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Department of the Treasury

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LEGEND

State =
Date 1 =
Date 2 =
Date 3 =
Bonds =
County 1 =
County 2 =
Corporations =
$a =
Bond Fund =
Year 1 =
State Bond Acts =

Dear :

This responds to the State's request for the following two rulings:

(1) The State's proposed use of proceeds of the Bonds (a use that if tested separately, would not meet § 141(a) of the Internal Revenue Code of 1986) will not cause less than 95 percent of the net proceeds of the Bonds to be used to provide an exempt facility under § 142(a); and

(2) The proposed use of the proceeds of the Bonds will not cause § 147(f) to be violated.

FACTS

The State represents the following facts. The State issued the Bonds on Date 1 as exempt facility bonds under § 142(a). The State satisfied all of the requirements of § 147 at the time the Bonds were issued. The Bonds are general obligation bonds of the State.

The State issued the Bonds to make loans to County 1 and County 2 to finance a portion of the costs of two exempt facilities within the meaning of § 142(a), one for each County (Project 1 and Project 2, collectively "the Projects"). On the issue date of

the Bonds, it was planned that each County would own its respective Project and that each Project would be operated by one of the Corporations pursuant to a 20-year management contract.

On Date 2, the State made a zero interest loan to County 1 in the amount of $a. County 1 spent a portion of $a on capital expenditures for Project 1. However, due to unforeseen events outside the control of the State and County 1 and 2, County 1 determined that it was not prudent to proceed with the facility as planned. As a result, on Date 3, prior to the expiration of the term of its loan, County 1 repaid the total outstanding balance of that loan to the State. Due to the same unforeseen events, County 2 determined that it would not proceed with Project 2. County 2 made this determination before it had borrowed any proceeds of the Bonds.

The balance of the Bond proceeds currently on deposit in the Bond Fund has been invested at a yield that is not in excess of the yield on the Bonds at all times since the issue date of the Bonds.

The same events that caused Counties 1 and 2 to abandon the Projects also caused several other similar projects to either be abandoned or suffer financial difficultly in meeting debt service payments.

The State Legislature amended the State Bond Acts in Year 1 (the "Amended State Bond Acts"). The Amended State Bond Acts authorize the State to make grants to local governments to assist in the payment of any costs incurred before the date of the unforeseen events noted above and to assist in the payment of, or as security for, debt service on bonds, notes, leases, and other obligations issued by those local governments (the "Emergency Grants").

The State proposes to use the unexpended proceeds of the Bonds to provide Emergency Grants. If the Bonds were issued solely to make the Emergency Grants, the Bonds would not meet the private business tests because the private security or payment test of § 141(b)(2) would not be met.

The Bonds are not subject to certain provisions of § 1.142, including § 1.142-1 through- 4.

LAW AND ANALYSIS

(1) Whether the State's proposed use of proceeds of the Bonds (a use that if tested separately, would not meet § 141(a) of the Internal Revenue Code of 1986) will cause less than 95 percent of the net proceeds of the Bonds to be used to provide an exempt facility under § 142(a)?

Section 103(a) of the Internal Revenue Code of 1986 generally provides that gross income does not include interest on any State or local bond. Section 103(b)(1)

provides that this exclusion does not apply to any private activity bond unless it is a qualified bond as defined under § 141.

Section 141(a) provides, in part, that the term “private activity bond” means any bond issued as part of an issue which meets both the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2).

Under § 141(e)(1)(A), an exempt facility bond is a qualified private activity bond. Under § 142(a), an exempt facility bond means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide for one of the specified purposes in § 142(a).

Prior to 1986, tax-exempt financing was permitted for industrial development bonds substantially all of the proceeds of which were to be used for certain exempt facilities. § 103(b)(4) of the Internal Revenue Code of 1954. Regulations issued under the 1954 Code provide, in part, that interest paid on obligations of state or local governments is not includible in gross income if substantially all of the proceeds are to be used to provide one or more specified exempt facilities. § 1.103-8(a)(1)(i) of the Income Tax Regulations. Substantially all of the proceeds of an issue of governmental obligations are used to provide an exempt facility if 90 percent or more of such proceeds are so used. Id.

Section 1.103-8(a)(1)(ii) provides, in part, that § 1.103-8(a)(1)(i) shall also apply to an issue of obligations substantially all of the proceeds of which are to be used to provide exempt facilities described in § 1.103-8(a) and to provide facilities to be used by an exempt person.

Under § 1.103-8(i) Example 6, a City issues $20 million of bonds and will use $6 million to finance residential rental property which qualifies as an exempt facility under § 103(b)(4)(A), $9 million to finance construction of a stadium which qualifies as an exempt facility under § 103(b)(4)(B), and $5 million for convention facilities which qualify as exempt facilities under § 103(b)(4)(C). Because the facilities will be used in the trades or businesses of nonexempt persons and rental payments with respect to the facilities and the facilities themselves will be the security for the bonds, the bonds are industrial development bonds. However, because all of the proceeds are to be used to provide exempt facilities under § 103(b)(4), generally, the interest on the bonds is tax-exempt under § 103(a). The Example also explains that this result would be the same if, instead of using a portion of the proceeds to finance construction of the stadium, that portion were used to finance construction of a capitol building (presumably a governmental use).

The Conference Report to the Tax Reform Act of 1986 (the “1986 Act”), P.L. 99-514, 1986-3 C.B. (Vol. 1) 1, provides that “the conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions.” H.R. Conf. Rept. No. 99-841 at II-686. (1986), 1986-4 C.B. (Vol. 4) 686.

Certain changes made by the 1986 Act affect how § 1.103-8(a)(1)(i) and (ii) apply to bonds to which the 1986 Act applies. For example, the 1986 Act amendments increase the percentage of proceeds required to be used to provide an exempt facility from 90 percent to 95 percent. In addition, the 1986 Act eliminated the concept of exempt persons.

The State issued the Bonds as exempt facility bonds, and reasonably expected to use the proceeds of the Bonds to provide exempt facilities. However, due to unforeseen circumstances outside the control of the State and the Counties, most of the Bond proceeds cannot prudently be used to provide the exempt facilities. Accordingly, the State proposes to use the proceeds to make the Emergency Grants. If the State had issued the Bonds to make these grants, the Bonds would not have met the private business tests of § 141.

The State argues that § 1.103-8(a)(1)(ii) permits the conclusion that use of the proceeds of the Bonds to make the Emergency Grants can be aggregated with use of the proceeds to provide an exempt facility to determine if the § 142(a) requirement that 95 percent or more of the net proceeds of the bonds be used to provide an exempt facility is met. We agree.

Although § 1.103-8(a)(1) has not been revoked, it must be read in light of the changes made by the 1986 Act. The 1954 Code provision to which § 1.103-8(a)(1)(ii) applies is very similar to § 142. In both Code provisions, it is necessary to consider whether a certain percentage of proceeds were used to provide an exempt facility. Indeed, the type of facility at issue in this case was also permitted to be financed as an exempt facility before the 1986 Act amendments. Thus, we conclude that § 1.103-8(a)(1) can be read to apply to § 142.

However, § 1.103-8(a)(1)(ii) refers to facilities to be used by an exempt person. The 1986 Act eliminated the definition of "exempt person." Nevertheless, a similar concept applies for a similar purpose in the private activity bond tests. That is, generally, for purposes of determining whether a bond is a private activity bond, a governmental unit is treated in a similar manner to the way an exempt person was treated for purposes of determining whether a bond was an industrial development bond.

Accordingly, we conclude it is reasonable to interpret a facility to be used by an exempt person in § 1.103-8(a)(1)(ii) as a facility to be used by a governmental unit.

Section 1.103-8(a)(1)(ii) raises two interpretative questions. The first is whether the facility must be used by a governmental unit or whether it is enough that the facility, if tested separately, would not meet the tests of § 141. We conclude that the better interpretation is that a facility, if tested separately, would not meet the tests of § 141.

The same principle which allows aggregation of expenditures for a facility that

fails the private business use test also applies to expenditures for facilities that fail the private payment or security test. The 1986 Code places limits on bonds that have the potential to transfer the benefits of tax-exempt financing to a private user. Section 141 sets forth the tests for determining whether that potential exists. We conclude that § 1.103-8(a)(1)(ii) should apply if that potential does not exist.

The second interpretative question is whether the term “facilities” is limited to capital expenditures. We find no compelling reason to read “facility” for a governmental user to mean only expenditures for capital assets.

Therefore, we conclude that the State's use of the proceeds of the Bonds to make the Emergency Grants will not cause less than 95 percent of the proceeds to be used to provide an exempt facility.

(2) Whether the proposed use of the proceeds of the Bonds will cause § 147(f) to be violated?

Section 147(f)(1) provides, in part, that a private activity bond shall not be a qualified bond unless such bond satisfies the requirements of § 147(f)(2). Section 147(f)(2)(A) provides that an issue must be approved by the governmental unit which issued the bond, or on behalf of which such bond was issued, and each governmental unit having jurisdiction over the area in which any facility, with respect to which financing is to be provided from the net proceeds of such issue, is located. Section 147(f)(2)(B) provides that for purposes of § 147(f)(2)(A), an issue shall be treated as having been approved by any governmental unit if such issue is approved by the applicable elected representative of such governmental unit after a public hearing following reasonable public notice, or by voter referendum of such governmental unit.

Section 5f.103-2(c)(1) provides that an issue is publicly approved if prior to the date of issue the governmental unit(s) described in § 5f.103-2(c)(2) and (3) approve the issue in the manner described in § 5f.103-2(d).

The Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 1982-2 C.B. 462, 493, added the requirements for public notice and approval of private activity bonds. It appears that Congress enacted this provision as a method of limiting the volume of industrial development bonds and to help ensure that the benefits of industrial development bonds were used for traditional governmental purposes. See General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 98-99.

In the instant case, the State complied with the requirements of § 147(f)(2) when it issued the Bonds. The issue is whether the State will violate that section when it uses the proceeds of the Bonds to make the Emergency Grants. The § 147(f) public approval requirement applies only to private activity bonds, not governmental bonds. If the State issued new bonds to make the Emergency Grants, § 147(f) would not apply to

the new bonds. The proceeds of the Bonds used for the Project were used to provide the exempt facility for which the Bonds were approved and any use of the proceeds for Emergency Grants will be a use that would not otherwise be subject to § 147(f)(2). Hence, we conclude that no public approval is required pursuant to § 147(f) with respect to the use of the proceeds of the Bonds to provide Emergency Grants. As a result, we conclude that use of the proceeds of the Bonds to make the Emergency Grants will not violate § 147(f)(2).

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) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of

the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)
By: Rebecca Harrigal
Chief, Tax Exempt Bonds Branch

cc: