

Internal Revenue Service

Department of the Treasury

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Legend

- Authority =
- Act =
- City =
- State =
- Notes =
- Bonds =
- Year =
- Date =
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Dear:

This letter is in response to your request on behalf of the Authority for rulings that:

1. The operating expenses to be paid with proceeds of the Notes are described in § 1.148-6(d)(3)(ii)(B) of the Income Tax Regulations, and therefore, are not subject to the proceeds-spent-last method of accounting set forth in § 1.148-6(d)(3)(i); and

2. The net sale proceeds and investment proceeds of the Notes qualify for the 3-year temporary period under § 1.148-2(e)(2)(i) and may be invested in higher yielding investments during such period without causing the

Notes to be arbitrage bonds within the meaning of § 148 of the Internal Revenue Code.

FACTS AND REPRESENTATIONS

The Authority was created in Year 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. 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).

On Date, * * * occurred in the City, * * * (the "Occurrence"). * * *

In response to the Occurrence, the legislature of the State amended the Act to permit the Authority to issue \$a of its bonds and notes to pay * * * (the "Recovery Project").

The Congress enacted emergency supplemental legislation to appropriate funds for various purposes related to and in response to the Occurrence * * *. A substantial portion of the federal assistance under such legislation requires further authorization by Congress. Moreover, there has not been a determination of which costs of the Recovery Project will be provided for with the federal assistance and when the City will receive such federal assistance.

The City has neither established any reserves nor set aside other available amounts for the Recovery Project. The City's costs of the Recovery Project are not covered by any insurance policies held by the City.

The Authority proposes issuing the Notes pursuant to the Act and an indenture, as amended and supplemented (the "Indenture"). The Notes will bear interest at a fixed rate and will mature no later than 13 months after their date of issuance. The proceeds of the Notes will be applied to pay for the costs of the Recovery Project that have not otherwise been paid for through the expected federal assistance. As of the issue date of the Notes, it will not be possible to determine the amount of proceeds that will be expended for capital expenditures and the amount for operating expenses. As a result, the proceeds of the Notes will be deposited into a single fund and spent on permitted expenditures under the Act as needed for the Recovery Project.

The Notes are payable from (1) the proceeds of the Bonds, which the Authority expects to issue pursuant to the Indenture prior to the maturity of the Notes, (2) renewal notes, and (3) revenues from certain income and sales tax revenues of the City (the "tax revenues"). The Authority reasonably expects the tax revenues to be sufficient to pay, when due, the interest on and the maturing principal of the Notes.

The City reasonably expects that: (1) it will allocate at least 85 percent of the net sale proceeds of the Notes on the Recovery Project within three years of the issue date of the Notes; (2) it has incurred or will incur within six months of the issue date of the Notes substantial binding obligations to spend at least five percent of the net sale proceeds of the Notes on the Recovery Project; and (3) it will proceed to complete the Recovery Project and to allocate the net sale proceeds of the Notes to expenditures with due diligence.

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 § 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. A bond is 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 (1) or (2).

Section 148(c) provides that a bond shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such bond is a part may be invested in higher yielding investments for a reasonable temporary period until such proceeds are needed for the purpose for which such issue was issued.

Section 1.148-2(e)(1) provides that during the temporary periods set forth in § 1.148-2(e), the proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds.

Section 1.148-2(e)(2)(i) provides that the net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of three years beginning on the issue date (the "3-year temporary period"). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. The expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period. The time test is met if the issuer incurs within six months of the issue date a substantial binding obligation to a third party to expend at least five percent of the net sale proceeds of the issue on the capital projects. An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control. The due diligence test is met if completion of the capital projects and the allocation of net sale proceeds of the issue to expenditures proceed with due diligence.

Section 1.148-1(b) defines capital project or capital projects as all capital expenditures, plus related working capital expenditures to which the de minimis rule under § 1.148-6(d)(3)(ii)(A) applies, that carry out the governmental purposes of an issue. For example, a capital project may include capital expenditures for one or more buildings, plus related start-up operating costs.

Section 1.148-2(e)(3)(i) provides that the proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Section 1.148-1(b) defines restricted working capital expenditures as working capital expenditures that are subject to the proceeds-spent-last rule in § 1.148-6(d)(3)(i) and are ineligible for any exception to that rule.

Section 1.148-2(e)(7) provides that gross proceeds not otherwise eligible for a temporary period described in § 1.148-2(e) qualify for a temporary period of 30 days beginning on the date of receipt.

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) 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)(ii)(B) provides that § 1.148-6(d)(3)(i) 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.

Section 1.148-10(g) provides that, notwithstanding any provision in §§ 1.148-1 through 1.148-11, the Commissioner may prescribe extensions of temporary periods,

larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under § 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or similar circumstances so warrant, consistent with the purposes of § 148.

We conclude that the operating expenses to be paid with proceeds of the Notes are described in § 1.148-6(d)(3)(ii)(B), and therefore, the proceeds of the Notes allocated to such expenses are not subject to the proceeds-spent-last method of accounting set forth in § 1.148-6(d)(3)(i). In accordance with the Act, the proceeds of the Notes may only be spent on expenses related to or arising from the Occurrence. Thus, the operating expenses to be paid from proceeds of the Notes are extraordinary, nonrecurring items that are not of the type which the City would pay from current revenues. Further, the City has neither established any reserves nor set aside other available amounts for the Recovery Project, and the City's costs of the Recovery Project are not covered by any insurance policies held by the City.

We believe the application of § 1.148-10(g) is appropriate under the facts and circumstances surrounding the Occurrence, and therefore, we conclude the net sale proceeds and investment proceeds of the Notes qualify for the 3-year temporary period for capital projects under § 1.148-2(e)(2)(i) and may be invested in higher yielding investments during such period without causing the Notes to be arbitrage bonds within the meaning of § 148.

Only a portion of the Recovery Project is a capital project within the meaning of § 1.148-1(b). However, all of the expenditures incurred for the Recovery Project are part of a single response to the damage caused by the Occurrence. The Act authorizes the Authority to issue bonds to pay for expenditures related to the Occurrence without distinction as to whether the expenses are capital expenditures or operating expenses. As of the issue date of the Notes, it will not be possible to determine the amount of proceeds that will be expended for capital expenditures and the amount for operating expenses. As a result, the proceeds of the Notes will be deposited into a single fund and spent on permitted expenditures under the Act as needed for the Recovery Project. With respect to the proceeds of the Notes as a whole, the Authority reasonably expects to satisfy the requirements (other than the requirement that proceeds be spent for capital projects) for the 3-year temporary period under § 1.148-2(e)(2)(i).

CONCLUSIONS

Based on the information submitted and representations made, we conclude that:

1. The operating expenses to be paid with proceeds of the Notes are described in § 1.148-6(d)(3)(ii)(B), and therefore, are not subject to the proceeds-spent-last method of accounting set forth in § 1.148-6(d)(3)(i); and

2. Under the authority of § 1.148-10(g), the net sale proceeds and investment proceeds of the Notes qualify for the 3-year temporary period under § 1.148-2(e)(2)(i) and may be invested in higher yielding investments during such period without causing the Notes to be arbitrage bonds within the meaning of § 148.

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

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 Authority's authorized representative.

Sincerely yours,
Assistant Chief Counsel (Exempt
Organizations/Employment Tax/Government
Entities)
By: Bruce M. Serchuk
Senior Technician Reviewer
Tax Exempt Bond Branch