Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:TEB-PLR-147413-02
Date:
October 16, 2002

In Re:

Legend

Authority =

Act =

City =

State =

Mayor =

Notes =

Series 1 Bonds =

Series 2 Bonds =

Series 3 Bonds =

Provision =

Year 1	=
Year 2	=
Year 3	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=

Dear :

This letter is in response to your request on behalf of the Authority for a ruling that the Bonds (hereinafter defined) will not be outstanding longer than necessary to accomplish the governmental purpose of the issue for purposes of section 148 of the Internal Revenue Code (the “Code”).

FACTS AND REPRESENTATIONS

Background

The Authority was created in Year 1 pursuant to the Act for the purpose of issuing debt secured by collections of specified taxes to aid the City in financing its capital needs. Under State law, the Mayor must issue a declaration of need in order for the Authority to be authorized to issue debt to meet the City's capital needs.

The City is a political subdivision of the State. The Authority and the City are related parties within the meaning of Section 1.150-1(e) of the Income Tax Regulations.

On Date 1, occurred in the City,

(the "Occurrence"). The City has incurred, and anticipates that it will continue to incur for the foreseeable future, substantial expenditures (the "Clean-up Costs") related to the Occurrence.

The Occurrence has had a severe economic impact on the City beyond the immediate physical damage it caused. The Occurrence was unprecedented in that it eliminated a significant portion of the City's economic base, resulting in a substantial reduction in business activity and the loss of numerous jobs in the City. In addition to significant expenditures for the Clean-up Costs, the City has determined that it has lost revenues, including Statutory Revenues (hereinafter defined), of more than $a in fiscal Year 2 and more than $b in fiscal Year 3 as a direct result of the Occurrence. The projected loss of revenues caused by the Occurrence is separate from and in addition to an expected decline in revenues from a general economic downturn the City is experiencing and has placed severe pressure on the City's finances. The City's latest financial plan projects substantial budget gaps (before a gap-closing program) in the next four fiscal years. The City also expects that it will have substantial budget gaps beyond the next four fiscal years.

In response to the Occurrence, the legislature of the State amended the Act to permit the Authority to issue $c of its bonds and notes to pay all costs in the City's budget that are, in the judgment of the Mayor, related to or arising from the Occurrence (the "Recovery Costs"). The Act provides that the maximum term of any bonds issued pursuant to the Act shall be thirty years. The City has neither established any reserves nor set aside other available amounts for the Recovery Costs. The Recovery Costs are not covered by any insurance policies held by the City.

On Date 2, the Authority issued the Notes pursuant to the Act and an indenture, as amended and supplemented (the "Indenture"). The Notes matured on Date 3. The proceeds of the Notes were initially deposited into a single fund to be expended on Clean-up Costs. Approximately $d of the proceeds of the Notes have been spent on

Clean-up Costs, consisting of capital as well as working capital expenses related to the Occurrence. Prior to Date 2, the Authority received a private letter ruling from the Internal Revenue Service that the Clean-up Costs to be paid with proceeds of the Notes that are working capital expenditures are extraordinary working capital expenditures described in section 1.148-6(d)(3)(ii)(B).

Subsequent to the issuance of the private letter ruling, the Mayor determined that Recovery Costs include the City's loss of revenues that are attributable to the Occurrence. For fiscal Year 3, the Mayor determined that, for purposes of the Act, at least $b in revenues will be lost as a direct result of the Occurrence. The Mayor's determination permitted the Authority to transfer the proceeds of the Notes not spent on Clean-up Costs to the City's general fund and to treat those proceeds as spent on Recovery Costs for State law purposes. Proceeds of the Notes transferred to the City's general fund have been or are expected to be used to pay ordinary operating expenses of the City that would have been paid from the City's revenues (the "Operating Expenses") if it were not for the Occurrence.

The Bonds

The Authority has issued three series of bonds pursuant to the Act and the Indenture for the purpose of financing additional Recovery Costs and current refunding the Notes. On Date 4, the Authority issued the Series 1 Bonds. On Date 5, the Authority issued the Series 2 Bonds. The Series 1 Bonds and Series 2 Bonds each consist entirely of variable rate bonds and have a term of e years, which is more than two years. On Date 6, the Authority issued the Series 3 Bonds (together with the Series 1 and Series 2 Bonds, the "Bonds"), consisting of fixed rate and variable rate bonds. The Series 3 Bonds also have a term of e years. Principal payments on each of the Bonds are amounts that would be paid if such bonds were issued as fixed rate bonds at prevailing market rates with level debt service. The weighted average maturity of each of the Bonds is approximately f years, which is more than two years.

The proceeds of the Series 1 and Series 2 Bonds were transferred to the City's general fund to compensate for the loss of revenues designated by the Mayor as Recovery Costs. The proceeds of the Bonds transferred to the City's general fund are expected to be used to pay the Operating Expenses. The proceeds of the Series 3 Bonds were used to currently refund the Notes. As noted above, the proceeds of the Notes that were transferred to the City's general fund have either been spent on the Operating Expenses or will be spent on such expenses as transferred proceeds of the Bonds. Thus, a total of $b of the proceeds of the Bonds and Notes were or will be used to finance the loss of revenues caused by the Occurrence, with the balance of the proceeds being used to finance the Clean-up Costs. The total Recovery Costs financed with the Bonds are approximately five percent of the City's budgeted operating expenses for fiscal Year 3.

The Bonds are payable from the Authority's revenues consisting of: (a) taxes imposed on the income of City residents, less overpayments and costs of administration (the "Personal Income Tax Revenues") and, under certain circumstances, (b) revenues from a tax on the sale of tangible personal property and services in the City, less costs of administration and amounts applied to pay debt service on certain other bonds (the "Sales Tax Revenues" and together with the Personal Income Tax Revenues, the "Statutory Revenues").

Under the Indenture, the Authority applies the Statutory Revenues on a quarterly basis to provide for the payment of the debt service on its bonds and notes, including the Bonds, that become due and payable in the next quarter. Any Statutory Revenues not used for debt service payments (the "Net Statutory Revenues") are transferred to the City's general fund and used for the general purposes of the City. The Net Statutory Revenues are generally a large portion of the City's revenues.

The Authority represents that the term and weighted average maturity for the Bonds are necessary in light of the severe pressure placed on City's finances as a direct result of the Occurrence. Absent the Occurrence, the City would not have the need to finance the Recovery Costs. The Authority represents that the term and weighted average maturity of the Bonds provide a reasonable and affordable debt service expense over the term of the Bonds. The term and weighted average maturity of the Bonds are expected to result in sufficient Net Statutory Revenues flowing to the City's general fund to enable the City to plan its future budgets and recover from the financial distress caused by the Occurrence. If the Bonds had been issued with a shorter maturity, it would reduce the amount of Net Statutory Revenues that are available to the City for basic operating needs, which would place additional strain on the City's operating budget and potentially force the reduction of essential City services. It is also currently impractical to increase the rates on taxes in an amount necessary to offset the revenue shortfall, including the loss from the Occurrence, that the City has experienced and expects to experience over the next several fiscal years. Businesses and residents have moved out of the City and there has been a decline in tourism in the City because of the Occurrence. Such a tax increase would likely put further pressure on the City's tax base beyond that caused by the Occurrence.

The Authority represents that the term and weighted average maturity of the Bonds permits the Authority and the City to maintain their current credit ratings. The maturity schedule for obligations issued by the Authority or the City impacts their debt burden and, thus, their respective credit ratings. The term and weighted average maturity of the Bonds reflect the view of the credit rating agencies that the debt service structure of the Bonds will not have a material negative impact on the City's overall economic condition.

By providing the City with a debt service expense it expects will be affordable and reasonable, the term of the Bonds is expected to assist the City in meeting its balanced budget requirement under State law. Under the Provision, the City is required to maintain a balanced budget under generally accepted accounting principles. If the City has an operating deficit of more than $g in any fiscal year, a board, which was created by the Provision and is controlled by the State, would assert its power over the City's finances. In that regard, the board would effectively take control of the City's budget and finances through its power to approve or disapprove certain contracts (including collective bargaining agreements), long-term and short-term borrowings, and the City's financial plans.

The City and the Authority believe that the issuance of the Bonds to finance the Operating Expenses on a long-term basis is a unique event necessitated only by the sudden and extraordinary nature of the Occurrence. Other than the Act, the Authority and the City do not have the authority to finance Operating Expenses on a long-term basis and the legal authority to issue the Bonds exists only because of the State legislature's response to the Occurrence.

The Authority represents that it would issue bonds with the same term and weighted average maturity even if the interest on the bonds were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable rate would be the same as the actual tax exempt interest rate) in order to recover from the economic impact of the Occurrence.

LAW

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that subsection (a) shall not apply to any arbitrage bond (within the meaning of section 148).

Section 148(a) defines an arbitrage bond as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that a bond is an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in (1) or (2).

Section 1.148-2(a) generally provides that, under section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. Section 1.148-1(b) defines gross proceeds as proceeds and replacement proceeds of an issue.

Section 1.148-1(c)(4)(i)(A) provides that replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that: (1) the term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue; and (2) there will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under section 1.148-10. Replacement proceeds are created under section 1.148-1(c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

Section 1.148-10(a)(1) provides that bonds of an issue are arbitrage bonds under section 148 if an abusive arbitrage device under section 1.148-10(a)(2) is used in connection with the issue. Section 1.148-10(a)(2) provides that any action is an abusive arbitrage device if the action has the effect of: (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and (ii) overburdening the tax-exempt bond market.

Section 1.148-10(a)(4) provides that an action overburdens the tax-exempt bond market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (*e.g.*, an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under sections 1.148-2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under section 1.148-1(c)(4)(i)(B). These factors may be outweighed by other factors, however, such as bona fide cost underruns or long-term financial distress.

Section 1.148-1(c)(4)(i)(B)(1) provides, as a safe harbor, that replacement proceeds do not arise under section 1.148-1(c)(4)(i)(A) for the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years. For the portion of an issue that is a refunding issue, section 1.148-1(c)(4)(i)(B)(3) provides that replacement proceeds do not arise if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies section 1.148-1(c)(4)(i)(B)(1) or (2). No safe harbor is provided for extraordinary working capital expenditures described in section 1.148-6(d)(2)(3)(ii)(B).

Section 1.148-1(b) defines restricted working capital expenditures as working capital expenditures that are subject to the proceeds-spent-last rule in section 1.148-6(d)(3)(i) and are ineligible for any exception to that rule.

Section 1.148-6(d)(3)(i) provides that, except as otherwise provided in section 1.148-6(d)(3) or (d)(4), proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in section 1.148-6(d)(3)(iii)) as of that date (*i.e.*, a proceeds-spent-last method). For this purpose, proceeds include replacement proceeds described in section 1.148-1(c)(4).

Section 1.148-6(d)(3)(iii) defines available amount as any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of the issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed. A reasonable working capital reserve is treated as unavailable.

Section 1.148-6(d)(3)(ii)(B) provides that the proceeds-spent-last method of accounting does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (*e.g.*, a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

ANALYSIS

The determination of whether the Bonds will be outstanding longer than reasonably necessary to accomplish the governmental purpose of the issue is based on all the facts and circumstances.

We first evaluate the nature of the expenditures of the proceeds of the Bonds and Notes. As noted above, the Authority previously received a letter ruling that certain of the Clean-up Costs paid with proceeds of the Notes are extraordinary, nonrecurring items as described in section 1.148-6(d)(3)(ii)(B). Subsequently, the Mayor determined that the Recovery Costs include $b in lost revenues for fiscal Year 3 that are attributable to the Occurrence. As a result, the Note proceeds that were not spent on Clean-Up Costs were transferred to the City's general fund. The proceeds of the Bonds not used to currently refund the Notes were also transferred to the City's general fund. The proceeds of the Bonds and Notes transferred to the City's general fund have either been spent on the Operating Expenses or will be spent on such expenses (in the case of the Notes, as transferred proceeds of the Bonds).

Although the City incurred extraordinary, nonrecurring expenses in connection with the Occurrence, $b of proceeds of the Bonds and Notes have been or are expected to be used to finance the Operating Expenses, which are amounts customarily paid from the City's revenues. The fact that the loss of revenues is attributable to the Occurrence does not cause the City's normal operating expenses to be classified as either extraordinary or nonrecurring. Accordingly, the Operating Expenses paid with proceeds of the Bonds and Notes are not expenses of the type described in section 1.148-6(d)(3)(ii)(B). Rather, the Operating Expenses are working capital expenditures within the meaning of section 1.148-1(b). As such, the proceeds allocable to such expenditures are subject to the proceeds-spent-last rule in section 1.148-6(d)(3)(i) and, thus, will not be expended to the extent there are available amounts.

We next evaluate whether, based on the nature of the expenditures, the Bonds are outstanding longer than reasonably necessary. Initially, we note that the Bonds that will be used to finance restricted working capital expenditures or currently refund the Notes do not meet the safe harbors against the creation of replacement proceeds under section 1.148-1(c)(4)(i)(B).

Notwithstanding the characterization of the Operating Expenses as restricted working capital expenditures, the use of the Bond proceeds to pay such expenses is a direct result of the Occurrence, which was a sudden and extraordinary event that has had a severe economic impact on the City. In that regard, proceeds of the Notes and Bonds used to finance Operating Expenses represent the cost of the Occurrence to the City in terms of lost revenues. The circumstances surrounding the City's current need to finance the Operating Expenses is, thus, different from other types of restricted working capital financings, such as tax and revenue anticipation notes ("TRAN") or long-term deficit financings.

A TRAN is typically a short-term borrowing used by municipalities to match revenue and expenditure patterns during the fiscal year. The deficit financing situation usually arises from a municipality's long-term economic distress. In contrast to these types of financings, the City and Authority are financing only that portion of the City's budget gap that is directly attributable to a discrete event, the Occurrence. Proceeds of the Bonds are not being used to finance any portion of the City's budget deficit arising from a general economic downturn. Further, the City has neither established any reserves nor set aside other available amounts for the Recovery Costs, and the Recovery Costs are not covered by any insurance policies held by the City. Because the Bonds were issued to finance the costs of a sudden, extraordinary event, it is appropriate to evaluate the maturity of the portion of the Bonds that is financing the Operating Expenses in a manner similar to bonds issued to finance extraordinary working capital expenditures. Further, because the remaining proceeds of the Bonds are, in fact, financing extraordinary working capital expenditures, we analyze the maturity of all the Bonds collectively. Accordingly, the safe-harbor for restricted working capital expenditures under section 1.148-1(c)(4)(i)(B) is not controlling in the instant case.

When evaluating whether the term of an issue to finance extraordinary working capital expenditures is reasonable, it is necessary to consider the nature of the event giving rise to the expenditures, the size of the expenditures relative to the size of the issuer's budget, and the issuer's overall economic condition. A relevant consideration is the impact of the expenditure on the issuer's operating budget over the term of the issue that will finance the expenditures.

Although the circumstances may warrant issuing the portion of the Bonds that is financing the Operating Expenses without regard to the two-year safe harbor prescribed by section 1.148-1(c)(4)(i)(B), we must still determine whether the maturity for the Bonds is longer than reasonably necessary to accomplish the governmental purpose of the issue. The governmental purpose of the Bonds is to finance the Recovery Costs, including the revenues lost as a result of the Occurrence. These costs represent a sizeable portion of the expenses of the City's operating budget. For fiscal Year 3, for example, the Recovery Costs represent approximately 5 percent of budgeted operating expenses. Viewed together with the sudden, extraordinary nature of the Occurrence, it is reasonable to issue long-term bonds to finance the Recovery Costs. To evaluate the reasonableness of the term and average maturity of the Bonds, it is appropriate to consider the City's need to finance the Recovery Costs with its long-term budget considerations. In this regard, the Recovery Costs have placed severe pressure on the City's finances, which is in addition to the general economic downturn the City is currently experiencing.

Issuing the Bonds with a term of e years and a weighted average maturity of f years provides the City with a reasonable and affordable debt service expense over the term of the issue which takes into account the City's economic condition. The City's latest financial plan projects significant budget gaps in the next four fiscal years and beyond. If the Authority had issued the Bonds with a shorter maturity, it would exacerbate the City's current financial condition and may have impaired the City's ability to provide essential services because of the need to cut costs to balance the City's budget. It is also reasonable to conclude that raising the tax rates in the City in an amount necessary to offset the loss of revenues would place additional strain on the City's tax base and is not a practical solution in light of the general economic impact of the Occurrence. Accordingly, the term and weighted average maturity of the Bonds are reasonably necessary to provide the City with sufficient revenues for basic operating expenses and to help the City recover from its financial distress. If, however, the City were not experiencing a general economic downturn, it would be necessary to consider whether a shorter maturity for the Bonds would be reasonable, notwithstanding the fact that the Bonds are financing the costs of a sudden, extraordinary event.

Issuing the Bonds with a term of e years and a weighted average maturity of f years, as opposed to the thirty year term permitted by the Act, also permits the Authority and the City to maintain their current credit ratings. The term and weighted average maturity of the Bonds reflect the view of the credit rating agencies that the Bonds will not have a material negative impact on the City's overall economic condition. If the Bonds had been issued with a longer maturity, for example, it might have further complicated the City's financial situation by imposing the Recovery Costs, including the lost revenues, on future budgets and potentially impaired the City's and the Authority's credit ratings. In addition, the City is not simply deferring the costs of the Occurrence to future years, but rather is exercising fiscal responsibility by having issued the Bonds with a level debt structure, even in the face of substantial budget gaps over the next four years and beyond.

By providing a debt service payment that is expected to be manageable, the term and weighted average maturity of the Bonds will also assist the City in meeting its balanced budget requirement under State law. If the term of the Bonds were shorter, the increase in annual debt service would jeopardize the City's ability to maintain a balanced budget as required under the Provision, potentially impairing the City's access to the public credit markets.

Furthermore, the issuance of the Bonds to finance the lost revenues on a long-term basis is a unique event caused by the Occurrence. Neither the Authority nor the City would have the statutory authority to issue the Bonds to pay for Operating Expenses of the City on a long-term basis if it were it not for the legislature's amendment to the Act in response to the Occurrence.

Finally, the Authority would issue bonds with a term of e years and a weighted average maturity of f years if the interest on the bonds were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate).

Considering all the facts and circumstances, particularly the sudden and extraordinary nature of the Occurrence, the size of the expenditures relative to the City's operating budget, and the financial distress that the City has experienced and reasonably expects to continue experiencing as a direct result of the Occurrence, the

Bonds, with a term of e years and a weighted average maturity of f years, will not be outstanding longer than reasonably necessary to accomplish the governmental purpose of the issue for purposes of section 148.

CONCLUSIONS

Based on the information submitted and representations made, we conclude that the Bonds will not be outstanding longer than necessary to accomplish the governmental purpose of the issue for purposes of section 148.

These conclusions 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 this request for rulings, it is subject to verification on examination.

Except as specifically ruled above, no opinion is expressed concerning this transaction under any other provision of the Code or regulations thereunder, including sections 103 and 141 through 150. Specifically, no opinion is expressed concerning whether interest on the Bonds is excludable from gross income under section 103(a).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,

Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

By: ________________________________

Bruce M. Serchuk
Senior Technician Reviewer
Tax Exempt Bond Branch

Enclosure:
Copy for section 6110 purposes