

PLR 9706008 (November 12, 1996)

This letter is in response to the request submitted on behalf of the City for a ruling about a proposed allocation of proceeds of the Bonds (as defined below) to certain governmental expenditures.

FACTS

The City is a municipal corporation and a political subdivision of State. Utility is a division of one of the City's departments. Utility supplies electricity to residential, commercial, and governmental customers located primarily in the City.

The State constitution and the City charter authorize the City to own and operate Utility. However, the City charter requires that Utility be financially independent of the City and prohibits the City from using the revenues or earnings of Utility for any purpose other than a Utility purpose.

Several years ago, the City made certain payments totalling approximately \$m from its general fund on behalf of Utility. A law suit was filed against the City challenging the use of tax revenues from the City's general fund to subsidize Utility. After several years of litigation, the City lost the law suit and was ordered by the court to reimburse the City's general fund for substantially all of the original payments made by the City on behalf of Utility and to pay interest on that amount (the "Judgment"). The court order allowed Utility to satisfy the Judgment by making annual installments to the City's general fund until Year B. On Date 1, the City council adopted an ordinance ("Ordinance 1") authorizing the issuance of the Series B Bonds to finance a lump sum payment to satisfy a portion of the Judgment.

In Year A, the City development staff began considering whether the City could use the payments from Utility to augment other economic development funds of the City that support neighborhood industrial, commercial, and housing investments. In pursuance of this plan, on Date 2, the City council adopted an ordinance ("Ordinance 2") directing that the amounts paid to the general fund to satisfy the Judgment (i.e., the net proceeds from the Series B Bonds and the payments made before issuance of the Series B Bonds) be deposited in a designated account (the "Program Account") in the City's general fund for purposes of the Program.

On Date 3, the City issued the Series A Bonds and the Series B Bonds (collectively, the "Bonds") as a single issue of bonds. The Bonds are special obligations of the City and are payable solely from, and secured by, Utility's net revenues and by a mortgage on certain of Utility's property. In accordance with the provisions of Ordinance 1 and Ordinance 2, \$n of the sale proceeds of the Bonds were transferred to the Program Account. The bond documents relating to the Bonds provide that proceeds of the Bonds will be used for multiple purposes, including satisfying the Judgment, making loans and grants to private parties, and constructing government infrastructure.

In furtherance of the purpose of the Program, the City has begun allocating moneys (through actual disbursements and commitments to disburse) from the Program Account to economic

development loans and projects. The City represents, however, that the amount of proceeds of the Bonds the City has allocated or intends to allocate from the Program Account to loans to entities other than governmental units does not exceed \$5 million, which is less than 5 percent of the proceeds of the Bonds. The City further represents that the amount of proceeds of the Bonds the City has allocated or intends to allocate from the Program Account to private business uses (including the loans described in the preceding sentence) does not exceed 5 percent of the proceeds of the Bonds.

The City proposes to allocate a portion of the proceeds of the Bonds in the Program Account to governmental expenditures of the City made with moneys other than the proceeds of tax-exempt bonds or other restricted funds. In connection with this proposed allocation, the City represents that it will adopt an ordinance (“Ordinance 3”) that will provide that the funds credited to the Program Account may be used for the purposes of general municipal operations, procurement of fixed assets or permanent improvements, payment of debt charges, the elimination of deficits in City funds, and all other lawful purposes. The City further represents that it will allocate to the governmental expenditures only those proceeds in the Program Account that have not been allocated previously through actual disbursements of funds or commitments to disburse funds in connection with the Program. In addition, the City represents that it will not allocate any of the proceeds of the Bonds to governmental expenditures that have been made before the adoption of Ordinance 3. The City requests a ruling that the proposed allocation of the proceeds of the Bonds to these governmental expenditures will be respected for federal tax purposes to determine the use of the proceeds under §§141(a) and 148 , even though for state or local law purposes the proceeds in the Program Account subsequently may be used for economic development loans to entities other than governmental units or for other private business uses.

LAW AND ANALYSIS

Under §103(a) , gross income does not include interest on any state or local bond. Section 103(b)(1) , however, makes §103(a) inapplicable to any private activity bond that is not a qualified bond under §141 . Additionally, §103(b)(2) makes §103(a) inapplicable to any bond that is an arbitrage bond under §148 .

Section 141(a) defines a “private activity bond” as any bond issued as part of an issue that meets both the private business use test of §141(b)(1) and the private security or payment test of §141(b)(2) . The private business use test of §141(b)(1) is met if more than 10 percent of the proceeds of an issue is to be used for any private business use. The private security or payment test of §141(b)(2) is met if the payment of principal or interest on more than 10 percent of the proceeds of an issue is directly or indirectly (i) secured by an interest in property, (ii) secured by an interest in payments in respect of property, or (iii) derives from payments, whether or not to the issuer, in respect of property or borrowed money. This private security or payment test is met only if the property or borrowed money is either used or to be used for a private business use. In addition, §141(b)(3) reduces the 10 percent threshold in §§141(b)(1) and 141(b)(2) to 5 percent when the private business use is either unrelated or disproportionate to the governmental use financed with the bonds.

Under §141(b)(6)(A) , “private business use” means use directly or indirectly in a trade or business that is carried on by any person other than a governmental unit. Section 141(b)(6)(B) states that any activity carried on by a person other than a natural person shall be treated as a trade or business.

Section 141(a) also defines a “private activity bond” as any bond issued as part of an issue that meets the private loan financing test of §141(c) . The private loan financing test of §141(c) is met if the amount of the proceeds of an issue used directly or indirectly to make or finance loans to persons other than governmental units exceeds the lesser of 5 percent of the proceeds or \$5,000,000.

Section 148(a) defines “arbitrage bond” as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected on the issue date of the bonds to be used directly or indirectly to acquire higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that, for purposes of §148(a) , a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue to acquire directly or indirectly higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments.

Section 148(b)(1) defines “higher yielding investments” as any investment property that produces a yield over the term of the issue that is materially higher than the yield on the issue. Section 1.148-2(d) of the Income Tax Regulations generally provides that the yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by more than one-eighth of 1 percentage point.

Section 148(f)(1) generally provides that a bond that is part of an issue will be treated as an arbitrage bond unless an amount equal to the sum of (i) the excess of the amount earned on all nonpurpose investments over the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue and (ii) any income attributable to that excess, is paid to the United States.

Section 148(f)(6)(A) defines “nonpurpose investment” as any investment property which is acquired with the gross proceeds of an issue and is not acquired in order to carry out the governmental purpose of the issue.

Section 1.148-6(a)(1) provides that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue. Section 1.148-6(b)(1) provides, in part, that amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose.

Section 1.148-6(d)(1)(i) provides, in part, that reasonable accounting methods for allocating funds from different sources to expenditures include a specific tracing method, a gross proceeds spent first method, a first-in, first-out method, or a ratable allocation method. However, §1.148-

6(d)(1) (ii) provides, in part, that an allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue.

In order to determine whether or not the private business tests of §141(b) or the private loan financing test of §141(c) are met for a particular bond issue, the issuer must allocate the proceeds of the bonds to specific uses. Similarly, in order to determine whether or not a particular bond issue is an arbitrage bond under §§148(a) or 148(f) , the issuer must allocate the proceeds of the bonds to investments and expenditures.

Neither the Code nor the regulations contain any rules relating to allocations of bond proceeds for purposes of §§141(b) or 141(c).¹ Because §148 also requires allocations of bond proceeds, however, the principles underlying the allocation rules of §1.148-6 are useful for determining how the proceeds should be allocated for purposes of §§141(b) and 141(c) .

In general, the §148 allocation rules set forth above provide that any reasonable, consistently applied accounting method may be used to allocate the proceeds of a bond issue to expenditures, as long as the expenditure involves a current outlay of cash. Furthermore, §1.148-6(b)(1) states that amounts cease to be allocated to an issue as proceeds when those amounts are allocated to an expenditure for a governmental purpose. Thus, it is possible for an issuer to allocate bond proceeds to one expenditure for federal tax purposes and then, because those moneys are no longer treated as bond proceeds, use the moneys for, and allocate the moneys to, a different expenditure for state or local law purposes.²

The City has already allocated a portion of the proceeds of the Bonds in the Program Account for federal tax purposes to certain economic development loans and projects by actually disbursing funds or making commitments to disburse funds. The remainder of the proceeds of the Bonds in the Program Account, however, have not been allocated either through the City's actions or through the general language in the Bond documents.

As required by the regulations, the governmental expenditures to which the City proposes to allocate the proceeds of the Bonds in the Program Account involve current outlays of cash. In addition, the City will not allocate any other tax-exempt bond proceeds or other restricted funds to these governmental expenditures. Finally, the proposed allocations are consistent with the Bond documents. Therefore, the City's use of a specific tracing method to allocate the proceeds of the Bonds to the governmental expenditures for purposes of §§141(a) and 148 will constitute a reasonable, consistently applied accounting method. Furthermore, this result is not changed by the fact that, after these federal tax allocations are made, the City may use the moneys for, and allocate the moneys to, the economic development loans made in connection with the Program or other private business uses.

CONCLUSION

Based on the representations made and the information submitted, we conclude that the City's proposed allocation of the Bond proceeds to the governmental expenditures will be respected for federal tax purposes to determine the use of the Bond proceeds under §§141(a) and 148, even though for state or local law purposes the Bond proceeds subsequently may be used for, and

allocated to, economic development loans to entities other than governmental units or other private business uses.

Except as specifically stated in this ruling, no opinion is expressed concerning any aspects of the Bonds under any section of the Code, including whether the interest on the Bonds was exempt under §103 when they were issued. Further, no opinion is expressed about the effects of the proposed allocations on any financing other than the Bonds.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the ruling. See §11 of Rev. Proc. 96-1, 1996-1 I.R.B. 7, 39. However, when the criteria in §11.05 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstance.

Sincerely yours, Acting Assistant Chief Counsel (Financial Institutions & Products) Timothy D. Jones Assistant to the Chief Branch 5.

¹ Proposed regulations addressing this issue were published in the Federal Register on December 30, 1994 (59 Fed. Reg. 67658). See §1.141-6 of the proposed regulations.

² For example, when an issuer makes a reimbursement allocation under §1.150-2, the bond proceeds are allocated to the original expenditure. Therefore, the money received from the sale of the bonds is no longer considered bond proceeds and may be used for, and allocated to, other expenditures for state or local law purposes.