***State of Washington v. Commissioner, 77 T. C. 664 (1981)***

The court invalidated IRS regulations defining 'purchase price' for calculating 'yield' on arbitrage bonds, emphasizing the legislative intent to prevent arbitrage profits rather than to force issuers into losses.

**Summary**

The State of Washington sought a declaratory judgment to determine if its general obligation refunding bonds were arbitrage bonds under section 103(c) of the Internal Revenue Code. The key issue was the definition of 'yield' and whether the IRS's regulations, which excluded certain costs from the 'purchase price,' were valid. The court found that the legislative intent of section 103(c) was to eliminate arbitrage profits, not to force issuers into losses. Consequently, the court invalidated the IRS regulations that ignored the issuer's actual costs, ruling in favor of the State of Washington.

**Facts**

The State of Washington issued public school building revenue bonds in 1971, which it later sought to refund with general obligation bonds in 1979. The State requested a ruling from the IRS to confirm that the refunding bonds were not arbitrage bonds. The IRS denied this request, leading to a dispute over the definition of 'yield' under section 103(c). The State argued that the 'purchase price' should account for actual money received minus issuance costs, while the IRS maintained it should be the full public offering price, excluding bond houses and brokers.

**Procedural History**

The State of Washington filed for a declaratory judgment in the U. S. Tax Court after the IRS denied its ruling request. The Tax Court reviewed the case based on the administrative record and held that the IRS's regulations defining 'purchase price' were invalid, ruling in favor of the State.

**Issue(s)**

1. Whether the IRS's regulation defining 'purchase price' as the initial offering price to the public, excluding bond houses and brokers, is valid under section 103(c)(2)(A) of the Internal Revenue Code.
2. Whether the IRS's regulation that administrative costs should not be considered in calculating the 'purchase price' is valid under the same section.

**Holding**

1. No, because the regulation is inconsistent with the legislative intent to eliminate arbitrage profits, not to force issuers into losses.
2. No, because the regulation does not reasonably relate to the purpose of the

 

enabling legislation, which is to prevent arbitrage profits, not to ignore actual issuing costs.

## Court's Reasoning

The court analyzed the legislative history of section 103(c), noting that Congress's primary concern was to eliminate arbitrage profits. The IRS's regulation, which defined 'purchase price' without considering actual issuing costs, was deemed inconsistent with this intent. The court cited the Treasury Department's initial interpretation, which allowed issuers to treat administrative costs as a discount, as evidence of the legislative purpose. Furthermore, the court found that the IRS's regulation could force local governments to incur losses, which was not intended by Congress. The court also considered the broad rulemaking power granted to the IRS but concluded that the regulation did not reasonably relate to the purposes of the enabling legislation. The court emphasized the need for regulations to align with congressional intent, quoting Helvering v. Stockholms Enskilda Bank to support its approach to statutory construction.

## Practical Implications

This decision clarifies the definition of 'yield' for arbitrage bonds, allowing issuers to include actual issuing costs in the calculation. It sets a precedent for challenging IRS regulations that do not align with legislative intent. Practitioners should consider this ruling when advising clients on bond issuances, ensuring that calculations of 'yield' account for all relevant costs. This case may influence future IRS regulations and legislative amendments to section 103(c), as it highlights the need for regulations to reflect the purpose of preventing arbitrage profits without imposing undue burdens on issuers. Subsequent cases may reference this decision when addressing similar issues of regulatory validity and statutory interpretation.

 