

## Internal Revenue Service

Department of the Treasury

Number: **200338004**  
Release Date: 09/19/2003  
Index Number: 148.01-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:TEB/PLR-116322-03

Date:

June 16, 2003

### LEGEND:

Issuer =

State =

Commission =

Bonds =

Date 1 =

a =

b =

Dear :

This is in response to your request for a ruling that bonds (the "Bonds") to be issued to finance certain costs of constructing, renovating, improving, equipping, furnishing, and demolishing public school facilities (the "Project"), will not be "hedge bonds" under §149(g)(3) of the Internal Revenue Code, and, consequently, that § 149(g) does not preclude the exclusion of interest on the Bonds from gross income under § 103(a).

### **Facts and Representations**

You make the following factual representations. Issuer is a city school district created under State law and a political subdivision of State for purposes of § 103, and is

authorized by State law to issue bonds.

The Project is a district-wide construction program undertaken by Issuer, with State financial assistance, to bring its public school facilities into compliance with State standards. The Project is one of a number of projects in State to modernize public school facilities, all of which will have State-financed assistance. Nearly every school building which Issuer has is in need of full modernization or replacement. As an extensive undertaking in terms of construction resources, students effected, and management issues, the Project will require a time period that exceeds the average public works project.

Issuer estimates that the Project will take approximately 10 years to complete and will cost approximately \$a, approximately \$b (53 percent) of which will be provided by State. A resolution approving the issuance of the proposed Bonds was passed by Issuer on Date 1. The proceeds of the Bonds will be used to pay for a portion of the costs of the Project that are to be funded by Issuer.

Issuer and Commission, acting on behalf of State, have approved a plan (the "Master Plan") for the Project as required by State law in order to receive financial assistance from State. The Master Plan divides the Project into four separate segments. Under State law, State funding must be paid in installments for each of the four segments of the Project. Before State will authorize funding for its share of the cost of a Project segment, Issuer must have available funds in an amount sufficient to pay for its share of the cost for that segment. State law requires that State's financial assistance (the "State match") must be spent on those qualified Project costs described in the Master Plan on a pro rata basis with the Issuer's contribution for such costs. Issuer represents that all funds constituting the State match, along with all proceeds of the Bonds, will be used by Issuer to complete the Project.

Issuer has determined that it should issue the Bonds as early as possible. Funding for the State match is a priority under State law. Nevertheless, the status of funding for the State match in future years is very uncertain. In the event that State fails to meet its matching fund obligations for school districts in State, State law provides that a school district that has already qualified to receive the State match for its co-funded projects is to be given priority for State funds over other school districts.

For all purposes of § 148, Issuer represents that it will allocate funds from different sources for the same governmental purpose to expenditures using the "gross proceeds spent first" allocation method permitted under § 1.148-6(d)(1)(i) of the Income Tax Regulations. All proceeds of the Bonds will thus be allocated to Project expenditures prior to allocating any other funds to Project expenditures, including the payments received from the State for the State match. Using this allocation method to allocate Bond proceeds to Project expenditures, Issuer reasonably expects to allocate more than 85 percent of the spendable proceeds of the Bonds to Project expenditures within three years from the issue date of the Bonds.

Issuer represents that not more than 50 percent of the proceeds of the Bonds will be invested in nonpurpose investments having a substantially guaranteed yield for four years or more.

Issuer also represents that the weighted average maturity of the Bonds will not exceed 120 percent of the reasonably expected economic life of that portion of the Project to be financed with the proceeds of the Bonds (determined in the same manner as under § 147(b)).

### **Law and Analysis**

Section 149(g)(1) provides that § 103(a) shall not apply to any hedge bond unless, with respect to the issue of which such bond is a part, the requirements of §§ 149(g)(2) and 149(f)(3) are met.

Section 149(g)(3) defines a hedge bond generally 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 § 148(f)(6)(A)) having a substantially guaranteed yield for 4 years or more.

Section 1.149(g)-1(a) provides that, except as otherwise provided, the definitions set forth in § 1.148-1 apply for purposes of § 149(g) and [§ 1.149(g)-1].

Section 1.149(g)-1(b) provides that § 1.148-6 applies for purposes of § 149(g), except that an expenditure that results in the creation of replacement proceeds (other than amounts in a bona fide debt service fund or a reasonably required reserve or replacement fund) is not an expenditure for purposes of § 149(g).

Section 1.148-1(c)(1) provides in part that amounts are replacement proceeds of an issue if they 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.

Section 1.148-1(c)(4)(i)(A) provides in part that replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that the term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue.

Section 1.148-1(c)(4)(i)(B)(2) provides that as a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of [§ 1.148-1], for the portion of an issue (including a refunding issue) that is to be used to finance or refinance capital projects, if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined

in the same manner as under § 147(b).

Section 1.148-6(a)(1) provides that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.

Section 1.148-6(a)(2) provides that an accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special state law restrictions imposed on specific funds or actions to avoid grant forfeitures.

Section 1.148-6(d)(1)(i) provides that reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

Issuer has represented that (i) it reasonably expects to use the gross proceeds spent first allocation method to allocate more than 85 percent of the spendable proceeds of the Bonds to Project expenditures within three years from the issue date of the Bonds, and (ii) not more than 50 percent of the proceeds of the Bonds will be invested in nonpurpose investments having a substantially guaranteed yield for four years or more. The Bonds will thus not be hedge bonds under § 149(g)(3), provided that replacement proceeds are not created by these expenditures of Bond proceeds. See § 1.149(g)-1(b).

In this case, the only other funds with a nexus to the Project are the funds provided by the State match. However, all funds constituting the State match, along with all proceeds of the Bonds, will be used by Issuer to complete the Project. The Bond proceeds will not be spent on Project costs in lieu of spending the State match, but rather in addition to spending the State match. Because all funds constituting the State match will be used for the governmental purpose, those funds are not replacement proceeds of the Bonds within the meaning of § 1.148-1(c)(1). This result is not changed because the State match must be spent on qualified Project costs on a pro rata basis with Issuer's payments.

Issuer has adopted the gross proceeds spent first accounting method for purposes of allocating Bond proceeds to Project expenditures, as allowed under § 1.148-6(d)(i). Pursuant to § 1.148-6(a)(1), Issuer represents that it will consistently apply this accounting method. An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Under § 1.148-6(a)(2), bona fide governmental purposes may include restrictions imposed on specific funds, such as the State law requiring pro rata expenditures of the State match.

**Conclusion**

Under the facts and circumstances of this case, we conclude that the Bonds will not be hedge bonds under §149(g)(3).

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 a ruling, 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.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

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

By: \_\_\_\_\_  
Timothy L. Jones  
Senior Counsel, Tax Exempt Bond Branch

cc: