



TREASURY DEPARTMENT

WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

AUG 1 1967

Dear Senator Long:

On July 5, 1967, you wrote us concerning a municipal bond issue being proposed by the City of Baker, Louisiana. With your letter, you enclosed certain correspondence indicating that the Internal Revenue Service had informed the City of Baker that in view of the "no ruling" policy announced in Technical Information Release-840, the Internal Revenue Service was unable to issue a ruling that interest on the proposed bonds would be exempt from federal income tax.

A portion of the proceeds from the proposed bond issue are intended to be invested in federal government obligations which would be held as security for the payment of certain outstanding bonds previously issued by the City of Baker. This type of transaction--a so-called advance refunding transaction--has been used by some local government units for the purpose of making an arbitrage profit by issuing tax-exempt securities and investing the proceeds in federal securities yielding a higher return. This profit arises solely because the nontaxable status of interest on local government bonds permits the local government to market bonds at a lower interest cost than the return paid on fully taxable federal government securities. In TIR-840, the Internal Revenue Service announced that it was undertaking a detailed study of the matter and that it would not issue any rulings as to the exempt status of advance refunding transactions where the proceeds of a new bond issue were to be invested in taxable securities yielding a higher return than that paid on the new issue for a period exceeding five years.

The City of Baker proposed to advance refund certain outstanding bonds by using a portion of the proceeds of a new issue to purchase federal government bonds which were to be held for the benefit of the outstanding bonds for seven years. Accordingly, the transaction was clearly within the ambit of TIR-840. The purpose of the transaction was to advance refund certain bonds which the City of Baker felt would have a prejudicial effect on its financial credit rating in connection with a new sewer bond issue. The City disclaimed any interest in making an arbitrage profit from the transaction.

On June 22, 1967, Mr. John W. S. Littleton, Director of Income Tax Division, Internal Revenue Service, wrote the City explaining the Internal Revenue Service's position in some detail. He asked the City to furnish information relative to the proposed interest rate that would be paid by the City in connection with the new bond issue and the return that the City expected to receive on the federal securities which were to be purchased with a portion of the proceeds of the new issue. The letter explained that if the yield on the federal securities was equal to or

less than the interest cost of the new issue, no arbitrage profit would result and the transaction would be outside the "no ruling" policy of the TIR-840.

After receiving the information you forwarded to us on July 5, 1967, Mr. Fred Becker of my staff spoke to Mr. Fred Benton, Jr., the attorney representing the City of Baker in this matter. Mr. Benton explained that in view of the uncertain state of the bond market it would be extremely difficult to furnish the type of information Mr. Littleton had requested. He reiterated the fact that the City of Baker was not proposing the transaction in order to earn an arbitrage profit.

Mr. Becker indicated that he recognized the difficulties of estimating interest rates in connection with proposed bond issues. Mr. Becker suggested that, as an alternative, if the City inserted a provision in the bond resolution restricting any investment in federal securities to securities yielding a return equal to or less than the interest cost of the new bonds, it would prevent an arbitrage profit from arising and would therefore place the advance refunding issue outside the "no ruling" policy of TIR-840. Mr. Benton indicated that in his views such a provision would be within the powers of the City of Baker and would probably be satisfactory to the City. Accordingly, Mr. Becker suggested that if the ruling request were to be resubmitted with such a restriction incorporated in the bond resolution, the Internal Revenue Service would be happy to reconsider the matter. Mr. Becker also indicated that if any additional problems developed with respect to the proposed bond issue, we would be happy to confer with Mr. Benton further in an effort to resolve those problems.

We are enclosing a copy of this letter, and would appreciate your forwarding it to Mr. Benton in order to provide him with written confirmation of his conversation with Mr. Becker.

If I can be of any further service to you in this matter, please do not hesitate to let me know.

Sincerely yours,

(Signed) Stanley S. Surrey

Stanley S. Surrey
Assistant Secretary

The Honorable
Russell B. Long
United States Senate
Washington, D. C. 20510

Enclosure

*Interest on
paid after
on return*