itself. and the bonds would become arbitrage bonds.

48. The 1975 amendments made any difference between the yield on advance refunding bonds and yield on securities in which the proceeds were invested a “material” difference. Prop. Reg. § 1.103-13(b)(5), 40 Fed. Reg. 56448 (1975).
paid on the purchased Treasury obligations. Since the proceeds of an advance refunding could not be invested in higher yielding securities, an issuer realized no profit on the investment.\footnote{49}

The last major amendments were made to the proposed regulations in 1978.\footnote{50} These amendments further restricted the yield calculation formula by eliminating the issuer's ability to recover administrative costs,\footnote{51} and regulating the investment of the issuer's sinking fund.\footnote{52}

\footnote{49. To comply with the regulation, some municipalities would enter into agreements with underwriters to pay artificially high prices for the securities purchased with the refunding proceeds. The high prices paid for the acquired security would make the security a premium bond and lower the investment yield on the security. The issuer would, therefore, be in accordance with the low yield restrictions required by the regulations, and the underwriter would reap a "windfall profit." If the issuer issues a refunding bond with an interest rate of 5\%, the regulations require that he invest the proceeds in securities with approximately the same 5\% yield. However, an underwriter could purchase a $100 bond on the market yielding 10\% and sell it at an artificial premium to the issuer for $104.70. The premium price would reduce the bond's 10\% yield to the issuer to 5\%. The $4.70 windfall would go to the underwriter. NATIONAL ASSOCIATION OF BOND LAWYERS—ARBITRAGE OUTLINE AND MATERIALS 6-19 (1981). Some underwriters donated the profits which they made through advance refunding to charities, Advance Refunding, supra note 43, at 1249. Congress passed legislation in 1978 designed to protect underwriters and their issuers who donated "windfall profits" to charities from tax penalties. Revenue Act of 1978, Pub. L. No. 95-600, § 337, 92 Stat. 842. Although the issuers could no longer retain arbitrage profits from the advance refundings, the financings were still practiced because the interest rates were lower in the mid-1970's than in the early 1970's. Also, whereas the proposed regulations prohibited arbitrage profits through investment of the major portion of the proceeds of the refunding issue, the regulations did permit a minor portion of the proceeds to be invested at a higher yield for a temporary period. Prop. Reg. § 1.103-14, 38 Fed. Reg. 10949 (1973). Consequently, issuers still could obtain some arbitrage advantages through advance refundings. Advance Refundings, supra note 43, at 1248. The Treasury Department again amended the proposed regulations in 1976 to eliminate the possibility of windfall profits by implementing the "Market Price Rules," Treas. Reg. § 1.103-13(c)(2)(ii). See Advance Refundings, supra note 43, at 1251. The rule provided that when an issuer purchases obligations from an underwriter, with the proceeds of an advance refunding issue, the yield on the acquired obligation had to be computed using the market price of the obligations, thus preventing any artificial premium or discount. See Rev. Rul. 92, 1980-1 C.B. 31 (amounts in excess of the fair market value paid for acquired obligations from the proceeds of advance refunding bonds may not be considered in determining whether the arbitrage yield restrictions are met). The practical effect of the rule is that proceeds of advance refunding issues only can be invested in specially designed federal securities to ensure that the investment does not exceed the permissible yields. These special governments obligations, State and Local Government Series (SLGS), were formulated by the Treasury Department to enable local governments to fix the yield on the SLGS so that the invested municipal bond proceeds will comply with the yield restrictions. 31 C.F.R. § 344 (1981). Advanced Refundings, supra note 43, at 1250-51.}


\footnote{51. Administrative costs incurred by municipalities during advance refundings could no longer be considered in determining whether the obligations were premium
These amendments also prohibited any transaction that the IRS deemed to be an "artifice or device." These financings exploit the interest differential between tax exempt and taxable securities to achieve a material financial advantage. This provision was directed at the increasingly sophisticated financing techniques developed by municipalities which enabled the municipal issuer to increase arbitrage profits without actually violating the regulations. If the IRS determines that a financing technique is an artifice or device, the bonds are deemed to be arbitrage bonds, and lose their tax exempt status. For example, in one revenue ruling applying the artifice or device rule, the IRS held that a municipality violated the rule when it issued refunding bonds and allowed the entire prior issue to remain outstanding until maturity, rather than gradually reducing principal and interest. The IRS determined that this transaction allowed the prior issue to remain outstanding longer than necessary, thereby increasing the burden on the tax exempt market.

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or discount bonds for the purposes of computing yield. See note 34 supra. Instead, the yield calculation had to be determined by the bond's initial offering price to the public. See also I.R.C. § 1232(b)(2) (P-H 1981). Therefore, issuers could no longer recover proceeds spent on administrative costs by using the costs in computing the yield on the issue. See 43 Fed. Reg. 39823 (1978).

52. A municipal sinking fund is a special fund, set apart from the other funds of an issue, which is used to retire the municipality's debt. The interest accumulated by the investment of the sinking fund is used to retire a portion of the municipality's debt. Generally, municipal obligations have serial maturities and a portion of the principal often is paid off gradually over a long period of time through the use of a sinking fund. A common practice during the 1970's was the "invested sinking fund." Instead of using the amount deposited in the sinking fund to retire principal serially on an annual basis, issuers would leave all of the bonds outstanding until the latest maturity date, and keep the deposits in the sinking fund and its accumulated interest invested in higher yielding securities. This practice often resulted in substantial arbitrage profits. The Treasury Department objected to invested sinking funds because the result of this financing device was that bonds were left outstanding longer than necessary. The Treasury Department also believed that many financings were motivated chiefly by the investment advantages presented by the invested sinking fund. 43 Fed. Reg. 39822 (1978). The amendment restricted the yield on the investment of any invested sinking fund not emptied out on an annual basis. Treas. Regs. § 1.103-13(b)(5)(vii); § 1.103-13(g); § 1.103-14(b)(8).


54. Statement of Assistant Secretary of Treasury (Tax Policy) on S.3370 (Aug. 24, 1978) (reprinted in BNA Tax Management Portfolio 1978). The Treasury Department stated that sophisticated financing devices used to circumvent the effects of the arbitrage regulations were used most frequently with advance refundings.

55. See Rev. Rul. 345, 1979-2 C.B.44. An issuer employs an artifice or devise if, by issuing refunding bonds he fails to comply with the indenture requirements to redeem semiannually a specified percentage of the principal of the bonds and allows the entire outstanding principal to remain outstanding until maturity). See also Rev. Rul. 13, 1980-1 C.B.27, 29. An issuer employs an artifice or device if it issues bonds to finance a feasibility study and the state is expected to appropriate funds annually.
The 1978 amendments, along with the existing proposed regulations, were finalized and adopted by the Treasury Department in 1979. As the IRS attempted to eliminate arbitrage profits from municipal financings, it has been confronted with "the continuing resilience of issuers and their advisors in the face of a blizzard of arbitrage rules." Municipalities continued with financings which complied with the regulations, but which permitted the investment of at least part of the bond proceeds in higher yielding securities. These creative financing methods motivated the IRS to announce that its "stance vis-a-vis the bond market was one of 'heightened vigilance.'" The IRS asserted a right to selective taxability, which would allow it to declare bond issues taxable when it believed equal to the cost of the study in any given year. The IRS held that the issuance of the bonds is not necessary and creates a burden on the tax exempt market.

57. In 1978, Bill S.3370 was introduced in Congress to provide for a year and one half suspension of all Treasury rulings and regulations by the IRS regarding municipal bonds. Sen. Bentsen, who introduced the bill, expressed concern that the IRS's interpretations of the tax laws had reached a point where they began to "frustrate efforts of state and local governments [in carrying] out their normal financings and administration of public funds." The Senator was particularly concerned about the impact that the Treasury Regulations would have on student loan programs. Id. at 430 n.11.
58. The IRS also began to develop a ruling policy aimed at enforcing the replacement restrictions described in § 103(c)(2)(B) of the Code preventing a municipality from using funds to acquire higher yielding securities and then issuing bonds to replace the funds invested in the securities. Replacement differs from refunding issues because replacements often involve funds from sources other than bond proceeds. If nonbond proceeds are invested in materially higher yielding securities, and the issuers use the proceeds of an obligation to invest materially higher yielding securities, thereby freeing up the invested nonbond funds for expenditure, the issue is a replacement issue.
59. Limits of Section 103(c), supra note 38, at 429.
60. Id. at 430.
61. Barrons, Aug. 29, 1980, at 29, col. 2. This statement was directed at what the Treasury Department considered to be abuses of the municipal exemption, particularly the use of tax exempt issues to finance single family housing mortgages. The Treasury Department also alleged that sophisticated financings had developed which prevented the Department from fully enforcing the regulations and enabled issuers to realize arbitrage profits in spite of the regulations. Id.
they violated the regulations. This policy of selective taxability was intended to slow down what the Treasury Department considered to be a "rash of abuses in the tax exempt market."

III. IRS “Enforcement” of Arbitrage Restrictions

Two methods the IRS uses to administer Code provisions are revenue rulings and private letter rulings. Revenue rulings, the IRS’s application of the tax law to a general fact situation, do not have the force of law but may be cited as precedent. Private letter rulings, however, apply only to the taxpayer who requested the opinion and may not be used as precedent. While revenue rulings are regarded by municipal issuers as the official IRS position on the Code and on the tax regulations, private letter rulings are directed only at limited fact situations. Nevertheless, both revenue rulings and private letter rulings have had an effect in shaping municipal financings.

A. Revenue Ruling 80-328

Shortly after announcing its policy of selective taxability, the IRS issued Revenue Ruling 80-328. The ruling held that the simultaneous issuance of short term notes and long term bonds causes the short term notes to be arbitrage bonds within the meaning of section 103(c) of the Code. This financing practice had been used by state housing authorities to finance low income, multi-family housing.

62. Id. The Assistant Secretary of the Treasury stated that a declaration of taxability of a municipal issue would put issuers who are trying to exceed the permissible limits set by the regulations on notice and slow down questionable financings. Id.
63. Id.
64. See generally INTRODUCTION, 1980-2 C.B. iii.
65. Id.
67. Rev. Rul. 328, 1980-2 C.B. 54. This discussion will be limited to Situation 2 presented in the ruling which deals with obligations issued for multi-family housing programs.
68. The fact pattern in the Revenue Ruling is as follows: $76,000,000 of three year term notes were issued at a 7% yield, and pending disbursement, the majority of the funds were invested at an unrestricted yield of 8.5% pursuant to IRC § 103(c)(4). At the same time, $80,000,000 of 30 year term bonds were issued at a yield of 9% and invested at a restricted yield of 9% pending retirement of the notes. The bonds would be used to retire the notes and secure long term-financings for the housing projects.
69. The construction projects are eligible for assistance payments under § 8 of the U.S. Housing Act of 1937, 42 U.S.C. § 1437f (1976). Rev. Rul. 328, 1980-2 C.B. 54. Consequently, many of the financings must be structured in accordance with HUD’s policies. See note 79 infra. One of these policies requires that construction of the projects be completed by the date of the notes’ maturity. Alexander, Gribetz, &
As a result, Revenue Ruling 80-328 has had a particularly adverse affect on the construction of public housing.  

In this type of construction project, an authority would simultaneously issue short term notes of up to three years and long term bonds. The proceeds of the notes, which bear a lower interest rate than the bonds, are used by issuers to provide a loan to the project developer to finance construction costs. The notes remain outstanding for the period of construction. Before the note proceeds are expended, however, they are invested temporarily in higher yielding Treasury obligations. The bonds bear a higher interest rate than the notes and are invested in restricted yield securities (SLGS) while the notes remain outstanding. After completion of the project, the proceeds of the bonds are used to redeem the notes.

The IRS argued that this financing method was a "replacement" device in violation of section 103(c) because the notes and bonds were issued for the same project, and the notes replaced the bonds, thus freeing the bond proceeds for arbitrage investment purposes. The IRS also contended that the issuance of the notes constituted an overissuance, unnecessarily increasing the amount of tax exempt securities on the market. The IRS maintained that the proceeds of the bonds alone were sufficient to finance the project. Finally, the IRS deter-

70. See note 83 infra.
71. Treas Reg. § 1.103-10.
72. See note 49 supra.
73. See note 58 supra. Although the bonds have a higher yield than the notes and ordinarily can be invested in higher yielding securities, they are nonetheless subject to the lower investment restrictions of the notes. Because the bond proceeds do not comply with these investment restrictions, they are considered to be invested at a "materially higher yield" in violation of I.R.C. § 103(c). Rev. Rul. 328, 1980-2 C.B. 54, 55.
74. Treas. Reg. § 1.103-13(b)(5)(iv). This regulation provides that if the proceeds of an issue exceed the amount necessary for the government purpose by more than 5%, the bonds are an overissuance and are subject to a more restrictive yield formula:

\[ Y + \frac{[\$(5,000 \times Y) + P]}{P} \]

(1) "Y" stands for the yield on the issue, and
(2) "P" stands for the amount of original proceeds of the issue.

Rev. Rul. 328, 1980-2 C.B. 54, 56. The IRS stated that the economic effect of issuing notes and bonds at the same time is equivalent to the use of the proceeds of the 9% bonds to provide for the project and the investment of the proceeds of the tax exempt 7% notes in taxable securities yielding 9%, and used the arbitrage gain to reduce the borrowing costs during the interim construction period by 2%. Id. at 56.
75. Rev. Rul. 328, 1980-2 C.B. 54, 55, states that because long term financing for the project already will be secured by the bond issue at the time the notes are issued, interim financing is not necessary for the project. Id. at 55.
minded that this financing technique violated the artifice or device regulation by allowing the housing authority to use the difference between the tax exempt interest rate and taxable interest rates to reduce its costs. The IRS reasoned that because the housing authority used the proceeds of the lower yielding notes, rather than the invested proceeds of the higher yielding bonds to finance the project, the cost reduction was a material financial advantage achieved by exploiting the difference between tax exempt and taxable securities.  

This revenue ruling raises several questions regarding the IRS's restrictive application of the arbitrage regulations. State housing authorities argue that the simultaneous issuance of notes and bonds is not a device aimed at circumventing the arbitrage restrictions, but a necessary financing technique which has been accepted by the business community and recommended by the Department of Housing and Urban Development. The housing authorities claim that financial realities require simultaneous issuance because the transaction is an effective means of reducing construction costs and stabilizing interest rates on the developers' long term mortgages. They argue that the financing does not constitute an overissuance because the reduction of project costs through the use of the interest rate differential serves a valid public purpose. The primary purpose of the financing

76. *Id.* at 56.
77. *See Arbitrage Issues, supra* note 69, at 276.
78. *Id.*
79. HUD's policies require that permanent mortgage rates be fixed for the developers before project construction begins. The housing authorities have been complying with this policy by issuing bonds along with the notes and securing long term financing of the mortgages with the bond proceeds at the beginning of construction. This practice assures the developers that the interest rates on the mortgages will not increase due to market fluctuations. Memorandum, *Arbitrage Issues Raised by Internal Revenue Service Concerning Contemporaneous Issuance of Bonds and Notes to Finance Multifamily Housing*, 6-8 (Mudge Rose Guthrie & Alexander, Apr. 14, 1981), cited in 12 Tax Notes 1011-12 (May 4, 1981).

Another reason for securing long term financing at the outset of the project through the issuance of bonds is to assure that long term investors exist for the permanent financing of the project. This eliminates the risk that at the end of the three year construction period the mortgagors will default for lack of long term financing. *Id.*

80. *See note 6 supra.* In this situation, the general public purpose is providing low income housing. Keeping construction costs down aids in the promotion of that purpose. *Arbitrage Issues, supra* note 69, at 279. If the contemporaneous issuance of notes and bonds is not permitted, financing the project becomes more expensive and the higher costs are passed on to the contractors. Consequently, greater federal expenditures on rental subsidies must be provided through HUD. The result is a reduction in the number of housing units available for low income citizens and a less efficient use of HUD rent subsidies. Use of public funds to provide for low cost housing has been held constitutional as an expenditure in the interest of the general public. Kleiber v. San Francisco, 18 Cal. 2d 718, 117 P.2d 657 (1941); Roe v.
technique is to furnish low cost housing for low income citizens. Any minor arbitrage advantage resulting in cost reduction which issuers realize by using the technique are incidental and not the motivating factor behind the transaction.

The IRS's stance toward this financing technique resulted in the cancellation and restructuring of several housing issues, considerable financial loss, and construction delay. In light of Revenue Ruling 80-328's detrimental effect on state housing construction, and the important business reasons and policy requirements which this technique accommodates, it seems inappropriate for the IRS to rule that this method constitutes an arbitrage violation within the meaning of section 103(c).

B. Private Letter Rulings

The IRS has issued several private letter rulings in which it determined that contemporaneous issuances of notes and bonds were not arbitrage violations. In one ruling, a housing agency issued notes...
and bonds to provide financing for a multi-family housing project. The note proceeds were used to secure a mortgage loan for the project, and the bond proceeds were invested temporarily in higher yielding securities until they were needed to refund the notes. Because the project was not completed by the time the notes matured, two new series of notes were issued. Unlike the notes in Revenue Ruling 80-328, the new series yielded approximately two percent more than the federal securities in which the bond proceeds were invested.

The IRS ruled that because the new series of notes bore a higher yield than the bond proceeds, the notes were not arbitrage bonds. Although the IRS indicated that the new series was an overissuance, the notes did not violate the regulations because, unlike the notes in Revenue Ruling 80-328, their proceeds were not invested at a "materially higher yield." Finally, the IRS stated that because the authority lost money on the transaction, rather than realizing a material financial advantage in the form of reduced project costs, the financing did not constitute an artifice or device.

The IRS's position on the simultaneous issuance of notes and bonds may be counterproductive. Any short term increase in federal revenues may be offset by a long term decrease in federal tax revenues resulting from the IRS's enforcement of Revenue Ruling 80-328. By refusing to permit the housing authorities to reduce costs through the contemporaneous issuance of notes and bonds, the IRS may be forcing the authorities to issue additional bonds to cover the projects' costs. The Treasury Department must then exempt the interest on these additional tax free bonds which will be outstanding at higher interest rates and for longer periods of time.

88. Id. In this ruling, the bond resolution stipulated that the bond proceeds could not be used to refund the notes until after the project was completed and endorsed by HUD. Because the project was not completed and endorsed by the time the notes matured, a second series of notes were issued to refund the original notes. After issuing the new notes, the project was still not endorsed by HUD, so the authority planned a third series of notes to redeem the original notes.


91. By preventing housing authorities from reducing construction costs through the use of long term bonds and short term notes, the IRS may force the authorities to issue more bonds than they normally would need. An analogous situation is presented in State of Washington v. Commissioner, 77 T.C. 656 (1981), where an issuer challenged the IRS's regulation against issuers discounting their administrative costs. The court observed that by insisting on the enforcement of this regulation, the Treasury Department was pursuing a Phyrric victory. Although the federal government may save a small amount of money if municipalities are prevented from recovering administrative expenses, the ultimate result is that municipalities will issue more bonds to cover the costs of issuance, and the Treasury will have to exempt interest on these additional bonds for decades. Id. at 674 n.18.
The IRS's overreaction to sophisticated financing methods such as the simultaneous issuance of notes and bonds may be a result of its policy of "heightened vigilance" toward the bond market. Unfortunately, in the Treasury Department's attempts to control what it deems to be issuers' "stretching the rules," it may have exceeded congressional intent and stretched the arbitrage regulations to include financings which were not motivated by arbitrage profits.

IV. Legislative Intent and Judicial Interpretation

A. Congressional Intent

The legislative history of section 103(c) suggests that its sponsors intended to curb arbitrage profits realized by local governments without curtailing the flexibility municipalities required to meet their financing needs. Although section 103(c) was intended to limit the use of financing techniques that produced arbitrage profit, it was not intended to eliminate all arbitrage effects. For example, the drafters provided special rules and exceptions regarding temporary investments, minor proceed investments, and reserve fund investments. Similarly, Senator Ribicoff, the sponsor of the bill, expressed the need to control advance refunding abuses, but indicated that the proposed restrictions were intended to ensure that profits from an advance refunding would be "primarily a by-product of the transaction rather than its essential purpose." Senator Ribicoff stated that if an issuer carefully drafts his bond agreement, he can ensure that his bonds will not fall within the category of arbitrage bonds. "This aspect of the bill as well as the exceptions . . . will allow state and local governments unfettered freedom to engage in any financing arrangement necessary to achieve the basic purpose of a particular bond issue."

92. See note 61 supra.
93. See note 61 supra.
94. Some municipal issuers consider Rev. Rul. 80-13 another example of the IRS's restrictive application of arbitrage regulations which goes beyond the meaning of the statute. I.R.C. § 103(c)(2)(B) (P-H 1981), states that bonds will be considered arbitrage bonds if their proceeds replace funds that directly or indirectly were used to acquire higher yielding securities. In Rev. Rul. 80-13, however, the IRS held that a bond issue was a replacement issue when the proceeds would be used to finance a feasibility study, and when the state would yearly appropriate funds equal to the cost of the study for any given year. The IRS stated that the bonds replaced the yearly appropriations even though the appropriations would not be available to the issuer until the future. See Gill, Arbitrage, 12 Urb. L. 534, 537 (1980). See also Limits of Section 103 (c), supra note 54, at 442-52.
95. See note 17 supra.
96. 113 Cong. Rec. 31617 (1967).
97. Id.
The Treasury Department, however, has not always complied with this legislative purpose. For example, the Department contends that arbitrage restrictions should be directed not only at financings where a "principal purpose" of the transaction is to produce arbitrage profit, but also at any financing where the "effect" is to produce arbitrage profit. Although the Treasury Department concedes that the legislators' language and rhetoric looked primarily at the purpose of the financing to determine if the transaction involved impermissible arbitrage, it nonetheless maintains that "every attempt to define arbitrage has looked to the effect of the transaction rather than its purpose." In order to reconcile its position with the legislative language, the Treasury Department adopted the presumption that the "purpose" of a transaction is to produce arbitrage profits if the "effect" of the transaction produces material amounts of arbitrage. It reasoned that material arbitrage profits act as an inducement for the bond issue.

B. State of Washington v. Commissioner

The state of Washington was one of the first tax exempt issuers to challenge an arbitrage regulation. In State of Washington v. Commissioner, the Tax Court held that the state's bonds were not arbitrage bonds under section 103(c), and invalidated part of an arbitrage regulation which it held was inconsistent with the legislative intent. This is the first case to suggest that the Treasury Department has exceeded its authority by infringing upon municipal financings with its arbitrage restrictions.

In State of Washington, the state proposed the issuance of advance refunding bonds to redeem a series of outstanding school revenue bonds. The refunding issue was intended to enable the state to take

98. Ltr. Rul. 7947117, Aug. 27, 1979 (examines the development of the arbitrage regulations and presents the Treasury Department's position on the financings analogous to the one described in State of Washington v. Commissioner). See notes 110-12 infra and accompanying text.
100. Id.
102. 77 T.C. 656 (1981).
103. The state issued the 30 years Revenue Bonds on April 21, 1971, yielding between six and eight percent. At the time of the state's ruling request, there were $19,880,000 in outstanding bonds. The outstanding bonds are limited revenue obligations of the state, and are payable only from specific revenues of certain pledged trust funds. Because they are not backed by the full taxing powers of the state, their credit rating is lower, and their interest is higher than general obligations bonds. Id. at 657-59.
advantage of lower interest rates and more advantageous issuing conditions. The state planned to invest the proceeds of the new issue until the outstanding bonds’ maturity. To ensure that the invested bonds would not be classified as arbitrage bonds, the state intended to acquire federal securities which would produce a yield that would not exceed the yield of the refunding bonds. The state requested a private letter ruling to determine whether the proposed bonds were arbitrage bonds, and whether the interest was exempt from taxation. The IRS ruled that the bonds would be arbitrage bonds because the state had deducted its issuance costs from the bonds’ purchase price in computing yield, in violation of the regulations. The proceeds of the refunding issue, according to the IRS, were invested above the permissible yield.

The state appealed to the Tax Court, challenging the IRS’s determination of the elements used to compute the yield. The conflict between the IRS and the state centers on the parties’ different methods of determining the “purchase price,” which is an important factor in determining the yield of the issue. The state asserted that the purchase price was the money received for the refunding bonds less administrative costs and underwriter’s commission, and that the regulation was invalid because it did not allow municipalities to recover expenses incurred by issuing bonds. The IRS contended, however, that the purchase price should be the initial offering price of the bonds to the public, and would not permit the administrative expenses or the underwriter’s commission to reduce the purchase price.

The Tax Court examined the legislative history of the statute to determine the congressional definition of the term “yield” as used with

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104. See notes 41-49 supra and accompanying text. A provision in the 1971 revenue bond resolution required the state to maintain a reserve account of at least two times the maximum amount of principal and interest due on the bonds in any given year.

After issuing these bonds, the state amended its constitution so that the state was authorized to pledge its full faith, credit and taxing power to pay debt service on new bonds. The state then planned to issue refunding bonds which had a higher credit rating because the bonds were backed by the credit of the state, and therefore, carried a lower interest rate than the old bonds. Moreover, the refunding bonds were not required to be secured by a reserve account, so the state could use the accumulated money in the reserve account to reduce the principal. 77 T.C. at 657-62.

105. Id. at 664.

106. Treas. Reg. § 1.103-13(d).

107. Elements used in the yield calculation include the bond’s original purchase price, its redemption price, and its coupon rate. Treas. Reg. § 1.103-13(c)(1)(ii).

108. Treas. Reg. § 1.103-13(d). The Treasury Department instituted this restriction in 1978 to prevent issuers from recovering their costs, see note 51 supra. The purpose behind this regulation was to prevent inflated administrative costs. 43 Fed. Reg. 39823 (1978).
respect to municipal arbitrage and noted that all legislative records referred to municipal arbitrage as profit received by governmental units from the interest differential between taxable and tax exempt obligations. The court, therefore, concluded that the primary purpose of Congress in enacting section 103(c) was to eliminate this "profit" element of arbitrage. In addition, the court found that the IRS's interpretation of yield in the regulation 1.103-13(d), requiring that the municipality bear the costs of the issue, was at "odds with the legislative history and the totality of circumstances surrounding the enactment of section 103(c). . . ." 111

The court noted that the statutory terms were "far from clear," because the term "yield," as interpreted by the IRS, draws an invalid comparison between the bondholders' return on the issue and the issuer's return on his investment of the bond proceeds. The comparison is invalid because by disallowing the deduction of the issuer's expenses.

109. For legislative documents referring to arbitrage as "profit" made by local governments, see Technical Information Release No. 840 (Aug. 11, 1966), STAND. FED. TAX REP. (CCH) ¶ 6701 (1966); 113 CONG. REC. 31613 (1967); 113 CONG. REC. 20033 (1967).

110. The court noted that the regulations allowed the administrative costs to be discounted from the purchase price until 1978 when the IRS repudiated its prior construction of the statute and disallowed the exclusion of issuing costs. See note 51 supra. The court concluded that when this type of change of position occurs, "the manner in which it evolved merits inquiry." 77 T.C. at 617 n.12, citing National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979). See also Kurzner v. United States, 413 F.2d 97, 112 (5th Cir. 1969). While the court acknowledged that the flexibility of administrative regulations enable changes to be enforced without an act of Congress, Helvering v. Wiltshire Oil Co., 308 U.S. 90, 101 (1934), and regulations must be upheld if they "implement the Congressional mandate in some reasonable manner," United States v. Correll, 389 U.S. 299, 307 (1967), if the regulation is not consistent "with what Congress surely . . . intended the statute to do, then it cannot stand." 77 T.C. at 675, citing United States v. Cartwright, 411 U.S. 546, 557 (1973). Both the dissent and the IRS in State of Washington maintained that the regulation conforms to the statutory scheme and should be upheld by the court. The dissent asserted that the majority had ignored the Supreme Court's guidance as to the standards that courts should use in questioning the validity of a regulation. 77 T.C. at 678. "These regulations command our respect, for Congress has delegated to the Secretary of Treasury, not to this Court, the task of administering the tax laws of the Nation." 77 T.C. at 678, citing Commissioner v. Portland Cement Co., 450 U.S. 156, 169 (1981), citing United States v. Cartwright, 411 U.S. 546, 550 (1973). The Treasury Department claimed that the regulation barring the recovery of administrative expenses reduced the number of advance refundings which the Department contended was a major source of arbitrage abuse, thereby promoting the congressional purpose behind § 103(c). Ltr. Rul. 794117, Aug. 27, 1979. The Department also argued that § 103(c)(6), which grants the Secretary of Treasury the power to promulgate regulations, should strengthen the Treasury Department's interpretation of the regulation. Id. See 77 T.C. at 666.

111. 77 T.C. at 672.

112. Id. at 669.
costs, it does not accurately measure the issuer's actual return on its investment.\textsuperscript{113} The court held that the IRS

accentuates the difference between "yield" and the issuer's costs and, in our opinion, expands the net of 103(c)(2) to encompass a formula for determining profits which sweeps in a fictitious element of profit and goes beyond what is necessary to achieve the legislative purpose of the statutory provision.\textsuperscript{114}

The court also determined that because the Treasury Department declined to define arbitrage, and specifically requested that Congress do so, the IRS would have to issue regulations in accord with the congressional "anti-profit" intent. The court acknowledged that regulations should be upheld if they reasonably enforced a congressional mandate,\textsuperscript{115} and recognized that, in this case, Congress granted the Treasury Department broad rulemaking power. It held, however, that the regulation was inconsistent with Congressional intent and beyond the bounds of permissible administrative flexibility, since the regulation resulted in a diminution of funds used by municipal and state governments for carrying out their valid public purposes.\textsuperscript{116}

\begin{enumerate}
\item The Treasury Department, however, argued that "yield" should be given its ordinary business meaning, Malat v. Riddel, 383 U.S. 569 (1966), and that the IRS's application of yield in this instance is consistent with the legislative purpose behind § 103(c). Ltr. Rul. 794117, Aug. 27, 1979. The sponsors of the bill referred to arbitrage bonds as bonds invested at a yield higher than the yield on the bond itself, see notes 27-29 supra and accompanying text, and the Treasury Department maintains, therefore, that the discussion of yield in the legislative records does not suggest that yield should have any other meaning but the ordinary one. The Department also argued that yield appears in relatively close proximity within the statute and should be interpreted consistently.

[A]rbitrage bonds means any obligation . . . used . . . (a)—to acquire securities . . . expected . . . to produce a yield over the term of the issue which is materially higher (taking into account any discount or premium) than the yield on obligations of such issue . . . .

I.R.C. § 103(c) (emphasis added). The first time yield is referred to, it means rate of return. The Treasury Department maintains that this definition should be applied to yield the second time it appears in the statute. Ltr. Rul. 794117, Aug. 27, 1979. Instead, the Tax Court appears to define the second yield to mean cost to the borrower. See 77 T.C. at 669. The Treasury Department's argument is supported by the dissent, which mentions that although the term yield appears twice in the statute, the majority neither gives the term its ordinary meaning nor interpreted yield consistently and, therefore, failed to give the Code "as great an internal symmetry and consistency as its words permit." Id. at 677, citing Commissioner v. Lester, 366 U.S. 299, 304 (1961), citing United States v. Olympic Radio & Tel., 349 U.S. 232, 235 (1955) (Chabot, J., dissenting).

\item 77 T.C. at 669.
\item Id. at 675, citing United States v. Correll, 389 U.S. 299, 307 (1967).
\item Id. at 676.
\end{enumerate}
V. Conclusion

The Treasury Department is concerned that arbitrage restrictions will be distorted by municipal issuers to achieve unfair tax advantages. While the IRS is committed to controlling abuse, its enforcement has restricted some financings to the point that they are no longer feasible. The regulations also have had the effect of reducing the number of advance refunding bonds issued by municipal governments. While the IRS believes that regulating the issuance of these bonds enables it to reduce a major source of arbitrage abuse, municipal issuers believe that these restrictions constitute unauthorized control of the bond market by the IRS. Municipalities have found that the IRS's application of the arbitrage provisions has continued to expand, prohibiting increasing numbers of financings and creating a feeling of uncertainty among municipal issuers. Consequently, local governments have constrained future financings for fear that the IRS may declare the bond issues taxable for violating the arbitrage provisions.

Revenue Ruling 80-328 and the Tax Court's opinion in *State of Washington v. Commissioner*, however, suggest that the Treasury Department may have exceeded its authority to regulate arbitrage and may have gone beyond the legislative purpose of section 103(c). The arbitrage statute is intended to control blatant arbitrage abuses. Therefore, regulations and revenue rulings which inhibit transactions not motivated by arbitrage profit may be invalid for exceeding the legislative purpose of section 103(c).

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118. See notes 79-84 *supra* and accompanying text.
120. See note 41 *supra*.
122. *Id.* at 1-11.
123. *Id.* at 1-10.