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The Final Allocation and Accounting Regulations - What Do They Mean For "Phantom Investment Proceeds"?

The flexibility to reallocate proceeds to expenditures using an accounting method other than direct tracing has been a well-recognized and much-appreciated opportunity under the allocation and accounting rules of IRC section 141. The former proposed section 141 regulations (REG-140379-02, Sept. 26, 2006) ("Proposed Regulations"), now replaced by the final section 141 regulations issued October 27, 2015 ("Final Regulations") on which we reported here, here, here, and here and cross-referenced the arbitrage allocation rules in 1.148-6 in allowing the reallocation of proceeds away from the expenditures for which the proceeds were actually spent to different expenditures producing more favorable tax results. If the expenditures to which the proceeds were reallocated were paid later than the proceeds were actually spent, the reallocation raised the question of whether the proceeds had to be treated as spent later for arbitrage purposes, resulting in additional, "phantom" (because they were never actually earned) investment proceeds that were deemed to arise during the time between the date when the issuer originally spent the proceeds, and the date of the expenditure to which it later reallocated proceeds. Fortunately, the Proposed Regulations included an explicit exception from the otherwise applicable consistency rule between the section 141 and section 148 allocation and accounting rules, thereby avoiding phantom investment proceeds. The Final Regulations do not include this rule. So where are we now? Might we have phantom investment proceeds?

Background

Proposed Regulation 1.141-6(a) stated:

> Except as otherwise provided in this section, for purposes of 1.141-1 through 1.141-15, the provisions of 1.148-6(d) apply for purposes of allocating proceeds and other sources of funds to expenditures (as contrasted with investments). Except as otherwise provided in this section, allocations of proceeds and other sources of funds to expenditures generally may be made using any reasonable, consistently applied accounting method. *Allocations of proceeds to expenditures under section 141 and section 148 must be consistent with each other. . . .* (Emphasis added.)

Had the Proposed Regulations stopped here, we would have been left with the question of the appropriate arbitrage analysis if proceeds were reallocated to different, later expenditures, e.g., to avoid private business use, and the expenditures to which the proceeds were reallocated were paid later than when the proceeds were actually spent. Specifically, would phantom investment proceeds be imputed for the period from the actual expenditure to the reallocated expenditure? Aside from the potential rebate cost of such a rule, the record-keeping burden would have been horrendous. Apparently to avoid this, Proposed Regulation 1.141-6(a) further provided:

> . . . For purposes of the consistency requirements in this paragraph (a), it is permissible to employ an allocation method under paragraph (a)(2), (c), or (d) of this section (for example, the general pro rata allocation method under paragraph (a)(2) of this section) to allocate

sources of funds within a particular project for purposes of section 141 in conjunction with an accounting method allowed under 1.148-6(d) (for example, the first-in, first out method) to determine the allocation of proceeds or other sources of funds to expenditures for that project.

The Proposed Regulations have now been replaced by the Final Regulations. Section 1.141-6(a) of the Final Regulations states: "The allocations of proceeds and other sources of funds to expenditures under §1.148-6(c) apply for purposes of §§1.141-1 through 1.141-15." As supported by the preamble explanation, this rule apparently requires consistency in accounting between IRC sections 141 and 148. This consistency rule, however, is not followed (as it was in the Proposed Regulations) by an exception eliminating the concern of phantom investment proceeds. So we are left to determine whether phantom investment proceeds might arise.

As we previously reported in this blog (here),the Final Regulations automatically allocate tax-exempt proceeds to governmental use and qualified equity to private business use, to the extent possible. Moreover, the allocation of proceeds and qualified equity shifts from time to time if and when the location of private business use within the project shifts. Since this rule does not purport to allocate proceeds to particular expenditures and that allocation can shift over time, it appears reasonably clear that the application of this rule will not result in phantom investment proceeds.

The Final Regulations, however, would also appear to permit an affirmative allocation of proceeds to expenditures that is not inconsistent with the general rule described above. For example, assume that all of the proceeds of an issue are actually spent for a particular project (the "first project"). Assume further that the issuer would prefer to allocate a portion of those proceeds to a second, contemporaneous project while allowing the remainder of the issue proceeds to remain allocated to the first project. (Such a reallocation can enable the issuer to increase the benefit of its qualified equity, particularly if both projects are then financed in part with qualified equity.) The Final Regulations would appear to permit this affirmative allocation, but might this reallocation result in phantom investment proceeds?

While the Final Regulations (and the preamble) are silent on this question, it does not appear that issuers need to be concerned with the prospect of phantom investment proceeds. If there were a possibility of having to calculate and track additional investment proceeds, surely Treasury would have made that requirement clear, at least in the preamble if not in the Final Regulations themselves. For example, the method of determining the investment earnings rate alone would raise many unanswered questions that, if Treasury thought applicable, we should be able to assume would have been addressed. Accordingly, it appears appropriate to conclude that under no application of the Final Regulations should an issuer have to calculate phantom investment proceeds resulting from a potential difference in timing of actual proceeds expenditure versus reallocated proceeds expenditure.

I would further submit that such a result should obtain under IRC section 142 (exempt facility financings), where the consequences of phantom investment proceeds would be much greater. Rather than largely an arbitrage issue as in the case of governmental bonds, under section 142 the consequences would include qualification under the 95% qualified cost requirement. Again in the absence of any indication from Treasury or the IRS to the contrary, a reallocation of proceeds in a section 142 financing should not result in the possibility of phantom investment proceeds.

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