

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

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Legend:

Issuer =

City =

Date 1 =

Date 2 =

Date 3 =

Year 4 =

a =

b =

\$c =

Dear Sir or Madam:

This is in response to your request for a letter ruling concerning Issuer's information reporting obligations as to the payments described below.

FACTS

Issuer adopted Basic Resolution b to establish a common bond fund (the "Bond Fund") in order to (a) consolidate the terms and conditions of its various bond resolutions and funds, (b) adjust the maturities of revenue bonds to coincide with the receipt of revenues available for their payment, and (c) to reduce the debt service requirements of such bonds. On Date 1, the a Bond Program had Bonds outstanding in b different series with an aggregate outstanding principal balance of \$c. The Bonds at issue in this ruling request are tax exempt and have different maturities and payment terms.

The a Bonds are payable from monies in the Bond Fund. All of the Bonds are equally and ratably secured by the same pooled sources of payment pledged to the Bond Fund, regardless of which property was financed with a particular series of the Bonds. The sources of payment may be divided into three categories: (1) cash flow generated by net revenues received from certain revenue-producing properties either owned or financed by the Issuer, and earnings on sums held by the Issuer in various reserve accounts; (2) sums held by the Issuer in various reserve accounts established to secure

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payment of the Bonds; and (3) sale of repossessed projects originally financed with the Bonds. A default by an underlying borrower does not create a corresponding default on any of the Bonds because all of the revenues under the Bond Fund are pooled to pay debt service on all outstanding Bonds. The Bonds are not secured by the revenue-producing properties.

To date, full and timely payment of principal and interest on the Bonds has been made by the Issuer from the Bond Fund. All payments timely received by holders of the Bonds are first allocated to accrued and unpaid interest on the Bonds and then to repayment of principal.

However, the Issuer reasonably believes that, at some point between the dates of Date 2 and Date 3 (the "Shortfall Date"), the sources of payment on the Bonds will no longer be sufficient to pay in full principal and interest due on the Bonds.

The Issuer expects to pay all principal and interest due on the Bonds through the Shortfall Date. On and after the Shortfall date, the Issuer has determined that there will be insufficient funds to pay all principal and interest due on Bonds maturing after that date. Under the Bond Resolution, debt service payments made on the Bonds on and after the Shortfall Date will be made first to interest on a pro rata basis in accordance with interest payments due on all of the Bonds that are outstanding, and then to principal, pro rata in accordance with principal payments due on all outstanding Bonds that have matured (i.e., the bond's maturity date or mandatory redemption date has then occurred or has already passed). To the extent that operating cash flow is inadequate to satisfy all of the interest and principal payments due at that time, there will be a shortfall. Shortfalls of principal and interest remain due and outstanding.

As indicated above, failure to make timely payment of principal and interest on the Bonds is not an event of default, and no specific remedies are available to the holders of the Bonds in the event of such a failure. For example, there is no right of acceleration of principal with respect to any of the Bonds or any foreclosure of properties by the holders of the Bonds.

The Bonds that mature after the Shortfall Date will remain outstanding until they are "liquidated". For this purpose, "liquidation" means termination of the Bonds for state law purposes. There is no established liquidation date for the Bonds. However, the cash flow used to make the Bond debt service payments is expected to cease, for all intents and purposes, when the last lease agreement terminates. This is currently scheduled to occur in Year 4, but may occur earlier. The Bondholders thus cannot expect to receive substantial payments on the Bonds after Year 4 at the latest, and for state law purposes the Bondholders' claims for debt service payments will be worthless at that time.

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It is possible that at some time after the Shortfall Date, but prior to the final lease payment date, the Bondholders will negotiate a settlement with the Issuer for payment in satisfaction of all unpaid amounts under the Bonds. The Issuer considers the term "liquidation" to include settlement of the Bonds under such circumstances.

REQUESTED RULINGS

You have requested that we rule as follows:

- (1) Issuer shall, for purposes of the information reporting requirements contained in § 6045(a) of the Internal Revenue Code, treat all payments to holders of tax-exempt Bonds made prior to the occurrence of the Shortfall Date in the manner provided under Basic Resolution a, namely, first as a payment of tax-exempt interest to the extent of accrued but unpaid interest, and second as a return of principal.
- (2) Issuer shall, for purposes of the information reporting requirements contained in § 6045(a), treat all installment payments to holders of tax-exempt Bonds made on or after the occurrence of the Shortfall Date but prior to the liquidation of Bonds, in the manner provided under Basic Resolution a, namely, first as a payment of tax-exempt interest to the extent of accrued by unpaid interest, and second as a return of principal.
- (3) Issuer shall, for purposes of the information reporting requirements contained within § 6045(a), treat payments made upon the liquidation of tax-exempt Bonds as allocable to return of principal and to unpaid interest on a basis proportional to the outstanding principal and unpaid interest at the time of the liquidating payment.
- (4) Issuer or its paying agent shall issue a Form 1099-B to holders of tax-exempt Bonds only if and when the Bondholders receive payments designated as a return of principal under the rulings herein.

LAW AND ANALYSIS

The general rule for allocating payments between principal and interest is that voluntary partial payments made by a debtor to a creditor are, in the absence of an arm's length agreement, applied first to interest, then, if the payment exceeds the interest due, to principal. Story v. Livingston, 38 U.S. 310, 371 (1839); Lackey v. Commissioner, T.C. Memo. 1977-213, 36 TCM 890, 894 (1977). If the parties have agreed to a binding, arm's length contract as to the allocation of the payments, then that agreement should be followed. Huntington-Redondo Co. v. Commissioner, 35 B.T.A. 116 (1937); Estate of Hagen v. Commissioner, T.C. Memo. 1969-59, 28 TCM 341, 345-346 (1969).

An exception to these general rules exists where there is an involuntary foreclosure of mortgaged property, and strong evidence indicates that the mortgagor is insolvent. In that case, a final payment in an amount less than the principal amount of the debt

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should be allocated to principal, in part because the total repayment of cash, or the value of the property, transferred in the foreclosure is less than the outstanding principal amount of the indebtedness. Newhouse v. Commissioner, 59 T.C. 783, 789 (1973). Even in the case of a foreclosure, however, if the debtor does not appear to be insolvent and continues to make partial payments in satisfaction of indebtedness, then, in the absence of an agreement to the contrary, the general rule allocating payments first to interest, then to principal, should apply. Estate of Bowen v. Commissioner, 2 T.C. 1 (1943); Lackey, supra; Rev. Rul. 77-135, 1977-1 C.B. 133.

In this case, all payments timely received (i.e., prior to the Shortfall Date) by holders of the Bonds are first allocated to accrued and unpaid interest on the Bonds and then to repayment of principal. As to these payments, the general rule allocating payments first to interest, then to principal, should apply. We thus conclude that the Issuer may treat all payments to holders of the Bonds made prior to the Shortfall Date first as a payment of interest to the extent of accrued but unpaid interest, and second as a return of principal.

Under the Bond Resolution, debt service payments made on the Bonds on and after the Shortfall Date are to be made first to interest on a pro rata basis in accordance with interest payments due on all of the Bonds that are outstanding, and then to principal, pro rata in accordance with principal payments due on all outstanding Bonds that have matured (i.e., the bond's maturity date or mandatory redemption date has then occurred or has already passed). To the extent that operating cash flow is inadequate to satisfy all of the interest and principal payments due at that time, there will be a shortfall. Pursuant to the Bond Resolution, the Issuer proposes to treat the debt service payments made after the Shortfall Date as allocable first to return of unpaid interest and then to return of principal on a basis proportional to the unpaid interest and outstanding principal at the time of each payment.

As to the debt service payments made after the Shortfall Date, even in the case of a foreclosure, if the debtor does not appear to be insolvent and continues to make partial payments in satisfaction of indebtedness, then, in the absence of an agreement to the contrary, the general rule allocating payments first to interest, then to principal, should apply. In this case, there is no indication that the Issuer is insolvent or in foreclosure. Thus, pursuant to the Bond Resolution, the debt service payments made after the Shortfall Date may be allocated first to interest on a pro rata basis in accordance with interest payments due on all of the Bonds that are outstanding, and then to principal, pro rata in accordance with principal payments due on all outstanding Bonds that have matured.

Finally, any liquidation of the Bonds will occur because all lease agreements have terminated and the cash flow used to make the debt service payments on the Bonds has ceased. The Bonds are thus being liquidated because, as far as paying the debt service on the Bonds, the Issuer has effectively become insolvent. As stated above, in

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the case of an insolvent borrower, a final payment in an amount less than the principal amount of the debt should be allocated all to principal, in part because the total repayment of cash, or the value of the property, transferred in the foreclosure is less than the outstanding principal amount of the indebtedness. Upon a liquidation of the Bonds, the Bondholders' claims for debt service payments will become worthless and the Bondholders will have been paid less than the amount owed.

Section 6045(a) and § 1.6045-1(a)(9) of the Income Tax Regulations, require a "broker" to file information returns on retirements of indebtedness. Under § 1.6045-1(b)(1), a "broker" is defined to include an obligor that regularly issues and retires its own debt. In the present case, Issuer will not be required to report under § 6045(a), payments, both before and after the Shortfall Date, that are allocated to tax exempt interest pursuant to the Bond Resolution. However, Issuer is required to report under § 6045(a), any liquidating payment that is in an amount less than the outstanding principal of the debt. Issuer is not required to report under § 6045(a), the amount of any liquidating payment that exceeds the outstanding principal and is allocated to tax exempt interest.

CONCLUSIONS

(1) Issuer may, for purposes of the information reporting requirements contained in § 6045(a), treat all payments to the holders of the Bonds made prior to the Shortfall Date as first a payment of accrued but unpaid interest and second as a return of principal.

(2) Issuer may, for purposes of the information reporting requirements contained in § 6045(a), pursuant to the agreement between the parties (the Bond Resolution) treat all debt service payments made on the Bonds on and after the Shortfall Date as allocable first to interest on a pro rata basis in accordance with interest payments due on all of the Bonds that are outstanding, and then to principal, pro rata in accordance with principal payments due on all outstanding Bonds that have matured (i.e., the bond's maturity date or mandatory redemption date has then occurred or has already passed).

(3) Issuer shall, for purposes of the information reporting requirements contained in § 6045(a), treat all payments in liquidation of the tax exempt bonds as allocated first, to outstanding principal and second, to outstanding tax exempt interest.

(4) Issuer or its paying agent shall issue a Form 1099-B to holders of tax-exempt Bonds only if and when the Bondholders receive payments designated as a return of principal under the rulings herein.

Caveats:

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A copy of this letter must be attached to any income tax return to which it is relevant. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Deputy Assistant Chief Counsel
(Income Tax & Accounting)

By _____
George Baker
Assistant to Branch Chief, Branch 2