

Bond Case Briefs

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IRS Approves Proposed Allocations of Build America Bond Proceeds.

The IRS ruled that the owner of a power plant can make allocations of Build America Bond proceeds, and the expenditure of earnings that accrue after the project period from the investment of sale proceeds of the bonds in a reasonably required reserve to pay principal and non-capital interest will not cause the bonds to fail to be qualified bonds.

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Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: ***, ID No. ***

Telephone Number: ***

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LEGEND:

Issuer = ***

Issue 1 = ***

Issue 2 = ***

Issue 3 = ***

Issue 4 = ***

Date 5 = ***

Date 1 = ***

Date 2 = ***

Date 3 = ***

Date 4 = ***

a = ***

Date 6 = ***

Dear ***:

This letter is in response to your request for rulings that (1) the Issuer can make certain proposed allocations related to Issue 2, Issue 3, and Issue 4 under sections 1.141-6(a) and 1.148-6 of the Income Tax Regulations as described below; (2) the expenditure of earnings that accrue subsequent to the project period (within the meaning of section 1.141-1) from the investment of sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve to pay principal and interest that is not a capital expenditure (non-capital interest) on an issue will not cause Issue 3 and Issue 4 to fail to be qualified bonds within the meaning of section 54AA(g)(2); and (3) section 1.148-6(d)(3)(ii)(A)(7) may be

applied to account for the expenditure of proceeds of Issue 3 and Issue 4.

FACTS AND REPRESENTATIONS

The Issuer makes the following representations. The Issuer has an undivided ownership interest in an electric generating facility (the Issuer's portion of this facility is referred to herein as the Project). The Project was not placed in service before Date 5. To finance the Project, the Issuer issued four issues of tax-advantaged bonds: (1) Issue 1, issued as tax-exempt bonds on Date 1, (2) Issue 2, issued as tax-exempt bonds on Date 2, (3) Issue 3, issued as direct pay build America bonds on Date 3, and (4) Issue 4, issued as direct pay build America bonds on Date 4 (Issue 2, Issue 3, and Issue 4 collectively, the Bonds). The Bonds are secured by a parity reserve fund which consists in part of some sale proceeds of Issue 3 and Issue 4. The Issuer represents that this parity reserve fund is a reasonably required reserve under section 148(d) and section 1.148-2(f) with respect to the Bonds. The Issuer expects the total costs of the Project to be lower than estimated as of the issue date of Issue 4 by \$a, and thus the Issuer will have unspent proceeds in this amount (the Unspent Amount).

Prior to Date 6, the Issuer had allocated its capital expenditures to proceeds of Issue 1 and the Bonds such that an amount of proceeds of Issue 4 equal to the Unspent Amount was not allocated to any capital expenditure. The Issuer proposes to revise its allocations of expenses to proceeds of the Bonds as described in the Issuer's request for this ruling (the Proposed Allocations) no later than the date that is 18 months after Date 5 and the date that is 60 days after the fifth anniversary of the issue of the Bonds to which it will allocate its expenditures. At the time that each of the expenses comprising the Proposed Allocations was actually paid, the Issuer had on hand sufficient proceeds of the specific issue of the Bonds to which the expense is allocated under the Proposed Allocations to pay the expense. The Issuer will allocate investments to proceeds of the Bonds for arbitrage and rebate purposes in a manner that is consistent with the Proposed Allocations.

The Issuer also proposes to deposit earnings that accrue subsequent to the project period, as defined in section 1.141-1(b), from the investment of sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve into a bona fide debt service fund and use those earnings to pay principal or interest.

LAW AND ANALYSIS

Revision of Allocations

Section 103(a) provides that, except as provided in subsection (b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that subsection (a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of section 141). Section 103(b)(2) provides that subsection (a) shall not apply to any arbitrage bond (within the meaning of section 148).

Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue which (1) meets the private business use test of section 141(b)(1) and the private security or payment test of section 141(b)(2), or (2) meets the private loan financing test of section 141(c). Section 141(b)(1) provides, in general, that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use.

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 section 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.

Section 1.141-6(a) provides that for purposes of sections 1.141-1 through 1.141-15, the provisions of section 1.148-6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under sections 141 and 148 must be consistent with each other.

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. However, under section 1.148-6(a)(3), if an issuer fails to maintain books and records sufficient to establish the accounting method for an issue and the allocation of the proceeds of that issue, the accounting and allocation rules under section 1.148-6 are applied using the specific tracing method.

Section 1.148-6(d)(1)(iii) provides that 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. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier.

Section 54AA(d)(1) provides that, for purposes of section 54AA, the term "build America bond" means any obligation (other than a private activity bond) if (A) the interest on such obligation would (but for section 54AA) be excludable from gross income under section 103; (B) such obligation is issued before January 1, 2011, and (C) the issuer makes an irrevocable election to have section 54AA apply.

The Issuer has requested that we rule on whether it can revise its allocations related to the Bonds under sections 1.141-6(a) and 1.148-6 as provided in the Proposed Allocations. The regulations under sections 141 and 148 apply to build America bonds as well as tax-exempt bonds because section 54AA(d)(1) defines a build America bond as other than a private activity bond and requires that, but for section 54AA, the interest on build America bonds be excludable from gross income under section 103. Accordingly, build America bonds cannot be private activity bonds under section 141 or arbitrage bonds under section 148 and are subject to the regulations under those sections to the extent that the regulations do not conflict with section 54AA.

By not requiring allocations to be determined when the expenditure is paid or incurred, the arbitrage regulations acknowledge that day-to-day practicalities require some flexibility regarding the timing of an issuer's allocations. We conclude that these practicalities also require flexibility to change allocations, so long as those changes are made within the time frame provided under section 1.148-6(d)(1)(iii). Here, at the time that each of the expenses described in the Proposed Allocations was actually paid, the Issuer had on hand sufficient proceeds of the specific issue of the Bonds to which the expense is allocated under the Proposed Allocations to pay the expense. The Issuer will also allocate investments to proceeds of the Bonds for arbitrage and rebate purposes in a manner that is consistent with the Proposed Allocations.

The Issuer tentatively made the Proposed Allocations within the time frame provided in section 1.148-6(d)(1)(iii). The Project was not placed in service before Date 5, which date is fewer than 18

months prior to Date 6, the date on which the Proposed Allocations were made. Date 6 occurred before the date that is 60 days after the fifth anniversary of any of the issues of the Bonds, and none of the issues of the Bonds have been retired. We conclude that, because the time frame provided in section 1.148-6(d)(1)(iii) had not yet closed and because there were sufficient proceeds on hand when the expenditures were made, Issuer can make the Proposed Allocations under sections 1.141-6(a) and 1.148-6.

Earnings on Sale Proceeds of BABs in Reserve

Section 54AA(a) provides that if a taxpayer holds a build America bond (BAB) on one or more interest payment dates of the bond during any taxable year, there shall be allowed as a credit against income tax for the taxable year an amount equal to the sum of the credits determined under section 54AA(b) with respect to such dates. Subject to limitations under section 54AA(c), section 54AA(b) provides that the amount of the credit with respect to any interest payment date for a build America bond is 35 percent of the amount of interest payable by the issuer with respect to such date.

Section 54AA(g) provides a special rule for qualified bonds issued before January 1, 2011. In the case of a qualified bond issued before January 1, 2011, in lieu of any credit allowed under Section 54AA with respect to such bond, the issuer of such bond shall be allowed a credit as provided in Section 6431.

Section 54AA(g)(2) provides that for purposes of Section 54AA(g), the term “qualified bond” means any BAB issued as part of an issue if (A) 100 percent of the excess of (i) the available project proceeds (as defined in Section 54A) of such issue, over (ii) the amounts in a reasonably required reserve (within the meaning of Section 150(a)(3)) with respect to such issue, are to be used for capital expenditures; and (B) the issuer makes an irrevocable election to have Section 54AA(g) apply.

Section 54A(e)(4) provides that the term “available project proceeds” means (A) the excess of the proceeds from the sale of an issue, over the issuance costs financed by the issue (to the extent that such costs do not exceed 2 percent of such proceeds), and (B) the proceeds from any investment of the excess described in (A).

Section 150(a)(3) provides that the term “net proceeds” means, with respect to any issue, the proceeds of such issue reduced by amounts in a reasonably required reserve or replacement fund.

Section 1.141-1(b) provides that for purposes of applying sections 1.141-1 through 1.141-16, the term “project period” means the period beginning on the issue date and ending on the date that the project is placed in service.

Section 1.148-6(d)(3)(i) provides that, except as otherwise provided in paragraph (d)(3) or paragraph (d)(4), 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 paragraph (d)(3)(iii)) as of that date (i.e., a “proceeds-spent-last” method). Section 1.148-6(d)(3)(ii)(A)(7) provides that the general rule in paragraph (d)(3)(i) does not apply to expenditures to pay principal or interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

The Issuer has requested that we rule on whether the expenditure of earnings that accrue subsequent to the project period (within the meaning of section 1.141-1) from the investment of sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve to pay principal and non-capital

interest on an issue will not cause Issue 3 and Issue 4 to fail to be qualified bonds within the meaning of section 54AA(g)(2). It has also requested that we rule on whether section 1.148-6(d)(3)(ii)(A)(7) may be applied to account for the expenditure of proceeds of Issue 3 and Issue 4.

The plain language of section 54AA(g)(2)(A) does not answer the question of whether investment earnings on the sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve may be used to pay principal and non-capital interest. The answer turns on whether such investment earnings are included in “available project proceeds” under section 54AA(g)(2)(A)(i) or in “the amounts in a reasonably required reserve” under section 54AA(g)(2)(A)(ii). Although section 54AA(g)(2)(A)(i) cross-references the definition of “available project proceeds” in section 54A(e)(4), proceeds of bonds issued under section 54A may not be used to fund a reasonably required reserve. Accordingly, the definition of “available project proceeds” in section 54A does not address investment earnings on sale proceeds deposited in a reasonably required reserve.

If earnings on sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve are included in “available project proceeds” under section 54AA(g)(2)(A)(i), then the Issuer would be required to spend those earnings on capital expenditures long after the Project is complete. We conclude, instead, that the earnings on the sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve that accrue after the end of the project period, as defined in section 1.141-1(b), are not “available project proceeds” within the meaning of section 54AA(g)(2)(A)(i) and, therefore, may be used to pay principal and non-capital interest without causing Issue 3 and Issue 4 to fail to be qualified bonds under section 54AA(g)(2).

As stated above, Issue 3 and Issue 4 are build America bonds and, therefore, subject to the regulations under section 148 to the extent that the regulations do not conflict with section 54AA. For example, any working capital expenditures permitted under section 54AA must be allocated for arbitrage purposes to the proceeds of Issue 3 and Issue 4 using a proceeds-spent-last method, as provided in section 1.148-6(d)(3)(i). We conclude that section 1.148-6(d)(3)(ii)(A)(7) applies to preclude application of the proceeds-spent-last method of allocation to the payment of principal or interest from earnings on sale proceeds of Issue 3 and Issue 4 in the reasonably required reserve that accrue after the end of the project period and that are first deposited in a bona fide debt service fund.

CONCLUSION

Based strictly on the information submitted and representations made, we conclude that (1) the Issuer can make the Proposed Allocations under sections 1.141-6(a) and 1.148-6; (2) the expenditure of earnings that accrue subsequent to the project period (within the meaning of section 1.141-1) from the investment of sale proceeds of Issue 3 and Issue 4 in a reasonably required reserve to pay principal and non-capital interest on an issue will not cause Issue 3 and Issue 4 to fail to be qualified bonds within the meaning of section 54AA(g)(2); and (3) section 1.148-6(d)(3)(ii)(A)(7) may be applied as provided above to account for the expenditure of proceeds of Issue 3 and Issue 4.

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, we express no opinion on any allocations related to Issue 1, whether Issue 1 or Issue 2 are tax-exempt under section 103, or whether Issue 3 or Issue 4 are build America bonds under section 54AA.

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.

Sincerely,

Timothy L. Jones
Senior Counsel
(Financial Institutions & Products)

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