Internal Revenue Service

Number: **200336004**
Release Date: 09/05/2003
Index Number: 103.02-00

Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:TEB - PLR-131424-03

Date:
May 28, 2003

In Re:

Legend:

State=

Warrants =

a=

b=

Date 1=

Date 2=

Year 3=

Dear :

This letter is in response to your request on behalf of the State for a ruling that the Warrants will be “obligations” of the State for purposes of § 103 of the Internal Revenue Code.

Facts and Representations:

The State makes the following representations. The State is facing a substantial shortfall in cash available for normal working capital payments. To meet this shortfall, the State proposes to issue obligations (the "Obligations") in Date 1 under applicable State law. The Obligations will mature in one year. The State anticipates having sufficient money to repay these Obligations. However, to enhance the marketability and reduce the cost of the Obligations, the State intends to enter into forward purchase warrant agreements (the "Agreements") with broker-dealers and commercial banks (the "Participants"), under which the Participants will agree to purchase "Warrants" from the State at the maturity of the Obligations if the State has insufficient funds to pay the Obligations. Each Warrant will have a principal sum specified on the Warrant that the State must repay to the Participant and will bear interest at a variable rate that will be a percentage of a market index.

The Warrants will be legal, valid and binding obligations of the State, enforceable against the State, except as such enforceability may be limited by insolvency, moratorium or other laws or equitable principles relating to or affecting the enforcement of creditors' rights generally, by application of equitable principles or by application of State laws regarding claims against the State.

The Warrants will state that they will be redeemed within one year of issuance, however this statement may not be enforceable. Nevertheless, the State represents that it and the Participants anticipate that the Warrants will be repaid quickly. Once issued, the Warrants must be repaid each day there are available funds in the State's general fund, determined after certain higher priority payments have been made. In the last a years, no warrant of the type at issue in this case has been outstanding more than a few months. Moreover, if on Date 2 of fiscal Year 3, which is the year that gave rise to the substantial cash shortfall, the Warrants had been issued in an amount necessary to pay all the Obligations, the Warrants would have been repaid within b months of issuance, a period that is less than one year.

Law and Analysis:

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(c)(1) provides that the term "State or local bond" means an obligation of a State or political subdivision thereof. Section 1.150-1(b), which generally provides definitions for §§ 103 and 141-150, defines an obligation as any valid evidence of indebtedness under general Federal income tax principles.

However, the word "obligation" in § 103(c)(1) does not extend to every obligation that includes the payment of interest by a state or political subdivision, but only to those obligations which are created in the exercise of a state's borrowing power, as compared with some other sovereign power. For example, courts have not found an obligation under § 103 in condemnation cases because the obligation did not arise as an exercise of a state's borrowing power. *See Drew v. United States*, 551 F.2d. 85 (5th Cir. 1977) (threat of condemnation is not the exercise of the borrowing power); *Holley v. United States*, 124 F.2d 909 (6th Cir.), *cert. denied*, 316 U.S. 685 (1942); *United States Trust Co. of New York v. Anderson*, 65 F.2d 575 (2d Cir.), *cert. denied*, 290 U.S. 683 (1933) (condemnation is not the exercise of the borrowing power).

Obligations under § 103 are not limited to a particular form such as bonds or other securities. *See, e.g., Rev. Rul. 60-179, 1960-C.B. 37* (interest paid by a state under ordinary written agreement for purchase and sale of a house was exempt).

In the instant case, the Participants will enter into voluntary arrangements to advance the State money under negotiated terms and will receive the Warrants in return. We conclude that the Warrants will be an exercise of the State's borrowing power and will be obligations under § 103 if the Warrants are debt under general Federal income tax principles.

Neither the Code nor the regulations define debt for Federal income tax principles. However, whether an instrument is a debt has been considered in several different areas. In *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957), *cert. denied*, 359 U.S. 1002 (1959), the court defined classic debt as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." The court noted that while some variation from this formula is not fatal to the taxpayer's efforts to have the advance treated as a debt for tax purposes, too great a variation will preclude such treatment.

The characteristics of debt have been explored in cases addressing whether an arrangement is debt or equity. In those cases, the determination is based on all the facts and circumstances, with no one factor being decisive. *Fin Hay Realty v. United States*, 398 F.2d 694, 696-697 (3d Cir. 1968); *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946). Among the factors courts have considered are the names given to the certificates evidencing the indebtedness, presence or absence of a fixed maturity date, source of the payments, right to enforce payments of principal and interest, participation in management as a result of the advances, status of the advances in relation to regular corporate creditors, intent of the parties, identity of interest between creditor and stockholder, "thinness" of capital structure in relation to debt, ability of the corporation to obtain credit from outside sources, use to which the advances were put, failure of the debtor to repay and risk involved in making advances. *See Dixies Dairies v. Commissioner*, 74 T.C. 476, 493 (1980); *see* also Notice 94-47, 1994-1 C.B. 357 (list of factors relevant in debt/equity determination). Not all of these factors are relevant in the instant case. We discuss certain relevant factors below.

The obligation to pay a sum certain is one aspect of a debt. Here, the Agreements and Warrants will require payment of a sum certain that will be determined at the time the Warrants are issued. In addition, the Warrants will provide for stated interest that is to be paid for the use or forbearance of money. *See Deputy v. du Pont*, 308 U.S. 488, 498 (1940). In exchange for the Participants advancing the State money, the State will pay a variable rate of interest, based on a percentage of a market index, to the Participants.

Another characteristic of a debt instrument is the right to enforce payment of principal and interest*. Estate of Mixon v. United States,* 464 F.2d 394 (5th Cir. 1972). The Warrants are legal, valid and binding obligations of the State, enforceable against the State, except as such enforceability may be limited to insolvency, moratorium or other laws or equitable principles relating to or affecting the enforcement of creditors' rights generally, by application of equitable principles, or by application of State laws regarding claims against the State. If the State fails to pay the Warrants, any holder of the Warrant may proceed to protect and enforce his rights under applicable law and equity. Accordingly, the Participants can enforce the State's obligation to pay principal and interest on the Warrants.

Another indicia of a debt instrument is a fixed maturity date. The existence of a fixed maturity date is a significant factor that indicates the existence of a debtor-creditor relationship*. Miele v. Commissioner*, 56 T.C. 556, 566 (1971), *aff'd*, 474 F.2d 133 (3d Cir.), *cert. denied,* 414 U.S. 982 (1973). However, courts have ruled that the absence of a fixed maturity date is not in itself sufficient to prevent an instrument from being classified as a debt where there is evidence that the parties expect the amount advanced will be repaid within a short time period.

In *Harlan v. Commissioner*, 409 F.2d 904 (5th Cir. 1969), the court ruled that two advances to insurance companies were debt instruments. The instruments had no fixed maturity date but were payable on demand. The court noted that both advances were repaid within three years and concluded that the repayment of the instruments in the relatively short time was an indication that the parties contemplated an early maturity date.

Similarly, in *Estate of Mixon*, the court ruled that the advance in question was a bona fide loan and that the absence of a fixed date of repayment was not conclusive evidence of equity. The court noted that there was evidence that the parties contemplated repayment within a maximum of three years. The court also noted that the advances were in fact repaid within two and one-half years of their funding.

Here, we assume that the Warrants will not have a fixed maturity date. Instead, once issued, the Warrants will be repaid each day to the extent that there are available funds in the State's general fund, determined after certain priority payments are paid. The State represents that it and the Participants will reasonably expect the Warrants to be repaid quickly. In support of its claim, the State represents that no registered warrants issued by the State without a maturity date in the last a years have been outstanding for more than a few months. The State further represents that if the Warrants had been issued in an amount necessary to pay all of the Obligations on Date 2 of Year 3, which is the year that gave rise to the substantial cash shortfall, the Warrants would have been repaid in less than one year.

Conclusion:

Based on all the facts and circumstances, we conclude that the Warrants will be "obligations" of the State for purposes of § 103.

The ruling contained in this letter is 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.

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, including whether interest on the Obligations or Warrants is tax exempt.

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 taxpayer.

Sincerely,

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

By: ______________________________
Rebecca L. Harrigal
Chief, Tax Exempt Bond