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Pennsylvania Intergovernmental Cooperation Authority
1429 Walnut Street, 14th Floor
Philadelphia, PA 19102

ATTN: Joe Vignola

Re: 1993A and 1996 Special Tax Revenue Bonds
"Swaption" Agreements

Ladies and gentlemen:

You have asked our opinion with respect to certain Federal tax matters concerning two Floating to Fixed (Synthetic Fixed) Forward Starting Interest Rate Swaption Agreements ("swaptions") that you propose to enter today with JP Morgan Chase Bank as provider.

The swaptions are option agreements that grant the provider an option to enter into an interest rate swap contract with the Authority on the dates that its outstanding 1993A and 1996 issues of special tax revenue bonds are redeemable. The swap contracts would provide for the Authority to make fixed rate payments at the same interest rate as the rate on the outstanding bonds and receive floating rate payments at a rate based on a short-term market index. The purchaser of an option will pay the Authority a nonrefundable cash fee (the "swaption fee") as the purchase price of the option. There will be no other payments other than the regular fixed and floating rate payments under the swap contract if the option is exercised.

The 1993A and 1996 bonds were issued as tax-exempt, fixed rate bonds in 1993 and 1996 respectively. The interest rates on both of these issues are higher than current fixed rates in the tax-exempt market, making a refunding generally desirable. However, the 1993A and 1996 bonds were in both cases issued in "advance refundings" of earlier issues. An advance refunding is characterized by the fact that the refunded bonds are not redeemed until at least 90 days after the issuance of the refunding bonds. Under the Internal Revenue Code an advance refunding issue, such as the 1993A or 1996 bonds, cannot itself be advance refunded. Use of the swaption plan as proposed in the present case will allow the Authority to capture the present value of current interest rates (through the receipt of the swaption fees) while deferring the issuance of the refunding bonds until the redemption dates of the 1993A and 1996 bonds, so that the refunding will not be an advance refunding. The payments under the swap contracts will have the effect of giving the Authority a net fixed rate burden at the fixed rate in the swap contracts, which is

equivalent to the rates on the outstanding bonds, in a refunding transaction in which the Authority would issue floating rate refunding bonds on or shortly prior to the redemption dates for the outstanding bond issues and use the proceeds of the refunding bonds to redeem those issues.

The swaption fees will be held in a special escrow from which disbursements will be permitted either to the account of the City of Philadelphia or for application to any termination fee due to the counterparty in the event that the Authority determines to terminate the swaption pursuant to its termination provisions. These provisions permit a termination at the election of the Authority, generally on payment of a termination fee based on the value of the agreement to the counterparty.

The swaptions were sold pursuant to a competitive bidding process managed by a broker with substantial experience in placing derivative financial products for issuers of tax-exempt bonds. Bidders were asked to bid a specific amount of swaption fee for each swaption, with the winning bid being the bid for each swaption with the largest swaption fee. The bid specification provided the terms for the fixed rate leg of the swap and the index basis for the floating leg, and bidders were required to bid on these terms without adjusting them. The winning provider is paying a fee to the broker.

The Treasury regulations on tax-exempt bond issues provide generally that a bond issuer may enter into a "qualified hedge" in order to modify its risk of interest rate changes with respect to a bond issue (Treas. Reg. § 1.148-4(h)). The regulations state that a qualified hedge may be an interest rate swap, a forward contract, or an option, among other arrangements. If a bond issuer elects to "identify" a qualified hedge to a bond issue, the general rule under the regulations is that yield on the bonds is determinable by including the net payments by or to the bond issuer under the qualified hedge. If the hedged bonds are issued with floating rate payments that "closely correspond" to the payments received by the bond issuer under a swap contract with a maturity equal to entire term of the issue, the yield calculation can be based solely on the fixed rate payments by the bond issuer, disregarding any small differences between the two floating rate streams of payments received under the swap contract and debt service paid on the bonds. In the present case the Authority will make the relevant identification of the swaptions to the refunding bonds by executing an identification certificate with respect to each issue of refunding bonds within three days of the present date as provided by the identification regulations. It will be able to determine at the time that the hedged refunding bonds are issued whether to use the general yield calculation method or the special method for "closely corresponding" payment streams.

The regulations provide that a qualified hedge may not contain a "significant investment element" (Treas. Reg. § 1.148-4(h)(2)(ii)). A significant investment element is present if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date. Examples given in the

relations are an "off-market" swap contract (which could arise if the fixed rate payments are above a market level for comparable swap contracts and this fact is compensated for by having the party who receives the fixed rate payments pay an initial premium to the counterparty) or an interest rate cap requiring the bond issuer's premium to be paid in a single, up-front payment.

The regulations provide specifically for the case in which the provider of a qualified hedge makes a single payment to the bond issuer in connection with the acquisition of a contract, such as a payment for an off-market swap. The regulations provide that in this case, the issuer may segregate the contract into a portion that is a qualified hedge and a portion that is not a qualified hedge, provided that the hedge provider's payment to the issuer and the issuer's payments under the contract in excess of those that it would make if the contract bore rates equal to the on-market rates for the contract are separately identified in a certification of the hedge provider (Treas. Reg. § 1.148-4(h)(2)(i)(C)).

The regulations provide specifically that a qualified hedge may be entered in advance of the hedged bonds. For this purpose, the regulations require the bond issuer to state, in its identification of the qualified hedge, whether it does or does not expect the contract to be closed substantially contemporaneously with the issuance of the hedged bond. In the case of contracts that are expected to be closed at the bond issuance, all payments made or received under the contract including any termination payment are taken into account in determining the yield on the bonds. In the case of contracts that are not expected to be closed at the bond issuance, the regulations are generally similar, except that payments by the issuer in advance of the bond issuance date are not taken into account. If the contract is in fact terminated in connection with the issuance of the bonds, payments by or to the issuer are taken into account in determining the yield and as an adjustment to the bond proceeds for purposes of the arbitrage bond rules on investment of bond proceeds (Treas. Reg. § 1.148-4(h)(5)(iii)). In the present case, the Authority is identifying the swaptions as contracts that are not expected to be closed substantially contemporaneously with the issuance of the hedged refunding bonds, since it expects to make and receive payments on the contracts over the life of the bonds.

The regulations do not deal specifically with options to enter swap contracts. In this situation, by analogy the regulations cited above, we believe the option element of the swaption is properly severable analytically from the swap contract, with the swaption fee being allocable to the option rather than the swap contract. On this basis we have concluded that:

1. The swaption fees are proceeds of the sale of options to enter swap contracts and therefore do not constitute proceeds of either the outstanding bonds or any bonds that may be issued to refund them. As with any other amount, regardless of its source, the swaption fees may be treated as replacement proceeds under Treas. Reg. § 1.148-1 if they are pledged or expected directly or indirectly to be used to pay debt service on bonds. The fee paid to the broker by the provider does not constitute yield to the Authority with respect to the 1993A and 1996 bonds or the refunding bonds.

2. The swap contracts covered by the swaptions will constitute qualified hedges such that the payments under the swap contracts will be properly taken into account in determining the yield on the refunding bonds.

3. The swaption fees, as proceeds of the sale of options, are not payments on qualified hedges and do not have to be included in determining the yield on the refunding bonds.

Very truly yours,

FLB/h/ktf