

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Date:

March 31, 2004

Legend:

Board =

Trust =

Bonds =

Date 1 =

State =

Beneficiaries =

Act =

Year 1 =

Year 2 =

Year 3 =

a =

b =

c =

Dear

This letter responds to the Board's request for a ruling that the Trust corpus will not constitute "replacement proceeds" of the Bonds under § 148 of the Internal Revenue Code (the "Code").

Facts and Representations:

The Board issued taxable bonds (the "Prior Taxable Bonds") on Date 1, in the amount of \$a, to fund the renovation of certain facilities in the State (the "Facilities"). The Facilities are used for the activities of the Trust's beneficiaries, the Beneficiaries. The Board intends to refund the Prior Taxable Bonds with the Bonds. Debt service on the Bonds will be payable from a portion of the distributable income of the Trust (the "Trust Distributable Income") as described below. The Trust corpus cannot be pledged to pay debt service on the Bonds and cannot be invaded for any reason.

The Trust consists of lands (the "Trust Lands") and a permanent fund (the "Permanent Fund"). The Trust Lands are lands granted in Year 1 by the Act to the State for the benefit of the Beneficiaries. The Act restricts the management of the Trust Lands. The Trust Lands may not be mortgaged or encumbered in any way. Trust Lands must be sold or leased through public auction to the highest and best bidder and cannot be sold or leased for less than fair market value. The Act requires that proceeds derived from the sale of the Trust Lands and the natural products of the Trust Lands be deposited in the Permanent Fund for the benefit of the Beneficiaries. Moneys derived from rental of Trust Lands and interest paid on installment sales of Trust Lands need not be deposited in the Permanent Fund.

Provisions implementing the Act were added to the State constitution in Year 1. The State constitution specifically provides that the State and its people consent to the provisions of the Act concerning the Trust Lands, and that the State constitution may not be amended to abrogate their acceptance of the terms and conditions of the Act without the consent of the United States Congress.

Proceeds from the sale of Trust Lands and natural products deposited in the Permanent Fund are invested. Since Year 1, amounts distributed from the Permanent Fund (the "Fund Distributions") have been limited, in part by the Act and in part by the State constitution, to the income of the Permanent Fund. Any State constitutional amendment increasing Fund Distributions must be proposed either by the State legislature or by an initiative petition signed by a number of qualified voters equal to b percent of the total number of votes cast for all candidates for governor in the preceding State general election, and then must be approved by a majority of the qualified voters in the State voting in the next general election. Any such constitutional amendment that would cause the Fund Distributions to exceed those permitted by the Act also would require the consent of the United States Congress.

The Trust Distributable Income consists of income generated by rental of the Trust Lands, interest from installment sales of the Trust Lands, and the Fund Distributions. State statute determines how these amounts are to be spent. Amounts of approximately \$6 are to be distributed first to pay debt service on bonds issued by the Board, including the Bonds. Amounts not used for debt service are designated for various other purposes related to the Beneficiaries' activities. Because certain portions of the State statute governing the expenditure of the Trust Distributable Income, including the cap on debt service, were approved by voter ballot, any change to the statute must further the purposes of those portions and must be approved by a 3/4 vote of the State legislature.

The Trust Distributable Income was first made available to pay debt service on any bonds issued by the Board in Year 2 (nearly 90 years after Year 1). It was a few years later, in Year 3, that the Board was authorized to issue debt for the renovations of the Facilities and that the Trust Distributable Income was made available to pay debt service on such debt. There is no authority under the Act, State constitution or State law to pledge the Trust corpus to pay debt service on the Bonds.

#### Law and Analysis:

Interest on state or local bonds generally is excluded from gross income under § 103(a) of the Code. Section 103(b)(2) provides, in part, that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148).

Section 148(a) defines the term "arbitrage bond" as 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.

Section 1.148-2(a) of the Income Tax Regulations provides, in general, that under § 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. Under § 1.148-1(b), gross proceeds are defined as proceeds and replacement proceeds of an issue.

Section 1.148-1(c)(1) provides in general, that 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. Under § 1.148-1(c)(1), replacement proceeds include, but are not limited to, sinking funds and pledged funds.

Section 1.148-1(c)(2) states that 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.

Section 1.148-1(c)(3)(i) defines a pledged fund, in general, as 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.

In Rev. Rul. 82-101, 1982-1 C.B. 21, a state established a permanent fund with proceeds from the sale of state-owned property and invested the fund in taxable obligations at a materially higher yield than the yield on the general obligation bonds that the state issued shortly thereafter. The income earned on the fund was reasonably expected to pay debt service on the bonds. The amounts deposited in the permanent fund could have been used to pay the project costs to be paid from the bond proceeds. Instead of using available funds to pay project costs, the bond proceeds were used to pay those costs, and the permanent fund was invested in materially higher yielding obligations. Restrictions were placed on the permanent fund in an attempt to prevent amounts from being treated as replacement proceeds. The ruling holds that the permanent fund was created for the purpose of avoiding arbitrage restrictions.

Unlike Rev. Rul. 82-101, where the permanent fund was created contemporaneously to the issuance of the bonds, here the Trust was created over 90 years ago by the Act, long before the State legislation that authorized issuance of the Bonds and that made the Trust Distributable Income available to pay debt service on the Bonds. In addition, because of the restrictions in the Act and the State constitution, the Trust corpus, unlike the amounts deposited in the permanent fund in the revenue ruling, has never been available to pay costs to be paid from the proceeds of the Bonds.

To be replacement proceeds of the Bonds, the Trust corpus must have a sufficiently direct nexus to the Bonds or the governmental purpose of the Bonds to conclude that the Trust corpus would have been used for that governmental purpose. The Trust corpus cannot be invaded for any purpose. There is no authority under the Act, State constitution or State law to pledge the assets of the Trust. The Act and the State constitution prohibit Trust Lands from being mortgaged or encumbered for any purpose. Any proceeds from the sale of Trust assets must become part of the Permanent Fund. The Act and the State constitution restrict the Fund Distributions. Neither the Board nor the State legislature can increase Fund Distributions without at least a State constitutional amendment. Only the Trust Distributable Income is available for support

of the Beneficiaries. State law further limits the amount of the Trust Distributable Income used for debt service on all of the Board's bonds, including the Bonds.

Therefore, as the Trust corpus cannot be used to pay debt service on the Bonds or to fund the renovation of the Facilities, the Trust corpus is not replacement proceeds of the Bonds. There is no sufficiently direct nexus to the Bonds or to the governmental purpose of the Bonds.

The Trust corpus will not be a sinking fund as it cannot be expected to be used to pay debt service on the Bonds. The Trust corpus will not be a pledged fund because it will not be available to pay debt service on the Bonds.

Conclusion:

We conclude that the Trust corpus will not constitute "replacement proceeds" of the Bonds under § 148.

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. Specifically, no opinion is expressed concerning whether the interest on the Bonds will be excludable from gross income under § 103(a).

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,

(Exempt Organizations/Employment  
Tax/Government Entities)

By: \_\_\_\_\_  
Johanna Som de Cerff  
Assistant Branch Chief  
Tax Exempt Bond Branch