



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR HELENE A. WINNICK
DEPUTY AREA COUNSEL CC:TEGE:PCCM

FROM: Mary Oppenheimer
Assistant Chief Counsel CC:TEGE:EOEG

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 16, 2001. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

County

Tax and Revenue Anticipation Notes (TRANS)

Date 1

Date 2

Date 3

Date 4

Date 5

Date 6

Fiscal Year 1

Fiscal Year 2

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\$a

\$b

\$c

ISSUES

1. Whether the 15-month term of the TRANs constitutes overburdening the market under § 1.148-10(a)(4) of the Income Tax Regulations because the TRANs are outstanding longer than necessary to accomplish the County's governmental purposes?
2. Whether the 2-year safe harbor against the creation of replacement proceeds set forth at § 1.148-1(c)(4)(i)(B)(1) permits a 15-month maturity for the TRANs?
3. Whether the Repayment Fund constitutes a bona fide debt service fund under § 1.148-1(b)?

CONCLUSIONS

1. Notice 2001-49, 2001-34 I.R.B. 188, applies to the TRANs. Therefore, the Internal Revenue Service will close the issue of whether the TRANs are outstanding longer than necessary for purposes of § 1.148-10(a)(4) in this examination.
2. See Conclusion 1.
3. The Repayment Fund constitutes a bona fide debt service fund under § 1.148-1(b).

FACTS

The County issued the TRANs on Date 1, the first date of Fiscal Year 1. Debt service payments for the TRANs were due on Date 5 and Date 6. Date 5 is the last date of the 12-month period of Fiscal Year 1. Date 6 is the maturity date of the TRANs. Hence, the TRANs were outstanding for a period of approximately 15 months, a period which included Fiscal Year 1 and Fiscal Year 2.

The County pledged a total amount of \$a from its General Fund unrestricted revenues to pay debt service on the TRANs. The County established a Repayment Fund and deposited a total amount of \$a into that Fund in two installments as follows: (1) on or before Date 4, \$b (an amount equal to 50 percent of the principal amount of the TRANs); and (2) on or before the Date 5, \$c (an amount equal to the remaining principal amount of the TRANs plus interest). The County made the

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required debt service payments from the Repayment Fund on Date 5 and on Date 6.

There were two sources for the County's General Fund unrestricted revenues, *i.e.*, property taxes (the "Property Taxes") and revenues received for licenses, permits, fines, grants, and fees for services (the "Other Revenues"). The Property Taxes, the primary source of revenues, were due in two installments. The first Property Tax installment was due without penalty or interest on Date 2. The second Property Tax installment was due without penalty or interest on Date 3. The Other Revenues were due without penalty or interest on Date 5. Hence, all Property Taxes and Other Revenues were due without penalty or interest and were received by the County within the 12-month period of Fiscal Year 1.

The County initially selected the 12-month period of Fiscal Year 1 as the first bond year, *i.e.*, 12-month period beginning on Date 1 and ending on Date 5. Subsequently, prior to Date 6, the County determined that its initial selection was in error and the County selected Date 6 as the last date of the second bond year. As a result, the first bond year is approximately a 3-month period and the second bond year is a 12-month period.

All of the tax and revenue anticipation notes that the County previously issued matured within the 12-month period of a fiscal year. The County responded to the revenue agent's request for the County's business purpose for choosing the 15-month maturity by stating that the Internal Revenue Code and relevant regulations permitted a 15-month maturity.

LAW AND ANALYSIS OF ISSUES

1. Whether the 15-month term of the County's TRANs constitutes overburdening the market under § 1.148-10(a)(4)?

The examination of the County's TRANs raised serious questions regarding overburdening and also identified a lack of clarity in the relevant regulations as is more fully described below in the second issue. To address these matters, Notice 2001-49 provides a proposed revenue procedure that includes the following safe harbor:

For purposes of § 1.148-10(a)(4), an issue of tax or revenue anticipation bonds within the scope of [the proposed] revenue procedure will not be treated as outstanding longer than is reasonably necessary to accomplish the governmental purposes of those bonds if the final maturity date of the issue is not later than the end of the applicable temporary period under § 1.148-2(e)(3)(i) or § 1.148-2(e)(3)(ii) for which proceeds of the issue qualify. [The proposed] revenue procedure does not apply to determine whether an issue

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of tax or revenue anticipation bonds meets the other requirements of section 148.

Notice 2001-49 further provides that the safe harbor will apply to bonds sold after the date the revenue procedure is published in the Internal Revenue Bulletin in final form. However, issuers may rely on the proposed revenue procedure with respect to any issue of tax or revenue anticipation bonds that is sold before the effective date of the proposed revenue procedure and on or after August 3, 2001. *Id.*

Notice 2001-49 further provides that the issue of whether a tax or revenue anticipation bond is outstanding longer than necessary for purposes of § 1.148-10(a)(4) will be closed in any current Internal Revenue Service examination and will not be raised in any issue of tax or revenue anticipation bonds that has a term of 2 years or less and was sold prior to August 3, 2001. However, Notice 2001-49 has no effect on any other issue that may be identified in any current or future examination. *Id.*

Because the TRANs were issued prior to August 3, 2001, and were issued with a term of less than 2 years, the Internal Revenue Service will close this issue in the County's current examination as provided in Notice 2001-49.

2. Whether the 2-year safe harbor against the creation of replacement proceeds set forth at § 1.148-1(c)(4)(i)(B)(1) permits a 15-month maturity for the TRANs?

Section 1.148-10(a)(4) provides that an action overburdens the tax-exempt bond market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). § 1.148-10(a)(4). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under § 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). *Id.* One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under § 1.148-1(c)(4)(i)(B).

Section 1.148-1(c)(4)(i)(A) provides that, in general, other replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that (1) the term of an issue will be longer than is reasonably necessary for the

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governmental purposes of the issue, and (2) there will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148-10. § 1.148-1(c)(4)(i)(A)(2). Replacement proceeds are created under § 1.148-1(c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date. § 1.148-1(c)(4)(i)(A)(2).

However, § 1.148-(c)(4)(i)(B)(1) provides that replacement proceeds do not arise under § 1.148-1(c)(4)(i)(A) for the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years.

The examination of the County's TRANs identified a lack of clarity in the above-noted regulations as to the appropriate maturity for an issue of tax and revenue anticipation notes. Notice 2001-49 addresses this lack of clarity by providing a maturity safe harbor as noted above.

Because the TRANs were issued prior to August 3, 2001, and were issued with a term of less than 2 years, the Internal Revenue Service will close this issue in the County's current examination as provided in Notice 2001-49.

3. Whether the Repayment Fund constitutes a bona fide debt service fund under § 1.148-1(b)?

Section 1.148-1(b) provides that the term "bona fide debt service fund" means a fund, which may include proceeds of an issue, that (1) is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and (2) is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of (i) the earnings on the fund for the immediately preceding bond year; or (ii) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

"Bond year" means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. § 1.148-1(b). The first and last bond years may be short periods. *Id.* If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date. *Id.*

The two Property Tax installments were due without penalty or interest on Date 2 and Date 3. The Other Revenues were due without penalty or interest on Date 5. On or before Date 4, the County deposited Property Taxes and Other Revenues in an amount equal to 50 percent of the principal amount of the TRANs (\$b) into the Repayment Fund. The County made the required debt service payment on Date 5 from that Fund. On or before the Date 5, the County deposited

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Property Taxes and Other Revenues in an amount equal to the remaining principal amount of the TRANs plus interest (\$c) into the Repayment Fund. The County made the required debt service payment on Date 6 from that Fund. Hence, all Property Taxes and Other Revenues pledged to pay debt service on the TRANs were due without penalty or interest within the 12-month period of the second bond year and were deposited into the Repayment Fund within the same 12-month period of the second bond year. The County used those Taxes and Revenues to make debt service payments that were due within the same 12-month period of the second bond year. Consequently, on the facts presented here, we conclude that the Repayment Fund was used primarily to achieve a proper matching of revenues with principal and interest payments within the second bond year. Moreover, within the 12-month period of the second bond year, the County depleted the Repayment Fund at least once. Accordingly, we conclude that the Repayment Fund constitutes a bona fide debt service fund under § 1.148-1(b).

The § 1.148-1(b) definition of “bond year” permits the County to make its selection by Date 6 because Date 6 is the earlier of the maturity date of the issue or the date that is 5 years after the issue date. Section 1.148-1(b) also permits the County to have a short first or last bond year. Consequently, the County’s change in its selection of the bond year does not alter the result that the Repayment Fund is a bona fide debt service fund under § 1.148-1(b).

OTHER ISSUES IN TAX AND REVENUE ANTICIPATION CASES

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 § 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) defines “available amount” broadly 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. § 1.148-6(d)(3)(iii). A reasonable working capital reserve is treated as unavailable. *Id.*

The significance of an issuer having available amounts on the date that any amount of the proceeds of TRANs are allocated to a working capital expenditure is that the allocation of the proceeds of TRANs to that expenditure is not respected. Instead, the issuer is deemed to have spent the available amounts rather than the proceeds of TRANs. As a result, it may be appropriate to question whether the


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issuer allocated the proceeds of TRANs to expenditures within the § 1.148-2(e)(3) 13-month temporary period and, hence, whether TRANs proceeds should have been subject to yield restriction. A related issue that may warrant consideration is whether the issuer reasonably expected to spend the proceeds of TRANs within 13 months of the issue date. See § 1.148-2(e)(3). If the issuer reasonably anticipated having available amounts on hand, then, considering the § 1.148-6(d)(3)(i) proceeds-spent-last rule, it is questionable whether the issuer could have reasonable expectations that it would spend the proceeds of TRANs within 13 months. Moreover, it is questionable whether TRANs were issued for a governmental purpose under § 1.148-10(a)(4) or, instead, were issued merely to permit anticipated revenues to remain invested for the purpose of earning arbitrage.

In addition, if the proceeds of TRANs are not allocated to an expenditure within the 6-month period under either the § 148(f)(4)(B)(i) general exception to rebate or the § 148(f)(4)(B)(iii) special exception for TRANs, it may be appropriate to question whether rebate is due on the issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Because the Internal Revenue Service will close this examination under the provisions set forth in Notice 2001-49, we see no litigation hazards as to the first two issues.



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Please call if we can provide further assistance.

Mary Oppenheimer
Assistant Chief Counsel
By: TIMOTHY L. JONES

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