

Internal Revenue Service

Department of the Treasury
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Person To Contact:

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Date:

July 15, 2004

In Re:

Legend:

Issuer =

Series B Bonds =

Series C Deficit Bonds =

Series D Bonds =

State =

A =

B =

C =

D =

E =

<u>F</u>	=
Legislation	=
Commission	=
<u>Year 1</u>	=
<u>Year 2</u>	=
<u>Year 3</u>	=
<u>Year 4</u>	=
<u>Date 1</u>	=
<u>Date 2</u>	=
<u>Date 3</u>	=
<u>Date 4</u>	=
<u>Date 5</u>	=
<u>Date 6</u>	=
<u>Date 7</u>	=

Dear

This is in response to your request for rulings concerning the application of the “proceeds-spent-last” allocation rule set forth in § 1.148-6(d)(3)(i) to proceeds of the Series C Deficit Bonds (as defined below).

FACTS AND REPRESENTATIONS

State funds the unemployment benefits it pays to its eligible unemployed workers (“Benefit Obligations”) under its unemployment compensation program by imposing a tax on employers within State (“State Unemployment Tax”). A component of the State Unemployment Tax is a deficit rate (“Deficit Rate”) that is imposed on employers if on October 1 of the preceding year the balance in the State’s unemployment trust account (“State’s Account”) in the Federal Unemployment Trust Fund (“FUTF”) is less than the Floor Amount described below.

Commission, an agency of the State, operates State's program. Under the Federal Unemployment Tax Act, most employers also must pay federal unemployment compensation taxes. The taxes are used by the federal government to pay administrative costs of state unemployment compensation programs and to pay one-half of extended unemployment benefits. State's program, including the Floor Amount described below, is certified by the United States Department of Labor.

The Social Security Act (42 U.S.C. § 503(a)(4)) requires that the state unemployment taxes collected for payment of State's Benefit Obligations are deposited in State's Account in the FUTF. State must maintain a minimum balance ("Floor Amount") in its State's Account. Under State law, the Floor Amount is the greater of A or one percent of the total taxable wages for the four calendar quarters ending the preceding June 30th. Issuer represents that the current Floor Amount requirement has been in existence since 1983.

RECENT AND PROJECTED UNEMPLOYMENT HISTORY

Due to an economic downturn in its economy in the beginning of Year 1 and continuing through Year 2, State's Benefit Obligations paid during that period exceeded the amount of State Unemployment Taxes collected and depleted the balance of State Unemployment Taxes built up prior to the economic downturn.

Although historically State has maintained the Floor Amount and generally avoided the Deficit Rate, State projected that as of Date 1 (a) the amount on deposit in the State's Account in the FUTF on Date 2, would be approximately C less than the Floor Amount that was required to be on deposit in order to avoid the Deficit Rate during Year 3; and (b) an additional amount of approximately D would be required to be on deposit in order to avoid imposing the Deficit Rate in Year 4. State projected that collections of State Unemployment Taxes were expected to continue to fall short of the Benefit Obligations payable by State during that period. During the six month period beginning on Date 1, the issuance date of the Series C Deficit Bonds described below, the shortfall was projected to be approximately E.

Legislation adopted by the State legislature authorized the issuance of bonds to pay Benefit Obligations, costs of issuance, provide a reserve fund and pay capitalized interest. The Legislation provides for the repayment of the bonds by directing the Commission to assess annually an obligation assessment (the "Obligation Assessment") in the form of an additional tax on employers throughout the State. The Obligation Assessment collected will be used to repay principal and interest on the bonds described below.

THE BONDS

Issuer issued the following bonds:

- (1) Series B Bonds were issued as taxable bonds on Date 1 and the proceeds were deposited in the State's Account in the FUTF to be used to pay future Benefit Obligations expected to accrue after Date 4.

(2) Series D Bonds were issued as taxable bonds on Date 1 in two series (Series D-1 through Series D-2). Proceeds were deposited into the State's Account in the FUTF to be used to pay future Benefit Obligations expected to accrue later in Year 3

(3) Series C Deficit Bonds were issued as taxable bonds on Date 1 in five series (Series C-1 through Series C-5). Proceeds were deposited in the State's Account in the FUTF and are to be used to pay future Benefit Obligations expected to accrue before Date 3. Issuer represents that if we issue a favorable ruling, the Series C Deficit Bonds will be converted to tax-exempt bonds. Issuer expected to spend the proceeds of the Series C Deficit Bonds within six months after the date of issuance on Date 1.

The Series B Bonds, issued as fixed rate bonds, mature on Date 5 and the Series D Bonds, issued as variable rate bonds, mature on Date 7. The Series C Deficit Bonds, issued as variable rate bonds, mature on Date 6 for Series C-1 and Date 7 for Series C-2 through C-5. The Series B Bonds and the Series D Bonds are referred to herein as the "Taxable Bonds". Issuer represents that the Series B Bonds, the Series D Bonds and the Series C Deficit Bonds were sold at substantially different times.

The deposit of the proceeds of the Series B Bonds, the Series D Bonds, and the Series C Deficit Bonds (in the aggregate, the "Bond Proceeds") resulted in an amount on deposit in the State's Account in the FUTF on Date 2 that satisfied the Floor Amount requirement under State law and avoided imposition of the Deficit Rate in Year 3. Issuer expects that the deposit of Bond Proceeds will also cause the Floor Amount to be met on Date 4, thus avoiding imposition of Deficit Rate in Year 4.

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 1.148-1(c)(1) defines replacement proceeds as amounts that 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. Under § 1.148-1(c)(4), replacement proceeds arise to the extent that the issuer reasonable expects as of the issue date that the term of an issue will be longer than is reasonable necessary for the governmental purposes of the issue, and there will be

available amounts during the period that the issue remains outstanding longer than necessary.

Other replacement proceeds are defined in § 1.148-1(c)(4) and include under § 1.148-1(c)(4)(ii)(A) amounts that arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund a working capital reserve, the issuer will have replacement proceeds. Section 1.148-1(c)(4)(ii) provides an exception to the creation of replacement proceeds with respect to an issue if all of the net proceeds of the issue are spent within 6 months of the issue date.

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

Under § 1.148-6(d)(3)(i), except as otherwise provided, proceeds of an issue may only allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts as of that date (the “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 amounts 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.

Under § 1.148-6(d)(3)(B), a reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it doesn't 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.

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 capital expenditures. Capital expenditures means any cost of a type that, under general Federal income tax principles, is properly chargeable to a capital account or would be so chargeable with a proper election.

Proceeds of the Taxable Bonds and Series C Deficit Bonds are to be used to pay Benefit Obligations and to satisfy the Floor Amount requirement under State law on Date 2. Issuer expected to spend the proceeds of the Series C Deficit Bonds within six months of their date of issuance, Date 1, to pay Benefit Obligations.

Benefit Obligations are a working capital expenditure as defined in § 1.150-1(b) so that the proceeds-spent-last rule applies to the allocation of the proceeds of the Series C Deficit Bonds. Under § 1.148-6(d)(3)(iii)(A), the term “available amounts” excludes proceeds of an issue so that the proceeds of the Series C Deficit Bonds will not be available amounts vis-à-vis other proceeds of that issue. The question, however, is whether the proceeds of the Taxable Bonds are available amounts vis-à-vis proceeds of the Series C Deficit Bonds.

Issuer has argued that proceeds of any bonds are unavailable for purposes of the proceeds-spent-last rule because bonds must be repaid. According to Issuer, repayment is equivalent to reimbursement and, under § 1.148-6(d)(3)(iii)(A), amounts that contractually must be reimbursed are excluded from the definition of “available amount”.

We disagree. If amounts subject to an obligation to repayment under a promissory note were equivalent to amounts subject to a reimbursement obligation arising as a result of a “legislative, judicial, or contractual requirement,” then it would have been unnecessary to specifically provide in § 1.148-6(d)(3)(iii)(A) that “proceeds of the issue” are unavailable. Moreover, because of the restricted nature of the working capital allocation rules, we believe that the term “reimbursement” under § 1.148-6(d)(3)(iii)(A) must be interpreted more narrowly than a simple obligation to repay. We conclude, however, that certain of the proceeds of the Taxable Bonds may be unavailable because of the specific nature of the facts in this case.

Under State law, the Floor Amount is the greater of A or one percent of the total taxable wages for the four calendar quarters ending the preceding June 30th. The Floor Amount insures that a reserve is available to pay unemployment claims if claims are greater than expected. The Floor Amount, thus, is a working capital reserve for purposes of expenditures from the State’s Account in the FUTF.

A reasonable working capital reserve is treated as unavailable under § 1.148-6(d)(3)(iii)(B). In this case, we conclude that the Floor Amount is a reasonable working capital reserve and that amounts allocated to the Floor Amount are unavailable for purposes of the proceeds-spent-last method of accounting. The Floor Amount requirement was established by State Law long before the transactions that are subject to this ruling request. The Floor Amount is determined using a formula set forth in State law. Finally, like the safe harbor in § 1.148-6(d)(3)(iii)(B), the Floor Amount varies in accordance with events that occur in the fiscal year previous to the year in which there must be a determination of available amounts. Because we conclude that the Floor Amount is a reasonable working capital reserve, we also conclude that proceeds of the Taxable Bonds allocated to fund the Floor Amount are unavailable vis-à-vis proceeds of the Series C Deficit Bonds.

For purposes of § 1.148-1(c)(4)(ii)(A), the Series C Deficit Bonds do not give rise to replacement proceeds because the Series C Deficit Bonds are not financing either directly or indirectly the Floor Amount. Although a portion of the proceeds of the Series C Deficit Bonds are used to satisfy the Floor Amount on Date 2, the Floor Amount is not

a newly created working capital reserve that is financed with bond proceeds. Instead, Issuer has maintained the Floor Amount for many years and has generally avoided the Deficit Rate. Also, Issuer expected to spend the proceeds of the Series C Deficit Bonds within six months of their issue date.¹

Conclusions:

Based on the facts and circumstances, we conclude that proceeds of the Taxable Bonds, to the extent they are allocated to the Floor Amount, are not “available amounts” within the meaning of § 1.148-6(d)(3)(iii)(A) for purposes of determining whether proceeds of the Series C Deficit Bonds are spent under the proceeds-spent-last method of accounting.

The rulings contained in this letter are 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.

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 authorized representative.

Sincerely,

Assistant Chief Counsel

(Exempt Organizations/Employment
Tax/Government Entities)

By: _____
Timothy L. Jones
Senior Counsel
Tax Exempt Bond Branch

¹ Similarly, the Series C Deficit Bonds are not financing a reserve or replacement fund for purposes of § 1.148-2(f).