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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 17, 1999

Index (UIL) No.: 148.09-00 Penalty in Lieu of Rebate
CASE MIS No.: TAM-107402-99 – CC:DOM FI & P:B5

District Director:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Issuer =

Bonds =

X =

Y =

Date 1 =

Date 2 =

Date 3 =

ISSUES:

FIRST: For purposes of meeting the spending requirements set forth in § 148(f)(4)(C)(ii) of the Internal Revenue Code, may Issuer allocate Bond proceeds to operating expenses that resulted in deficits in Issuer's operating funds in each of the spending periods following the issue date of the Bonds?

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SECOND: For purposes of meeting the spending requirements set forth in § 148(f)(4)(C)(ii), may Issuer allocate Bond proceeds to capital expenditures by retroactively changing its method of accounting for Bond proceeds from a "proceeds spent last" method to a "proceeds spent first" method?

CONCLUSIONS:

FIRST: Issuer may not meet the spending requirements set forth in § 148(f)(4)(C)(ii) by allocating Bond proceeds to operating expenses that resulted in deficits in Issuer's operating funds.

SECOND: Issuer may allocate Bond proceeds to capital expenditures by retroactively changing its method of accounting for Bond proceeds to a "proceeds spent first" method. Under this revised accounting method, Bond proceeds may only be allocated to capital expenditures for which the Bonds were issued.

FACTS:

The Bonds were issued on Date 1 to fund certain municipal projects undertaken or to be undertaken by Issuer (the "Capital Program"), The Capital Program includes the acquisition of interests in real estate, the construction and improvement of various municipal facilities and other capital expenditures. As of the issue date of the Bonds, Issuer reasonably expected that at least 75% of the net proceeds (including investment earnings thereon) of the Bonds would be used for "construction expenditures" (as defined in § 148(f)(4)(C)(iv)). The Issuer elected to use the 2-year rebate exception in § 148(f)(4)(C)(ii) and to pay the penalty in lieu of rebate, if any, under § 148(f)(4(C)(vii).

Bond proceeds were deposited into Issuer's consolidated cash account. This account contained the Issuer's operating funds (general fund, water fund, etc.) and its capital improvement funds. Within the consolidated cash account, separate accounting ledgers were kept that identified the Bonds and combined Bond proceeds with other available capital proceeds to arrive at a total equity balance for capital projects.

In the months following the issuance of the Bonds, Issuer experienced financial difficulties that caused it to have insufficient moneys in its operating funds to meet operating expenses. As a result, operating expenses were paid with moneys in its capital improvement funds (including funds containing Bond proceeds) creating deficits in the operating funds. These payments were treated as loans from the capital improvement funds to the operating funds, which were later repaid. The amount of deficits in the operating funds during each of the 6-month spending periods under § 148(f)(4)(C)(ii) exceeded the amount of available construction proceeds required to be spent for each such spending period.

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Due to the complexity of the tax laws governing arbitrage and on the advice of counsel, Issuer initially accounted for Bond proceeds using a "proceeds spent last" method. Thus, if the Issuer had other capital proceeds (such as grant proceeds) available to be spent on a project, those proceeds were deemed spent prior to the expenditure of Bond proceeds. Issuer represents that other than as a result of this accounting method, other available capital proceeds were not required to be spent prior to the expenditure of Bond proceeds. Under this accounting method, Issuer met the spending requirement for the first spending period specified under § 148(f)(4)(C)(ii), but failed to meet the spending requirements for the next two periods, Accordingly, on Date 2, Issuer paid a penalty amount of $X to the United States accompanied by Form 8038-T. On Date 3, Issuer paid a penalty amount of $Y to the United States accompanied by Form 8038-T.

Prior to the end of the fourth spending period, on the advice of new counsel, Issuer changed its method of accounting for Bond proceeds to a "proceeds spend first" method. Under this method, Bond proceeds are treated as spent on a project prior to the expenditure of other capital proceeds available for the project.

Immediately following the expenditure of all the Bond proceeds, Issuer filed a request for a refund of the penalty amounts paid. Issuer advanced two theories in support of the refund request. Its first theory is that all of the penalty amounts paid to the United States should be refunded because the deficits in Issuer's operating funds during each of the spending periods were in excess of the amount of Bond proceeds required to be spent during that spending period. Under this theory, Bond proceeds would be treated as expended for operating expenses despite Issuer's treatment of these expenditures as inter-fund loans to be repaid out of future revenues.

The second theory advanced by Issuer is that it should receive a refund to the extent that penalty amounts paid under its first accounting method, the "proceeds spent last" method, exceed the penalty amounts payable under its revised method of accounting, the "proceeds spent first" method, assuming that the revised method was applied as of the issue date of the Bonds. It argues that the "proceeds spent first" method of accounting is a reasonable method and that it should be permitted to retroactively apply this method within a reasonable period of time after the issue date of the Bonds.

LAW AND ANALYSIS:

Under § 103(a), gross income does not include interest on any state or local bond, Section 103(a) does not apply to a bond that is an arbitrage bond within the meaning of § 148.

An arbitrage bond is defined in § 148(a) as any bond issued as part of an issue any portion of which is reasonably expected at the time of issuance of the bond to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investment. Under § 148(f)(2), a bond is treated as an arbitrage bond if the excess of the amount earned on nonpurpose investments over the amount that would have been earned if the nonpurpose investments had been invested at a rate equal to the yield on the bond is not paid to the United States in accordance with the requirements set forth in § 148(f)(3).

Section 148(f)(4)(C)(i) provides that in the case of a construction issue, § 148(f)(2) shall not apply to the available construction proceeds of the issue if these proceeds are spent for the governmental purposes of the issue in accordance with the spending schedule in § 148(f)(4)(C)(ii). Under that schedule, at least 10 percent of the available construction proceeds must be spent within the first 6-month period beginning on the date the bonds are issued; 45 percent must be spent within the first year; 75 percent must be spent within the first 18 months; and 100 percent must be spent within the first two years. Available construction proceeds are subject to the rebate requirements of § 148(f)(2) if they are not spent in accordance with this spending schedule.

Under § 148(f)(4)(C)(vii), an issuer may elect to pay a penalty in lieu of satisfying the rebate requirements under § 148(f)(2). The penalty is equal to 1 ½ percent of the difference between the amount of available construction proceeds, as of the close of each 6-month spending period, which were required to be spent for the governmental purposes of the issue and which were actually spent for the government purposes of the issue. Generally, § 148(f)(4)(C)(xvi) requires any penalty payment to be made no later than 90 days after the end of a spending period.

Section 1 .103-1 3(f)(I), issued under § 103(c) of the Internal Revenue Code of 1954, provides rules for allocations of investments and expenditures to bond proceeds, Under that section, allocations may be made at any time under any reasonable method chosen by the state or local government provided that the requirements of § 1 .103-13(9(4) are met. One requirement of § 1.103-I 3(f)(4) is that allocations must be consistent with one another.

The Conference Report accompanying the Tax Reform Act of 1986 states with regard to the tax-exempt bond provisions that, "The conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions." 2 H.R. Conf. Rep. No. 841, 99"' Cong., 2d Sess. II-686 (1986), 1986-3 (Vol. 4) C.B. 686. Section 1.103-13(f)(1) was in effect as of the date of the Tax Reform Act of 1986.

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ISSUE ONE:

Issuer's accounting procedures for its consolidated cash account permit a system of inter-fund loans which occasionally results in the temporary use of capital funds for operating funds and vice versa. These procedures require that the loans be repaid from future receipts into the borrowing fund. In this case, Issuer followed these procedures and repaid the loans from the capital improvement funds, including funds that included Bond proceeds, with future operating revenues. Thus, on Issuer's books, Bond proceeds were never allocated to operating expenses.

Even if Bond proceeds were treated as paying Issuer's operating expenditures, the spending requirements of § 148(f)(4)(C)(ii) would not have been met. Section 148(f)(4)(C) was added by § 7652(b) of the Revenue Reconciliation Act of 1989, P.L. 101-239 (the "1989 Act"). Significant modifications were made by the Revenue Reconciliation Act of 1990, P.L. 101-508. The legislative history of the 1989 Act indicates that this provision was added because Congress believed that in situations where bond proceeds are to be used for short-term construction purposes, the administrative burdens of compliance with the arbitrage rebate regulations outweigh the benefit to the Federal Government from the revenues to be received from rebate of arbitrage.

The spending provisions set forth in § 148(f)(4)(C)(ii) provide specific percentages of bond proceeds that must be spent for each 6-month spending period. These provisions require that the applicable percentage of available construction proceeds be spent for the "governmental purposes of the issue." The Conference Report accompanying the 1989 Act contains the specific statement, "The expenditure test is only met if the expenditures are for the purpose for which the bonds were issued." H.R. Rep. No. 101-386, at 639 (1989). In this case, the Bonds were issued for capital purposes, not to fund operating expenses.

Therefore, we conclude that Issuer did not meet the spending requirements of § 148(f)(4)(C)(ii) either as a result of using Bond proceeds to pay operating expenses or of allocating Bond proceeds to operating fund deficits.

ISSUE TWO:

At the time the Bonds were issued, comprehensive regulations dealing with rebate had not been adopted. The Conference Report accompanying the Tax Reform Act of 1986 provides that current law in existence as of its effective date is carried forward. For arbitrage purposes, the rules then in existence for allocating investments and expenditures to bond proceeds provided that allocations can be made at any time and under any reasonable method chosen by the state or local government provided the allocations are consistent. These general allocation rules were the only rules in existence until new arbitrage regulations with more specific allocation rules were published in 1992 (T.D. 8418, 57 Fed. Reg. 20971) (the "1992 regulations"). The 1992 regulations are inapplicable to the Bonds.

In the context of this case, it is important to examine the facts and circumstances. First, the regulations in effect as of the issue date of the Bonds provided limited guidance regarding allocations. Second, it was unclear how these allocation rules were impacted by the penalty in lieu of rebate provisions in the 1989 Act. Third, there were no rules in existence as of the issue date of the Bonds that required the use of a "proceeds spend last" accounting method to account for Bond proceeds. Further, Issuer's revised method, the "proceeds spent first" method, is a reasonable accounting method that will be consistently applied if Issuer is permitted to retroactively apply the method. Fourth, within less than 2 years after the Bonds were issued, Issuer changed its method of accounting and within a short time thereafter sought permission from the Service to retroactively apply the revised method as of the issue date of the Bonds. Finally, under Issuer's initial accounting method and under Issuer's revised accounting method, Bond proceeds are allocated only to investments or capital expenditures. Therefore, retroactive application of the "proceeds spent first" method of accounting will not cause Bond proceeds to be reallocated from or to uses that are inconsistent with the governmental purpose of the Bond issue.

Based on theses facts and circumstances, we conclude that for purposes of § 148(f)(4)(C)(ii) and § 148(f)(4)(C)(vii), Issuer may apply its "proceeds spent first" accounting method as of Date 1, the issue date of the Bonds. Amended 8038-T(s) should be filed within 90 days after Issuer's receipt of this letter ruling.

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

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