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Date:

March 31, 2005

Legend:

Bonds =

Fund A =

Program =

Issuer =

State =

Fund B =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

a =

b =

c =

This is in response to your request for a ruling that a guarantee of the Bonds backed by Fund A pursuant to the Program will not cause the amounts in Fund A to be treated as replacement proceeds of the Bonds.

### Facts and Representations

The Issuer is a public school district within the State. Like all public school districts in the State, it is a political subdivision of the State with general taxing powers. The Issuer plans to issue the Bonds, substantially all of the proceeds of which will be used for school purposes. The Bonds will be *ad valorem* tax bonds and the Issuer represents that the Bonds will not be private activity bonds. The Issuer intends to apply to the Program for a guarantee of the Bonds backed by Fund A.

The Program, established pursuant to the State constitution in Year 2, reduces public school districts' borrowing costs by providing a guarantee of the payment of principal and interest on bonds issued by public school districts for the acquisition, construction improvement and equipping of public schools. The guarantee is backed by the amounts in Fund A. In Year 3, the State constitution was amended to provide that the Program may also guarantee bonds issued by the State to make loans to public school districts or to purchase bonds issued by public school districts for the acquisition, construction, improvement and equipping of public schools.

Fund A is a perpetual state trust fund, created under the State constitution to support the funding of public, free schools for present and future generations of State schoolchildren. The State Board of Education manages the investment of and distributions from Fund A within limits set forth under State law. Since the adoption of the State constitution in Year 1, Fund A has consisted of public lands and sale proceeds and other revenues of such land. Fund A has also received gifts, bequests, and escheats of land. Over time, the corpus of Fund A has grown as the sale proceeds and revenues have been invested in bonds, and later in equities and purchased real estate. Distributions are made from the total return of the investment assets of Fund A to Fund B described below. The expense of managing Fund A land and investments are paid from Fund A. Fund A may be used for payments resulting from the guarantees under the Program discussed above. Fund A may not be used for any other purpose and the State constitution has never authorized the use of Fund A for any other purpose.

Fund B consists of the distributions made to it from Fund A, the taxes authorized by the State constitution or general law to be part of Fund B, and appropriations made to Fund B by the State legislature. Fund B is required by the State constitution to be applied annually to the support of the public, free schools and has been so required since the adoption of the State constitution in Year 1. The State constitution also allows the

legislature to appropriate funds from Fund B to pay the expenses of administering the Program. Since its adoption in Year 1, however, the State constitution has provided that the legislature may not enact a law appropriating or using any part of Fund A or Fund B for any purpose except as expressly provided in the State constitution.

At all times between Year 1 and Date 1, the State constitution required all of the interest received on the investments derived from the sale of land in Fund A to be included in Fund B. This interest thus comprised the available income of Fund A. On Date 1, the State constitution was amended to require a percentage of the average market value of Fund A, excluding real property, be distributed annually from Fund A to Fund B. The percentage is to be determined biennially by the State Board of Education. If the State Board of Education does not adopt a percentage prior to the beginning of the regular session of the State legislature, the State legislature will adopt such percentage. Such adopted percentage may not exceed a percent of the average market value of Fund A. In addition, the amount distributed from Fund A to Fund B in any year may not exceed the total return on all investments in Fund A over a b year period including the current fiscal year and the c fiscal years preceding it. Thus, beginning on Date 1, this distribution from the total return of the investment assets of Fund A became the available income of Fund A.

The State Board of Education is required to strive to manage Fund A consistently with respect to generating income for the benefit of the State public schools, growing Fund A's corpus, protecting Fund A's capital, and balancing the needs of present and future generations of State school children. The State Board of Education is further required to strive to maintain intergenerational equity by attempting to pay out a constant annual distribution per student after adjusting for inflation.

Prior to Date 1, the State constitution provided that the expense of managing Fund A could be paid by appropriation from Fund B. On Date 1, the State constitution was amended to provide that the expense of managing Fund A land and investments are to be paid by appropriation from Fund A.

As of the submission of this ruling request, the amount of outstanding bonds guaranteed by the Program and backed by Fund A has never exceeded 250 percent of the lower of the cost or fair market value of Fund A.

### Law & Analysis

Under §103(a) of the Internal Revenue Code (the "Code"), gross income does not include interest on any state or local bond. 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 1.148-11(d)(1) provides a rule excepting certain state guarantee funds from the definition of replacement proceeds for purposes of the arbitrage regulations. It provides:

A guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if—

(i) Substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests.

(ii) The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers;

(iii) Substantially all of the available income of the fund is required to be applied annually to support designated functions;

(iv) The issue guaranteed consists of general obligations that are not private activity bonds substantially all of the proceeds of which are to be used for designated functions;

(v) The fund satisfied each of the requirements of paragraphs (d)(1)(i) through (d)(1)(iii) of this section on August 16, 1986; and

(vi) The guarantee is not attributable to a deposit to the fund made after May 14, 1989, unless—

(A) The deposit is attributable to the sale or other disposition of fund assets; or

(B) Prior to the deposit, the outstanding amount of the bonds guaranteed by the fund did not exceed 250 percent of the lower of the cost or fair market value of the fund.

Fund A, established by the State constitution, was created and is controlled by the State. Thus, guarantees backed by Fund A will not be considered replacement proceeds of the Bonds if the six elements required for the perpetual trust fund exception are met. The six elements are addressed below in the order in which they appear in the regulation.

1. Substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts and bequests.

Fund A consists of public lands and land sale proceeds and other revenues of such land invested in bonds, equities and purchased real estate, as well as some gifts, bequests, and escheats of land. Accordingly, substantially all of the corpus of Fund A consists of nonfinancial assets, revenues derived from these assets, gifts and bequests.

2. The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers.

School districts within the State are political subdivisions with general taxing powers and provide essential governmental functions involving the education of children throughout the State. Pursuant to the State constitution, Fund A may only be used to make distributions to Fund B, to guarantee bonds under the Program for the purpose of acquisition, construction, improvement or equipping of public schools or to pay expenses of managing the assets of Fund A. Accordingly, this element of the regulation is met.

3. Substantially all of the available income of the fund is required to be applied annually to support designated functions.

The available income of Fund A consists of the distributions from the total return of all of the investments of Fund A to Fund B as specified in the State constitution. Because Fund B is required to be applied annually to the support of public, free schools and may only be used for such purpose and to pay the expenses of the Program, this element of the regulation is met.

4. The issue consists of general obligations that are not private activity bonds substantially all of the proceeds of which are to be used for designated functions.

The Bonds will be secured by *ad valorem* taxes and substantially all of the proceeds will be used for school purposes. The Issuer represents that the Bonds will not be private activity bonds. As such, this element of the regulation is met.

5. The fund satisfied each of the requirements of paragraphs (d)(1)(i) through (d)(iii) of § 1.148-11(d) on August 16, 1986.

Since the adoption of the State constitution in Year 1, Fund A has consisted only of public lands and land sale proceeds and other revenues of such land, as well as some gifts, bequests, and escheats of land. Accordingly, on August 16, 1986, the requirement of § 1.148-11(d)(1)(i) was met. Moreover, on August 16, 1986, the State constitution authorized amounts in Fund A to be used solely to guarantee bonds pursuant to the Program. On August 16, 1986, the State constitution required the available income as then defined to be deposited into Fund B, and required amounts in Fund B, other than those permitted to be used to pay the expense of managing Fund A and the Program, to be applied annually to support public, free schools. Accordingly, on August 16, 1986, the requirements of § 1.148-11(d)(1)(ii) and (d)(1)(iii) were met. As such, this element of the regulation is met.

6. The guarantee is not attributable to a deposit to the fund made after May 14, 1989, unless—(A) The deposit is attributable to the sale or other disposition of fund assets; or (B) Prior to the deposit, the outstanding amount of the bonds guaranteed by the fund did not exceed 250 percent of the lower of the cost or fair market value of the fund.

A guarantee of bonds, even if attributable to a deposit made after May 14, 1989, will not cause the amounts in Fund A to be treated as replacement proceeds of the Bonds if on the date such deposit was made, the outstanding bonds guaranteed by the Program and backed by Fund A did not exceed 250 percent of the lesser of fair market value or the cost of Fund A or if such deposit is attributable to the sale or other disposition of Fund A assets. We think it is appropriate to determine whether this element of the regulation is met on the sale date of bonds to be guaranteed by the Program. Deposits subsequent to the sale date are not relevant in determining whether Fund A is to be treated as replacement proceeds of such bonds, and therefore changes in either the amount of outstanding bonds guaranteed by the Program and backed by Fund A or the fair market value of Fund A occurring after the sale date of bonds to be guaranteed by the Program need not be taken into account with respect to such bonds. As of the date of the submission of this private letter ruling request, the amount of bonds guaranteed by the Program and backed by Fund A has never exceeded 250 percent of the lower of cost or fair market value of Fund A. Assuming this is still true as of the sale date of the Bonds, the last element of the regulation will be met.

#### Conclusion:

We conclude that a guarantee of the Bonds backed by Fund A pursuant to the Program will not cause the amounts in Fund A to be treated as replacement proceeds of the Bonds. This ruling is conditioned on the amount of bonds guaranteed by the Program and backed by Fund A not exceeding 250 percent of the lower of cost or fair market

value of Fund A on each date on which a deposit is received, or such deposit being attributable to the sale or other disposition of Fund A assets, at all times prior to the sale date of the Bonds.

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,

Assistant Chief Counsel  
(Exempt Organizations/Employment  
Tax/Governmental Entities)

By: \_\_\_\_\_  
Johanna Som de Cerff  
Senior Technical Reviewer  
Tax Exempt Bond Branch