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Department of the Treasury
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Date: July 31, 2002

Legend
Issuer =
Borrower =
Bonds =
State =
Date 1 =

Dear

This is in response to your request for a ruling permitting the Borrower to utilize the "gross proceeds spent first" method for allocating funds from different sources to expenditures for the same governmental purpose under Income Tax Regulation § 1.148-6 for the purpose of determining whether the Borrower has met the two-year spending exception to the arbitrage rebate requirement under § 148(f)(4)(C) of the Internal Revenue Code (the "Code") and § 1.148-7(e).

FACTS AND REPRESENTATIONS

The Issuer is a State non-business corporation established under the laws of State as a public corporate body and agency of the State for the principal purpose of issuing tax-exempt bonds for the benefit of healthcare and educational organizations. The Borrower is a non-profit educational institution chartered under the laws of State.

On Date 1, the Issuer issued the Bonds under § 145 of the Code, a portion of the proceeds of which were lent to the Borrower to finance capital improvements to the Borrower's facilities. As of the issue date, the Borrower expected to apply the Bond proceeds as well as other funds available to the Borrower (the "Non-Bond funds") to finance construction expenditures for capital improvements. Under its method of accounting, the Borrower also expected to expend the Bond proceeds for the construction expenditures in accordance with §§148(f)(4)(C) and 1.148-7(e). Construction expenditures were first paid with Non-Bond funds and then, for some of these expenditures, requisitions were submitted for reimbursement of the expenditure from Bond proceeds. Borrower allocated Bond funds to expenditures upon receipt of the Bond proceeds. For various reasons, including construction delays, the Bond proceeds were not requisitioned in accordance with the spending schedule specified by §§148(f)(4)(C) and 1.148-7(e). In order to accelerate the spending of Bond proceeds, the Borrower has requested a ruling permitting it to reallocate Bond proceeds to Non-Bond fund expenditures in accordance with the gross proceeds spend first method under § 1.148-6(d).

LAW AND ANALYSIS

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

Section 148(a) provides that 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. Further, 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).

Section 148(f) provides, in part, that a bond is an arbitrage bond unless the issuer timely rebates to the United States the excess of the amount earned on certain nonpurpose investments over the amount that would be earned on those investments had those investments had a yield equal to the bond yield, plus any income attributable to the excess. Under § 148(f)(6)(A), a nonpurpose investment is any investment property that is acquired with gross proceeds of an issue and is not acquired to carry out the governmental purpose of the issue.

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; 45percent 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.

Section 1.148-6(a)(1) provides that and issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue. However, under § 1.148-6(a)(3), if an issuer fails to maintain books and records sufficient to established the accounting method for an issue and the allocation of the proceeds of that issue, the accounting and allocation rules under § 1.148-6 are applied using the specific tracing method.

Under § 1.148-6(d)(1)(i), reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following: (1) a specific tracing method, (2) a gross proceeds sent first method, (3) a first-in, first-out method, or(4) a ratable allocation method, any of which must be consistently applied. Section 1.148-6(d)(1)(ii) provides that an allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue. A current outlay of cash means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made. Id.

Under § 1.148-6(d)(1)(iii), an issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. For bonds issued on or after May 16, 1997, the allocation under § 1.148-6(d)(1) must be made in any event by the date 60days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier. Id.

By not requiring allocations to be determined when the expenditure is paid or incurred, the regulations acknowledge that day-to-day practicalities require some flexibility for when issuers must make allocations. We conclude that these practicalities also require flexibility to correct allocations, so long as those corrections are made within the time frame provided under § 1.148-6(d)(1)(iii).

In the instant case, the Borrower had reasonable expectations that it would comply with the two-year spending exception for construction proceeds. The Borrower, however, believed that Bond proceeds should be allocated to expenditures upon receipt of the proceeds pursuant to its requisitions. As a result, allocations of Bond proceeds to expenditures failed to meet the requirements of the two-year spending exception to rebate under § 148(f)(4)(C).

We conclude that the Borrower may use the gross proceeds spent first method to allocate Bond proceeds to Non-Bond fund expenditures provided that any reallocation of Bond proceeds is accomplished within the time frame specified in § 1.148-6(d)(1)(iii). The gross proceeds spent first method is a reasonable accounting method under § 1.148-6(d)(1)(i) and will be consistently applied if the Borrower is permitted to apply it retroactively. Also, under the Borrower's initial allocation method and revised allocation method (gross proceeds spent first), Bond proceeds are allocated only to capital improvements that could have been financed with the Bond proceeds. Therefore, retroactive application of the gross 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.

CONCLUSION

Accordingly, the Borrower is permitted to utilize the gross proceeds spent first method to allocate Bond proceeds to expenditures as of Date 1, the issue date of the Bonds.

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 or implied concerning the meaning of the term "project" or the appropriate starting date of the 18-month period for the allocation of Bond proceeds to expenditures under § 1.148-6(d)(1)(iii). Also, no opinion is expressed or implied whether the requirements of §§ 148(f)(4)(C) and 1.1487(e) for the two-year spending exception to the rebate were met, whether the Bonds are arbitrage bonds under § 103(b) (within the meaning of § 148), or whether interest on the Bonds is excludable from gross income under § 103(a) of the Code.

This ruling is directed only to the taxpayer 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.

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.

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