Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:TEB
PLR-148695-04

Date:
March 24, 2005

In Re:

Legend:

State=

A=

B=

C=

D=

E=

F=

G=

H=

I=

Obligations=

Notes=

Date 1=

Date 2=

Date 3=

Date 4=

Date 5=

Date 6=

Date 7=

Date 8=

Year 1=

Code=

State Deficit =

Budget Account=

Subaccount=

Fund=

Special Fund=

Series 1 Bonds =

Series 2 Bonds =

Series 3 Bonds=

Dear :

This letter is in response to your request on behalf of State for a ruling that amounts, if any, in State's General Fund, Special Fund and Budget Account, described below, will not result in “other replacement proceeds” of the Bonds within the meaning of § 1.148-1(c)(4).

Facts and Representations:

State’s general fund is the principal operating fund (the General Fund) through which most of State’s expenditures are paid. State revenues not designated by law to be deposited elsewhere are placed in the General Fund. State also has a special fund that was created to protect State from unforeseen revenue reductions and unanticipated expenditure increases (the Special Fund). Under State law, State’s controller may transfer as necessary from the Special Fund such amounts as are needed to meet cash needs of the General Fund. The controller must repay any money transferred without payment of interest as soon as there are sufficient moneys in the General Fund.

State is facing a substantial shortfall in cash available for normal working capital payments. To meet the shortfall, State issued approximately $A in Obligations on Date 1 that matured on Date 2. Proceeds of the Obligations were deposited in State’s General Fund and paid ongoing State expenditures not payable from other revenues. State represents that proceeds of the Obligations were in a sufficient amount to cover State’s cash management needs in the beginning months of fiscal Year 1, but that expected cash receipts were less than expected cash expenditures during the remainder of that fiscal year by at least $B. To cover the expected additional shortfall, State issued Notes on Date 3 that matured on Date 4.

State represents that it continues to experience budget shortfalls. To address the existing cumulative budget deficit, State’s Code was amended to permit State to issue bonds, described below, in the total amount of $C to finance the State Deficit. State’s director of finance has certified that the State Deficit is $D. State’s constitution was also amended to create an account in the General Fund (the Budget Account) that includes a subaccount (the Subaccount) that will be used to retire the bonds. The amendment requires State’s controller to transfer from the General Fund to the Budget Account on certain dates a specified percentage of the estimated amount of General Fund revenues. The transfers are not required in any fiscal year if the resulting balance in the account would exceed 5 percent of the General Fund revenues estimate set forth in the budget bill for that fiscal year or $E, whichever is greater. Over the bonds’ term, $E may exceed 5 percent of the General Fund revenues estimate. Funds transferred to the Budget Account are deemed to be General Fund revenues.

The transfers to the Budget Account may be suspended or reduced for a fiscal year as specified by an executive order issued by the governor no later than Date 5 of the preceding fiscal year. However, State represents that it is reasonably expected that the governor would only act to suspend or reduce the transfers if there were a projected shortfall in the General Fund for the upcoming fiscal year and any suspended amount would be needed to cover the projected shortfall. A projected shortfall in the upcoming fiscal year could include a budget shortfall occurring in the current fiscal year

Of the money transferred to the Budget Account in each fiscal year, 50 percent, up to a total amount of $F for all fiscal years will be deposited in the Subaccount. Money in this Subaccount will be continuously appropriated to the Treasurer to be used to retire the bonds. In the event any transfer to the Budget Account is suspended or reduced in any fiscal year, the transfer from the Budget Account would be suspended or similarly reduced for that fiscal year.

Bonds Issued

State has issued three series of bonds. On Date 6, State issued Series 1 and Series 2 Bonds. On Date 7, State issued the Series 3 Bonds (together with the Series 1 Bonds and Series 2 Bonds, the “Bonds”). All three series of Bonds have a term of approximately G years, which is longer than two years. State represents that the term of the Bonds is necessary in light of the long-term financial distress it has experienced and reasonably expects to continue experiencing. Based on current fiscal year cash flows for the General Fund, State estimates that it will continue to have ongoing deficits in its General Fund.

The proceeds of the Bonds were deposited in the General Fund and immediately allocated to the payment of a portion of the State Deficit which included the remaining principal amount of the Obligations and Notes, and to the payment of working capital expenditures arising after the Bonds were issued. State represents that by Date 8, approximately two months after the Bonds were issued, using a “proceeds spent last method” of expenditure under § 1.148-6(d)(3) all of the proceeds of the Bonds were spent and there was a zero balance in the General Fund, the Special Fund and the Budget Account.

The Bonds are payable from and secured by a pledge of amounts on deposit in a newly created fund (the Fund) within the State Treasury which consists primarily of the net proceeds of special sales tax revenues. The special sales tax revenues are amounts collected by State from proceeds of a new statewide tax on retailers for the sale of all tangible personal property sold at retail within State and an excise tax imposed by State on the storage, use or other consumption in State of tangible personal property purchased from any retailer. Amounts deposited in the Fund are not available for any other purpose other than payment of the principal, interest, premium, if any, and replenishment of reserves of the Bonds. State law provides that special sales tax revenues deposited in the Fund do not constitute General Fund revenues and amounts held in the Fund may not be borrowed by, or be available for transfer to, the General Fund.

Under the Master Indenture, the special sales tax revenues collected are deposited into various accounts within the Fund to fund debt service on the Bonds. Any surplus special sales tax revenues in excess of those needed for scheduled debt service payments are deposited into a supplemental redemption account. The Master Indenture requires the State Treasurer to transfer money from the supplemental redemption account into a redemption fund which must be applied for the redemption, purchase or defeasance of the Bonds. The Master Indenture also provides that any money received by State from the Subaccount will be deposited in a redemption fund and applied to the redemption, purchase, or defeasance of the Bonds.

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(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 § 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of an 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)(1) provides that amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in § 1.148-1(c)(4), to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the 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 § 1.148-10. Replacement proceeds are created under § 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 1.148-1(c)(4)(i)(B)(1) provides, as a safe harbor, that replacement proceeds do not arise under § 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.

Section 1.148-10(a)(1) provides that bonds of an issue are arbitrage bonds under § 148 if an abusive arbitrage device under § 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 § 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 §§ 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 § 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)(ii)(A) provides that except as otherwise provided § 1.148-1(c)(4)(ii)(B), replacement proceeds arise to the extent a working capital reserve is, directly or indirectly financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund a working capital reserve, the issuer will have replacement proceeds. To determine the amount of a working capital reserve maintained, an issuer may use the average amount maintained as a working capital reserve during annual periods of at least 1 year, the last of which ends within 1 year before the issue date. For example, the amount of a working capital reserve may be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (net of unexpended gross proceeds) during the 1 year period preceding the issue date.

Section 1.148-1(c)(4)(ii)(B) provides that replacement proceeds do not arise under paragraph (c)(4)(ii)(A) of the section with respect to an issue (1) all of the net proceeds of which are spent within 6 months of the issue date under section 148(f)(4)(B)(iii)(I); or (2) that is not subject to the rebate requirement under the exception provided by section 148(f)(4)(D).

Section 1.148-6(d)(3)(i) provides that, except as otherwise provided in § 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 § 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 § 1.148-1(c)(4).

Section 1.148-6(d)(3)(iii)(A) 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.

Section 1.148-6(d)(3)(iii)(B) provides that a reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

Initially, we note that the Bonds do not meet the safe harbor against replacement proceeds under § 1.148-1(c)(4)(i)(B)(1), because the term of the Bonds is longer than 2 years. We must decide whether the Bonds will be outstanding longer than is reasonably necessary for the governmental purposes of the issue and whether there will be available amounts in the State’s General Fund, Special Fund and Budget Account during a period that the Bonds are outstanding longer than necessary. Whether bonds are outstanding longer than is reasonably necessary for the governmental purpose of the issue is determined under § 1.148-10 and is based on a weighing of factors.

The governmental purpose of the Bonds is to fund a portion of the State Deficit which includes paying the remaining principal amount of the Obligations, Notes, and working capital expenditures arising after the Bonds were issued. State represents that it has experienced and reasonably expects to continue experiencing severe long-term financial distress. Based on current fiscal year cash flows for the General Fund, State estimates that it will continue to have ongoing cash flow deficits in its General Fund. Issuing the Bonds with the term of approximately G years provides State with a reasonable and affordable debt service expense over the term of the Bonds which takes into account State's severe economic situation.

State has mechanisms in place that provide for the early retirement of the Bonds should State's financial situation improve during the years the Bonds are outstanding. The Master Indenture requires that any excess special sales tax revenues remaining after scheduled payments of principal and interest on the Bonds are made must be applied on an annual basis to the redemption, purchase, or defeasance of the Bonds. The Master Indenture also provides that the money in the Subaccount must be applied to the redemption, purchase, or defeasance of the Bonds. It is expected that suspension or reduction of transfers from the General Fund to the Budget Account and hence to the Subaccount will only occur if there is a projected shortfall in the General Fund for the upcoming fiscal year and any suspended amount would be needed to cover the projected shortfall.

Accordingly, considering all the facts and circumstances, the Bonds will not be outstanding longer than reasonably necessary for the governmental purpose of the issues.

State acknowledges that in the future there may be available amounts because amounts in the Budget Account alone could reach the greater of E or 5 percent of the estimated General Fund revenues for the current year. However, since we conclude that the term of the Bonds is not outstanding longer than is necessary to accomplish the governmental purposes of the issues, we find that amounts in the General Fund, the Special Fund and the Budget Account will not result in "other replacement proceeds" within the meaning of § 1.148-1(c)(4)(i).

We must also decide whether working capital replacement proceeds will arise under § 1.148-1(c)(4)(ii) because a working capital reserve is financed with the proceeds of the Bonds. Section 1.148-1(c)(4)(ii)(A) provides that replacement proceeds arise to the extent that a working capital reserve is directly or indirectly, financed with proceeds of the issue. Since by Date 8, all of the proceeds of the Bonds were spent and there was a zero balance in the General Fund, the Special Fund and the Budget Account, the Bonds will meet the safe harbor under § 1.148-1(c)(4)(ii)(B)(1). Accordingly, we conclude that § 1.148-1(c)(4)(ii) will not cause working capital replacement proceeds to arise with respect to the Bonds.

Conclusion:

Based on all the facts and circumstances, we conclude that amounts, if any, in the State's General Fund, Special Fund and Budget Account, if any, will not be treated as "other replacement proceeds" of the Bonds within the meaning of § 1.148-1(c)(4).

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 Bonds 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: ______________________________
Timothy L. Jones
Senior Counsel, Tax Exempt Bond Branch