Rev. Rul. 87-19 1987-1 C.B. 249--Waiver of Rate Adjust. Clause (NOO)

Rev. Rul. 87-19; 1987-1 C.B. 249; 1987 IRB LEXIS 334;
1987-11 I.R.B. 20

Section 1001.--Determination of Amount of and Recognition of Gain or Loss
26 CFR 1.1001-1: Computation of gain or loss. (Also Sections 103, 265; 1.103-1, 1.265-2).

March 16, 1987

Reissuance; tax-exempt bonds; interest adjustment clause waiver.

The waiver of a right under an interest adjustment clause to receive additional interest results in a reissuance of a municipal bond.

ISSUES

(1) If a financial institution holds an issue of bonds the interest on which is tax-exempt under section 103 of the Internal Revenue Code and waives its right under an interest adjustment clause to receive a higher rate of interest, does the waiver result in a deemed exchange under section 1001 of the old bonds for new bonds?

(2) If so, and if the interest on the new bonds is exempt from tax, is the financial institution subject to the interest expenses disallowance rule of section 265(b) of the Code?

FACTS

FI, a financial institution described in section 265(b)(5) of the Code, is the holder of $1,000,000 of bonds with a base interest rate of 7 percent issued by city *CI* in 1981. *CI* issued the bonds in connection with a conduit financing in which *CI* loaned the proceeds to *X*, a business corporation, and *X* issued a note to *CI* that was assigned to *FI* as the security for *CI*'s obligation on the bonds. *X* used the proceeds of the loan to acquire a newly constructed manufacturing facility that it owns and operates. The bonds were issued as an exempt small issue of bonds described in section 103(b)(6) of the Code, the interest on which is exempt from federal income tax under section 103(a).

Interest on the bonds is payable each January 1 and July 1 until maturity. The terms of the bonds provide that in the event there is a change in the maximum marginal federal corporation income tax rate, the interest rate on the bonds will be equal to the base interest rate multiplied by the quotient of (1 minus the new maximum marginal federal corporation income tax rate) divided by (1 minus the original maximum marginal federal corporation income tax rate). For example, a reduction in the maximum marginal federal corporation income tax rate from 46 to 34 percent would result in an interest rate on the bonds of 8.56 percent computed as follows:

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An amendment of section 11 of the Code by section 601 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B., decreases the maximum marginal federal corporation income tax rate. This reduction will trigger the interest adjustment clause for *CI*'s bonds.

On January 15, 1987, *FI* waived its right to receive the higher rate of interest under the interest adjustment clause with the result that interest will continue to be paid at the base rate of 7 percent after the change in the maximum tax rate becomes effective. In connection with FI's waiver, *CI* and *X* satisfied all applicable requirements for interest on a refunding bond to be tax-exempt under section 103 of the Code. These requirements include the registration requirement, the information reporting requirement, the maturity limitation requirement, and other applicable requirements imposed by the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, 1982-2 C.B. 462, the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 1, and the Tax Reform Act of 1986.

LAW AND ANALYSIS

Section 1001 of the Code provides that gain or loss from the sale or other disposition of property will be determined by reference to the amount realized and the adjusted basis of such property. The entire amount of the gain or loss will be recognized unless otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss from the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained.

Rev. Rul. 81-169, 1981-1 C.B. 429, concludes that an exchange of bonds that contain materially different terms is a taxable event under section 1001 of the Code. In Rev. Rul. 81-169, the taxpayer exchanged a municipal bond bearing interest at 9 percent, maturing February 1, 1996, and subject to sinking fund payments calculated to provide for level debt service, for a bond of equal face amount bearing interest at 8 1/2 percent, maturing February 1, 2006, and not subject to a sinking fund provision.

Section 265(b)(1) of the Code provides that in the case of a financial institution no deduction shall be allowed for that portion of the taxpayer's interest expense that is allocable to tax-exempt interest.

Section 265(b)(2) of the Code provides that the portion of the taxpayer's interest expense that is allocable to tax-exempt interest is an amount that bears the same ratio to such interest expense as (A) the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to (B) such average adjusted bases for all assets of the taxpayer. For purposes of the disallowance of interest rule of section 265(b), the acquisition date of an obligation is the date on which the holding period begins with respect to the obligation in the hands of the acquiring financial institution. See 2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-333 (1986). Generally the holding period of an obligation begins on the day after it is acquired. See Rev. Rul. 70-598, 1970-2 C.B. 168.

An adjustment to the interest rate on an issue of bonds pursuant to an interest adjustment clause does not result in an exchange under section 1001 of the Code. Although the interest payable on the bonds changes as the result of the adjustment, the adjustment is fixed by the terms of the bonds upon issuance and does not change.

In this case, however, *FI* has waived its right under the interest adjustment clause and will receive interest at the rate of 7 percent rather than at the higher rate to which it would have been entitled under the terms of the bonds issued in 1981. This represents a material change in the terms of the bonds and results in a taxable exchange under section 1001 of the Code and a deemed issuance of new bonds. See Rev. Rul. 81-169.

The date that the new bonds will be deemed to have been issued is January 15, 1987, the date of the waiver. Even though this date is prior to the date that the interest adjustment is triggered and the date on which interest at the new rate is due, it is the waiver of the interest adjustment clause that changed the terms of the bonds and resulted in a reissuance.

Because *FI*'s waiver on January 15, 1987, resulted in a deemed acquisition by *FI* of new bonds on that date, and because the new bonds satisfied all the requirements for interest on a refunding bond to be tax-exempt, *FI* is deemed to hold tax-exempt obligations acquired after August 7, 1986.

HOLDINGS

(1) *FI*'s waiver of its right under the interest adjustment clause to receive a higher rate of interest results in a material change in the terms of the bonds and, therefore, is a deemed exchange under section 1001 of the Code of the old bonds for new bonds.

(2) Because *FI* is deemed to have acquired on January 15, 1987, new bonds the interest on which is tax-exempt and the acquisition occurred after August 7, 1986, *FI* is precluded from

deducting the portion of its interest expense that is allocable to tax-exempt interest on the new bonds under section 265(b) of the Code.