INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

January 19, 2011

Number: **201118012**
Release Date: 5/6/2011

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 148.00-00
CASE-MIS No.: TAM-114306-10

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Date of Conference:

LEGEND:

Bonds =

Borrower =

Indenture =

Issuer =

State =

Trustee =

Date =

Year =

ISSUE:

Whether the entrance fees collected by Borrower are properly characterized as replacement proceeds within the meaning of § 148 of the Internal Revenue Code (the "Code") and § 1.148-1(c) of the Income Tax Regulations.

CONCLUSION:

The entrance fees collected by Borrower are not properly characterized as replacement proceeds within the meaning of § 148 of the Code and § 1.148-1(c) of the Income Tax Regulations because the bondholders have no reasonable assurance that the fees will be available to pay debt service on the Bonds.

FACTS:

On Date, Issuer issued its Bonds and loaned the proceeds of such Bonds to Borrower, an organization described in § 501(c)(3) of the Code. Borrower used the proceeds of the Bonds to expand its retirement community facility (the "Facility") and to refund a prior series of tax-exempt bonds, which were used to construct the initial Facility.

Prior to occupying a unit of the Facility, residents are required to remit to Borrower an entrance fee. Borrower is not required to refund the resident's entrance fee (or the applicable percentage thereof) until a resident has left the Facility and the vacated unit is re-occupied by a new resident who has paid an entrance fee. In rare cases, Borrower may decide, in its sole discretion, to refund an entrance fee without these conditions having been met upon a resident's demonstration of a hardship.

Borrower is not required to hold the entrance fees collected from its residents in trust for the residents. On the contrary, pursuant to Borrower's agreements with its residents, Borrower may invest the entrance fees or otherwise use these amounts for its own purposes.

Pursuant to the Indenture and related documents executed in connection with the issuance of the Bonds, Borrower granted Trustee a first priority security interest in its revenues, including the entrance fees, and certain other collateral not presently at issue. This security interest was recorded via the filing of one or more financing statements under the State Uniform Commercial Code.

Trustee has not taken physical possession of, nor does it control, the entrance fees, which are commingled with Borrower's other cash. However, pursuant to its security interest filing, Trustee has the ability to take possession of the entrance fees and other commingled moneys to perfect its security interest. Until possession is taken, Borrower has unrestricted use of the entrance fees, including use of such fees to pay other creditors. The amount of cash in Borrower's accounts varies with the occupancy of the Facility. Borrower uses its cash, including the entrance fees, to cover operating deficits, the replacement of its facilities, and other capital needs.

At the end of Year, the amount of cash that Borrower had invested was approximately one half of the total amount of entrance fee revenue Borrower had received as of the end of Year.

LAW AND ANALYSIS:

Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(2) provides that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148).

Section 148(a) provides that, for purposes of § 103, 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. 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) of the previous sentence.

Section 148(b) defines the term "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 provides that § 148 was enacted to minimize the arbitrage benefits from investing 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 1.148-1(c) provides that, in general, amounts are replacement proceeds of an issue if the amounts 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. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee. A sinking fund includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue. A pledged fund is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue.

Revenue Ruling 78-348, 1978-2 C.B. 95, provides that, for purposes of determining whether certain collateral constitutes replacement proceeds, a pledge of collateral need not be cast in a particular legal form. Thus, for example, the bondholders need not take actual or constructive possession of the collateral. However, there must be a reasonable assurance that the collateral will be available if needed to pay debt service, even if the issuer encounters financial difficulties. Thus, for example, an arrangement will not have the effect of a pledge of collateral if the issuer has discretion to defeat the "pledge" merely by liquidating the "collateral" and disposing of the proceeds.

In the present case, Borrower "pledged" all of its revenues, including the entrance fees, as security for the Bonds. Therefore, a nexus exists between the entrance fees and the Bonds. However, the pledge does not provide reasonable assurance that the entrance fees will be available to pay debt service on the Bonds in the event Borrower encounters financial difficulties, and there are no other facts, such as provisions in the Indenture or other financing documents (such as financial covenants that require the maintenance of certain asset levels) from which such reasonable assurance can be inferred. Borrower has commingled all of its revenues in its accounts. Borrower is not limited in its ability to spend these moneys. Additionally, at the end of Year, Borrower's investment balance was approximately one-half of its collected entrance fee revenues. Although there are no facts regarding the level of cash in Borrower's checking account during Year, it is reasonable to conclude that Borrower would only have transferred cash from its investments to its checking account to the extent necessary to cover its immediately anticipated operating expenses. Thus, Borrower spent a substantial portion of its cash, including the entrance fees, after the bonds were issued and continues to expect to spend its cash as necessary on future expenditures, both without any interference by Trustee, Borrower's creditors, or the residents. Thus, it is reasonable to conclude that, in the absence of further action by Trustee, the moneys could and would be dissipated to cover operating shortfalls and to finance other items prior to any payment to the bondholders. There are also no facts to suggest that Borrower's level of cash when the bonds were issued was such that bondholders, considering the nature of the Facility and Borrower's level of operating expenses, could have reasonably relied on this level being maintained while the bonds were outstanding.

Consequently, even though there is a nexus between the entrance fees (and other revenues) and the Bonds, there is no reasonable assurance that the entrance fees will be available to pay debt service on the Bonds in the event Borrower encounters financial difficulties. Therefore, the entrance fees are not properly characterized as replacement proceeds.

CAVEAT(S):

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