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Person To Contact:
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Date:
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Legend

Bonds =

County =

District =

State =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Date =

a =

b =

c =

d =

Dear :

This letter is in response to your ruling request that amounts received by the District as part of a settlement of a judicial proceeding are not “available amounts” as defined in § 1.148-6(d)(3)(iii) of the Income Tax Regulations.

FACTS AND REPRESENTATIONS

The District is a school district in the State. The governing body of the District is the District’s Board of Education (the “Board”), the members of which are elected at large.

In Year 1, the State initiated a voluntary desegregation program (the “Program”). The District elected to participate in the Program, and the State reimbursed the District for expenses it incurred. As a result of the State’s audits of the District’s Program expenses, the State decided to recover reimbursements of certain past Program expenses by offsetting the District’s general funding and to reduce future Program funding for the District beginning with Year 2. During the period in which the District received reduced funding from the State, the District had to curtail its expenditures for all of the programs funded by its general fund.

In response to the State’s decision, the District sued the State and, after protracted litigation and settlement, in Year 3, received the settlement amount of $a from the State. The settlement agreement did not impose any restrictions on the use of the settlement amount. The District, according to its policy, invested the settlement amount in the County Investment Pool. The settlement amount equaled approximately b percent of the District’s actual working capital expenditures in the fiscal year beginning in Year 3. The State requires a minimum reserve of c percent of general fund expenditures, an amount not in excess of 5 percent.

In Year 4, after receiving community input from a wide variety of stakeholders, the Board voted to accept the recommendations to preserve the principal of the settlement amount by investing it and allocating d percent (substantially all) of the annual interest earnings for the support of the District’s programs, as such programs are approved by the Board. The Board approved the use of the interest earnings for visual and performing arts and an instructional technology plan. The Board, thus, in essence, created an endowment-like fund (the “Fund”).

On Date, the Board adopted a resolution (the “Resolution”) formally affirming its decision. The Resolution specifies that none of the principal of the Fund is to be allocated to the District’s programs and further provides that the District must reimburse any use of the principal of the Fund, without interest, as soon as sufficient monies are available in the District’s general fund, but no later than within one year. The District’s financial advisor has opined that restriction of the Fund is reasonably necessary for the

District to be able to fund programs and equipment purchases such as those the District approved in Year 4.

Prior to and following the receipt of the settlement amount, the District has issued tax and revenue anticipation notes (TRANs). Taking into account the interest earnings on the Fund but not the corpus of the Fund, the District will continue to face cash-flow shortfalls that will require proceeds of TRANs. In Year 4 and Year 5, the District issued TRANs on a taxable basis. The District proposes to issue the Bonds on a tax-exempt basis to fund the cash-flow shortfall anticipated in the current year.

LAW AND ANALYSIS

Section 103(a) of the Internal Revenue Code (the "Code") 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 section 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. Section 148(a) further provides that a bond is 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(b)(1) defines "higher yielding investments" as any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue.

Section 1.148-0(a) provides that § 148 of the Code was enacted to minimize the arbitrage benefits from investment gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. To accomplish these purposes, § 148 restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that certain earnings on higher yielding investments be rebated to the United States. Violation of these provisions causes the bonds in the issue to become arbitrage bonds, the interest on which is not excludable from the gross income of the owners under § 103(a). The regulations in §§ 1.148-1 through 1.148-11 apply in a manner consistent with these purposes.

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)(A) 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)(iii)(B) provides that a reasonable working capital reserve is treated as unavailable. 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 amounts 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.

Section 1.148-6(d)(3)(iii)(C) provides that for a 501(c)(3) organization, a qualified endowment fund is treated as unavailable. A fund is a qualified endowment fund if –

(1) The fund is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures;

(2) Pursuant to reasonable, established practices of the organization, the governing body of the 501(c)(3) organization designates and consistently operates the fund as a permanent endowment fund or quasi-endowment fund restricted as to use; and

(3) There is an independent verification that the fund is reasonably necessary as part of the organization's permanent capital.

Section 1.148-10(e) provides that if an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of §§ 1.148-1 through 1.148-11 as necessary to clearly reflect the economic substance of the transaction. For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148.

The District asks us to conclude that the Fund is not available within the meaning of § 1.148-6(d)(3)(iii) because the requirement to reimburse the Fund for any of the principal withdrawn is a legislative requirement; because the amount in the Fund plus five percent of the District's prior year working capital expenditures is a reasonable working capital reserve; or because the Fund is equivalent to a qualified endowment fund.

The exception for qualified endowment funds applies only to 501(c)(3) organizations; yet, the District argues that governmental entities such as the District should not be treated more harshly than 501(c)(3) organizations. Regardless, even if this exception were available to governmental entities, the Fund does not meet the other requirements of § 1.148-6(d)(3)(iii)(C) to be a qualified endowment fund. For example, the settlement amount is not a gift or bequest.

Alternatively, the District argues that the facts and circumstances of this case establish that the Fund, which is equal to approximately b percent of its actual working capital expenditures, plus an additional five percent of such expenditures should be treated as a reasonable working capital reserve for purposes of § 1.148-6(d)(3)(iii)(B). We believe that the reasonableness of the size of a reserve must relate to the purpose of that reserve; *i.e.*, the expenses potentially to be paid from such a reserve. Here, the size of the Fund is that of the settlement amount, its source. The State requires a minimum reserve of only c percent of general fund expenditures. The District has not provided any other facts or factors regarding its needs for a working capital reserve. We are, therefore, unable to conclude that the amount of the Fund plus five percent of actual working capital expenditures as provided under § 1.148-6(d)(3)(iii)(B) would be a reasonable working capital reserve.

The District also argues that the Fund is not available because of the reimbursement requirement imposed by the Resolution, which the District argues is a legislative requirement for purposes of § 1.148-6(d)(3)(iii)(A). We need not decide whether the Resolution is legislation, because we conclude that the self-imposed restrictions on the use of the Fund (the "Transaction") is a transaction entered into for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of § 148. Thus, even if the Resolution were to be considered legislation for purposes of § 1.148-6(d)(3)(iii)(A), we would disregard such legislation to clearly reflect the economic substance of the Transaction and to apply § 1.148-6(d)(3) in a manner consistent with the purposes of § 148.

The principal purpose of the Transaction is to invest the Fund for the production of income, rather than to spend the Fund for a governmental purpose. Instead of using the corpus of the Fund to pay its working capital expenditures, the District proposes to issue the Bonds to pay working capital expenditures, while the Fund is invested in potentially materially higher yielding investments. The District will use substantially all of the investment earnings on the Fund for working capital expenditures of the same type as that for which the Bonds will be issued. The Transaction enables the District to exploit the difference between the tax-exempt and taxable interest rates to obtain a material financial advantage. *Cf.* Rev. Rul. 82-101, 1982-1 C.B. 21.

CONCLUSION

Accordingly, we conclude that, under the facts and circumstances described above, the amount in the Fund is an "available amount" under § 1.148-6(d)(3)(iii).

Except as specifically ruled above, no opinion is expressed or implied concerning this matter under any provision of the Code or the regulations thereunder. 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 upon examination.

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 District=s authorized representative.

Sincerely,

Associate Chief Counsel
Financial Institutions & Products

By_______________________
Johanna Som de Cerff
Senior Technician Reviewer
Branch 5