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Public Finance TAX UPDATE

A NEWSLETTER HIGHLIGHTING RECENT FEDERAL INCOME TAX DEVELOPMENTS AFFECTING THE PUBLIC FINANCE INDUSTRY

December, 2004

This Issue

Solid Waste Technical Advice Memorandum

The IRS recently released a technical advice memorandum (the *"TAM"*) concluding that, in the case of obligations subject to the Tax Reform Act of 1986, radioactive waste is not solid waste for purposes of private activity bonds issued to finance solid waste disposal facilities. The TAM, which was dated August 27, 2004, arose out of an audit of a post-1986 new money solid waste private activity bond issue that financed a facility that stores radioactive spent fuel rods.

The IRS stated that the Internal Revenue Code itself was unclear as to whether solid waste could include radioactive waste. Thus, in reaching its conclusion, the IRS analyzed the legislative history to the Tax Reform Act of 1986. The IRS stated that, in its view, the legislative history means that solid waste for these purposes does not include any radioactive waste.

In the TAM, the IRS specifically declined to determine whether solid waste could include radioactive waste in the case of obligations not subject to the Tax Reform Act of 1986. Generally, obligations issued before August 16, 1986, as well as obligations issued under certain transition rules to refund obligations issued before August 16, 1986 and new money obligations issued under certain other transition rules are not subject to the Tax Reform Act of 1986.

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Background. On December 20, 2004, the Treasury released final and proposed rules governing the requirements for written advice concerning federal tax issues. The rules are divided into three parts: general rules, rules for "covered opinions" and proposed rules for certain municipal bond opinions. In addition, the rules require firms to institute procedures to assure compliance with the rules. We are in the process of analyzing these new rules and how best to ensure that our practice and opinions comply with them. This update provides only a general outline of the new rules.

General Rules. To give any written tax advice (including e-mails) with respect to any tax issue, an advisor must: (i) base the advice only on reasonable factual or legal assumptions; (ii) rely only upon reasonable representations, statements, findings or agreements of the taxpayer or any other person; (iii) consider all relevant facts; and (iv) not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit or that an issue will be settled. Unlike the rules for covered opinions, discussed below, the general rules do not require that the written advice describe the relevant facts (including assumptions and representations), the application of the law to those facts, or the

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CHAPMAN AND CUTLER LLP
FOCUSED ON FINANCE™

Chicago, IL
111 West Monroe Street
Chicago, IL 60603
(312) 845-3000
FAX: (312) 701-2361

San Francisco, CA
595 Market Street
San Francisco, CA 94105
(415) 541-0500
FAX: (415) 541-0506

Salt Lake City, UT
50 South Main Street
Salt Lake City, UT 84144
(801) 533-0066
FAX: (801) 533-9595

chapman.com

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practitioner's conclusion with respect to the law and the facts.

Covered Opinions. Under the final rules, an advisor providing a *"covered opinion"* must in the opinion: (i) identify and ascertain all relevant facts; (ii) relate the applicable law to the relevant facts; (iii) evaluate each significant federal tax issue; and (iv) provide an overall conclusion. In addition, covered opinions may be required to contain certain disclosures.

A covered opinion includes written advice (including e-mails) that concerns one or more federal tax issue(s) arising from:

(i) a listed transaction;

(ii) any plan or arrangement, the *principal* purpose of which is the avoidance or evasion of any tax; or

(iii) any plan or arrangement, a *significant* purpose of which is the avoidance or evasion of tax if the written advice is: (a) a reliance opinion, (b) a marketed opinion, (c) subject to conditions of confidentiality, or (d) subject to contractual protection.

A reliance opinion includes "more-likely-than-not," "should" and "will" opinions, so opinions written on such standards will be covered opinions, unless another exception applies.

Written advice is not to be treated as a reliance opinion or a marketed opinion if the advisor makes certain disclosures, including prominently disclosing in the written advice that it was not written to be used and cannot be used for the purpose of avoiding penalties. This exception does not apply to written advice for a listed transaction or a transaction with a principal purpose of avoiding tax.

Written advice is not treated as a covered opinion if the advice concerns the qualification of a qualified plan or is included in documents required to be filed with the SEC, unless the transaction is a listed transaction or a transaction with a principal purpose of avoiding tax.

Preliminary advice is also not treated as a covered opinion if the advisor is reasonably expected to provide qualifying written advice later.

We are continuing to examine the distinction between transactions with a principal purpose of avoiding tax and transactions with a significant purpose of avoiding tax for the purposes of applying certain of the exceptions described above.

State or Local Bond Opinions. State or local bond opinions are subject to the general rules described above, but *certain of them* are not treated as "covered opinions."

Instead, the Treasury has proposed new regulations that will specifically provide the requirements for certain state or local bond opinions. As defined, a state or local bond opinion does NOT include all municipal bond opinions, but rather includes only written advice that is included in any materials delivered to a purchaser of a state or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared) that concerns only:

(i) the excludability of interest on a state or local bond from gross income under Section 103 of the Internal Revenue Code;

(ii) the application of Section 55 of the Internal Revenue Code to state or local bonds;

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Definition of Available Amounts

In Private Letter Ruling 200446006, released in November, 2004, the IRS ruled that proceeds of taxable obligations used to fund a minimum floor amount in a State unemployment account are not "available amounts" for purposes of determining whether the proceeds of tax-exempt obligations used to fund a deficit in the account are spent under the proceeds-spent-last accounting method.

Under the facts of the ruling, a State issued taxable obligations to fund its unemployment trust account in the Federal Unemployment Trust Fund. The State uses the account to pay unemployment benefits to unemployed workers and generally funds the account from the revenues of an unemployment tax it imposes on employers in the State. The State is required under federal law to deposit the unemployment taxes it collects into the account to pay unemployment benefits. In addition, the United States Department of Labor certifies the State's unemployment benefits program, including the floor amount.

One component of the unemployment tax the State uses to fund the account is a deficit rate that the State imposes on employers if the balance in the account is less than a certain floor amount on October 1 of the preceding year. The State must maintain a minimum floor amount in the account based on a formula set forth in State law. The current floor amount has been in existence since 1983.

Due to a continuing economic downturn in its economy, the State has paid out unemployment benefits in excess of the unemployment taxes it collected, thereby

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Qualified Zone Academy Bonds. On October 4, 2004, President Bush signed the Working Families Tax Relief Act of 2004, which, among other things, continued to permit issuers to issue Qualified Zone Academy Bonds ("*QZABs*") at an annual nationwide level of $400 million and extended the QZABs program through 2005. The state-by-state allocations for 2005 of the $400 million annual nationwide limit were recently published by the IRS in Rev. Proc. 2004-72.

Qualified Small Issue Bonds. On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (the "*Act*"), which, among other things, amended Section 144 of the Internal Revenue Code to exclude up to $10,000,000 of capital expenditures in determining whether an obligation qualifies as a "qualified small issue bond." Section 340 of the Act provides that, with respect to obligations issued after September 30, 2009, in addition to certain capital expenditures not currently taken into account in determining whether an obligation is a qualified small issue bond (such as expenditures to replace destroyed property, expenditures required by changes in law or certain expenditures which could not be reasonably foreseen), issuers may exclude up to $10,000,000 of capital expenditures for purposes of the small issuer limit of Section 144. The Act also contains a conforming amendment for obligations issued after September 30, 2009, that disallows the exclusion of amounts expended on projects with respect to which an urban development action grant has been made.

Green Bonds. Section 701 of the Act added a new subsection to Section 142 of the Internal

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For additional information on any of the articles contained in this issue, please contact:

Jeffrey D. Berry
(312) 845-3713

David J. Cholst
(312) 845-3862

Anthony R. Rosso
(312) 845-3913

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depleting the amounts held in the account below the floor amount. Although historically the State has maintained the floor amount in the account and generally avoided imposing the deficit rate on employers, the State has projected continuing deficits in the floor amount for the next few years because collections of unemployment taxes are expected to continue to fall short of expected unemployment benefit claims. To address this problem, the State legislature authorized the issuance of obligations to pay unemployment benefits. The State will pay debt service on the obligations with the revenues of an annual tax imposed on employers in the State.

Pursuant to legislation, an issuer issued several series of taxable obligations (sold at substantially different times) to fund the State's account (the *"Taxable Bonds"*) and certain other taxable obligations expected to be spent to pay unemployment benefits within six months of the date of issuance (the *"Deficit Bonds"*).

The State satisfied the floor amount in the account and avoided imposing the deficit rate by depositing the proceeds of both the Taxable Bonds and the Deficit Bonds into the account. The issuer initially issued the Deficit Bonds as taxable bonds and requested this ruling from the IRS to enable it to convert the taxable Deficit Bonds into tax-exempt obligations. To enable the issuer to convert the Deficit Bonds into tax-exempt obligations and treat the proceeds as spent on working capital expenditures under the proceeds-spent-last method of accounting, the issuer asked the IRS to determine that the proceeds of the Deficit Bonds exceeded "available amounts" to be used to fund the deficit in the account. Specifically, the issuer argued that proceeds of any debt obligation are unavailable for purposes of the proceeds-spent-last method because the obligations must be repaid. The issuer argued that repayment is equivalent to reimbursement and that, under the regulations, amounts that contractually must be reimbursed are excluded from the definition of "available amount."

In the ruling, the IRS disagreed with the issuer's reasoning but nevertheless concluded that the proceeds of the Taxable Bonds, to the extent they are allocated to the floor amount, were not "available amounts" under the regulations. In rejecting the issuer's reasoning, the IRS determined that if amounts subject to an obligation for repayment under a promissory note were equivalent to amounts subject to a reimbursement obligation arising as a result of a "legislative, judicial, or contractual requirement," then it would have been unnecessary to specifically provide in the regulations that "proceeds of the issue" are unavailable. Moreover, the IRS reasoned that because of the restricted nature of the working capital allocation rules, the term "reimbursement" must be interpreted more narrowly than a simple obligation to repay. The IRS concluded, however, that the proceeds of the Taxable Bonds were unavailable to fund working capital expenditures, and therefore not "available amounts," because of the specific nature of the facts in the ruling.

The IRS noted that the floor amount was determined by a formula under State law and was established by State law long before the transactions that were the subject of the ruling request. In addition, the IRS noted that the floor amount varied in accordance with events that occurred in the fiscal year previous to the year in which there must be a determination of available amounts and met the safe harbor in the regulations concerning a reasonable working capital reserve. Accordingly, the IRS ruled that the floor amount insures that a reserve is available to pay unemployment benefits in the event claims are greater than expected and thus functioned as a working capital reserve which is treated as unavailable for purposes of the proceeds-spent-last method of accounting.

Finally, the IRS ruled that the Deficit Bonds did not give rise to replacement proceeds because the State expects to spend the proceeds of the Deficit Bonds within six months and because the Deficit Bonds are not financing the floor amount, either directly or indirectly. In supporting its determination, the IRS concluded that the floor amount is not a newly created working capital reserve that is financed with bond proceeds but has instead been maintained for many years.

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(iii) the status of the bond as a qualified tax-exempt obligation under Section 265(b)(3) of the Internal Revenue Code;

(iv) the status of the bond as a qualified zone academy bond under Section 1397E of the Internal Revenue Code;

or any combination of these issues.

The proposed requirements for state or local bond opinions generally include the requirements outlined above for covered opinions, except that an advisor may provide a single state or local bond opinion or may provide a combination of documents if the documents, taken together, satisfy the requirements. If a state or local bond opinion is changed or otherwise updated after bonds are issued, the altered opinion is not a state

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Unfinished Mass-Produced Units Not Nongovernmental Output Property

In Private Letter Ruling 200448017, released in November, 2004, the IRS ruled that the acquisition of certain electric generators with proceeds of tax-exempt obligations will not be considered the acquisition of nongovernmental output property where such generators were not previously used or held for use by a nongovernmental power producer.

A governmental authority issued tax-exempt obligations, on behalf of one of the entities that created it, to finance a natural gas-fired, combustion turbine-based combined cycle facility that included the cost of acquiring certain electric generators. After the issuance of the obligations, a district, which, along with another entity, established the authority, solicited bids for two generators. The district received six offers, including offers from a manufacturer of power generation equipment (the *"Manufacturer"*) and a for-profit independent power producer (the *"Power Company"*).

The Manufacturer's generator sets are non-customized, mass-produced items that are generally available for sale to both public and private electric power companies. The Manufacturer begins to manufacture a generator set once an order is placed according to the following process: (1) it manufactures or purchases several hundred of the component parts that comprise the generator set; (2) each component part is then allocated to one of several generator sets that the Manufacturer may have in progress; (3) the allocated components are crated and segregated in storage; (4) at a time specified

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by the purchaser, the component parts are delivered to purchaser's designated site; (5) the component parts are assembled and installed at the purchaser's site over a period of six to nine months; and (6) the generator set is made ready for commercial operation after six to eighteen weeks of testing. The entire process from placement of the order to final operation takes approximately twenty to twenty-six months.

Prior to its offer to provide generators to the district, the Power Company had entered into an agreement with the Manufacturer to purchase four generators to be manufactured and assembled by the Manufacturer. Approximately eight months after entering into the agreement with Manufacturer, the Power Company concluded that it did not need the generators. Because the Manufacturer was approximately halfway through steps one and two of the manufacturing process (discussed above), the Power Company could not terminate the agreement without incurring great cost and, instead, decided to sell the right to the generators. The Manufacturer continued to manufacture the generators and the Power Company arranged to have the component parts of the generators stored until sold. The Manufacturer's offer to the district provided that it would only commence manufacturing the generators after it was awarded the contract. The Power Company was the lowest bidder. The district and the Power Company entered into a purchase agreement for the generators. The Manufacturer acknowledged the Power Company's sale of the right to the generators to the district in a revised purchase contract.

The authority requested a ruling from the IRS that the acquisition of the generators with the proceeds of tax-exempt obligations will not constitute the acquisition of "nongovernmental output property" under the Internal Revenue Code.

In the ruling, the IRS analyzed the term "nongovernmental output property." Nongovernmental output property is defined in the Internal Revenue Code as any property (or interest therein) which before such acquisition was used (or held for use) by a person other than a governmental unit in connection with an output facility (other than a facility for the furnishing of water). The IRS noted that legislative history defines the term "output facility" to include facilities such as electric and gas generation, transmission distribution and other related facilities. The IRS also noted that the term "nongovernmental output property" includes property that was constructed by or for an investor-owned utility with the expectation that it would be placed in service by an investor-owned utility but that is not actually placed in service before its acquisition by a governmental unit. Legislative history also noted that if property is constructed for an investor-owned utility, that property is treated as nongovernmental output property and such determination is made without regard to whether the investor-owned utility actually placed the property in service.

The IRS analyzed whether the generators were used or held for use by the Power Company prior to the Power Company entering into the purchase agreement with the district. The IRS concluded that the generators were not used (or held for use) by the Power Company because at the time of sale to the district the Manufacturer had not yet manufactured all of the component parts. The IRS noted that the generators are mass-produced items that were not customized for the Power Company's use and determined that if the district had not purchased the generators from the Power Company it could have purchased generator sets from one of four other companies.

Based on the facts of the ruling, the IRS determined that the generator sets will be assembled and installed for the first time at the financed facility and thus will not be "nongovernmental output property" because the generators will first be constructed for and used by the district, a governmental unit.

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Revenue Code authorizing the issuance of tax-exempt bonds to finance "qualified green building and sustainable design projects" (*"Qualified Projects"*) that are submitted to the Secretary of the Treasury (the *"Secretary"*) by a state or local government within an application period ending 180 days after the enactment of the Act. Obligations issued for Qualified Projects pursuant to Section 701 of the Act are not subject to general state volume caps under Section 146 of the Internal Revenue Code.

A project will be considered a Qualified Project if it is designated as a Qualified Project by the Secretary (after consultation with the Administrator of the EPA) within sixty days after the end of the application period. Of the Qualified Projects designated by the Secretary, at least one of the projects must be located in, or within a 10-mile radius of, an empowerment zone and at least one of the projects must be located in a rural state. A rural state is defined in the Act as any state with, according to the 2000 census, a population of less than 4,500,000, a population density of less than 150 people per square mile and that saw an increase in population that was less than half of the national increase between the 1990 and 2000 censuses. No more than one project can be designated in a state. Further, a project cannot include a professional sports stadium or arena or a facility the principal business of which is the sale of food or alcohol for consumption on the premises.

In addition to the requirements discussed above, a Qualified Project must satisfy the following criteria:

(i) at least 75 percent of the square footage of commercial buildings that are part of the project must be registered for (and reasonably expected to receive) Leadership in Energy & Environmental Design (*"LEED"*) certification from the United States Green Building Council;

(ii) it must include a brownfield site;

(iii) it must receive specific state or local government resources (which may include tax abatement benefits and contributions in kind) in support of the project equal to at least $5,000,000;

(iv) it must include either a building of at least 1,000,000 square feet or at least 20 acres of land;

(v) it uses the benefit of tax-exempt financing for one or more of the following: (a) the purchase, construction, integration or other use of energy efficiency, renewable energy and sustainable design features

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of the project; (b) compliance with LEED certification standards; or (c) the purchase, remediation, and foundation construction and preparation of the brownfield site; and

(vi) the project is projected to provide permanent employment of at least 1,500 full time equivalents (150 in rural states) when completed and construction employing at least 1,000 full time equivalents (100 in rural states).

The Secretary (in consultation with the Administrator of the EPA) will ensure that, in the aggregate, the Qualified Projects will:

(i) reduce electric consumption by more than 150 megawatts annually as compared to conventional generation;

(ii) reduce daily sulfur dioxide emissions by at least 10 tons as compared to coal-generated power;

(iii) expand by 75 percent the domestic solar photovoltaic market as compared to such market expansion from 2001 to 2002; and

(iv) use at least 25 megawatts of fuel cell energy generation.

Applications to the Secretary for Qualified Project designation must describe how the project will reduce electric consumption, reduce the amount of sulfur dioxide daily emissions, expand domestic solar photovoltaic use and use fuel cell energy.

Each issuer is required to maintain an interest-bearing reserve account equal to one percent of the net proceeds of the obligations issued under these provisions for a Qualified Project. The amounts in the reserve fund may be released to the project when the Secretary certifies that the project has substantially complied with the provisions of Section 701 of the Act and the project application. The Secretary shall make such a determination no later than five years after the issue date.

The Secretary may set an aggregate face amount of tax-exempt financing for a Qualified Project and, in the aggregate, the Secretary may not allocate bonds for Qualified Projects in excess of $2,000,000,000.

Section 701 of the Act applies to obligations issued after December 31, 2004 and will not apply to any obligation issued after September 30, 2009. Neither the $2,000,000,000 ceiling nor the sunset provision will apply to obligations issued to refund an obligation for a Qualified Project before October 1, 2009, if (i) the average maturity date of the issue is not extended, (ii) the amount of the refunding obligation does not exceed the outstanding amount of the refunded obligation and (iii) the refunding is a current refunding.

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or local bond opinion, and is subject to the requirements for covered opinions.

Effective Dates. The final regulations on general rules and on covered opinions will be effective June 20, 2005. The proposed regulations for state and local bond opinions will be effective 120 days after they are published in final form. The Treasury has scheduled a hearing on the proposed regulations governing state and local bond opinions for March 22, 2005, and comments are due by March 1, 2005.

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Public Finance Tax Update
has been prepared by the Chapman and Cutler LLP Tax Department for Firm clients to highlight recent federal income tax developments affecting the public finance industry. Tax advice requires a detailed analysis of the particular facts of each situation and transaction. Accordingly, the items contained herein are not intended as legal advice and readers should contact an attorney with regard to any specific questions raised by the items in this issue.