Internal Revenue Service

Department of the Treasury

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Legend

State =

Issuer =

Board =

Specified Bonds =

Dear :

This letter is in response to your ruling request concerning the allocation of certain of the proceeds of the Specified Bonds for arbitrage purposes. The proceeds that are the subject of your request are those Specified Bond proceeds that are invested in commingled funds operated by the State Treasurer (the “Treasurer”).

Facts

The Issuer was created by the State as a division of the Board and is authorized by State law to issue State bonds and bonds on behalf of any State agency. Pursuant to this authority, the Issuer issued the various issues of the Specified Bonds for the use by certain of the State agencies. The Specified Bonds are subject to either the arbitrage rules published May 18, 1992 (T.D. 8418, 57 Fed. Reg. 20971 (1992), the “1992 regulations”), those published June 18, 1993 (T.D. 8476, 58 Fed. Reg. 33510 (1993), the “1993 regulations”), or those currently in effect.

With respect to the Specified Bonds, the Board is responsible for investing any moneys held in a sinking fund (including any reserve fund); any proceeds held in a refunding escrow; and any moneys held in a rebate account to meet rebate liabilities under § 148(f) of the Internal Revenue Code. All other moneys held in any fund or account established in connection with the Specified Bonds were transferred to and are invested by the Treasurer. For example, the Treasurer invests any Specified Bond proceeds held in a “project fund”, “construction fund”, “acquisition fund”, or similar fund. As of the respective issue date of each issue of the Specified Bonds, the proceeds

invested by the Treasurer were expected to be expended over a relatively short period following the issue date and generally qualified for the 3-year temporary period for capital projects under § 1.148-2(e)(2) of the Income Tax Regulations.[1]

The Treasurer is responsible for investing all moneys of the State and its agencies, other than those invested by the Board. The Treasurer invests the moneys among several pools, some of which are managed internally by the Treasurer (the "internally-managed pools") and some of which are managed by external managers (the "externally-managed pools"). The internally-managed pools consist of obligations that are readily converted into cash with no loss of principal. The weighted average maturity of the investments in the internally-managed pools varies between 4 and 9 months. The externally-managed pools primarily consist of fixed-income obligations, convertible bonds, and mortgage-backed securities. The weighted average maturity of the investments in the externally-managed pools is approximately 4.7 years.

The Treasurer regularly consults with the State agencies to determine when moneys will be available for investment and when expenditures will occur (including the agencies' expectations regarding the rate of expenditure of bond proceeds). The purpose of this consultation is to ensure that the moneys in the internally-managed pools are sufficient to meet the aggregate liquidity needs of the State and its agencies for routine and unexpected disbursements. The Treasurer invests any moneys made available by the State or a particular agency between the internally-managed pools and the externally-managed pools based on the overall liquidity needs of the State and its agencies, rather than on the particular liquidity needs of the State or any agency. The internally-managed pools always have been, and are expected to continue to be, sufficient to meet the liquidity needs of the State and its agencies. The moneys in the externally-managed pools never have been, and are not anticipated ever to be, needed to meet the liquidity needs of the State and its agencies.

There is no statutory provision that requires any particular portion of a State agency's moneys be invested in the externally-managed pools; rather, the externally-managed pools were created to provide enhanced investment returns. Since the creation of the externally-managed pool program, the balance in the externally-managed pools has increased each fiscal year. In contrast, the balance in the internally-managed pools has been relatively stable.

The amount of bond proceeds invested by the Treasurer has always been, and is expected to continue to be, less than 40 percent of the total amount invested in the internally-managed pools, and less than 25 percent of the total amount invested in the

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[1] For convenience, we cite to the current regulations. The applicable provisions of the 1992 and 1993 regulations are, in substance, the same, and thus, the analysis is not affected by whether the 1992, 1993, or current regulations apply.

internally-managed and externally-managed pools. None of the resolutions or trust indentures for the Specified Bonds require that the State continue the externally-managed pool program or that any particular amount of proceeds be invested in the externally-managed pools.

For State law purposes, the Treasurer is required to allocate the earnings on moneys invested by the State agencies on a pro rata basis. State regulations set forth the method to be used in allocating investment earnings to the State agencies. First, the Treasurer calculates the earnings rate each month on an accrual basis. The earnings rate is calculated by totaling accrued interest earnings and capital gains or losses for the internally-managed pools and the externally-managed pools. The accrued interest earnings are calculated by taking into account accruals of any original issue discount, market discount, and purchase premium on the investments. The earnings rate does not take into account unrealized gains or losses. Second, the total accrued earnings amount is distributed to each State agency on a pro rata basis, calculated by comparing the average daily balance of the moneys invested with the Treasurer by a particular agency during the month to the total average daily balances of all agencies during the month. For this purpose, no distinction is made between bond proceeds and other moneys.

The result of the application of the State regulations is that each agency is deemed to be invested in both the internally-managed pools and the externally-managed pools. During any month, the deemed allocation of an agency's moneys between the pools is the same for all agencies, even though each agency may have different liquidity needs for that month. For example, if 40 percent of the moneys invested by the Treasurer are in the internally-managed pools and 60 percent are in the externally-managed pools in a particular month, then each agency's moneys will be deemed to be invested in the internally-managed pools and the externally-managed pools in that same proportion.

The Issuer proposes, for arbitrage purposes, to allocate all of the proceeds of the Specified Bonds that are invested by the Treasurer to the internally-managed pools (the "proposed allocation method"). In the event that the balance in the internally-managed pools drops below the amount of the Specified Bond proceeds invested with the Treasurer, the Issuer will allocate the excess proceeds by allocating a pro rata portion of the remaining proceeds of each issue of the Specified Bonds to the externally-managed pools, and treat any investments allocated to such proceeds accordingly. The Issuer will apply the proposed allocation method uniformly within and between fiscal periods. It also will comply with the applicable requirements contained in § 1.148-6(e) for commingled funds.

The Issuer represents the following with respect to any discrepancy resulting from the difference between the Treasurer's internal accounting method and the proposed allocation method: (1) If the amount of investment proceeds attributed for a

particular month to an issue of the Specified Bonds under the proposed allocation method is greater than the amount of investment proceeds attributed for the month under the Treasurer's internal accounting method, the Issuer will allocate the excess to expenditures for governmental purposes (other than the project expenditures identified for State law purposes), if the requirements of § 1.148-6(d)(6) are met, and otherwise will continue to treat such amounts as proceeds until allocated in accordance with §1.148-6(d); (2) As of the date that the proceeds of the Specified Bonds, as calculated under the Treasurer's internal accounting method, have been allocated to expenditures (the "State law expenditure date"), the Issuer will determine the amount of any unspent proceeds as calculated under the proposed allocation method and continue to treat such amount as proceeds until allocated in accordance with § 1.148-6(d); and (3) If the proceeds of the Specified Bonds under the proposed allocation method are allocated to expenditures under § 1.148-6(d) before the State law expenditure date, the amounts treated as unspent under the Treasurer's internal accounting method will not be treated as proceeds, but will be treated as replacement proceeds if required by §1.148-1(c).

Law and Analysis

Section 103(a) provides that gross income generally does not include interest on any state or local bonds. This exclusion from income does not apply, however, to interest on any arbitrage bond (within the meaning of § 148). § 103(b)(2).

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 to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments. In addition, 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 such a manner. *Id.* However, a bond shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such bond is a part may be invested in higher yielding investments for a reasonable temporary period until such proceeds are needed for the purpose for which such issue was issued. § 148(c).

Section 148(f) provides generally that a bond which is part of an issue shall be treated as an arbitrage bond if, with respect to such issue, the issuer fails to pay to the United States an amount equal to the sum of (1) the excess of the amounts earned on all nonpurpose investments over the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue, plus (2) any income attributable to the excess. A nonpurpose investment is any investment property which is acquired with the gross proceeds of an issue, and is not acquired to carry out the governmental purpose of the issue. § 148(f)(6)(A).

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. Consistently applied means applied uniformly within a fiscal period and between fiscal periods to account for gross proceeds of an issue and any amounts that are in a commingled fund. § 1.148-1(b). An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. § 1.148-6(a)(2). Bona fide governmental purposes may include special state law restrictions imposed on specific funds or actions to avoid grant forfeitures. *Id.*

Section 1.148-6(d)(1)(i) provides that reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method, a gross proceeds spent first method, a first-in, first-out method; or a ratable allocation method. Section 1.148-6(d)(1)(ii) requires 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. Section 1.148-6(d)(6) applies to any issue of governmental bonds and provides that investment proceeds of an issue (other than investment proceeds held in a refunding escrow) are treated as allocated to expenditures for a government purpose when the amounts are deposited in a commingled fund with substantial tax or other revenues from governmental operations of the issuer and the amounts are reasonably expected to be spent for governmental purposes within 6 months from the date of the commingling.

The term "commingled fund" means any fund or account containing both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of that issue if the amounts in the fund or account are invested and accounted for collectively, without regard to the source of funds deposited in the fund or account. § 1.148-1(b). Section 1.148-6(e)(1) provides that an accounting method for gross proceeds in a commingled fund, other than a bona fide debt service fund, is reasonable only if it satisfies the requirements of § 1.148-6(e)(2) through (6).

We conclude that the proposed allocation method is a reasonable, consistently applied accounting method. First, the proposed allocation method reflects the Issuer's expectations regarding the timing of investments and expenditures of the proceeds of the Specified Bonds. The proceeds of the Specified Bonds invested with the Treasurer are used principally for capital projects. Accordingly, they are expected to be expended over a relatively short period of time following the issuance of the respective Specified Bonds and generally qualify for a 3-year temporary period. These expectations better correlate with the weighted average maturity of the investments in the internally-managed pools (between 4 and 9 months) than that of the investments in the externally-managed pools (approximately 4.7 years).

Second, the proposed allocation method reflects the actual flows of the moneys expended. Actual draws of moneys for expenditures of bond and non-bond moneys are made from the internally-managed pools. The internally-managed pools have been, and are expected to be, sufficient to meet all the liquidity needs of the State and the State agencies. If the amount in the internally-managed pools ever is less than the amount of the Specified Bond proceeds invested by the Treasurer, the Issuer will allocate the excess proceeds by allocating a pro rata portion of the remaining proceeds of each issue of the Specified Bonds to the externally-managed pools. In addition, there is no statutory provision, bond resolution, or bond trust indenture that requires bond proceeds be invested in the externally-managed pools.

Third, while the proposed allocation method is different from Treasurer's internal accounting method, this does not by itself cause the proposed allocation method to be unreasonable. Neither of the methods specifically traces the moneys invested or spent. However, as described above, the proposed allocation method reflects Issuer's expectations regarding the timing of investments and expenditures as well as the actual flows of the moneys expended. Moreover, the Issuer has adopted a reasonable approach to handle the discrepancies that will occur between the proposed allocation method and the Treasurer's internal accounting method.

Finally, the Issuer will apply the proposed allocation method consistently within and between fiscal periods. In applying the proposed allocation method, the Issuer will also comply with the applicable requirements contained in § 1.148-6(e) for commingled funds.

Conclusion

Based on the facts and the Issuer's representations, we conclude that the proposed allocation method is a reasonable, consistently applied accounting method for purposes of § 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. No opinion is expressed whether interest on the Specified Bonds is excludable from the gross income of the holders 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,
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(Exempt Organizations/Employment Tax/Government)
By: Bruce M. Serchuk
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Tax Exempt Bond Branch