

Internal Revenue Service

Department of the Treasury

Number: **200116004**
Release Date: 4/20/2001
Index Number: 148.00-00, 148.02-01

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:TEB-PLR-114781-00
Date:

December 5, 2000

Legend:

City =

Bonds =

Authority =

State =

River =

Commission =

Date 1 =

Date 2 =

Date 3 =

A =

B =

C =

D =

E =

F =

G =
H =
K =
L =
M =
N =
O =
P =

Dear :

This letter is in response to your request on behalf of the City for a ruling that the interest on the Bonds will be excluded from gross income under § 103 of the Internal Revenue Code (the "Code"). This letter ruling was submitted as a letter ruling subject to review under the declaratory judgment provisions of § 7478.

FACTS AND REPRESENTATIONS

The City has represented that the following facts are true and correct.

In State, water is a limited resource. Persons wishing to use the available surface water must obtain a certificate of adjudication or a permit from the Commission. A certificate of adjudication or a permit grants the holder a "run of the river" right to a specified amount of water per year. A holder of a run of the river right may divert and use water under the right only when the water is available from the natural flow. If there is insufficient water to supply all persons holding permits or certificates, such as during a drought, priority is given according to the date the rights were acquired.

Persons can also obtain a right to a supply of "firm water." A firm water right is a right to a supply of stored water that is drawn from the combined firm yield of a reservoir system. A firm water right to divert water from a reservoir system is a more certain source of water than water secured only by a run of the river water right. Holders of run of the river rights often ensure their water needs are met by purchasing firm water rights.

The City is a political subdivision of the State. Among other things, the City provides water to residential and commercial customers.

The Authority is a State created entity authorized to control, store, distribute, and sell water from the River for various purposes. The Authority operates multiple dams, each of which forms a reservoir. The Authority is the only entity with the right to sell firm water rights from the reservoirs. The Authority is also the only entity with the right to sell firm water rights from the River. The City and the Authority are unrelated.

The City and the Authority each hold certificates of adjudication and/or permits that give them run of the river rights to water in the River. In addition, under an agreement between the Authority and the City, the Authority provided the City with the right to a firm water supply of A acre-feet of water per year. Under the agreement, the City could divert up to the first B acre-feet of water per year without charge. The City was required to pay for any water that the City diverted above B acre-feet per year at the then current rate established for firm water.

The City's population and related water needs have increased rapidly over the past decade. Several studies conducted in the last few years project the City's water needs over the next C years to exceed the amount of water for which the City had firm water rights. In addition, the State recommended that the City plan for a C year supply of water for its citizens. Thus, the City determined that it needed to increase its rights to firm water for the next C to D years to ensure its continued growth and to protect the health of the City's citizens.

On Date 1, the City and the Authority amended their agreement ("the Amendment"). Under the Amendment, the Authority agreed to increase the City's right to a firm water supply by E acre-feet per year (the "Additional Water") for the term of the Amendment, including any renewals, if the City paid a reservation fee (described further below). The City does not expect to use any of the Additional Water for approximately F years. If the City had not made the reservation payment as structured in the Amendment, the City would not have been able to secure the long-term right to the Additional Water.

Under the Amendment, the City continues to receive the first B acre-feet of water per year free of charge. In addition, the City will not pay for any water that the City diverts for certain purposes between B and G acre-feet per year until the City has diverted greater than G acre-feet per year for H consecutive calendar years. For any amount of water that the City diverts greater than G acre-feet per year, and for all water that the City diverts over B acre-feet per year and less than G acre-feet per year after the City has diverted G acre-feet per year for H consecutive years, the City will pay the water rate in effect when the City diverts the water.

Pursuant to the Amendment, the City paid the Authority \$M. The Amendment allocates the \$M payment between two different rights:

- (1) City paid \$N as a reservation fee for the Additional Water (the "Reservation Fee"). This payment reserves for the term of the Amendment and any renewal

the City's right to purchase the Additional Water at the water rate in effect when the City diverts the water. The City has not and will not receive any credit against the purchase price or any other reduction in the rate it must pay for water because it paid the Reservation Fee.

(2) The City paid \$O for all water the City diverts between B and G acre-feet per year until the City diverts more than G acre-feet per year for H consecutive calendar years ("the Prepayment").

The parties allocated the \$M between the Reservation Fee and the Prepayment in proportion to the expected present values of the two rights.

The Amendment provides that the Authority will use the \$M received from the City for improvements to dams and hydroelectric facilities along the River, for the purchase of water rights, for expansion of a particular system, for flood management projects, for water quality and other river management costs, and for other general and administrative costs.

The City's right to the Additional Water is not transferable. While the Amendment contemplates that the Authority, as an agent for the City, may engage in short-term sales of water rights reserved but unused by the City, the City represents that it expects there to be no short-term sales.

The Amendment also provides that every K years the City may elect to reduce the amount of water reserved under the Reservation Fee. Over the course of the Amendment, the City may reduce the Additional Water by a maximum of L acre-feet per year. If the City elects to reduce the Additional Water, the parties will negotiate an offsetting credit based upon the value of water at the time and/or will increase the amount of prepaid water. The City represents that it does not expect to exercise its rights under this provision.

The Amendment extends the agreement until Date 2. The Amendment provides that the City has the right to renew the agreement, as amended, for an additional C years.

Upon execution of the Amendment, the City paid the Authority \$M in cash. On the same day, the City council passed a reimbursement resolution expressing its intent to finance the Reservation Fee with tax-exempt bonds. The resolution meets the official intent requirements of § 1.150-2(e) of the Income Tax Regulations.

On Date 3, the City drew on the City's taxable commercial paper in the amount of \$P (the "Taxable Paper") and used the proceeds of that paper to partially reimburse itself for the payment of the Reservation Fee. Date 3 is within 18 months of Date 1.

Now, the City seeks to issue tax-exempt revenue bonds (the "Bonds") to cover

the cost of the Reservation Fee. The City represents that on the day the Bonds are issued, the Bond proceeds will be used to refund the Taxable Paper and to reimburse itself for any portion of the Reservation Fee not reimbursed by the Taxable Paper. If the Bonds cannot be issued within 18 months of Date 1, the City will use additional taxable commercial paper to reimburse itself for the Reservation Fee within 18 months of Date 1, and will refund that paper with the Bonds.

The Bonds will be valid under State law. While some of the Additional Water will be sold to private business, these sales will not meet the private business tests of § 141. In addition, the Bonds will meet the relevant requirements of § 149. The central issue in this letter is whether the bonds will be arbitrage bonds under § 148.

LAW AND ANALYSIS

Generally, under § 103(a), gross income does not include interest on any state or local bond. Interest on a state or local bond is not excluded from gross income if the bond is an arbitrage bond within the meaning of § 148.

Under § 148(a), an arbitrage bond is,

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.

For purposes of this subsection, a bond shall be treated as 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 paragraph (1) or (2).

A "higher yielding investment" is "any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue." § 148(b)(1).

Section 148(f) provides, in part, that a bond is an arbitrage bond unless the issuer timely rebates to the United States the excess of the amount earned on certain nonpurpose investments over the amount that would be earned on those investments had those investments had a yield equal to the bond yield, plus any income attributable to the excess. A nonpurpose investment is any investment property that is acquired with gross proceeds of an issue and is not acquired to carry out the governmental purpose of the issue. § 148(f)(6)(A).

Section 148(a) and (f) consider whether proceeds of the state or local obligation acquire investment property. Investment property includes investment-type property. § 148(b)(2). Investment-type property includes any property (other than property defined in § 148(b)(2)(A), (B), (C), or (E)) that is held principally as a passive vehicle for the production of income. Production of income includes any benefit based on the time value of money, including the benefit from making a prepayment. § 1.148-1(e)(1), Income Tax Regulations.

Investment-type property includes certain prepayments. Under § 1.148-1(e)(2), unless one of the exceptions in that regulation section applies, a prepayment for property or services gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made.

Proceeds subject to the arbitrage rules include any sale proceeds, investment proceeds, and transferred proceeds of an issue. § 1.148-1(b). Amounts cease to be treated as proceeds under § 148 when they are allocated to an expenditure for a governmental purpose. § 1.148-6(b)(1). Amounts cease to be proceeds of an issue when the proceeds of a reimbursement bond are used for a reimbursement in a manner meeting the requirements of § 1.150-2. Amounts also cease to be proceeds of an issue when they are used to refund another bond.

A reimbursement bond is the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date. § 1.150-2(c). “Original expenditure” means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond. § 1.150-2(c). A nonpurpose investment is not an original expenditure.

A reimbursement allocation is an expenditure for governmental purposes only if (1) not later than 60 days after payment of the original expenditure, the issuer adopts an official intent for the original expenditure that satisfies § 1.150-2(e) (the “official intent requirement”); (2) the reimbursement allocation is made not later than 18 months after the later of the date the original expenditure is paid or the date the project is placed in service, but in no event more than 3 years after the original expenditure is paid (the “time requirement”); and (3) the original expenditure is a capital expenditure, a cost of issuance for a bond, an expenditure described in § 1.148-6(d)(3)(ii)(B) (relating to certain extraordinary working capital items), a grant (as defined in § 1.148-6(d)(4)), a qualified student loan, a qualified mortgage loan, or a qualified veteran’s mortgage loan (the “expenditure requirement”). § 1.150-2(d).

A “capital expenditure” is any cost of a type that is properly chargeable to a capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles. § 1.150-1(b). An extraordinary working capital expenditure item is an expenditure for extraordinary, nonrecurring items that are not customarily payable from

current revenues, such as casualty losses. § 1.148-6(d)(3)(ii)(B).

Generally, the reimbursement rules do not apply to an allocation to pay principal or interest on an obligation. Those allocations are analyzed under the refunding rules. § 1.150-2(g)(1). However, in the case of a refunding issue, proceeds of a prior issue purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was a valid expenditure under applicable law of reimbursement expenditures on the issue date of the prior issue. § 1.150-2(g)(2). The Taxable Paper was issued after the effective date of § 1.150-2.

A refunding issue is an issue of obligations the proceeds of which are used to pay principal, interest or redemption price on another issue. § 1.150-1(d). When proceeds of a refunding issue discharge any of the outstanding principal amount of a prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue. § 1.148-9(b)(1).

In the instant case, the City proposes to issue the Bonds and use some of the proceeds to reimburse itself for the Reservation Fee and the rest of the proceeds (minus issuance costs) to refund the Taxable Paper.

We first consider whether the Bond proceeds not used to refund the Taxable Paper will be used for a reimbursement expenditure under § 1.150-2. The proceeds cannot be allocated to a reimbursement expenditure unless the official intent, time, and expenditure requirements are met. As noted in the facts, the official intent requirement is met. Moreover, the City expects to issue the Bonds in time to meet the time requirement. If the Bonds cannot be issued in time, the City will, within 18 months of Date 1, use taxable commercial paper to reimburse itself for the portion of the Reservation Fee not previously reimbursed, and the City then will use proceeds of the Bonds to refund that paper. We now need to consider whether the expenditure requirement is met. That requirement cannot be met if the Reservation Fee acquired investment property.

The rights acquired by the City when it paid the Reservation Fee most closely resemble investment-type property. Investment-type property includes property that is held principally as a passive vehicle for the production of income, and it includes certain prepayments. § 1.148-1(e). We first consider whether the Reservation Fee is either a prepayment for water or a prepayment for the right to purchase the Additional Water.

The Reservation Fee is not a prepayment for the Additional Water because it did not reduce the City's obligation to pay for any Additional Water. When the City diverts Additional Water, it must pay the then current water rate for the diverted water. Furthermore, the Reservation Fee is not a prepayment for any other water that the City is permitted to divert. Although the Amendment provides that the City will be entitled to divert the first B acre-feet of water per year without cost, this right is not connected to the Reservation Fee. Finally, the Reservation Fee is not a prepayment for water that

the City diverts between B and G acre-feet per year until the City has diverted more than G acre-feet per year for H calendar years; this water is fully paid for by the Prepayment.

The City also did not prepay for its right to purchase the Additional Water. The City needed to obtain a long-term firm water supply to ensure continued community growth and to protect community health. On the day that the City paid the Reservation Fee, it acquired the right to firm water for the next D years. While the City does not expect to use any of the Additional Water for a considerable period of time, the City could not have secured the long-term right to the Additional Water unless it paid the Reservation Fee when it did.

Further, when the City paid the Reservation Fee, the City did not acquire property for it to hold principally as a passive vehicle for the production of income. The rights that the City acquired will not produce income until the City exercises those rights to acquire Additional Water and sells that water to its residents. When the City exercises its rights, it will not be holding those rights in a passive manner. The City's water rights are not transferable and, thus, the City cannot sell those rights. While the Amendment contemplates short-term sales of reserved water that the City does not need, the City expects no short-term sales to occur. Similarly, while the Amendment contemplates that the City could receive a credit if it exercises its right to reduce the amount of Additional Water, even if these credits were sufficient to be considered income from a passive investment, the City does not expect to exercise this right. Moreover, the transaction was not done principally to obtain benefits from the time value of money. The parties first determined through negotiations the payment that City was required to pay the Authority, \$M. Then, time value of money principles were used to determine how to allocate the \$M between the right to the Additional Water and the Prepayment. Thus, the City did not acquire investment property when it paid the Reservation Fee.

The expenditure requirement also requires that the expenditure be of a particular type, such as a capital expenditure or an expenditure described in § 1.148-6(d)(3)(ii)(B) (an extraordinary working capital item). We conclude that the Reservation Fee meets the expenditure requirement. Thus, the reimbursement of the Reservation Fee meets all the requirements of § 1.150-2(d). Consequently, the portion of the Bond proceeds used to reimburse the City for the Reservation Fee will cease to be allocated to the Bonds for purposes of § 148 on the day the Bonds are issued.

We next consider the refunding portion of the Bond issue. Because this portion of the Bond issue will be used to currently refund the Taxable Paper, we must consider whether the proceeds of the Taxable Paper are spent. The proceeds of the Taxable Paper were used to reimburse the City for at least a portion of the Reservation Fee. These proceeds are not spent unless the reimbursement rules of § 1.150-2 are satisfied.

As noted above, the official intent requirement is met. Moreover, the City has reimbursed, or will reimburse, itself for the Reservation Fee in time to meet the time

requirement. Finally, for the reasons noted above, the expenditure requirement is met. Thus, the proceeds of the Taxable Notes were spent when those notes were issued and there are no proceeds to transfer to the Bonds upon refunding.

CONCLUSION

Based on the representations made by the City, we conclude that interest on the Bonds will be excluded from gross income.

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. This office has not verified any of the material submitted in support of the request for rulings.

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) 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 the taxpayer.

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

cc: