Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:TEB– PLR-135136-03
Date:
September 11, 2003

LEGEND:

District =

Commission =

State =

Year 1 Bonds =

QZABs =

Notes =

Proposed Bonds =

a =

b =

c	=
d	=
e	=
f	=
Date 1	=
Date 2	=
Year 1	=
Year 2	=

Dear :

This is in response to your request for a ruling that § 149(g)(1) of the Internal Revenue Code does not preclude the exclusion of interest on the Notes and the Proposed Bonds.

Facts and Representations

You make the following representations. District is a city school district created under State law and a political subdivision of State for purposes of § 103, and is authorized by State law to issue bonds.

Every school building located within District is in need of full modernization or replacement. District has thus undertaken a comprehensive school facility improvement program (the "Project") that includes constructing a new school buildings and substantially renovating b others. In order to receive State financial assistance, the Project is designed to meet State standards for school construction and renovation.

The Project is a very large undertaking in terms of construction resources, students impacted, and management issues, and will require construction over a time period that exceeds the average public works project. The Project involves nearly every District school and will take approximately 10 years to complete.

The total projected cost of the Project is $c. The amount State will contribute to the cost of the Project, $d, is 21.4 percent of the total expected Project cost. District issued two bond issues in Year 1 to pay part of the cost of the Project, the Year 1 Bonds and an issue of Qualified Zone Academy Bonds (the "QZABs"). A resolution authorizing the issuance of $e of bonds to help finance the cost of the Project was approved by the voters of District on Date 1. Pursuant to this authorization, District issued the Notes on Date 2. Also pursuant to this authorization, District expects to issue the Proposed Bonds in Year 2 to redeem the Notes and to provide an additional $f for the cost of the Project. Regarding the Notes and the Proposed Bonds, District represents that only the Notes proceeds will be allocated to Project expenditures until the Proposed Bonds are issued; thereafter, all proceeds of the Notes and the Proposed Bonds will be allocated ratably to monthly expenditures on the Project by District. District also represents that all proceeds of the Year 1 Bonds and the QZABs will be allocated ratably to District's monthly expenditures on the Project.

District and Commission, acting on behalf of State, have approved a plan (the "Master Plan") for the Project that is required by State law in order to receive financial assistance from State. The Master Plan divides the Project into four separate segments. Under State law, State funding must be paid in installments for each of the four segments of the Project. Before State will authorize funding for its share of the cost of a Project segment, District must have available funds in an amount sufficient to completely pay for its share of the cost for that segment. State law requires that State's financial assistance (the "State Match") must be spent on those qualified Project costs described in the Master Plan on a prorata basis with District's contribution for such costs. District represents that all funds constituting the State Match, along with all proceeds of the Year 1 Bonds, the QZABs, the Notes, and the Proposed Bonds will be used by District to pay for the Project.

For all purposes of § 148, District represents that it will allocate funds from different sources for the same governmental purpose to expenditures using the "gross proceeds spent first" allocation method permitted under § 1.148-6(d)(1)(i) of the Income Tax Regulations. All proceeds of the Notes and the Proposed Bonds, together with the proceeds of the Year 1 Bonds, will thus be allocated ratably to Project expenditures prior to allocating any other funds to Project expenditures, including the payments received from the State for the State Match. Using this allocation method to allocate Note and Proposed Bond proceeds to Project expenditures, District expects to allocate more than 10 percent of the spendable proceeds of the Notes and the Proposed Bonds for such purposes within the one-year period beginning on the issuance date of each issue, at least 30 percent of the spendable proceeds of each issue for such purposes within the two-year period after each issue was issued, at least 60 percent within the three year period after each issue was issued, and at least 85 percent within the five-year period after each issue was issued. District represents that its expectations are not related to changes in interest rates.

District represents that (1) all of the legal and underwriting costs associated with the Notes and the Proposed Bonds were or will be paid not later than the 180th day after the respective issue dates of each issue, and (2) the weighted average maturity of the Proposed Bonds will not exceed 120 percent of the reasonably expected economic life of the portion of the Project to be financed with the proceeds of the Proposed Bonds (determined in the same manner as under § 147(b)).

Law and Analysis

Section 149(g)(1) provides that § 103(a) shall not apply to any hedge bond unless, with respect to the issue of which such bond is a part, the requirements of §§ 149(g)(2) and 149(f)(3) are met.

Section 149(g)(3)(A) defines a hedge bond generally as any bond issued as part of an issue unless (i) the issuer reasonably expects that 85 percent of the spendable proceeds of the issue will be used to carry out the governmental purposes of the issue within the 3-year period beginning on the date the bonds are issued, and (ii) not more than 50 percent of the proceeds of the issue are invested in nonpurpose investments (as defined in § 148(f)(6)(A)) having a substantially guaranteed yield for 4 years or more.

An issue meets the requirements of § 149(g)(2) if the issuer reasonably expects that 10 percent of the spendable proceeds of the issue will be spent for the governmental purposes of the issue within the 1-year period beginning on the date the bonds are issued; 30 percent of the spendable proceeds will be spent for such purposes within the 2-year period beginning on such date; 60 percent of the spendable proceeds will be spent for such purposes within the 3-year period beginning on such date; and 85 percent of the spendable proceeds will be spent for such purposes within the 5-year period beginning on such date.

An issue meets the requirements of § 149(f)(3) if the payment of legal and underwriting costs associated with the issuance of the issue is not contingent, and at least 95 percent of the reasonably expected legal and underwriting costs associated with the issuance of the issue are paid not later than the 180th day after the date of the issuance of the issue.

Section 1.149(g)-1(a) provides that, except as otherwise provided, the definitions set forth in § 1.148-1 apply for purposes of § 149(g).

Section 1.149(g)-1(b) provides that § 1.148-6 applies for purposes of § 149(g), except that an expenditure that results in the creation of replacement proceeds (other than amounts in a bona fide debt service fund or a reasonably required reserve or replacement fund) is not an expenditure for purposes of § 149(g).

Section 1.148-1(c)(1) provides in part that amounts are replacement proceeds of an issue if they 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.

Section 1.148-1(c)(4)(i)(B)(2) provides a safe harbor against the creation of replacement proceeds under § 1.148-1(c)(4)(i)(A) for the portion of an issue (including a refunding issue) that finances or refinances capital projects. This safe harbor is met if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined in the same manner as under § 147(b).

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(a)(2) provides that an accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special state law restrictions imposed on specific funds or actions to avoid grant forfeitures.

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.

The Notes and the Proposed Bonds are hedge bonds because District does not reasonably expect that the Notes and the Proposed Bonds will meet the three-year spending requirement of § 149(g)(3)(A). Section 149(g)(1) will thus preclude the exclusion of interest on the Notes and the Proposed Bonds under § 103(a) unless the Notes and the Proposed Bonds meet the requirements of §§ 149(g)(2) and 149(f)(3).

District has represented that it expects to use the gross proceeds spent first accounting method, without regard to the terms of the State grant law, to allocate more than 10 percent of the spendable proceeds of the Notes and the Proposed Bonds for such purposes within the one-year period beginning on the issuance date of each issue, at least 30 percent of the spendable proceeds of each issue for such purposes within the two-year period after each issue was issued, at least 60 percent within the three-year period after each issue was issued, and at least 85 percent within the five-year period after each issue was issued. These expectations are based on a Master Plan prepared by professionals and are not related to interest rate changes. District has also represented that all of the legal and underwriting costs associated with the Notes and the Proposed Bonds were or will be paid not later than the 180^{th} day after the respective issue dates of each issue. The Notes and the Proposed Bonds thus meet the requirements of §§ 149(g)(2) and 149(f)(3), and § 149(g)(1) will not preclude the application of § 103(a) to the Notes and Proposed Bonds, provided that replacement proceeds are not created by these expenditures of the Note and Proposed Bond proceeds. See § 1.149(g)-1(b).

In this case, the only other funds with a nexus to the Project are the proceeds of the Year 1 Bonds, the proceeds of the QZABs, and the funds provided by the State Match. However, the Note and Proposed Bond proceeds will not be spent on the Project in lieu of these funds. Rather, the proceeds of the Year 1 Bonds, the QZABs, and all funds constituting the State Match, will also be used by District to finance the Project. These amounts are thus not replacement proceeds of the Notes and the Proposed Bonds within the meaning of § 1.148-1(c)(1). This result is not changed because the State Match must be spent on qualified Project costs on a prorata basis with District's payments.

District has adopted the gross proceeds spent first accounting method for purposes of allocating Proposed Bond proceeds to Project expenditures, as allowed under §§ 1.149(g)-1(b) and 1.148-6(d)(1)(i). Pursuant to § 1.148-6(a)(1), District will consistently apply this accounting method. An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Under § 1.148-6(a)(2), bona fide governmental purposes may include restrictions imposed on specific funds, such as the State law requiring pro rata expenditures of the State Match.

Conclusions

We conclude that § 149(g)(1) does not preclude the exclusion of interest on the Notes and the Proposed Bonds.

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 a ruling, 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) provides that it may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Government Entities)

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