

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200413010**
Release Date: 03/26/2004
Index Number: 103.02-00

Person To Contact:
 , ID No.
Telephone Number:

In Re:

Refer Reply To:
CC:TEGE:EOEG:TEB - PLR-161592-03
Date:
December 11, 2003

Legend:

State=

Warrants=

Registered
Warrants =

a=

b=

\$X=

\$Y=

Obligations=

Notes=

PLR-161592-03

Date 1=

Date 2=

Date 3=

Date 4=

Year 1 =

Year 2=

Dear

This letter is in response to your request on behalf of the State for a ruling that the Registered Warrants will be “obligations” of the State for purposes of § 103 of the Internal Revenue Code.

Facts and Representations:

The State is facing a shortfall in cash available for normal working capital payments. To meet the shortfall the State issued approximately \$X in Obligations on Date 1 under applicable State law. The Obligations mature on Date 3. The State anticipates having sufficient money to repay these Obligations. To enhance the marketability and reduce the cost of the Obligations, the State entered into forward purchase warrant agreements with broker-dealers and commercial banks (the “Participants”) under which the Participants agreed to purchase “Warrants” from the State at the maturity of the Obligations if the State had insufficient funds to pay the Obligations. These Warrants were the subject of a prior ruling (PLR 200336004). The prior ruling provided that the Warrants will be “obligations” of the State for purposes of § 103.

The State represents that proceeds of the Obligations were in a sufficient amount to cover the State’s cash management needs in the beginning months of Year 2 but that expected cash receipts will be less than expected cash expenditures of the State during the remainder of that year by at least \$Y. To cover the expected additional shortfall, the State issued Notes on Date 2 that mature on Date 4. The State anticipates having sufficient money to repay these Notes. However, to enhance the marketability of the Notes and reduce their cost, the State entered into letter of credit and loan agreements (the “Agreements”) with commercial banks (the “Banks”), under which the Banks agreed

PLR-161592-03

to provide letters of credit to secure the payments on maturity of the Notes. If the letters of credit are drawn upon and not immediately repaid by the State because the State has insufficient funds, the State will issue the Registered Warrants which will be delivered to the Banks for the unreimbursed draws. Some Notes were issued without credit enhancement (the “Unenhanced Notes”). If the State does not have sufficient cash resources to pay the Unenhanced Notes at maturity, the holders of the Notes also will receive a Registered Warrant.

Each Registered Warrant will specify the principal amount that the State must repay to holders of the Registered Warrants and also will bear interest at a variable rate that will be a percentage of a market index. The Registered Warrants will be legal, valid and binding obligations of the State that are enforceable against the State.

The State represents that it expects that the Registered Warrants will be repaid within one year. According to an opinion from the State Attorney General, the controller may not legally refuse to pay the principal of or interest on any Registered Warrant on any date that unapplied money is available in the State’s general fund. In addition, the State represents that in the last a years, no registered warrant of the type at issue in this case has been outstanding for more than a few months. The State also represents that if in Year 1, (the year that gave rise to the substantial cash shortfall), both the Warrants and the Registered Warrants had been issued, the Registered Warrants and the Warrants would have been repaid within b months of their date of issuance, a period which is less than one year.

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(c)(1) provides that the term “State or local bond” means an obligation of a State or political subdivision thereof. Section 1.150-1(b), which generally provides definitions for §§ 103 and 141-150, defines an obligation as any valid evidence of indebtedness under general Federal income tax principles.

However, the word “obligation” in § 103(c)(1) does not extend to every obligation that includes the payment of interest by a state or political subdivision, but only to those obligations which are created in the exercise of a state’s borrowing power, as compared with some other sovereign power. For example, courts have not found an obligation under § 103 in condemnation cases because the obligation did not arise as an exercise of a state’s borrowing power. See *Drew v. United States*, 551 F.2d. 85 (5th Cir. 1977) (threat of condemnation is not the exercise of the borrowing power); *Holley v. United States*, 124 F.2d 909 (6th Cir. 1942), *cert. denied*, 316 U.S. 685 (1942); *United States*

PLR-161592-03

Trust Co. of New York v. Anderson, 65 F.2d 575 (2d Cir. 1933), *cert. denied*, 290 U.S. 683 (1933) (condemnation is not the exercise of the borrowing power).

Obligations under § 103 are not limited to a particular form such as bonds or other securities. See, e.g., *Rev. Rul. 60-179*, 1960-C.B. 37 (interest paid by a state under ordinary written agreement for purchase and sale of a house was exempt).

In the instant case, the Banks entered into voluntary arrangements with the State to advance the State money under negotiated terms and will receive the Registered Warrants in return. The issue is whether the Registered Warrants will be debt under general Federal income tax principles.

Neither the Code nor the regulations define debt for Federal income tax principles. However, whether an instrument is a debt has been considered in several different areas. In *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957), *cert. denied*, 359 U.S. 1002 (1959), the court defined classic debt as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor’s income or lack thereof.” The court noted that, while some variation from this formula is not fatal to the taxpayer’s efforts to have the advance treated as a debt for tax purposes, too great a variation will preclude such treatment.

The characteristics of debt have been explored in cases addressing whether an arrangement is debt or equity. In those cases, the determination of debt is based on all the facts and circumstances, with no one factor being decisive. *Fin Hay Realty v. United States*, 398 F.2d 694, 696-697 (3d Cir. 1968); *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946). Among the factors courts have considered are the names given to the certificates evidencing the indebtedness, presence or absence of a fixed maturity date, source of the payments, right to enforce payments of principal and interest, participation in management as a result of the advances, status of the advances in relation to regular corporate creditors, intent of the parties, identity of interest between creditor and stockholder, “thinness” of capital structure in relation to debt, ability of the corporation to obtain credit from outside sources, use to which the advances were put, failure of the debtor to repay and risk involved in making advances. See *Dixies Dairies v. Commissioner*, 74 T.C. 476, 493 (1980); see also Notice 94-47, 1994-1 C.B. 357 (list of factors relevant in debt/equity determination). Not all of these factors are relevant in the instant case. We discuss certain relevant factors below.

The obligation to pay a sum certain is one aspect of a debt. Here, the Agreements and the Registered Warrants will require payment of a sum certain that will be determined at the time the Registered Warrants are issued. In addition, the Registered Warrants will provide for stated interest that is to be paid for the use or

PLR-161592-03

forbearance of money. See *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). In exchange for the Banks advancing the State money, the State will pay a variable rate of interest, based on a percentage of a market index, to the Banks.

Another characteristic of a debt instrument is the right to enforce payment of principal and interest. *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972). The Registered Warrants are legal, valid, binding obligations of the State and are enforceable against the State. If the State fails to pay the Registered Warrants, any holder of a Registered Warrant may proceed to protect and enforce its rights under applicable State law. Accordingly, the Banks can enforce the State's obligation to pay principal and interest on the Registered Warrants.

Another indicia of a debt instrument is a fixed maturity date. The existence of a fixed maturity date is a significant factor that indicates the existence of a debtor-creditor relationship. *Miele v. Commissioner*, 56 T.C. 556, 566 (1971), *aff'd*, 474 F.2d 133 (3d Cir. 1973), *cert. denied*, 414 U.S. 982 (1973). However, courts have ruled that the absence of a fixed maturity date is not in itself sufficient to prevent an instrument from being classified as a debt where there is evidence that the parties expect the amount advanced will be repaid within a short time period. In *Harlan v. Commissioner*, 409 F.2d 904 (5th Cir. 1969), the court ruled that two advances to insurance companies were debt instruments. The instruments had no fixed maturity date but were payable on demand. The court noted that both advances were repaid within three years and concluded that the repayment of the instruments in the relatively short time was an indication that the parties contemplated an early maturity date.

Similarly, in *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972), the court ruled that the advance in question was a bona fide loan and that the absence of a fixed date of repayment was not conclusive evidence of equity. The court noted that there was evidence that the parties contemplated repayment within a maximum of three years. The court also noted that the advances were in fact repaid within two and one-half years of their funding.

Here, the Registered Warrants will not have a fixed maturity date. Instead, once issued they will be repaid each day to the extent that there are available funds in the State's general fund. The State represents that it expects that the Registered Warrants will be repaid within one year. In support of its claim, the State represents that in the last a years, no registered warrant issued by the State without a maturity date has been outstanding for more than a few months. The State also represents that if in Year 1, (the year that gave rise to the cash shortfall), both the Warrants and the Registered Warrants had been issued, the Registered Warrants and the Warrants would have been repaid within b months of their date of issuance, a period which is less than one year. Therefore, we find that the Registered Warrants are debt for Federal income tax

PLR-161592-03

purposes and are incurred by the State pursuant to the exercise of its borrowing power. Accordingly, we conclude that the Registered Warrants are obligations of the State under § 103.

Conclusion:

Based on all the facts and circumstances, we conclude that the Registered Warrants will be “obligations” of the State under § 103.

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 Obligations or Warrants 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