



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Qualified Redevelopment Bond

This Field Service Advice responds to your memorandum dated July 8, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

- Year 1 =
- Year 2 =
- City =
- Authority =
- State =
- Date 1 =
- Bonds =

- Building =
- Lender =
- \$a =
- \$b =
- \$c =
- \$d =
- \$e =

ISSUES:

1. Whether tax-exempt bond proceeds deposited in a fund established at the requirement of a third party lender are spent, thereby precluding the issuer from using such proceeds to satisfy the requirement that 95 percent of the net proceeds be expended for qualified redevelopment activities.
2. Whether the term redevelopment activities, as used in section 1317(6) of the Tax Reform Act of 1986, differs from the term redevelopment purposes as used in I.R.C. § 144(c)(3)(A).

CONCLUSION:

1. Proceeds deposited in the fund were not spent within the meaning of the allocation and accounting rules for tax-exempt bonds because the proceeds remain invested and were not used for a governmental purpose of the issue. However, the current information suggests that the 95 percent spending requirement has not been met.
2. The term redevelopment activities as used in section 1317(6) of the Tax Reform Act of 1986 does not differ from the term redevelopment purposes as used in I.R.C. § 144(c)(3)(A).

FACTS:

In Year 1, City created the Authority as an urban renewal authority under State statute. Authority is a corporate body authorized to exercise governmental powers in planning and implementing redevelopment projects. In Year 2, Authority engaged in an urban renewal project for the stated purpose of renovating an area in downtown City and stimulating the growth and development of City's business district.

On Date 1, Authority issued its Bonds in the amount of \$a to finance redevelopment of the Building, located in a designated blighted area of City. Approximately \$b of proceeds from the Bonds were deposited in a reserve fund for the issue.

As part of the redevelopment plan for the Building, Authority borrowed \$c from Lender. Lender is an unrelated, quasi-governmental state agency. As a condition of the loan, Authority and Lender entered into an agreement which required that proceeds in the amount of \$d be placed in an operating reserve fund. The agreement between Authority and Lender states that such fund is to be under

the control of Lender. With Lender's approval, Authority may withdraw money from the fund to reimburse itself for reasonable expenses incident to the operation of the development. In addition, Lender may direct that all or any portion of the balance in the operating reserve fund be applied as a prepayment of the loan or other development related purpose. However, provided Authority is not in default under the loan, Lender shall allow the organization to maintain sufficient funds in the operating reserve fund to operate the development in a proper fashion.

The proceeds in the operating reserve fund purportedly have not been withdrawn, and the account is earning interest. Authority has represented it will request that Lender release approximately \$e of the proceeds for use in the redevelopment of the Building. The release and expenditure of an additional \$e would purportedly result in 95 percent of the net proceeds of the Bonds being spent on the redevelopment of the Building.

Authority filed a Form 8038 for the Bonds identifying the bonds as tax increment revenue bonds that were issued pursuant to transitional rule section 1317(J)(6) of the Tax Reform Act of 1986.

LAW AND ANALYSIS:

1. Deposit In Operating Reserve Fund

The Bonds purportedly were issued pursuant to section 1317(6)(J) of the Tax Reform Act of 1986 ("the '86 Act"). That section provides that a bond issued as part of an issue, 95 percent or more of the net proceeds of which are to be used to finance redevelopment activities as part of a project within a specific designated area, shall be treated as a qualified redevelopment bond for purposes of part IV of subchapter B of chapter 1 of the 1986 Code if-

(i) with respect to such project the city council adopted on December 16, 1985, an ordinance directing the urban renewal authority to study blight and produce an urban plan,

(ii) the blight survey was accepted and approved by the urban renewal authority on March 20, 1986, and

(iii) the city planning board approved the urban renewal plan on May 7, 1986.

The aggregate face amount of bonds to which this transitional rule applies shall not exceed \$60,000,000.

Section 1318(5) of the '86 Act states that the term "net proceeds" has the meaning given such term by I.R.C. § 150(a). Pursuant to that section, the term "net proceeds" means, with respect to any issue, the proceeds of such issue reduced by amounts in a reasonably required reserve or replacement fund. I.R.C. § 150(a)(3).

The primary question here is whether the deposit in the operating reserve fund, coupled with other issuance costs, causes the bonds to fail to meet the 95 percent requirement of section 1317(6)(J) of the '86 Act. Such a result would be premised on a determination that the entire amount deposited in the operating reserve account was "spent" and cannot be allocated to qualified redevelopment activities. The question of whether bond proceeds are considered spent is best addressed by the allocation and accounting rules.

Because the Bonds were issued after June 17, 1992, they are subject to the allocation and accounting rules set forth in section 1.148-4 of the 1992 regulations.¹ Under Treas. Reg. § 1.148-4(a)(1), an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds of an issue. Gross proceeds of an issue may be allocated to expenditures pursuant to any reasonable, consistently applied accounting method. Treas. Reg. § 1.148-4(d)(1)(i). Further, an allocation of gross proceeds of an issue to an expenditure must involve a reasonably current outlay of cash and must carry out a governmental purpose of the issue. Thus, an investment in a nonpurpose investment is not an expenditure. Treas. Reg. § 1.148-4(d)(1)(ii). The basic objective of this and similar rules under the current regulations is to subject bond proceeds to the arbitrage rules until the proceeds have been spent for a valid purpose of the issuance.

There does not appear to be a dispute as to whether proceeds of the Bonds remain invested in the operating reserve fund. Furthermore, the proceeds have not been spent for a governmental purpose. Therefore, under the applicable allocation and accounting rules, the proceeds are unspent and remain subject to arbitrage restrictions.

We recognize there is a concern that the proceeds in the operating reserve fund, while treated as unspent for allocation and accounting purposes, are beyond Authority's reach and cannot be spent on qualified redevelopment activities. Under that scenario, Authority would be unable to meet the spending requirement of section 1317(6)(J). Based on the information submitted, approximately \$e must be released and expended on qualified redevelopment activities to meet the 95 percent requirement of the transitional rule.

¹ Treas. Reg. § 1.148-6 contains the current allocation and accounting rules.

While the loan agreement provides that the fund is under the control of Lender, there are provisions under which Authority may use proceeds in the fund. For example, the terms of the agreement state that Lender shall allow the Authority to maintain funds to operate the development in a proper fashion. From the information provided, however, the circumstances under which Authority may use proceeds in the operating reserve fund are unclear. [REDACTED]

2. Redevelopment Activities/Redevelopment Purposes

As discussed above, section 1317(6)(J) of the '86 Act provides that a bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to finance redevelopment activities as part of a project within a specific designated area shall be treated as a qualified redevelopment bond. Section 144(c)(1), however, provides that the term qualified redevelopment bond means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used for 1 or more redevelopment purposes in any designated blighted area. You have requested advice as to whether the use of the term "redevelopment activities" in section 1317(6)(J) differs from the term "redevelopment purposes" as used in section 144(c).

Section 1317 does not provide a definition of the term redevelopment activities. For purposes of section 144(c), the term redevelopment purposes means, with respect to any designated blighted area-

(i) the acquisition (by a governmental unit having the power to exercise eminent domain) of real property located in such area,

(ii) the clearing and preparation for redevelopment of land in such area which was acquired by such governmental unit,

(iii) the rehabilitation of real property located in such area which was acquired by such governmental unit, and

(iv) the relocation of occupants of such real property.

The term redevelopment purposes does not include the construction (other than the rehabilitation) of any property or the enlargement of an existing building. I.R.C. § 144(c)(3).

We do not see a distinction between the use of the term redevelopment activities as used in section 1317(6) of the '86 Act and the use of the term redevelopment purposes as used in section 144(c). In fact, the legislative history of the '86 Act, which added section 144(c) as well as the transitional rule in issue, uses the terms interchangeably. H.R. Rep. No. 99-426, at 542 (1986); Sen. Rep. No. 99-313, 837 (1986). Accordingly, reliance on section 1317(6)(J) does not permit Authority to use Bond proceeds for a broader category of activities than those enumerated in section 144(c) or discussed in the legislative history of the '86 Act.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As concluded above, the amounts deposited in the operating reserve fund have not been spent for purposes of the allocation and accounting rules. [REDACTED]

If additional facts establish that the proceeds in the operating reserve fund are beyond Authority's reach, the Authority may be unable to meet the applicable spending requirements. The Bonds, as a result, would be taxable. [REDACTED]

Although Authority may negotiate for the release of sufficient funds to satisfy section 1317(6)(J), the fact that proceeds remain unspent nearly seven years after the Bonds were issued invites inquiry as to whether other requirements for tax-exempt bonds have been met. For example, I.R.C. § 149(g) provides that section 103(a) shall not apply to any hedge bond unless, with respect to the issue of which such bond is a part, the issuer reasonably expects that 85 percent of the spendable proceeds will be spent for a governmental purpose within 5 years of the bond's issuance date. Section 149(g)(2) provides the specific times by which certain percentages of the proceeds must be spent. Section 149(g)(3) generally defines a hedge bond as any bond issued as part of an issue unless (i) the issuer reasonably expects that 85 percent of the spendable proceeds of the issue will be used to carry out the governmental purposes of the issue within the 3-year period beginning on the date the bonds are issued, and (ii) not more than 50 percent of the proceeds

of the issue are invested in nonpurpose investments (as defined in section 148(f)(6)(A)) having a substantially guaranteed yield for 4 years or more.

[REDACTED]

In addition to the hedge bond considerations discussed above, please be aware of potential overissuance questions where bond proceeds remain unspent long after issuance. Under former Treas. Reg. § 1.103-13(j)², bonds may be taxable arbitrage bonds if there is a deliberate overissuance of bonds. This includes the sale of more obligations than necessary to accomplish the governmental purpose of the issuance. Current regulations provide additional guidance for identifying an overissuance. For example, Treas. Reg. § 1.148-10(a)(4) states that 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 (as defined in section 148(e)) 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. We mention the overissuance rules merely as a potential issue, however. The current facts would not support a determination that Authority engaged in a deliberate overissuance. Such determinations are factually sensitive and generally involve substantial litigation hazards.

[REDACTED]

[REDACTED] Section 148(d) limits the size of a reasonably required reserve or replacement fund to 10 percent of proceeds of the issue. This section does not require that a reserve fund secure the bond issue the proceeds of which fund the reserve fund. Rather, the use of bond proceeds for any reserve or replacement fund in excess of that permitted will cause the bonds to be arbitrage bonds. I.R.C. § 148(d)(2).

Neither the Code nor the regulations provide a definition of a reserve fund. There is also no definition of the term in the legislative history of this provision. However, the common meaning of a reserve fund includes a fund held by a trustee to provide security to bondholders in the event of an unexpected expense or unforeseen occurrence causing an interruption in the flow of revenues used to pay

² Section 1.148-9(g) of the 1992 regulations states that section 1.103-13(j) applies for purposes of section 148 generally.

principal or interest on the bonds. In general, a reserve fund must be reasonably expected to be available to pay debt service on bonds. This reasonable expectation is generally met if covenants in bond documents require a fund to be maintained as security for bonds.

As stated, Authority established a reserve fund for the issue in the amount of \$b. If the amount deposited in the operating reserve fund was established as a reserve or replacement fund, the aggregate of the two funds would exceed the size limitations of section 148(d).

Please call if you have any further questions.

By: _____
CAROL P. NACHMAN
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cc: Martha Sullivan
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