

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 26,2003

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Third Party Contact:
Index (UIL) No.: 148.00-00
CASE-MIS No.: TAM-156939-03, CC:TEGE:EOEG:TEB

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Issuer =

Bonds =

X =

ISSUE:

For purposes of the "5 percent rule" (see below) under § 1.148-6(d)(3)(iii) of the Income Tax Regulations, does the "actual working capital expenditures of the issuer in the prior fiscal year" include expenditures made from amounts that in the prior fiscal year were restricted to use for expenditures other than working capital expenditures of the type financed.

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CONCLUSION:

For purposes of the "5 percent rule", the "actual working capital expenditures of the issuer in the prior fiscal year" include (1) all working capital expenditures of the issuer in the prior fiscal year, regardless of the source of funds, and (2) all capital expenditures of the issuer paid from current revenue of the issuer in the prior fiscal year.

FACTS:

The Issuer issued the Bonds in order to finance a projected cash flow deficit in its working capital expenses in its current fiscal year. According to the Issuer's tax certificate for the Bonds, when determining the size of its projected cash flow deficit, the Issuer treated as unavailable "amounts that are actually held or set aside in a reasonable working capital reserve of at least \$[X], which does not exceed five percent (5%) of the [Issuer's] working capital expenditures from its available funds in [the prior fiscal year]."

Under § 1.148-6(d)(3)(iii)(B), any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amount is made." (The "5 percent rule.") The Issuer has taken the position that for purposes of the 5 percent rule the prior fiscal year's working capital expenditures includes amounts from restricted funds as well as funds available for any purpose. The agent disagrees with the Issuer's position, and the Issuer requested that the agent obtain technical advice from this office.

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 bonds. Section 103(b) provides, in part, that subsection (a) shall not apply to any arbitrage bond (within the meaning of § 148).

Section 148(a) provides that the term "arbitrage bond" means 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. Further, for purposes of § 148(a), 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 (1) or (2).

Section 148(f)(1) provides that a bond is also an arbitrage bond if it is part of an issue for which the rebate requirements of § 148(f)(2) and (3) are not met. The rebate requirements are met if the issuer pays to the United States, in a timely manner, an amount equal to the sum of the excess of the amount earned on all nonpurpose

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investments (other than investments attributable to the excess), over the amount which would have been earned if those nonpurpose investments were invested at a rate equal to the yield on the issue, plus any income attributable to the excess.

Section 148(f)(4)(B)(i) provides that an issue shall be treated as meeting the requirements of § 148(f)(2) if the gross proceeds of such issue are expended for the governmental purposes for which the issue was issued no later than the day which is 6 months after the date of issuance of the issue; and the requirements of § 148(f)(2) are met with respect to amounts not required to be spent.

Section 148(f)(4)(B)(iii)(I) provides that in the case of an issue of tax or revenue anticipation bonds, the net proceeds of such issue (including earnings thereon) shall be treated as expended for the governmental purpose of the issue on the 1st day after the date of issuance that the cumulative cash flow deficit to be financed by such issue exceeds 90 percent of the proceeds of such issue.

Under § 148(f)(4)(B)(iii)(II) and (III) the term “cumulative cash flow deficit” means, as of the date of computation, the excess of the expenses paid during the period (beginning on the date of issuance of the issue and ending on the earlier of the date 6 months after such date of issuance or the date of the computation of cumulative cash flow deficit) which would ordinarily be paid out of or financed by anticipated tax or other revenues over the aggregate amount available (other than from the proceeds of the issue) during such period for the payment of such expenses.

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(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.

Section 1.148-6(d)(3)(i) provides that 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 paragraph (d)(3)(iii) of the section) 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 1.150-1(b) defines the term “working capital expenditure” as any cost that is not a capital expenditure. Generally, current operating expenses are working

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capital expenditures. Section 1.150-1(b) defines the term "capital expenditure" as any cost of a type that is properly chargeable to 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.

Section 1.148-6(d)(3)(iii)(A) provides that "available amount" means 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 an 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)(iii)(B) states that a reasonable working capital reserve is treated as unavailable (the "reserve rule"). The regulation provides that any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amount is made. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

The reserve rule recognizes that issuers may maintain a reasonable working capital reserve in the current fiscal year's budget. The 5 percent rule is a safe harbor that provides that any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the prior fiscal year.

The regulations modify the general definition of working capital expenditures by providing that, for purposes of the 5 percent rule, all expenditures paid from current revenue may be treated as working capital expenditures. Thus, even capital expenditures in the prior fiscal year may be treated as working capital expenditures if they were paid from the prior fiscal year's current revenue. Under the language of the regulations, the rule that capital expenditures had to have been paid from current revenue in order to be treated as working capital expenditures is the only limitation on the source of funds used to pay expenditures taken into account for purposes of the 5 percent rule.

The agent argues that, for purposes of determining the amount under the 5 percent rule, the prior fiscal year's working capital expenditures should not include amounts that were paid out of restricted funds. As mentioned above, the language of the regulations contains no such limitation. Furthermore, we do not believe such

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limitation should be implied. The preamble to the final regulations indicates that the reliance on the prior year's expenditures was meant as a measuring device to facilitate calculation of the reserve and to limit overissuance. There is no suggestion in the preamble that the issuer should ignore a portion of these expenditures just because they were paid with restricted revenue. See T.D. 8476, 1993-2 C.B. 13, 17.

The agent also argues that, for purposes of determining the amount under the 5 percent rule, including expenditures paid out of funds which were restricted during the prior fiscal year in effect allows the issuer to double count restricted funds—once when restricted funds are excluded from available amounts during the prior fiscal year and then again when the same restricted funds are included in the calculation of the current fiscal year's 5 percent reserve. Even though restricted funds are taken into account both when calculating available amounts in the prior fiscal year and for purposes of the 5 percent rule in the current fiscal year, we believe the restricted amounts are taken into account under both provisions because they serve a separate purpose in each provision. Amounts that are restricted in a manner that makes them unavailable to the issuer for expenditures of the type being financed are treated as unavailable because the issuer cannot be expected to spend those amounts instead of bond proceeds on the financed expenditures. On the other hand, for purposes of the 5 percent test, expenditures from restricted funds are included in order to better gauge the size of the issuer's budget for use in setting a safe harbor for the size of a reasonable reserve.

Therefore, for purposes of the 5 percent rule, the "actual working capital expenditures of the issuer in the prior fiscal year" include (1) all working capital expenditures of the issuer in the prior fiscal year, regardless of the source of funds, and (2) all capital expenditures of the issuer paid from current revenue of the issuer in the prior fiscal year.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.