City of Columbus v. Commissioner, 106 T. C. 325 (1996)

Prepayments with a principal purpose of obtaining a financial advantage can be treated as arbitrage bonds if they produce a materially higher yield than the bonds issued to finance them.

Summary

The City of Columbus sought a declaratory judgment that interest on bonds issued to prepay a pension obligation to the Ohio State Fund would be tax-exempt. The court ruled that the prepayment, facilitated by a 35% discount, constituted the acquisition of investment-type property with a materially higher yield (7. 57484%) than the proposed bonds (6%). The decision hinged on the economic substance of the transaction, emphasizing the City's principal purpose of profiting from the discount. Consequently, the proposed bonds were deemed arbitrage bonds, and their interest was not exempt from taxation under IRC section 103(a).

Facts

In 1967, the City of Columbus transferred its unfunded pension liabilities to the Ohio State Fund, incurring a long-term obligation. In 1994, the City prepaid this obligation at a 65% discount, using bond anticipation notes (BANs). The City then sought to issue long-term bonds to finance this prepayment, aiming for tax-exempt status under IRC section 103(a). The yield on the prepayment, considering the discount, was calculated at 7. 57484%, while the proposed bonds were to have a 6% yield.

Procedural History

The City submitted a ruling request to the IRS in 1994, seeking confirmation that the proposed bonds' interest would be tax-exempt. After the IRS denied the request, the City sought a declaratory judgment from the U. S. Tax Court, which upheld the IRS's decision.

Issue(s)

1. Whether the City's prepayment of its obligation to the State Fund constituted the acquisition of investment property.
2. Whether the prepayment produced a materially higher yield than the proposed bonds.
3. Whether the proposed bonds were arbitrage bonds under IRC section 148.

Holding

1. Yes, because the prepayment was for property held principally as a passive vehicle for the production of income.
2. Yes, because the prepayment yield of 7. 57484% was materially higher than the

proposed bonds’ 6% yield.
3. Yes, because the economic substance of the transaction revealed a principal purpose of obtaining a material financial advantage, making the proposed bonds arbitrage bonds.

Court’s Reasoning

The court focused on the economic substance of the transaction, emphasizing the City’s principal purpose of profiting from the 35% discount offered by the State Fund. The court rejected the City’s argument that the prepayment was merely discharging its own indebtedness, instead treating it as an acquisition of investment-type property. The court also dismissed the City’s contention that the discount should not be considered in calculating yield, as it was the foundation of the prepayment’s economic justification. The court relied on the broad regulatory authority under IRC section 148(i) and the regulations to adjust the yield calculation, concluding that the proposed bonds were arbitrage bonds under IRC section 148.

Practical Implications

This decision underscores the importance of economic substance over form in determining whether a transaction constitutes an arbitrage bond. Municipalities must carefully consider the yield of prepayments and the purpose behind them when issuing tax-exempt bonds. The ruling may deter municipalities from using tax-exempt financing for prepayments that offer significant discounts, as such transactions could be treated as arbitrage bonds. This case also highlights the IRS’s broad discretion to adjust yield calculations to reflect the economic reality of a transaction, which could impact future bond issuances and prepayments by public entities.

