01. ARBITRAGE AND REBATE

Chair:

Marybeth E. Frantz **Harris Beach PLLC – Pittsford, NY**

A – Introductory Principles Panel

This panel will address introductory concepts of arbitrage and rebate, including "gross proceeds", yield restriction and related exceptions, allocation of proceeds, computation of bond and investment yields, rebate computation, payment requirements, and exceptions to the rebate requirement. The information will be presented primarily in a lecture-style, with a focus on basic issue spotting through the use of hypotheticals. The session will be geared for the less-seasoned tax practitioner and more seasoned bond practitioners.

B – Intermediate and Advanced Principles Panel

This panel will focus on intermediate and advanced concepts relating to arbitrage and rebate compliance. Likely topics include: issue price; allocations; hedge bonds; the bidding of investment agreements; the termination of investment agreements; qualified guarantees; temporary period considerations; the impact of swap terminations on bond yield; yield reduction payments; and other current arbitrage issues, including any recent guidance from the federal government. This panel assumes that the audience has a general understanding of basic arbitrage and rebate principles and is geared for more seasoned tax practitioners. These sessions will include a discussion of best practices for issuers and conduit borrowers with respect to arbitrage and rebate matters.

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ARBITRAGE-OVERVIEW[1]

This outline provides a broad basic overview of arbitrage and arbitrage rebate principles of Section 148 of the Internal Revenue Code of 1986, as amended (the "Code").[2]

PART I —ARBITRAGE

I. ARBITRAGE—INTRODUCTION

The arbitrage restrictions of the Code, together with other Code restrictions, govern the investment and expenditure of "proceeds" of a tax-exempt bond issue. Generally, the arbitrage restrictions limit the amount of interest or other return that can be made (or retained) from the investment of the proceeds of a tax-exempt bond issue.

The basic statutory rule is that interest on a bond is not tax-exempt if it is an "arbitrage bond" under Code § 103(b)(2). "Arbitrage bond" is defined under Code § 148(a) 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. Code § 148(a) also provides that a bond shall be treated as an arbitrage bond if an issuer intentionally uses any portion of the proceeds of an issue in a manner described in (1) or (2) of the preceding sentence.

II. THE LAW

A. The Code

Originally addressed solely in Section 103(c) of the Internal Revenue Code of 1954, as amended (the "1954 Code"), the statutory provisions relating to arbitrage (and related matters) are now contained in Code §§ 148, 149(d) (relating to advance refundings), 149(g) (relating to hedge bonds) and 150 (relating to reimbursement expenditures).

B. Regulations

Sections 1.103-13, 1.103-14, and 1.103-15, the first comprehensive set of arbitrage regulations (the "1979 Regulations"), related to the arbitrage provisions under Section 103(c) of the 1954 Code. Section 1.103-13 addressed the certification of reasonable expectations, the definition of "proceeds," the definition of "materially higher," the computation of yield, and

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[1] This outline has been developed as a project of the faculties of the 1991 through 2016 NABL Bond Attorneys' Workshops and Tax and Arbitrage Seminars. Grateful acknowledgement is made for the contributions of prior workshop chairs and panelists.

[2] Part I discusses arbitrage principles; Part II discusses the rebate provisions of Code § 148(f) and Section 1.148-3. For ease of reference and understanding in context, certain concepts are discussed in both Parts I and II. Unless otherwise indicated, all citations to the "Code" are to the Internal Revenue Code of 1986, as amended, and all citations beginning with "Section 1.148" are to the current Treasury Regulations. This outline presents an evolution of the provisions of the Internal Revenue Code and the Treasury Regulations governing arbitrage and rebate, including the exceptions to rebate. Prior versions of this outline provide greater detail with regard to earlier versions of the current Treasury Regulations.

"artifice and device." Section 1.103-14 addressed primarily temporary periods, working capital deficit financings, and refundings. Section 1.103-15 addressed certain issues in connection with advance refundings.

Commencing in 1989, the Internal Revenue Service (the "IRS") began issuing regulations under Code § 148. On June 18, 1993, the IRS published final arbitrage regulations (the "1993 Final Regulations"). Included in the 1993 Final Regulations were provisions relating to compliance with the bond maturity limits, arbitrage rules, federal guarantees, limits on advance refundings, hedge bonds, a number of definitions, and reimbursement. The 1993 Final Regulations generally apply to all issues issued after June 30, 1993.[3] On July 18, 2016, the IRS published final arbitrage regulations related to working capital, yield, rebate, qualified hedges, and related matters (the "2016 Final Regulations"). The 2016 Final Regulations generally apply to all issues issued after, or qualified hedges entered into or modified after, October 16, 2016. The 1993 Final Regulations, as modified by the 2016 Final Regulations, are hereinafter referred to as the "Final Regulations."

C. Other Guidance

The balance of the arbitrage restrictions are gleaned from case law, revenue procedures, revenue rulings, notices, and private letter rulings, which are cited in the text where relevant.

D. General Yield Restriction Rules and Certification Requirements.

In general, the determination of whether a bond is an arbitrage bond is based on the reasonable expectations of the issuer at the time of issuance of the bond. An officer of the issuer responsible for issuing the bonds must, in good faith, certify as to the issuer's expectations, including the facts and estimates that form the basis of such expectations. A certification given as provided in Section 1.148-2(b)(2) will not protect the issuer (or the bondholders) from "intentional actions." Section 1.148-2(c); Rev. Rul. 80-91; Rev. Rul. 80-92. This rule is also codified in the second sentence of Code § 148(a), as follows: "[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 manner described in paragraph (1) or (2)" (*i.e.*, to acquire higher yielding investments or to replace funds that are directly or indirectly so used). In addition to "intentional actions" causing a bond to become an arbitrage bond, notwithstanding reasonable expectations to the contrary, a certification that is given in bad faith will not protect a bond from being an arbitrage bond. *See* Rev. Rul. 85-182.

III. PROCEEDS

A. Definitions

Identifying the "proceeds" of a tax-exempt bond issue is generally the first step to ensure compliance with the arbitrage restrictions, since it is the "proceeds" of tax-exempt bonds that may not be invested in higher yielding investments unless otherwise excused by a "temporary period" or special exception. Over time, the IRS has expanded the statutory concept of "proceeds" to include certain funds that, while not necessarily reflecting the generally understood meaning of

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[3] The chronology of the arbitrage regulations is discussed in greater length in versions of this outline from prior Workshops.

the term proceeds, are treated as proceeds subject to yield restriction or rebate. For example, Section 1.103-13(g) of the 1979 Regulations provided that amounts in a sinking fund for an issue were treated as proceeds of the bond issue, and Rev. Rul. 78-348 concluded that certain pledges of securities were also treated as proceeds of the bond issue. Under the 1993 Final Regulations, "gross proceeds" are defined as "proceeds and replacement proceeds of an issue" and "proceeds" are defined as "sale proceeds, investment proceeds and transferred proceeds of an issue."

1. ***Sale Proceeds and Investment Proceeds.***

Sale proceeds are the amounts received, actually or constructively, from the sale of the bonds, including amounts used to pay underwriter's discount and accrued interest (other than pre-issuance accrued interest[4]). Sale proceeds also include amounts derived from the sale of a right that is associated with a bond (*e.g.*, a call right). Investment proceeds are any amounts actually or constructively received from investing proceeds.[5]

2. ***Transferred Proceeds.***

Transferred proceeds are proceeds of a refunded issue that remain unexpended at the time the principal of that refunded issue is paid from the proceeds of the refunding issue. These "leftover" proceeds of the refunded issue are "transferred" pro rata to the refunding bonds and subjected to a number of complicated rules in Section 1.148-9(b). No proceeds transfer until an actual payment or "discharge" of principal of the prior issue using proceeds of the refunding issue. Thus, no transfer occurs upon the establishment of an escrow fund (e.g., for an advance refunding), and no transfer occurs merely because money in the escrow fund is used to pay interest on the prior issue. Further, amounts held in funds or accounts for the prior issue that are not "proceeds"[6] of that issue, such as money contributed by the issuer to a reserve fund or debt service fund, do not become transferred proceeds of the refunding bonds. This distinction is often misunderstood.

The 1993 Final Regulations provide as follows: when proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction: (1) the numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge; and (2) the denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge.[7]

Section 1.148-9(b) defines the principal of a bond as, with respect to a "plain par bond,"[8] its stated principal amount, and, with respect to all other bonds, its present value.

[4] Section 1.148-l(b). Pre-issuance accrued interest is interest (i) that accrues for a period of not more than one year and (ii) is paid within one year after the issue date.

[5] Section 1.148-l(b).

[6] Proceeds of an issue include only sale proceeds, investment proceeds and transferred proceeds, not replacement proceeds.

[7] Section 1.148-9(b)(1).

[8] Section 1.148-9(b)(2).

Section 1.148-9(b) also contains numerous technical rules relating to the selection of the investments that transfer.[9]

3. ***Replacement Proceeds.***

a. General.

"Proceeds" of an issue include only sale proceeds, investment proceeds, and transferred proceeds. But the arbitrage and rebate requirements apply to "gross proceeds" of an issue, which include proceeds and "replacement proceeds" of an issue. Amounts are classified as "replacement proceeds" 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 (including the payment of debt service) if the proceeds of the issue were not used for that governmental purpose. Under Section 1.148-1(c), "replacement proceeds" include amounts in a sinking fund, a pledged fund, and other amounts constituting "replacement proceeds" to the extent that the funds are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary typically includes the issuer, any related party to the issuer or the state in which the issuer is located, and any conduit borrower of proceeds; a substantial beneficiary does not include any entity solely because the entity is a guarantor of the issue. Thus, collateral provided by a letter of credit bank (but not a borrower) to secure the bank's obligations under a letter of credit is generally not treated as proceeds. In addition, if an organization solicits donations to fund construction a particular facility, but then uses tax-exempt bond proceeds to pay for that facility, the funds raised may comprise replacement proceeds under the "nexus" theory, especially if those funds can only be used for that facility. *See* Section 1.148-1(c)(1).

b. Sinking Funds.

Under Section 1.148-1(c)(2), a sinking fund "includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue."[10]

Another example of the sinking fund concept is an "indirect" sinking fund, as where a bond issue is structured with a "bare" bullet maturity (*i.e.*, a term bond with no requirement that portions of the bond be retired in installments before the final maturity date) and amounts are accumulated yearly to pay the future operation and maintenance expenses in the year in which the bullet maturity comes due, thereby freeing all revenues earned in the final year for payment of the bonds. The amounts saved to pay operation and maintenance expenses are an "indirect" sinking fund and therefore "proceeds" even though they will be used to pay operation and maintenance expense rather than debt service.[11] Similarly, where a fund was created simultaneously with the issuance of bonds (from a source other than sale proceeds), the interest on which was expected to be used "indirectly" to pay debt service (interest income on the fund was deposited into the issuer's general fund; amounts in the general fund were used, among other things, for payment of debt service on

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[9] In addition, transferred proceeds may be limited under the universal cap rules of Section 1.148-6(b)(2).

[10] For more discussion of the history of the "sinking fund" concept, see versions of this outline from prior Workshops. *E.g., see* Section 1.103-13(g) of the 1979 Regulations and *City of Tucson v. Commissioner*, 820 F.2d. 1283 (D.C. Cir., 1987).

[11] Rev. Rul. 78-302.

the bonds), the IRS held that the fund was an indirect sinking fund for the bonds and amounts in the fund "proceeds."[12]

It is often difficult to tell whether a particular fund is a "sinking fund." The portion of an income fund or revenue fund into which all revenues of an enterprise of a city are deposited and out of which all expenses of the enterprise (including transfers to a bond fund to pay debt service) are paid, that is reasonably expected to pay debt service, is a "sinking fund." *See* Rev. Rul. 78-349. If an issuer maintains an investment fund funded with its tax revenues and also has outstanding general obligation bonds, the investment fund is generally not treated as a sinking fund unless the issuer reasonably expects to use such moneys to pay debt service on the bonds. *See* Rev. Rul. 78-302. If the size of the debt service payments due on the bonds are such that the issuer would be unable to make those payments if investment income from the investment fund was not available, the investment income generally would be considered part of a sinking fund.

c. *Pledged Funds.*

A "pledged fund" is any amount that is directly or indirectly pledged to pay principal or interest on the issue in such a manner that provides reasonable assurance that the amount will be available for that purpose if the issuer encounters financial difficulties, even if it is not reasonably expected that such amounts will be used to pay debt service on the bonds.[13] Under the 1993 Final Regulations, a pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the bonds (*e.g.*, amounts pledged to a bank pursuant to a letter of credit reimbursement agreement relating to a letter of credit that secures payment of the bonds). A pledged fund can arise even where it is not the issuer who pledges the fund to the payment of bonds. For example, if a state pledges one of its funds to a local government's debt, this fund will be a pledged fund. *See* Rev. Rul. 78-348. This result is in part dependent on the IRS's perception that the State is an indirect beneficiary of a borrowing by one of its local governments. However, a pledge made by other than a substantial beneficiary of the financing is not "replacement proceeds."

In many instances it may be difficult to ascertain whether a fund constitutes a pledged fund. For example, a letter of credit bank may hold funds of a conduit borrower to be used for operation and maintenance, capital replacement and debt service. If pursuant to the terms of the bank documents the bank has complete discretion over developer withdrawals, the fund might be considered a pledged fund.

Under Section 1.148-l(c)(3)(ii), amounts are treated as a pledged fund if held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of bondholders unless: (1) the issuer may grant rights that are superior to the rights of the bondholders or the guarantor; or (2)(a) the amount does not exceed reasonable needs for which it is maintained; (b) the level is tested no more frequently than every six months; and (c) the amount may be spent without substantial restriction other than replenishment by the next testing date. An arrangement like this is often referred to as a "negative pledge."[14]

[12] Rev. Rul. 82-101.
[13] Section 1.148-1(c)(3).
[14] See PLR 8334103, revoked by PLR 8841027.

Three private letter rulings provide insight into IRS's analysis of replacement proceeds. In PLR 9243051, the IRS held under the 1992 Final Regulations that accumulated fees charged underground storage tank owners in connection with a state's arrangement of the clean-up costs for underground storage tanks would be replacement proceeds of long-term bonds issued to pay the costs of claims for property damaged by leaking storage tanks. In PLR 9509035, the IRS found that long-term bonds issued in connection with the refinancing of a city's pension arrangements with a state would produce replacement proceeds in the state's funds and accounts under the 1993 Final Regulations. Although the Tax Court held for the IRS in a declaratory judgment pursuant to Code § 7478, the D.C. Circuit Court of Appeals vacated and remanded that decision. In PLR 9534014, the IRS revisited underground storage tank bond financing structures and found under the 1993 Final Regulations that replacement proceeds would not arise if no significant balances of fees charged were accumulated during the life of long-term bonds issued to pay the costs of claims for property damaged by leaking storage tanks. *See also* PLR 9243051 and PLR 9233041 with regard to the 1992 Final Regulations.

In January of 2009, the Montana Facility Finance Authority issued a material-event notice stating that a series of bonds issued in 2002 for the Mission Ridge retirement community was under IRS audit, and that the IRS had issued a "Notice of Proposed Issue" in October, 2008, concluding that the bonds were arbitrage bonds. The agent had determined that certain funds and accounts held by the borrower, including entrance fees contributed by residents, constituted replacement proceeds that should have been yield restricted, but were not. Almost three years later, in May of 2011, the IRS released Technical Advice Memorandum[15] which concluded that the entrance fees were not, in fact, replacement proceeds of the bonds. Although there appeared to be a nexus between (1) the entrance fees and other facility revenues and (2) and the bonds, the bond owners had no reasonable assurance that those entrance fees would be available to pay principal or interest on the bonds if Mission Ridge encountered financial difficulties.

d. *Other Replacement Proceeds.*

"Other Replacement Proceeds" arise to the extent that an issue is outstanding longer than necessary, and the issuer expects there to be "available amounts," defined as described in Part I, Section V.C., below. The Regulations provide a safe harbor which clarifies that an issue does not give rise to Other Replacement Proceeds if (1) it is a working capital issue that is outstanding no longer than 13 months; (2) the bonds (including a refunding bond) meet the bond maturity limit in Code § 147(b) relating to the economic life of assets financed; or (3) in the context of a refunding, the weighted average maturity of the refunding bonds is not longer than the weighted average maturity of the refunded bonds (and the refunded issue satisfied one of the above two tests).[16] Under the 1993 Final Regulations, Other Replacement Proceeds also arose if a working capital reserve is directly or indirectly financed with the issue unless all the net proceeds of the issue are spent within six months or the bonds are exempt from rebate under Code § 148(f)(4)(D) (the small issuer exception). The 2016 Final Regulations eliminated the restriction against financing a working capital reserve. The 2016 Final Regulations also provide a new safe harbor against the creation of replacement proceeds for longer-term working capital financings of issuers

[15] T.A.M. 201118012 (Jan. 19, 2011).

[16] *See* the anti-abuse rules under Section 1.148-10. See also PLRs 9424043 and 200306004, Notice 2001-49, and, more importantly, Rev. Proc. 2002-31.

experiencing financial distress which generally requires the issuer to determine the actual available amounts as of the first day of each fiscal year beginning with the year it expects to have such available amounts and apply such available amounts to redeem or to invest in tax-exempt bonds that are not subject to AMT.

e. *Disposition Proceeds.*

In some situations, proceeds are created as a result of an event that was not reasonably expected at the time the bonds were issued. Under Section 1.141-12, one requirement for taking remedial action in the event of a change in use of bond financed property (e.g., a change that causes the private business or private loan tests to be met) is for the issuer to treat any "disposition proceeds" as "proceeds" for purposes of Code § 148. These "disposition proceeds" are any amounts derived from the sale, exchange, or other disposition of property financed with proceeds of the issue. Remedial action under Section 1.141-12 may require disposition proceeds to be used to redeem or defease debt or to finance a new qualifying project. In the latter situation, the issuer may treat the date of receipt of the disposition proceeds as the issue date of the bonds for purposes of temporary periods (*see* Part I, Section IV.B.8.) and rebate exceptions (*see* Part II, Section VIII.). Further, the receipt of disposition proceeds will not disqualify the use of an expenditure exception (*see* Part II, Section VIII.) for rebate. *See* Section 1.141-12.

f. *Exceptions from the Definition of Replacement Proceeds.*

The corpus and investments of certain perpetual trust funds of states and the investments of certain permanent university funds have been exempted from the definition of replacement proceeds. The fund must be described in Section 648 of the Deficit Reduction Act of 1984, Pub. L. 98-369. In PLR 20048022, the IRS recognized another class of State permanent funds as being exempt from the definition of replacement proceeds.

B. Reserve Funds

A reserve fund, including one known as a "reasonably required reserve or replacement fund" (or "4R Fund"), is not as much a type of proceeds as a way of categorizing proceeds, primarily for purposes of dealing with the investment limits described in Part I, Section IV below. Under Code § 148(d), sale proceeds of up to 10% of the stated principal amount of a bond issue[17] may be deposited into a 4R Fund without the bonds being "arbitrage bonds." Note that if that 10% limit is exceeded, the bonds will be arbitrage bonds even if the money in the 4R Fund is invested at yields below the bond yield. Amounts other than sale proceeds may be placed in a 4R Fund without regard to that 10% limit, but the investment of those amounts may be subject to yield restriction as discussed in the next paragraph.[18]

Regardless of how a 4R Fund is initially funded, Section 1.148-2(f)(2) imposes a limit on the amount that can be invested without regard to yield. This limit is equal to the least of (1) the maximum annual principal and interest requirements on the issue; (2) 10% of the stated principal

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[17] 10% of issue price minus pre-issuance accrued interest if the bonds have more than a de minimis amount of original issue discount or premium.

[18] Such other amounts, however, may be subject to yield restrictions and eligible for "yield reduction payments" under Section 1.148-5(c).

amount (or issue price if applicable, as discussed in Footnote 19) of the issue; and (3) 125% of the average annual principal and interest requirements of the issue.[19] Amounts in excess of this limit may not be invested above the bond yield.[20]

IV. INVESTMENT OF PROCEEDS

A. General

The purpose behind the various arbitrage rules is to prevent the perceived abuse whereby issuers and conduit borrowers of tax-exempt bonds, typically political subdivisions or 501(c)(3) organizations and hence not subject to income tax, borrow at tax-exempt rates, invest the bond proceeds at taxable rates, and use the arbitrage profit for discretionary purposes.

As previously described, the first step in the arbitrage analysis is to identify gross proceeds subject to arbitrage limits. The second step is to identify investments allocated to gross proceeds. Investments can include both "purpose investments" (*i.e.*, those acquired to further the governmental purpose of the issue, such as a conduit loan for a multifamily transaction) and "nonpurpose investments" (*i.e.,* investments that are not purpose investments, such as investments held in a project fund or debt service reserve fund). *See* Section 1.148-1(b).

Investments can include a prepayment for property or services if a principal purpose of the prepayment is to receive an investment return. The 1993 Final Regulations restrict the definition of qualifying prepayments in situations that involve customary prepayments (including prepayments for common types of equipment or software maintenance or extended warranty contracts), prepayments within 90 days of date of delivery of property or services, or certain narrowly defined prepayment contracts for natural gas and electricity.[21] Investments also include the investment elements of a hedge, if a payment by the issuer corresponds to a conditional or unconditional obligation by the hedge provider to make a payment on a later date (*e.g.*, a one-time upfront payment to purchase an interest rate cap).[22]

B. Yield Restriction

1. *General Rules.*

In general (and subject to the "yield reduction payment rules" described below and in Part II), unless eligible for a temporary period, gross proceeds must not be invested at a yield "materially higher" than the yield on the bonds. "Yield" is discussed below. In order to permit appropriate comparison, the same methods and compounding intervals must be used in calculating the yield on the investments and the bonds.[23]

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[19] Under Rev. Proc. 84-26, a 4R Fund is also not ordinarily reasonably required if it secures general obligation bonds. The effectiveness of this rule is in doubt, given the issuance.

[20] Such amounts, however, may be eligible for "yield reduction payments" under Section 1.148-5(c), discussed below in Part I, Section IV.B.7.

[21] Section 1.148-1(e); see also Section 148(b)(4) (providing a separate safe harbor for certain prepayments for natural gas).

[22] *Id*. Section 1.148-4(h)(2)(ii).

[23] Section 1.148-4(a) and Section 1.148-5(b).

2. ***Bond Yield.***

The yield on an issue is calculated under Section 1.148-4 both for purposes of determining whether a bond is an "arbitrage bond" under Code § 148(a), and for computing rebate liability under Code § 148(f). The yield on a fixed yield bond issue is generally computed once, on the issue date, but it must be recomputed upon the transfer by the issuer of certain rights associated with the bonds (*e.g.*, a call right) and upon termination of a qualified hedge. Yield on variable yield bond issues is calculated separately for each computation period (*e.g.*, every year or every five years), based on the actual (not expected) bond payments and payments for qualified guarantees and hedge payments. A variable yield issue is any issue that contains at least one variable yield bond. The computation of bond yield, including the treatment of credit enhancement and interest rate swaps, is discussed in detail in Part II, Section VII below.

3. ***Issue of Bonds.***

Yield is calculated separately on each "issue" of bonds. Two or more bonds are part of the same "issue" if they are sold at substantially the same time (less than 15 days apart), sold pursuant to the same plan of financing, and are reasonably expected to be paid out of substantially the same source of funds, and this definition applies for all purposes of Code §§ 103 and 141 through 150.[24] Taxable and tax-exempt bonds are not part of the same issue but may constitute an abusive arbitrage device (*see* Part I, Section VI) or a device to avoid other limits in Code §§ 141 through 150.[25] Section 1.150-1(c)(4) addresses the single issue analysis for commercial paper and draw-down loans.[26] In addition, there are provisions that allow a single issue to be treated as separate issues for certain purposes—for example Section 1.150-l(c)(3) includes a special rule permitting an issue financing separate governmental purposes to be treated as separate issues for certain purposes (*i.e.*, facility qualification), and Sections 1.141-13(d) and 1.148-9(h) permit elections to allocate portions of an issue to separate purposes—but that separate issue treatment generally does not apply for purposes of determining yield on the entire issue.[27]

4. ***Materially Higher.***

"Materially higher" is not defined in Code § 148, but under Section 1.148-2(d)(2), materially higher is generally 1/8 of 1 percentage point (0.125%). Special rules apply for refunding escrows and replacement proceeds (1/1000 of 1%); program investments (1.5%);[28] qualified mortgage bonds (1.125%) and student loan bonds (2%).[29]

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[24] Section 1.150-1(c).

[25] *Id.*

[26] *See also* Section 1.150-1(4)(c)(iii) (special rule regarding general obligation bonds).

[27] See Section 1.150-1(c)(3)(ii); Section 1.148-9(h)(1)(i).

[28] Program investments (defined under Section 1.148-l(b)) are investments acquired to carry out the governmental purposes of the issue pursuant to a loan program for the public, governmental units, 501(c)(3) organizations, or housing facilities.

[29] The materially higher spread is 1.125% for qualified mortgage loans under Code § 143(g) and 2.0% for student loans under Section 1.148-2(d)(2).

5. ***Yield on Investments.***

Generally, the yield on investments is computed on the same basis as the bonds and is determined separately for each separate class of investments. Yields on investments in separate classes may not be blended for arbitrage purposes, although they may for rebate purposes. Separate classes of investments include each category of yield restricted purpose investments and program investments subject to a different yield limit, yield restricted nonpurpose investments, and all other nonpurpose investments. Section 1.148-5(b)(2). An issuer may waive temporary periods and other exceptions to yield restriction under Section 1.148-3(h). Note that yield reduction payments may be available (see below) to reduce yield. All investments in a refunding escrow must be treated as one investment.

6. ***Yield Over the Term of Issue.***

It is the yield on investments "over the term of the issue" that is relevant under Code § 148(b)(1). Under this rule, it is permissible to have proceeds invested in higher yielding investments for a period of time so long as later (or earlier) investments in lower yielding investments offset the higher yielding investments and result in an overall investment yield over the term of the issue that is not materially higher than the bond yield.[30] An issuer that intends to blend after a rebate computation date (other than with respect to proceeds in a refunding escrow and a sinking fund expected on the issue date to reduce the escrow yield) may be required to actually make a rebate payment despite the intended future blending. The 1993 Final Regulations effectively allow yield blending to be broken up into 5-year computation periods for variable rate bonds. If investments within the same class have different "materially higher" standards, the lowest prevails.

7. ***Yield Reduction Payments.***

Section 1.148-5(c) allows an issuer to make a "yield reduction payment" to the United States to reduce the yield on yield-restricted investments with a yield that is "materially higher" than the yield on the issue to the appropriate rate. Not all "gross proceeds" are eligible for yield reduction payments. The major categories of investments or issues that are eligible for such payments are (1) investments entitled to an initial temporary period, (2) investments allocable to most variable yield issues, (3) investments in a 4R Fund not meeting the size limit in Section 1.148-2(f)(2)(ii), but only to the extent that the amounts are less than or equal to 15% of the principal of the issue or are not (except for investment earnings) expected to pay debt service on the issue (*e.g.*, a revolving loan fund program), and (4) certain transferred and replacement proceeds in the context of a refunding. The major categories of investments <u>not</u> eligible to use yield reduction payments are proceeds of an advance refunding and replacement proceeds. The yield reduction payment rules are particularly useful in three areas that historically have required yield restriction: (1) unexpended proceeds in a construction fund after the temporary period expires (*see* Part I, Section IV.B.8.a. below), (2) variable yield issues with yield restricted pledged funds, and (3) "transferred proceeds" held in a prior escrow as a result of a current refunding. *See also* Part II.

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[30] *See* Section 1.148-2(d)(1).

8. ***Temporary Periods.***

a. *New-Money Issues.*

Generally, sale and investment proceeds of a new-money issue will qualify for a three-year "temporary period" (*i.e.*, a three-year period during which the proceeds may be invested at a yield materially higher than the bond yield) if the issuer reasonably expects to satisfy (1) the expenditure test, (2) the time test, and (3) the due diligence test.[31] Under the expenditure test, the issuer must expect to spend at least 85% of the net sale proceeds (*i.e.*, sale proceeds minus any amounts deposited into a 4R Fund and any amount invested as part of a minor portion) by the end of the three-year temporary period. Under the time test, the issuer must expect to incur, within six months of the issue date, a substantial binding obligation to a third party to expend at least 5% of the net sale proceeds on capital projects. Under the due diligence test, the issuer must expect the completion of the capital projects and the allocation of the net sale proceeds to expenditures to proceed with due diligence. This three-year temporary period is not available for working capital financings. A rarely-used five-year temporary period is allowed for construction issues if a certification of a licensed architect or engineer is obtained prior to issuance stating that a period of longer than three years is necessary.[32]

b. *Refunding Issues.*

(i) General.

Section 1.150-1(d) defines "refunding issue" as an issue the proceeds of which are used to pay principal, interest, or redemption price on another issue, including issuance costs, accrued interest, a 4R Fund, or similar costs properly allocable to the refunding issue. An issue is not a refunding issue if the obligor[33] of the would-be refunding issue is not the obligor of the other issue (or a party related to the obligor of the other issue). Thus, if County X financed a water and sewage facility with tax-exempt bonds in 1994 and in 1998 sells it to unrelated County Y, which finances such purchase with a tax-exempt bond issue, that transaction will be treated as an acquisition of the facility and not as a refunding, even though County X used the proceeds from the sale to discharge its tax-exempt bond issue.

(ii) Current v. Advance Refundings; Temporary Periods.

A current refunding issue is an issue that is issued not more than 90 days before the last payment of principal or interest on the prior issue. All other refunding issues are advance refunding issues.[34] Generally, the temporary period for an advance refunding issue is 30 days, and the temporary period for a current refunding is 90 days.[35] The temporary period for transferred proceeds of a current refunding is the temporary period for those proceeds if such proceeds had

[31] Section 1.148-2(e)(2)(ii).

[32] *Id.*

[33] In general, the actual issuer of a bond issue is treated as the obligor of such issue, however, with respect to refundings of a "conduit financing" the "conduit borrower" is treated as the issuer.

[34] Section 1.150-1(d)(3); see also Section 149(d)(5)("a bond shall be treated as issued to advance refund another bond if it is issued more than 90 days before the redemption of the refunded bond.")

[35] Sections 1.148-9(d)(ii).

remained proceeds of the prior issue; however, the temporary period for transferred proceeds of an advance refunding terminates on the issue date of the advance refunding issue.[36]

c. *Other Financings.*

The temporary period for a working capital financing, whether a restricted working capital financing or an extraordinary working capital financing, is 13 months.[37] Code § 148(c)(2) limits the temporary period for pool bond proceeds (other than single family mortgage bonds) to six months (or two years for "construction issues," *see* Part II, below) in the hands of the issuer prior to being loaned to borrowers; the balance of the otherwise available temporary period for proceeds by the borrower is reduced by the amount of time the proceeds were held by the issuer.[38]

C. Rebate

Rebate, introduced first in the Mortgage Subsidy Bond Act of 1980[39] for single family mortgage bonds and extended to virtually all bonds by the 1986 Act, has the same economic effect for issuers as does yield restriction: investment return over the yield on the issue, if earned, is paid over, or rebated, to the U.S. Treasury. Failure to rebate arbitrage profits may result in taxability of the bonds.[40] Further, compliance with the rebate requirement does not obviate the need for compliance with the yield restriction rules (through making yield reduction payments where available) and, to that extent, the two rules are duplicative. Thus, the rebate requirement primarily impacts proceeds that are entitled to a temporary period. For a comprehensive description of rebate and exceptions to rebate, *see* Part II, below.

D. Fair Market Value Rules

To address the concern that issuers would purchase investments with proceeds at artificially high prices (thus artificially lowering yields and reducing rebate or avoiding yield restriction), the IRS has issued rules relating to the fair market value of investments purchased with bond proceeds.

1. ***Market Price Rules.***

The yield on an investment of bond proceeds must generally be based on a purchase price for the investment that does not exceed its "fair market value." Section 1.148-5(d) also contains some very specific valuation rules. Under Section 1.148-6(c), gross proceeds cannot be allocated to an investment in an amount greater than its fair market value (with any adjustments described below for qualified administrative costs). In other words, if an issuer accepts a below-market yield on an investment (by paying an above-market price), the investment will be deemed to have a yield

[36] Sections 1.148-9(d)(iii).
[37] Section 1.148-2(e)(3).
[38] Section 1.148-2(e)(4).
[39] Pub. L. 96-499.
[40] *See Harbor Bancorp v. Commissioner*, (105 T.C. 260 (1995), aff'd, 115 F.3d 722 (9th Cir. 1997), *cert. den*. 118 S. Ct. 1035 (1998)) (bonds issued by housing authority were deemed issued after December 31, 1985 and subject to the rebate requirement).

based on the fair market price, and rebate will be due based on the excess of the market yield over the bond yield.

2. ***Administrative Costs.***

When an issuer computes yield on an investment, costs or expenses paid directly or indirectly to purchase, carry, sell, or retire the investment (administrative costs) are generally *not* taken into account.[41] In other words, administrative costs generally do not increase the purchase price of the investment or reduce the receipts from the investment. But certain "qualified administrative costs" may be taken into account in determining the yield of the investment. "Qualified administrative costs" are reasonable, direct administrative costs (other than carrying costs), such as separately stated brokerage or selling commissions, but not (a) legal, accounting, recordkeeping, custody, or similar costs, (b) general overhead or similar internal, indirect costs, like employee salaries, or (c) rebate computation costs. Special rules also apply to purpose investments (such as qualified mortgage loans and qualified student loans) and to shares in a regulated investment company or a "commingled fund." *See* the discussion of the safe harbor for qualified administrative costs in Part I, Section IV.D.4 below.

3. ***Safe-harbor for Guaranteed Investment Contracts and Investments for Defeasance Escrows.***

Section 1.148-5(e) of the 1993 Final Regulations sets forth criteria to establish a safe harbor that GICs and United States Treasury obligations for yield restricted defeasance escrow, not purchased directly from the Treasury, are purchased at fair market value. The safe harbor rules are *summarized* below:

a. *Bona Fide Solicitation.*

The issuer must make a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation that satisfies all of the following requirements: (i) the bid specifications are in writing and are timely forwarded to potential providers; (ii) the bid specifications include all material terms of the bid; (iii) the bid specifications include a statement notifying potential providers that submission of a bid is a representation that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any other formal or informal agreement that the potential provider has with the issuer or any other person, and that the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the three-bid requirements described below; (iv) the terms of the bid specifications are commercially reasonable; (v) for purchases of GICs only, the terms of the solicitation take into account the issuer's reasonably expected deposit and drawdown schedule for the amounts to be invested; (vi) all potential providers have an equal opportunity to bid (for example, no potential provider is given the opportunity to review other bids (*i.e.*, a "last look") before providing a bid); and (vii) at least three reasonably competitive providers are solicited for bids; a reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

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[41] Section 1.148-5(e).

b. *Bid Requirements.*

The issuer must receive at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of paragraph a. above and that do not have a material financial interest in the issue;[42] at least one of the three bids described above must be from a reasonably competitive provider; and if the issuer uses an agent to conduct the bidding process, the agent cannot bid to provide the investment.

c. *Bid Selection Requirements.*

For a GIC, the winning bid is the highest yielding bona fide bid (determined net of any broker's fees). For a portfolio of securities for a defeasance escrow, the following requirements must be met: (1) the winning bid is the lowest cost bona fide bid, including any broker's fees,[43] (2) the lowest cost bona fide bid (including any broker's fee) is not greater than the cost of the most efficient portfolio of securities containing exclusively of SLGS,[44] and (3) if sales of SLGS are suspended on that day, the cost comparison to SLGS is not required.

d. *Other requirements.*

The provider of the investments or the obligor on the GIC must certify to the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment. In addition, the regulations require that the issuer retain key records relating to the bid with the bond documents until three years after the last outstanding bond is redeemed. These would include, for example, a copy of the GIC itself or security confirmations; a record of the amount actually paid by the issuer for the investments, including administrative costs; the names of the persons and entities submitting the bids; the time and date of the bids and the bid results; the bid solicitation form. Also, if the terms of the investment deviated from the bid solicitation form, or if a submitted bid is modified, a brief statement explaining the deviation should be retained.

4. ***Qualified Administrative Costs.***

For GICs and yield restricted defeasance escrow investments, direct administrative costs will be treated as "qualified" only if they are "reasonable" within the meaning of those regulations. If treated as qualified administrative costs, broker's commissions and similar fees paid by the provider of the GIC or the securities are not treated as additional yield to the issuer. The safe harbor under the 1993 Final Regulations Section 1.148-5(e) includes two components, a "per-investment safe harbor" and a "per-issue safe harbor."

a. *Per-investment Safe Harbor.*

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[42] A lead underwriter in a negotiated underwriting transaction is deemed to have a material financial interest in the issue until 15 days after the issue date of the issue.

[43] Any payment received directly or indirectly by the issuer from a provider at the time a guaranteed investment contract is purchased (*e.g.*, an escrow float contract) is taken into account in determining the lowest cost bid.

[44] Securities issued by the United States Treasury pursuant to the State and Local Government Series program described in 31 CFR part 344.

A broker's commission or similar fee with respect to the acquisition of a GIC or investments purchased for a yield restricted defeasance escrow is "reasonable" and not treated as additional yield to the issuer to the extent that the amount of the fee the issuer treats as a qualified administrative cost does not exceed the lesser of: (A) $39,000 or (B) 0.2% of the computational base, or if more, $4,000 (the "per-investment safe harbor"). *See* "Cost-of-living Adjustment" below. The computational base for a GIC is the amount of gross proceeds the issuer reasonably expects, as of the date the contract is acquired, to be deposited over the term of the GIC. For investments in a yield restricted defeasance escrow, the computational base is the amount of gross proceeds initially invested in the escrow.

b. *Per-issue Safe Harbor.*

For any bond issue, the issuer cannot treat as qualified administrative costs more than $110,000 in brokers' commissions or similar fees with respect to all GICs and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue (the "per-issue safe harbor"). *See* "Cost-of-living Adjustment" below.

c. *Exceeding the Safe-Harbor.*

This regulation does not restrict the ability of the issuer to pay a fee that exceeds the safe harbor amount. The portion of the fee that is within the safe harbor constitutes a qualified administrative cost, and any amounts in excess of the safe harbor are qualified administrative costs if they are "reasonable." The regulations do not specify factors for determining the reasonableness of fees in excess of the safe harbor. Instead, the determination of whether a fee is reasonable is based on all the facts and circumstances, including whether the fee is comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

d. *Cost-of-living Adjustment.*

The 1.148-5(e) regulations also provide for a cost-of-living adjustment for both the per-investment safe harbor and the per-issue safe harbor. The adjusted safe harbor dollar amounts are published by the IRS in an annual revenue procedure that sets forth inflation-adjusted items. The cost of living adjustment for calendar year 2016 allows $39,000 in qualified administrative costs per GIC and $110,000 per issue, with a floor of $4,000.[45]

E. Investment of Commingled Funds

1. ***Investment Rules.***

Special rules apply with respect to the investment of commingled funds. Fund earnings, gains and losses must be allocated among investors[46] on the basis of a "consistently applied, reasonable ratable allocation method." As described above, a "consistently applied" accounting method accounts uniformly for amounts that are commingled with proceeds and accounts

[45] Rev. Proc. 2015-53, 2015-44 I.R.B. 615 (Nov. 2, 2015).

[46] An investor is a depositor to the commingled fund.

consistently for proceeds of the bonds for each fiscal year (or portion) during which the bonds are outstanding. See Section 1.148-6(e)(2).

2. *Special Rules for Common Reserve Funds or Sinking Funds.*

Certain special rules apply to commingled funds that serve as common reserve funds or sinking funds. Under Section 1.148-6(e)(6), investments in such a fund must be allocated (after adjustment under the universal cap[47]) among the various issues the fund serves at least every three years and on each date that a new issue covered by the commingled fund is issued (or the date an issue is retired in certain cases the case of (iii) below) in accordance with one of three specified allocation methodologies: (i) the outstanding relative values of the issues as of the date of allocation;[48] (ii) the relative amount of the issues' remaining maximum annual debt service requirements; or (iii) the aggregate relative original principal amounts.

F. Hedge Bond Rules

A bond is a "hedge bond" if either (i) the issuer does not reasonably expect to spend 85% of the spendable proceeds[49] of the issue within three years or (ii) more than 50% of the proceeds are invested in investments having a substantially guaranteed yield of four years or more. A hedge bond is taxable unless it meets the following three requirements: (a) payments of costs of issuance are not contingent; (b) at least 95% of those costs are paid within 180 days of the date of issuance; and (c) the issuer reasonably expects to spend 10% of the proceeds within one year, 30% within two years, 60% within three years, and 85% within five years. In determining whether a bond is a hedge bond and whether or not it is taxable, expectations regarding changes in the Code and changes in interest rates may not be taken into account even if reasonable.

The hedge bond provisions contain exceptions for certain refunding bonds because most advance refunding bonds would be taxable hedge bonds without the exception, and for bonds 95% of the net proceeds of which are invested in tax-exempt bonds not subject to the alternative minimum tax. Note that the term "hedge bond" used in Code § 149(g) is completely separate from, and not related to, the "qualified hedge" described in Section 1.148-4(h), relating to the computation of bond yield.

G. Minor Portion

Under Code § 148(e), an amount of up to the lesser of 5% of the sale proceeds or $100,000 may be invested in materially higher yielding investments; however, these amounts remain subject to the rebate requirement.

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[47] The "universal cap" rule provides an overall limitation on the amount of gross proceeds allocable to an issue. See Section 1.148-6(b)(2).

[48] *See* Section 1.148-4(e) to the determination of "value."

[49] A concept equivalent to net sale proceeds. Section 1.149(g)-1(a).

V. EXPENDITURE OF PROCEEDS

"Expenditure" of proceeds removes them from the realm of arbitrage. The rules for when proceeds are "spent" are generally simple, but special rules exist for determining expenditure for working capital purposes, reimbursement purposes, and from a commingled fund.

A. Capital Expenditures

Proceeds may be treated as spent when applied to a "current outlay of cash for a governmental purpose"[50] and for a "capital expenditure," defined as "any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of 'placed-in-service' under Section 1.150-2(c) under general federal income tax principles)."[51]

B. Reimbursement

The rules are more complex in the context of reimbursement bonds. Simply stated, proceeds are not treated as spent unless, (1) not later than 60 days after the expenditure the issuer (or in a qualified 501(c)(3) bond financing, the conduit borrower) adopted or expressed an official intent (meeting the requirements of Section 1.150-2(e)(1));[52] (2) the expenditure is a capital expenditure, a cost of issuance of a bond, an extraordinary working capital item[53] or a grant;[54] and (3) the reimbursement is made not later than 18 months after the later of (a) the date of the expenditure or (b) the date the project was placed in service or abandoned, but not more than three years after the date of expenditure.[55] An issuer may also not use the reimbursed amount so that it becomes replacement proceeds (other than a bona fide debt service fund) or employ an abusive device or attempt to avoid the rules of Code §§ 142 through 147.

C. Working Capital Purposes

1. *General.*

Section 1.148-6(d)(3) provides guidance on the expenditure of proceeds for working capital purposes. As a general rule, "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 of that date." This rule also applies to replacement proceeds, but is subject to some exceptions as described below.

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[50] A current outlay of cash is one reasonably expected to occur not later than five banking days after the proceeds are allocated to the expenditure Section 1.148-6(d)(1)(ii).

[51] Section 1.150-1(b)

[52] Section 1.150-2(d). A special rule applies to certain preliminary expenditures such as architectural, engineering, surveying, soil testing and bond issuance costs.

[53] Defined in Section 1.148-6(d)(3)(ii)(B).

[54] Defined under Section 1.148-6(d)(4); Section 1.150-2(d)(3) also includes certain types of loans.

[55] Section 1.150-2(d)(2) includes a rule extending the 18-month limit to 3 years for small issuers (and relieving them of the 3-year limit) and to 5 years for long-term construction projects upon a certification similar to that for a 5-year temporary period.

Section 1.148-6(d)(3)(ii) excepts from the rule stated in the previous paragraph expenditures for the following specified purposes: (i) issuance costs and "qualified administrative costs;" (ii) "qualified guarantee" fees or payments for a "qualified hedge;" (iii) certain amounts paid to the United States, such as rebate payments; (iv) payment of debt service on an issue from unexpected excess sale proceeds and debt service reserve fund earnings; (v) working capital expenditures that "do not exceed 5% of the sale proceeds of an issue and . . . are directly related to capital expenditures financed by the issue;" (vi) extraordinary items (*e.g.*, casualty losses or an extraordinary legal judgments in excess of reasonable insurance coverage), provided that any available amounts in a reserve for that purpose have been expended; and (vii) interest on new money issues for at least three years from the issue date.

For a discussion of the six-month spending exception for working capital financings, see Section VIII.B. herein.

2. ***Available Amounts***

"Available amount" is defined as "any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue."[56] Generally, the available amount excludes proceeds of any issue but includes cash, investments and other amounts that may be used without "legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed." "Available amounts" may be held by the issuer or a related party. A reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures in the previous fiscal year.[57]

3. ***Long Term Working Capital Financing.***

Working capital financings are frequently done as short-term tax revenue anticipation notes ("TRANs"). It is possible to issue long term working capital financings, subject to the restrictions against other replacement proceeds, which generally require that there be no available amounts during the period the bonds remain outstanding. *See* Sections 1.148-6(d)(3) and 1.148-1(c)(4). The 2016 Final Regulations provide a new safe harbor against the creation of replacement proceeds for longer-term working capital financings for issuers experiencing financial distress. These Final Regulations require the issuer to determine the actual available amounts as of the first day of each fiscal year beginning with the year it expects to have such available amounts and apply such available amounts to redeem or to invest in "eligible tax-exempt bonds."[58]

D. Grants

Under Section 1.148-6(d)(4), proceeds may be treated as expended when applied to the making of a grant.[59] The 2016 Final Regulations maintain the favorable rule that bond proceeds

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[56] Section 1.148-6(d)(3)(iii)(A).

[57] Section 1.148-6(d)(3)(iii)(B).

[58] Section 1.148-1(c)(4)(ii).

[59] The grantor may not impose any obligation or condition on the grantee to repay the grant, but conditions designed to insure expenditure of the moneys for the desired governmental purposes are acceptable. If the grant is repaid, the moneys are treated as unspent proceeds unless expended within 60 days of receipt. Section 1.148-6(d)(4).

are deemed spent on the date of the grant, but provide that the "character and nature" of the grantee's use of bond proceeds are taken into account in determining which rules apply to such bond proceeds. Accordingly, the 2016 Final Regulations clarify whether proceeds constitute capital or working capital expenditures, the temporary period to the issuer prior to making the grant and the useful life of the financed assets.

E. Allocation Methodology

An issuer may generally use any reasonable, "consistently applied" accounting method to determine when proceeds are expended, provided that proceeds must be accounted for in the same manner for purposes of both Code §§ 141 and 148. An issuer is not required to use the same accounting method for different issues of bonds, even if the issues finance the same project. If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue, the specific tracing method is used. Further, Section 1.148-6(d) provides that an issuer must account for the expenditure of proceeds not later than 18 months after the later of the date the expenditure is paid or the date the project financed is placed in service, provided that, in any event, this allocation must be made 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.[60]

In many instances, issuers (and other governmental entities) enter into agreements regarding the usage of moneys, including intergovernmental loans. Under what circumstances are transfers between governmental entities treated as expenditures? Under Section 1.148-6(d)(7), any payment of proceeds to a related party is not an expenditure of those proceeds. Related parties, with respect to governmental units and 501(c)(3) organizations, are members of the same "controlled group" under Section 1.150-1(e) and, with respect to other persons, a related person as defined in Code § 144(a)(3). In certain instances, it may be possible to trace the expenditures of proceeds to "out-of-pocket" expenditures of the related party.

F. Certain Investment Proceeds

For governmental bonds and private activity bonds financing governmentally owned assets, investment proceeds (other than investment proceeds held in a refunding escrow) that are commingled with substantial tax and other revenues from governmental operations of the issuer may be treated as spent when commingled as long as the issuer reasonably expects the amounts to be expended for governmental purposes within six months of the date of commingling, using any reasonable accounting assumption.[61]

[60] *See* Technical Advice Memorandum 9723012, in which the Service refused to permit the reallocation of proceeds to expenditures several years after the initial allocation. However, the Service concluded in PLR 200248002 (November 29, 2002) that § 1.148-6(d)(1)(iii) permits issuers both to allocate and then to reallocate proceeds to expenditures as long as the reallocations are made within the time frame permitted by the regulation.

[61] *See* Section 1.148-6(d)(6).

VI. ANTI-ABUSE RULES

A. Abusive Arbitrage Device

Under Section 1.148-10, if an "abusive arbitrage device" is employed in connection with the issuance of governmental obligations, the obligations will be considered to be arbitrage bonds. An abusive arbitrage device is a transaction or series of transactions that attempt to circumvent the provisions of Code § 148 by (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain material financing advantage; and (ii) overburdening the tax-exempt bond market. The 2016 Final Regulations revised Section 1.148-10 to add an issuer's bona fide need to finance "extraordinary" working capital items to the list of factors that could outweigh factors tending to show overburdening of the market.

B. Abusive Advance Refunding Transactions

Code § 149(d)(4) prohibits use of a "device" in an advance refunding "to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates." Certain transactions are described as "devices" in the legislative history of Code § 149(d)(4) and in the General Explanation of the Tax Reform Act of 1986, at p. 1215. In addition to giving the Commissioner fairly broad discretion to re-characterize perceived abusive transactions to reflect their economic substance, Section 1.148-10(d) also sets out five additional examples of transactions that are considered abusive. Finally, in Rev. Rul. 94-42, the IRS indicated that another type of transaction (one involving certain types of bond insurance arrangements under which the bond insurer was expected to pay the debt service on the bonds) would cause the interest on bonds to be taxable; interestingly, the IRS did not use the abusive device provisions of Section 1.148-10 to stop such transactions.

C. Clearly Reflect the Transaction

Under Section 1.148-10(e), the Commissioner "may exercise his or her discretion to depart from the rules of § 1.148-1 through § 1.148-11 as necessary to clearly reflect the economic substance of the transaction" if an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates. For an example of this situation, *see City of Columbus, Ohio v. Commissioner,*[62] which involved a state pension fund created to replace local plans, in exchange for agreements by the local entities to repay the state over a 65-year period with interest at 4.25%. The State had then proposed that municipalities could "prepay" their "obligation" at a 35% discount, and the City of Columbus proposed issuing tax-exempt bonds for this purpose. The Tax Court concluded that-

> irrespective of the technicalities of the arbitrage regulations . . . , respondent was entitled to make the adjustment of the yield calculation to take the 35-percent discount into account and to reject petitioner's [the IRS] application for ruling under Section 1.148-10(e), on the ground that the *economic substance of the transaction clearly revealed a materially higher*

[62] 106 T.C. 325 (May 14, 1996), supplemented by T.C. Memo. 1996-343 (1996), vacated and remanded 97-1 U.S.T.C. ¶ 50,424 (1997).

yield . . . . Consequently, the interest on the proposed bonds will not be exempt under § 103(a). (Emphasis added).

The Tax Court did not treat the investments held by the pension fund as the "acquired obligation." Rather, the Tax Court determined that the "arbitrage" was the difference between the yield on the proposed bonds of 6% and the offered discount on the obligation to the State with a resulting "yield" of 7.57484%. After appeal and remand, the Tax Court determined that since there was no prepayment for property and the prepayment, in and of itself, did not constitute investment-type property. *City of Columbus v. Commissioner*, T.C. Memo. 1998-135 (1998). For an application of the "economic substance" doctrine to an advance refunding transaction, *see* PLR 200424003 (a technical advice memorandum), which required two bond issues to be treated as a single issue based upon the economic substance of the transactions.

PART II —REBATE AND EXCEPTIONS TO REBATE

VII. ARBITRAGE REBATE

A. Rebate Generally

1. *The Code.*

Under Code § 103(b)(2), the exclusion of interest pursuant to Code § 103(a) is not applicable to any arbitrage bond. Under Code § 148(f)(1), a bond that is part of an issue will be treated as an arbitrage bond unless the rebate requirements set forth in Code §§ 148(f)(2) and (3) are satisfied for that issue. The amount to be paid is the sum of (i) the excess of the amount earned on all nonpurpose investments over the amount that would have been earned on those investments had those investments been invested at a rate equal to the yield on the issue, plus (ii) any income attributable to that excess.

Code § 148(f)(3) specifies that rebate payments be made in accordance with an installment payment schedule over the life of the issue. A payment must be made at least once every five years in an amount such that at least 90% of the excess earnings amount at the time payment of the installment is required will be paid on such date, and a final payment of the balance must be made within 60 days of the final retirement of the issue.

2. *Summary of Rebate Methodology under the Regulations.*

The history of the arbitrage regulations is discussed in versions of this outline from prior Workshops.

a. *Computation and Payment Dates.*

(i) *Rebate Amount*. The rebate amount for an issue as of any date is the excess of: (a) the future value of all receipts on nonpurpose investments; over (b) the future value

of all payments on nonpurpose investments. Future value is computed as of the computation date.[63]

(ii) *Rebate Payment Dates*. No later than 60 days after each computation date (other than the final computation date), rebate must be paid in an amount that, when added to the future value as of the computation date of previous rebate payments made for the issue, equals at least 90% of the rebate amount as of that computation date. No later than 60 days after the final computation date, rebate must be paid in an amount that, when added to the future value of previous rebate payments made for the issue, equals 100% of the rebate amount as of that computation date.[64] For issues retired within three years of the issue date, the final payment need not occur before the end of eight months after the issue date or the end of the period in which the issuer reasonably expects that any spending exceptions will apply to the issue.[65]

(iii) *Late Payments; Interest Due*. Under Sections 1.148-3(g) and (h), a rebate payment is considered made only when paid at the place or places designated by the IRS and accompanied by the form provided by the IRS for payment purposes (Form 8038-T). For late payments, payment of a penalty and interest will normally be required, but the penalty is automatically waived if the rebate amount is paid (with interest) within 180 days after the discovery of the failure to pay, unless (A) the Commissioner determines the failure was due to "willful neglect," or (B) the issue is under examination by the IRS during the period beginning on the date the failure first occurs and ending on the date 90 days after the receipt of the rebate amount. Waiver outside these circumstances will only occur in unusual circumstances. Section 1.148-3(h)(3).[66] For late payments and underpayments, interest accrues at the underpayment rate defined by Code § 6621 beginning on the date the correct rebate amount was due and ending on the date 10 days before actual payment is made. Section 1.148-3(h)(2).

(iv) *Computation Dates*. Under Section 1.148-3(e), a computation date means each date on which the rebate amount for an issue must be computed, which includes the first required payment date, subsequent required payment dates and the final computation date.

(1) For a fixed yield issue, the first required payment date is any date selected by the issuer that is not later than the fifth anniversary date of the issue. The subsequent required payment dates are any dates selected by the issuer that are not later than five years after a previous computation date for which a rebate installment was made. The final computation date is the date that an issue is retired (unless delayed under Section VII.A.2.a(ii) above). Section 1.148-3(e)(2).

(2) For a variable yield issue, the first required payment date is the last day of any bond year selected by the issuer ending on or before the fifth anniversary date of the issue date. After the first required payment date, the issuer may not change previous computation dates and must consistently treat either the end of each bond year or the end of each subsequent fifth bond year as a subsequent required payment date. The selection of computation

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[63] Sections 1.148-3(a) through (c) provide the general rules for determining the rebate amount.

[64] Section 1.148-3(f).

[65] Section 1.148-3(e)(2).

[66] Rev. Proc. 2005-40 also provides procedures for corrections of a failure to timely pay the proper amount of arbitrage rebate.

dates may be critical for these issues. The final computation date is the date an issue is retired (unless delayed under VII.A.2.a(ii) above). Sections 1.148-3(e)(1) and (2). After the first date payment is made the issuer may not change its choice of the first required payment date or its choice of subsequent required payment dates. Section 1.148-3(e)(1).

(3) "Bond year" for these purposes is each one-year period selected by the issuer (with short first and last bond years permitted). If no day is selected by the issuer for these purposes before the earlier of the final maturity date of the issue or the date that is five years after the issue date, each bond year ends on the anniversary date of the issue date and on the final maturity date. Section 1.148-1(b).

b. *Investment Receipts.*

(i) *Relationship to Rebate*. The rebate amount as of any computation date is the excess of the future value of all receipts on nonpurpose investments ("nonpurpose receipts") over the future value of all payments on such nonpurpose investments ("nonpurpose payments"). Significantly, there is no rebate obligation with respect to purpose investments (for example, in a conduit issue, the loan of proceeds by the issuer to the borrower). Section 1.148-1(b).

(ii) *Types of Receipts*. There are three classes of nonpurpose receipts: actual/constructive receipts; disposition receipts; and computation date receipts. Section 1.148-3(d)(2).

(a) *Actual/Constructive Receipts*. Receipts include any amount that is actually or constructively received from a nonpurpose investment, including interest earnings, return of principal, and gain from the sale or retirement of the investment, with no adjustments for costs or expenses paid to purchase, carry, sell, or retire the investment (unless those costs are qualified administrative costs). Code § 148(f)(4)(A) and Section 1.148-3(d)(2)(i). *See* the discussion of qualified administrative costs in Part I, Section IV.D.2. above.

(b) *Disposition Receipts*. Under Section 1.148-3(d)(2)(ii), a disposition receipt arises when a nonpurpose investment ceases to be allocated to an issue or ceases to be subject to the rebate requirements of an issue, other than by reason of a sale or redemption of the nonpurpose investment. This will occur, for example, when an investment becomes allocable to transferred proceeds of another issue, ceases to be allocable to the issue as a result of the operation of the universal cap rules of Section 1.148-6(b)(2), or qualifies for an exception to rebate (*e.g.*, a bona fide debt service fund).[67] An investment that is de-allocated from an issue is generally treated as if sold for its fair market value on the date of de-allocation.

(c) *Computation Date Receipts*. Nonpurpose receipts also include computation date receipts. Section 1.148-3(d)(2)(iii). Computation date receipts arise on the computation date in an amount equal to the value of all nonpurpose investments allocated to the issue at the end of the computation period.

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[67] Allocation of investments to gross proceeds is addressed under the 1993 Final Regulations in Sections 1.148-6(b), (c), and (e).

(d) *Commingled Fund Receipts*. The rules of Section 1.148-6(e) control when receipts are allocated among the various investors of a commingled fund (as defined above). Section 1.148-3(d)(3) provides that the commingled fund rules control the required determinations of receipts and not the rules for actual/constructive receipts, disposition receipts, and computation date receipts stated above.

(e) *Value of Nonpurpose Investments*. The value of a nonpurpose investment on a date is generally determined by the consistent application (on that date) of one of the following three valuation methods: (1) outstanding stated principal amount plus accrued interest for "plain par investments;" (2) present value for fixed rate investments; and (3) fair market value for any investment.

A plain par investment (1) is issued with no more than a "*de minimis*" amount of original issue discount or premium,[68] or acquired after issuance at no more than a *de minimis* amount of market discount or premium; (2) is issued for a price that does not include interest other than pre-issuance accrued interest; (3) bears interest that is unconditionally payable at least annually from the issue date at a single, stated, fixed rate, or is a variable rate instrument,[69]; and (4) has a lowest stated redemption price that is not less than its outstanding stated principal amount. The present value of an investment on any date is defined, generally, as the present value as of that date of all future unconditionally payable receipts to be received from and payments to be paid for the investment, using the yield on the investment as the discount rate.[70] The determination of fair market value is governed by Section 1.148-5(d)(6). See Part I, Section IV.D above.

When valuing investments, certain restrictions apply. First, all yield restricted investments must be valued at present value. Section 1.148-5(d)(2). Second, for an investment that is not yield restricted, it must generally be valued at fair market value on the date it is first allocated to an issue, or first ceases to be allocated to an issue, as a result of a deemed acquisition or disposition, except as described in the following sentence. Section 1.148-5(d)(3)(i). The fair-market-value rule does not apply if that disposition is the result of the transferred proceeds rules (Section 1.148-9(b)) or the universal cap rules (Section 1.148-6(b)(2)) or the investment is in a commingled fund. Section 1.148-5(d)(3)(ii). These rules are complex; if you have to make these determinations, read the regulations carefully.

c. *Investment Payments.*

(i) *Relationship to Rebate*. Recall that rebate amount as of any computation date is the excess of the future value of all nonpurpose *receipts* over the future value of all nonpurpose *payments*. Five different types of payments must be considered, as discussed below: actual/constructive payments; allocated payments; computation period payments; computation date credits; and yield reduction payments.

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[68] "De minimis" discount or premium means an amount that does not exceed the sum of 2% times the stated redemption price at maturity. Section 1.148-1(b).

[69] A bond, debenture, note or certificate of indebtedness under Code § 1275.

[70] Under Section 1.148-5(b)(2), all yield restricted investments of the same class are treated as a single investment, and investments held in a refunding escrow (no matter how funded) are treated as a single investment.

(ii) *Types of Payments*.

(a) *Actual/Constructive Payments*. Payments include the amounts of gross proceeds of an issue actually or constructively paid to acquire a nonpurpose investment or treated as paid to a commingled fund. Section 1.148-3(d)(1)(i). These amounts may not generally be increased by any brokerage commissions or administrative expenses, and the price paid may not exceed the fair market value as of the purchase date (Section 1.148-6(c)).[71]

(b) *Allocation Payments*. Payments include the value of nonpurpose investments on the date that a previously acquired nonpurpose investment first becomes allocable to an issue or becomes subject to the rebate requirements of an issue. Section 1.148-3(d)(1)(ii). For example, this type of allocation will arise (1) upon the pledge of a reserve or other fund of existing investments as security for an issue and (2) when proceeds of a refunded issue transfer to the refunding issue.

(c) *Computation Period Payments*. Payments include the value of an investment at the beginning of a computation period if the investment was allocated to an issue at the end of the preceding computation period. Section 1.148-3(d)(1)(iii). This rule provides symmetry for the determination of receipts and payments on an obligation that is held at the end of a computation period. The value of an investment for computation date receipt purposes should equal the value of an investment for computation period payment purposes.

(d) *Computation Date Credits*. Section 1.148-3(d)(1)(iv) provided a computation date credit of $1,000 on (1) the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to rebate requirements and (2) the final maturity date of an issue. The 2016 Final Regulations increased the credit to $1,400 and adjusts it for inflation. The computation credit was $1,590 for bond years ending in 2013, $1,620 for bond years ending in 2014, $1,650 for bond years ending in 2015, and $1,650 for bond years ending in 2016.[72]

(e) *Yield Reduction Payments*. Finally, any amounts paid to the United States to reduce the yield on a nonpurpose investment, including rebate amounts, are treated as nonpurpose payments, Sections 1.148-3(d)(1)(v) and -5(c), and recoveries of overpayment of rebate pursuant to Section 1.148-3(i) are treated as negative yield reduction payments. Section 1.148-5(c)(2). *See* the discussion at Part I, Section IV.B.7 above concerning yield reduction payments.

d. *The Future Value Method*.

The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when paid, received or

[71] But qualified administrative costs may act to decrease the yield and rebate amount due with respect to a nonpurpose investment. *See* Section 1.148-6(c) and the discussion at Part I, Section IV.D. above.

[72] For 2013, Rev. Proc. 2012-41, 2012-45 IRB 539, 540 (Nov. 5, 2012); for 2014, Rev. Proc. 2013-35, 2013-47 IRB 537 (Nov. 18, 2013); for 2015, Rev. Proc. 2014-61, 2014-47 I.R.B. 860 (Nov. 17, 2014); for 2016, Rev. Proc. 2015-53, 2015-44 I.R.B. 615 (Nov. 2, 2015).

treated as paid or received, plus interest assumed to be earned and compounded on such value over the period at a rate equal to the yield on the issue. Section 1.148-3(c).

B. Computation of Yield on Fixed Yield Issues

1. *Introduction.*

The basic rule is that the yield on fixed yield issues, unlike variable yield issues, will not change over the life of the issue, with two exceptions as described in Section VII.B.3 below.

2. *Definitions.*

a. *Fixed Yield Issue.*

A fixed yield issue is any issue comprised exclusively of fixed yield bonds. A fixed yield bond is any bond whose yield is fixed and determinable on its issue date. Section 1.148-1(b).[73]

b. *Issue Price.*

(i) *In General*. Under Code § 148(h), the issue price is determined under Code §§ 1273 and 1274. Under Section 1.148-1(b), the issue price of bonds that are publicly offered is the first price at which a substantial amount (10%) of the bonds is sold to the public. The public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. The issue price does not change if part of the issue is later sold at a different price. Such price is determined separately for bonds that are not substantially identical (*e.g.*, different maturities and different interest rates). If a bond is issued for property, Section 1.148-1(b) directs that the applicable federal tax-exempt rate is used in lieu of the applicable federal rate for determining the issue price under Code § 1274.

(ii) *Reasonable Expectations*. The issue price of publicly offered bonds is determined on the basis of reasonable expectations regarding the initial public offering price as of the sale date and does not change if part of the issue is later sold at a different price. Section 1.148-1(b). The issue price of bonds may not exceed their fair market value as of the sale date under Section 1.148-1(b).

(iii) *Impact of 2015 Proposed Regulations.* On September 13, 2013, the IRS published proposed arbitrage regulations that would have significantly modified the definition of "issue price." The 2013 Proposed Regulations eliminated "reasonable expectations" and provided that issue price is the first price at which a "substantial amount" of each maturity of a bond is actually sold to the public within the offering period. The 2013 Proposed Regulations provided a safe harbor for determining issue price as the first price at which at least 25% of bonds of a maturity are sold to the public. On July 13, 2015, the IRS withdrew the portion of the 2013

[73] A variable yield issue will automatically be treated as a fixed yield issue as of the first day on which it would qualify as a fixed yield issue if newly issued on such conversion date (or the next computation date at the option of the issuer). Section 1.148-4(d).

Proposed Regulations related to the definition of issue price and proposed regulations as to the definition of issue price.[74]

The 2015 Proposed Regulations define the issue price of bonds issued for money as the first price at which a substantial amount of the bonds is sold to the public, with ten percent (10%) being a substantial amount. The 2015 Proposed Regulations further provide an alternative method for determining issue price in instances where a substantial amount of bonds is not sold at the initial offering price. Use of the alternative method entails the following requirements: (1) underwriters must fill all orders at the initial offering price placed by the public and received by the underwriters on or before the sale date, (2) underwriters do not fill any order received by the underwriters on or before the sale date at a price higher than the initial offering price, (3) the sole or lead underwriter must certify that no underwriter will fill an order received from the public after the sale date and before the issue date at a price higher than the initial offering price, except if the higher price is the result of a market change for those bonds after the sale date for which it will provide the issuer with supporting documentation therefor.

3. ***Computation of Yield (Fixed Yield).***

a. *Basic Method.*

Yield on a fixed yield issue is defined as the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments over the life of the issue of principal of and interest and (in certain instances) stated redemption prices on the issue, qualified guarantee fees (both paid and reasonably expected to be paid), and payments made or received under a qualified hedge, produces an amount equal to the present value of the aggregate issue price of the bonds of the issue as of the issue date. Section 1.148-4(b)(1). Yield is computed based upon the compounding of interest at the end of each compounding interval (a method referred to variously as the economic accrual method, constant interest method or actuarial method). Compounding intervals cannot exceed more than one year, yield is calculated to at least four decimal places, and reasonable standard financial conventions (*e.g.*, 30/360 day counts) may be used but must be consistently applied. Sections 1.148-1(b) and -4(a).

b. *Redemption Provisions.*

(i) *Mandatory and Expected Redemptions.* If any bond is subject to mandatory early redemption or expected contingent redemption, it is treated as redeemed on its reasonably expected early redemption date at its value on that date. Section 1.148-4(b)(2)(i).

(ii) *Deep Discount: Mandatory Sinking Fund Redemption of Term Bonds*. In most cases, if the issue includes term bonds with mandatory sinking fund redemptions, bond yield is computed by treating those bonds as redeemed on their scheduled dates at a price of par plus accrued interest. But if those bonds are issued at a "deep" discount (discussed below), bond yield is computed by using the *value* of those bonds on the redemption date (not their stated

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[74] The 2015 Proposed Regulations are proposed to be effective for bonds sold 90 days or more after the regulations are finalized.

principal amount), plus accrued interest.[75] This special rule applies to a term bond if the "stated redemption price of the bond at maturity" (usually the face amount), exceeds the issue price of the bond by more than the product of (A) 0.25% per year times (B) the number of years to the weighted average maturity of the expected mandatory sinking fund schedule. Section 1.148-4(b)(2)(ii).

(iii) *Yield-to-Call: Certain Bonds Subject to Optional Early Redemption*. This rule affects callable premium bonds, short-call bonds, and stepped coupon bonds. For certain fixed yield bonds subject to optional early redemption, the yield on the issue is computed assuming the bonds are redeemed at their stated redemption prices on the optional redemption dates that would produce the lowest yield on each of the bonds subject to optional redemption.[76] Stated redemption price for this purpose means the total redemption price of the bonds including any call premium. The three classes of fixed yield bonds subject to this yield-to-call requirement are: (A) bonds subject to optional redemption within five years of the issue date, but only if the yield on the issue (computed by assuming those bonds are redeemed at maturity) is more than 1/8 percentage point higher than the yield on the issue (computed by assuming those bonds are redeemed at their earliest redemption date); (B) premium bonds when the premium is more than the product of (x) .25%, (y) the stated redemption price of the bonds at maturity and (z) the number of complete years to the first optional redemption date for the bonds; and (C) stepped coupon bonds when the bonds bear interest at increasing interest rates.[77]

Prior to the adoption of the 2016 Final Regulations, the calculation of bond yield on an issue with bonds subject to optional early redemption was complex, because it was often necessary to run multiple scenarios with different redemption dates for different bonds to determine which combination produces the lowest yield on the *issue*. The 2016 Final Regulations changed the Regulations to require that the issuer assume each callable bond would be redeemed on the optional redemption date that would produce the lowest yield *on that bond*.

(iv) *Change in Bond Yield*. Yield on a fixed yield issue is computed under the 1993 Final Regulations as of the issue date and is not affected by subsequent unexpected events, with two exceptions. First, yield must be recomputed for rebate purposes as of any date there is a transfer, waiver, modification or similar transaction of any right that is part of the terms of a bonds or otherwise associated with a bond in a transaction separate and apart from the original sale of a bond (such as sale or waiver of a redemption option). Second, if an issuer issued variable yield bonds and then entered into a qualified hedge that caused the issue to be treated as a fixed yield issue under Section 1.148-4(h)(4) (a "super-integrated hedge"), then it subsequently terminates that hedge within five years of the issue date of the bonds, the bond issue is treated as retired and reissued as a variable yield issue on the termination date. Section 1.148-4(h)(4)(iii). *See also* Section VII.E. below (qualified hedges). The deemed new issue is apparently a new issue for purposes of triggering the final computation date provisions of Code § 148(f) for the "retired" issue. Section 1.148-4(b)(4) and (h)(4)(ii).

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[75] This rule was written to force valuation of heavily discounted term bonds at the lower, accreted value, not par value, under the theory that, if the bonds are trading on the market at a significant discount, the issuer could simply purchase them at the market price and then cancel them.

[76] Section 1.148-4(b)(3)(i).

[77] Section 1.148-4(b)(3).

C. Computation of Yield on Variable Yield Issues

1. *Introduction.*

A variable yield issue is any issue that is not a fixed yield issue.[78] If interest on any or all of the bonds of an issue is determined by reference to market interest rates, the issue is a variable yield issue. Thus, all of the bonds of a variable yield issue may be variable yield bonds, but in many cases a variable yield issue will include some fixed yield bonds. Yield on a variable yield issue is computed separately for each computation period as of the first date of each computation period. *See* the discussion of rebate computation dates in Section VII.A.2 above.

2. *Computation of Bond Yield (Variable Yield).*

a. *General Rule.*

The yield on a variable yield issue for a computation period is computed as of the first day of the computation period and is the discount rate that, when used in computing the present value of all the payments of principal and interest, fees for qualified guarantees, and payments on a qualified hedge that are attributable to the computation period, produces an amount equal to the present value (using the same discount rate) of the aggregate issue price of all the bonds of the issue for the computation period. Section 1.148-4(c). For yield computation purposes, the bonds are treated as if retired and reissued at the end of each computation period.

b. *Issue Payments.*

These payments include (a) principal (including for bonds redeemed during the computation period an amount equal to the greater of the bond value or actual redemption price including any call premium) and interest paid during the computation period; (b) amounts paid or deemed to be paid during the computation period for a qualified guarantee; (c) amounts paid or deemed to be paid during the computation period for a qualified hedge; and (d) for bonds outstanding at the end of a computation period, an amount equal to the bonds' value on the last day of the computation period. Section 1.148-4(c)(2). See Section VII.C.2.d. below.

Up-front and other "non-level" payments for a qualified guarantee for variable yield bonds must be allocated to each computation period. The 1993 Final Regulations provide a safe harbor for an allocation of non-level payments if an equal amount is treated as paid as of the first day of each bond year over the term of the qualified guarantee. This amount is sometimes referred to as the "constant payment amount." Section 1.148-(f)(6).

c. *Issue Price.*

The issue price for both variable yield bonds and fixed yield bonds in a variable yield issue as of the issue date is the general issue price definition discussed at Part II, Section VII.B.2 above. Any bond (including a fixed yield bond) outstanding at the end of a computation period is treated as if it were immediately reissued on the next day (the first day of the subsequent computation

[78] Section 1.148-1(b).

period) for a deemed issue price equal to the value of the bond used as the issue payment on the previous day.

d. *Determination of the Value of a Bond.*

There are three methods for valuing outstanding bonds:

(i) *Plain Par Bonds*. Plain par bonds are valued at their outstanding stated principal amount plus accrued unpaid interest. "Plain par bonds" are bonds (a) with not more than a "*de minimis*"[79] amount of original issue discount or premium; (b) bearing only pre-issuance accrued interest; (c) bearing a single, stated fixed rate or a variable rate debt instrument (under Code § 1275); (d) paying interest at least annually; and (e) having a lowest stated redemption price not less than the outstanding stated principal amount. Section 1.148-4(e)(1).

(ii) *Other Bonds*. Fixed yield bonds that are not plain par bonds are valued at their present value on a given date calculated using the yield on the bond as the discount rate (or for term bonds subject to mandatory tender, the yield on the term bond to maturity) and their expected remaining payments including fees to be paid for a qualified guarantee in connection with the issue. Section 1.148-4(e)(2). Variable yield bonds that are not plain par bonds are valued at their present value on a given date calculated using the yield giving effect to the initial interest rate on the bond and their expected remaining payments under such initial interest rate including fees to be for a qualified guarantee in connection with the issue. Section 1.148-4(e)(2).

e. *Special Rules.*

As of the first day on which a variable yield issue would qualify as a fixed yield issue if it were newly issued, the variable yield issue is treated as if it were reissued as a fixed yield issue at an issue price equal to the aggregate values of all bonds on the conversion date. If such conversion date occurs on a date other than a computation date, the conversion date may be treated as occurring on the next succeeding computation date. Section 1.148-4(d).

D. Qualified Guarantees

1. ***Elements of Qualified Guarantees.***

Bond yield is computed by taking into account payments made for a qualified guarantee, such as bond insurance or a letter of credit.[80] The regulations contain a number of requirements regarding what constitutes a qualified guarantee, including the character of the entity that issues a credit enhancement device, the terms of the device and the fees paid for it. The following considerations are discussed below, in the order listed: (a) risk shifting; (b) fees for the credit enhancement; (c) non-guarantee element; (d) purpose investment guarantees; and (e) allocation of guarantee fees.

a. *Risk Shifting.*

The guarantee arrangement must create a guarantee in substance. The guarantee must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or

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[79] Section 1.141-1(b).
[80] Section 1.148-4(f).

part of the payments on a bond, such as payments of principal, interest, and redemption or tender prices on the bonds. Thus, the guarantor may not be a co-obligor with respect to the bonds and the guarantor must not expect to make any payments (other than under a direct-pay letter of credit or similar arrangement for which the guarantor will be reimbursed immediately). Commercially reasonable limits on credit risk, limits on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor do not cause the guarantee to be conditional. The guarantor and related parties must not use more than 10% of the proceeds of the guaranteed bonds. Section 1.148-4(f)(3).

b. *Fees for Credit Enhancement.*

The fees for a guarantee must not exceed a reasonable, arm's-length charge for the transfer of credit risk. In complying with this requirement, the issuer may not rely on representations of the guarantor. Section 1.148-4(f)(4)(i). The issuer must demonstrate expected savings as of the date the guarantee is obtained, and the issuer must reasonably expect that the present value of fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee.[81] A fee for a guarantee must not include any payment for any direct or indirect services other than the transfer of credit risk, unless the compensation for those other services is separately stated, reasonable, and excluded from the guarantee fee. Section 1.148-4(f)(4)(ii).[82]

c. *Non-guarantee Element.*

A qualified guarantee fee may not include fees for services other than the transfer of credit risk. Those fees, if any, must be separately stated and excluded from the yield computation. See Section 1.148-4(f)(4)(ii) for examples of these non-credit risk fees. Fees for the transfer of credit risk include, however, fees for the guarantor's overhead and other costs relating to the transfer of credit risk. Section 1.148-4(f)(4)(ii).

d. *Purpose Investment Guarantees.*

The guarantee of a purpose investment, except for guarantees of qualified mortgage loans and qualified student loans, may be a qualified guarantee. Section 1.148-4(f)(5). Purpose investments are investments including program investments that are acquired to carry out the governmental purpose of an issue. Section 1.148-1(b). In a typical conduit issue, the loan of the bond proceeds by the issuer to the borrower is the purpose investment, from the perspective of the issuer. All payments on the purpose investment must reasonably coincide with payments on the underlying bonds, and the payments on the purpose investment must be unconditionally payable no more than six months before the corresponding interest payments and twelve months before the corresponding principal payments on the bonds. The guarantee of the purpose investment must be, in substance, a guarantee of the bonds allocable to the purpose investment and to no other bonds. Section 1.148-4(f)(5).

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[81] Present value for this purpose is computed using the yield of the issue (determined with regard to guarantee payments) as the discount rate.

[82] Payments by a borrower for a credit enhancer's attorneys are qualified guarantee fees because such attorneys' fees are "other costs relating to the transfer of credit risk" within the meaning of Section 1.148-f(4)(ii). PLR 200813022.

e. *Allocation of Fees for a Qualified Guarantee.*

The fee payments must be allocated in a manner that properly reflects the credit risk. Examples in the 1993 Final Regulations include allocating risk based on the ratio of total principal and interest paid and to be paid on a guaranteed bond to the total principal and interest paid on all bonds of the guaranteed issue. An allocation is not reasonable if a substantial portion of the fee is allocated to the construction portion of the issue. Reasonable letter of credit set-up fees may be allocated ratably during the initial term of the letter of credit.[83] If, as a result of an investment of proceeds of a refunding issue in a refunding escrow, there will be a reduction in, or refund of, payments for a guarantee, the savings must be treated as a reduction in the payments of the refunding issue. Section 1.148-4(f)(7).

E. Hedging Transactions

1. *Introduction.*

Generally, payments made or received under a "qualified hedge," such as an interest rate swap or forward purchase contract, are taken into account in determining yield on an issue. This rule applies solely for purposes of Code §§ 143(g), 148, and 149(d). Except to the extent that a special fixed yield treatment rule applies, as described in paragraph d. below, an issue covered by a qualified hedge is treated as a variable yield issue.

2. *Summary of Rules for Hedging Transactions.*

a. *Definition of a Qualified Hedge.*

In order for a bond issuer to treat a hedge as qualified, it must meet a number of very specific, technical requirements. These are summarized below.

(i) The contract is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond (a hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.[84] If a hedge provider makes a single payment to the issuer (*e.g.*, an acquisition payment for an off-market swap, where the rate the issuer pays is above the market) in connection with the acquisition of a contract, the issuer may treat a portion of that contract as a hedge, if the acquisition payment to the issuer and the issuer's payments under the contract in excess of the on-market rate are separately identified in a certification of the hedge provider and not treated as payments on the hedge.

(ii) The contract does not contain a "significant investment element," which would be the case if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date (*e.g.*, a payment for an off-market swap or prepayment of part or all of one leg of a swap, or an interest rate cap requiring the issuer's premium for the cap to be paid in a single, up-front payment).

[83] Section 1.148-4(f)(6).

[84] If the contract modifies the issuer's risk of interest rate changes with respect to a bond that is part of an issue that, absent the contract, would be a fixed rate issue, the contract must generally be entered into no later than 15 days after the issue date (or the deemed issue date) of the issue. Section 1.148-4(h)(2)(i)(B).

(iii) The contract is entered into between the issuer and a hedge provider that is an unrelated party; the contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity, and terms); and the contract is primarily interest based. See Section 1.148-4(h)(2)(v).

(iv) The payments received by the issuer under the contract correspond closely in time to either the specific payments being hedged on the hedged bonds, and the issuer's payments to the hedge provider are reasonably expected to be made from the same source of funds that the issuer would expect to use to pay the hedged bonds.

(v) The contract must be *identified* by the actual issuer on its books and records maintained for the hedged bonds not later than 3 days after the date on which the issuer and the hedge provider enter into the contract. *But see* Section VII.E.3 below. The regulations are very specific as to what information must be included in the identification. Also, the issuer must indicate on its Form 8038 or 8038-G that it entered into a hedge.

b. *Accounting for a Qualified Hedge.*

Payments made or received by the issuer under a qualified hedge are generally treated as payments made or received on the hedged bonds and are taken into account in determining the yield on those bonds. Payments made or received include payments deemed made or received when a contract is terminated or deemed terminated. Payments reasonably allocable to the modification of risk of interest rate changes and to the hedge provider's overhead are included as payments made or received under a qualified hedge.

A termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer or the acquisition by the issuer of an offsetting hedge. A deemed termination occurs when the hedged bonds are redeemed or when a hedge ceases to be a qualified hedge of the hedged bonds or if a transaction otherwise results in a deemed exchange of the hedge and a realization event under Code § 1001 to the issuer.

A payment made or received by an issuer to terminate a qualified hedge, including loss or gain realized or deemed realized, is treated as a payment made or received on the hedged bonds, as appropriate. The payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge. Except as provided below, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the fair market value of the qualified hedge on the redemption date is treated as a termination payment made or received on that date.

When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but not below zero, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The remainder of the payment, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess. To the extent that the hedged bonds are redeemed with a refunding issue, the termination payment is accounted for as a payment on the refunding issue, rather than the hedged bonds. To the extent that the refunding issue is redeemed during the period to which the

termination payment has been allocated, the payment is treated as a payment on the redeemed refunding issue. Section 1.148-4(h)(3)(iv) provides a safe harbor for allocating a hedge termination payment.

c. *Special "Super-Integration" Rule Resulting in Fixed Yield Treatment for Certain Bonds.*

If the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if the hedge meets certain specific requirements set forth in Section 1.148-4(h)(4). This is often called a "super-integrated hedge." Special rules apply if the hedge is terminated. See Section 1.148-4(h)(iii).

d. *Anticipatory Hedges.*

Sometimes a bond issuer will enter into a hedge contract relating to an issue of bonds that the issuer expects to issue in the future, perhaps many months down the road. For example, an issuer may enter into a hedge in February to effectively lock in current market interest rates for an issue of bonds to be issued the following November. These hedges are commonly known as "anticipatory hedges." Section 1.148-4(h)(5) provides special rules for these hedge transactions, but this topic is beyond the scope of a basic arbitrage discussion.

3. ***Impact of 2016 Final Regulations on Hedges.***

The 2016 Final Regulations modify several rules relating to qualified hedges. The size and scope of a qualified hedge are limited to a level reasonably necessary to hedge the issuer's risk of interest rate changes on the hedged bonds. Hedge payments are treated as corresponding close in time to the payment on the hedged bonds if the payments are made within 90 calendar days of each other. The amount of any termination payment (for a deemed or actual termination of a hedge) is equal to the fair market value of the hedge on the termination date. The time limit for an issuer to identify a hedge increased from 3 days to 15 calendar days. The 2016 Final Regulations also require that as part of the identification of a qualified hedge, the hedge provider certify that (1) the terms of the hedge were agreed to in a bona fide arm's-length transaction, (2) the rate payable by the issuer under the hedge was comparable to the rate that the hedge provider would have quoted in similar circumstances, (3) no payments to third parties are being made except as provided in the hedge documents, and (4) any amounts paid or received pursuant to the hedge do not include any payments other than payments reasonably allocable to the modification of risk of interest changes and the hedge provider's overhead.

In addition, the 2016 Final Regulations expand the ability to make yield reduction payments under Section 1.148-5(c) by allowing those payments with respect to nonpurpose investments in an advance refunding escrow, if (1) the issuer has entered into a variable-to-fixed interest rate swap with respect to the variable yield bonds of the issue allocable to the advance refunding escrow, (2) the swap covers a period at least as long as the escrow, and (3) the issuer restricts the yield on the escrow to a yield not greater than the yield on the hedge bond issue, based on the fixed leg of the swap.

The 2016 Final Regulations also remove some complexity related to modifications of a hedge or the continuation of a hedge in the case of a refunding by providing that if the modified

hedge or the hedge associated with the refunded bonds continues to be a "qualified hedge," then the "off-market" element of the hedge is disregarded and no deemed termination results. The modified hedge or continuing hedge in a refunding must be identified within the time period measured from the date of the modification or date of issue of the refunding bonds and without regard to the requirement for a hedge provider's certification.

4. ***Reissuance; Notice 2008-41.***

IRS Notice 2008-41[85] provides that a qualified hedge will not be terminated under §1.148-4(h) upon a modification of the terms of the Bonds if (1) as of the date of the modification, the modification is not reasonably expected to change the yield on the affected hedged bonds by more than 0.25% (25 basis points), and (2) the payments and receipts on the qualified hedge, as modified, are fully taken into account as adjustments to the yield on those hedged bonds under Code § 148. The Notice also provides that, for purposes of Code § 148, any premium received by an issuer pursuant to a conversion of the interest rate on a qualified tender bond to a fixed interest rate will be treated as additional sale proceeds of the bonds.

VIII. EXCEPTIONS TO REBATE

The exceptions to rebate are presented in the following order:

SPENDING EXCEPTIONS

A. Six-Month Spending Exception

B. Six-Month Spending Exception for Working Capital Financings

C. 18-Month Spending Exception

D. Two-Year Construction Spending Exception

ISSUER/ISSUE EXCEPTIONS

E. $5 / $15 million Small Issuer Exception

OTHER REBATE EXCEPTIONS

F. Investments in Bona Fide Debt Service Funds

G. Investments in Tax-Exempt Obligations

H. Other Miscellaneous Exceptions (including yield restriction)

[85] 2008-15 I.R.B. 742, 745 (April 14, 2008).

SPENDING EXCEPTIONS

A. Six-Month Spending Exception

1. ***General.***

If the gross proceeds of a bond issue are fully expended for the governmental purposes of the issue within six months of the issue date of the bonds, the bond issue will be treated as meeting the rebate requirements, as long as any gross proceeds that are not required to be spent, such as proceeds in a 4R Fund (other than earnings on amounts in any bona fide debt service fund), continue to meet the rebate requirement.[86] Use of the six-month exception is not mandatory. Amounts not required to be spent also include gross proceeds arising after six months that were not reasonably expected to arise as of the issue date, payments received on purpose investments and earnings on those payments, and amounts representing repayments of grants.[87] The governmental purposes of the issue may include payment of interest, but not principal, on the issue. Code § 148(f)(4)(B)(iv) and Section 1.148-7(b)(3). The *de minimis* rule contained in Section 1.148-7(b)(4) does not apply under the six-month exception.

2. ***Additional Six Months.***

For governmental-purpose issues and qualified 501(c)(3) bonds, the six-month spending period is extended for an additional six months for an amount not exceeding 5% of the proceeds of the issue.[88]

3. ***Refunding Issues.***

A refunding issue meets the six-month exception only if all proceeds of the issue (other than transferred proceeds of the issue and proceeds not required to be spent, such as proceeds in a 4R Fund) are spent within six months of the issue date of the refunding issue. Proceeds of a prior tax-exempt issue that become transferred proceeds of the refunding issue continue to be treated as unexpended gross proceeds of the prior issue for purposes of the spending exceptions. Even if the refunding issue meets the six-month exception, transferred proceeds will be subject to rebate unless the prior issue meets its own spending exception. *See* Section 1.148-7(b)(1)(ii).

4. ***Pooled Financings.***

For pooled financings, the general rule is that the six-month spending period begins on the issue date of the pool bonds (not on the date of the loan to the borrower), and the gross proceeds are not expended until the gross proceeds are spent for their ultimate purposes (rather than on the making of a loan). But Section 1.148-7(b)(6) permits the pooled bond issuer to elect (on or before the issue date) to apply the spending requirements separately to each loan to a conduit borrower, as discussed below under the two-year construction spending exception. If the election is made and proceeds are loaned to the ultimate borrower, the six-month spending period will begin for

[86] Sections 1.148-7(b), 1.148-7(c)(1), and 1.148-7(a)(3).
[87] Section 1.148-7(c)(3). A grant is defined in Section 1.148-6(d)(4).
[88] Code § 148(f)(4)(B)(ii)(I). Also, the six-month exception cannot be used for TRANS.

that loan on the earlier of (A) the date the loan is made or (B) the date 12 months from the issue date of the pooled bonds.

B. Six-Month Spending Exception For Working Capital Financings

1. *The Statutory Exception.*

For purposes of applying the six-month spending exception to rebate to working capital financings, Code § 148(f)(4)(B)(iii) carves out a special safe harbor in which TRANs (*i.e.*, tax or revenue anticipation notes) will be treated as meeting the six-month spending exception to rebate. If, as of the date six months after the issue date of the TRANs, the cumulative cash flow deficit of the issuer exceeds 90% of the proceeds of the issue, all the net proceeds of the issue (proceeds less amounts deposited in a 4R Fund for the issue), plus investment earnings thereon, will be treated as spent for the governmental purposes of the issue in satisfaction of the six-month spending exception. As described below, the statutory safe harbor provides an alternative method of satisfying the six-month exception.

2. *Deficit Definition.*

"Cumulative cash flow deficit" for this purpose means the excess of actual expenses paid during the period that would ordinarily be paid out of or financed by anticipated tax or other revenues, over the aggregate "amount available" (other than from the proceeds of the issue) during such period for the payment of such expenses. Code § 148(f)(4)(B)(iii)(II). The defined deficit must actually occur within the six-month period. If the actual deficit is less than 90% of the proceeds of the issue, the issue is subject to rebate.

3. *Amount Available.*

The amount available to an issuer for this purpose includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type financed without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed. Section 1.148-6(d)(3)(iii)(A). For purposes of the TRANs safe harbor, an otherwise permitted "reasonable working capital reserve" is specifically treated as part of the available amount. Section 1.148-6(d)(3)(D).

4. *Allocation of Proceeds to Expenditures.*

Section 1.148-6(d)(3) provides that gross proceeds of an issue and available amounts may be allocated to working capital expenditures only under a "gross-proceeds-spent-last" method. Thus, gross proceeds are treated as spent for working capital expenditures only to the extent the expenditures exceed the available amounts as of that date.[89]

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[89] *See* PLR 8740027 (delinquent TRANs).

5. ***$5,000,000 Small Issuer Exception.***

TRANs are eligible for the small issuer exception to rebate discussed below. Thus, small issuer TRANs may be sized for the deficit plus a reasonable working capital reserve, not to exceed 5% of the prior fiscal year's working capital expenditures. *See* Section 1.148-6(d)(iii).

6. ***Application of Traditional Six-Month Spending Exception.***

Section 1.148-6(d)(3) provides issuers of working capital financing with an alternative to the TRANs statutory safe harbor, which may be of particular interest for TRANs issuers that do not experience the requisite 90% deficit. Under Section 1.148-6(d)(3), bond proceeds may be spent for working capital purposes on a "proceeds-spent-last" basis, determined with respect to "available amount" (as described above). Under this rule, "available amounts" may include proceeds of a taxable bond issue, but do not include amounts held by an issuer as a reasonable working capital reserve maintained as defined in Section 1.148-1(c)(4)(ii). *See* PLR 200446006.

A reasonable working capital reserve may not exceed an amount equal to 5% of the issuer's actual working capital expenditures in the previous fiscal year.[90] In other words, unlike the TRANs safe harbor, in which the deficit must be measured assuming all available amounts are spent first, the six-month spending exception would allow an issuer to treat its bond proceeds as spent on working capital on a "proceeds-spent-last" basis while retaining a reasonable working capital reserve. Section 1.148-6(d)(3)(ii) sets out exceptions from the "proceeds-spent-last" rule in Section 1.148-6(d)(3)(i) for certain *de minimis* expenditures and for extraordinary, nonrecurring expenditures (*e.g.*, casualty losses). Replacement proceeds will arise, however, to the extent that a working capital reserve is financed with bond proceeds in excess of the reserve that the issuer historically maintained. Section 1.148-1(c)(4)(ii).

C. 18-Month Spending Exception

1. ***General Requirements.***

Under Section 1.148-7(d), the 18-month exception borrows elements of both the two-year construction spending exception discussed in Section VIII.D below and the six-month spending exception in VIII.B above. An issue will be treated as meeting the rebate requirement if the following requirements are met:

a. *Spending Schedule.*

The gross proceeds of the issue must be spent for the governmental purposes of the issue at least as fast as the following schedule: (i) 15% within six months of the issue date; (ii) 60% within one year of the issue date; and (iii) 100% within 18 months of the issue date. Section 1.148-7(d)(1)(I). For purposes of this exception, Section 1.148-7(d)(3)(i) provides that gross proceeds do not include amounts in a bona fide debt service fund, a 4R Fund, amounts that are not expected to be gross proceeds but arise after the end of the 18-month spending period, payments received under any purpose investment of the issue, and repayments of grants (the "gross

[90] *See* TAM 200413012 for additional guidance on how this 5% limit may be computed.

proceeds exclusions"), and those amounts do not have to be spent within the 18-month spending period.

b. *Certain Proceeds Exempt; Temporary Period.*

The gross proceeds of the issue that need not be spent within the 18-month spending period, such as proceeds in a 4R Fund (other than earnings on a bona fide debt service fund), must comply with the rebate requirement. Section 1.148-7(d)(ii). All of the gross proceeds of the issue, other than the gross proceeds exclusions, must qualify for the initial three-year or five-year temporary period provided under Section 1.148-2(e)(2) for capital project financings in order to qualify for the 18-month exception. Section 1.148-7(d)(1)(iii)

2. ***Other Rules.***

The 18-month exception extends the 18-month spending period to 30 months for amounts that qualify as a "reasonable retainage," with the same meaning as provided for the two-year construction spending exception (Section VIII.D below). Section 1.148-7(d)(3). For purposes of determining compliance with the six-month and 12-month spending periods, the amount of investment earnings included is based on the issuer's reasonable expectations as of the issue date. Section 1.148-7(d)(4). The 18-month exception is not applicable to any portion of an issue that is treated as meeting the rebate requirement under the two-year construction spending exception. Section 1.148-7(d)(4).

3. ***De minimis Rule.***

The 18-month exception has the same *de minimis* rule that applies to the two-year construction spending exception. Under the *de minimis* rule, the failure to spend an amount that does not exceed the lesser of 3% of the issue and $250,000 will not exclude an issue from qualifying for the 18-month exception, as long as the issuer continues to exercise due diligence to complete the project financed. Section 1.148-7(b)(4).

D. Two-Year Construction Spending Exception

1. ***General.***

Code § 148(f)(4)(c) provides an exception to the arbitrage rebate rules for the "available construction proceeds" ("ACP") of "construction issues," if the proceeds are expended pursuant to a prescribed maximum time schedule, generally within a two-year period (the "two-year rule"). In order to qualify for the two-year rule, the bonds must be (A) governmental bonds, (B) qualified 501(c)(3) bonds, or (C) private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization. Section 1.148-7(f)(3)(i).[91] Obligations issued by "on-behalf-of" issuers can qualify as construction issues, with the issuer being treated as a governmental unit. Section 1.148-7(f)(3)(i).

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[91] The safe harbors provided by Code § 142(b)(1)(b), as augmented by Code § 146(h)(2) in the case of solid waste disposal facilities, may be applied to determine the ownership of bond-financed property. Code § 148(f)(4)(C)(iv); Section 1.148-7(f)(3)(ii).

If the expenditure schedule described below is met, the ACP are not subject to arbitrage rebate. Code § 148(f)(4)(C)(i); Section 1.148-7(e). The two-year rule applies only to ACP; gross proceeds that are not ACP are, therefore, subject to rebate, unless another exception from rebate is applicable to them. Code § 148(f)(4)(C)(xvii). If the construction issue qualifies for the six-month exception, then the two-year rule need not be used. Section 1.148-7(a)(2). Finally, even though the issue may qualify for this rebate exception, an issuer is not required to apply the exception, and may instead apply the arbitrage rebate requirement of Code § 148(f)(2), except where the issuer has elected to pay the penalty in lieu of rebate, as described below. *See* Section 1.148-7(a)(3).

2. ***Construction Issue.***

A "construction issue" is an issue that is not a refunding issue and with respect to which at least 75% of the ACP are to be used to finance construction expenditures. Code § 148(f)(4)(C)(iv).[92] The 1993 Final Regulations provide, however, that for purposes of the two-year rule, the issuer may elect, on or before the issue date, to apply all of the provisions based on actual facts. Section 1.148-7(f)(2).

3. ***Construction Expenditures.***

The statute does not contain a definition of "construction" other than to provide that it includes reconstruction and rehabilitation. Code § 148(f)(4)(C)(iv). The 1993 Final Regulations, however, define "construction expenditures" as capital expenditures[93] that are allocable to the cost of:

a. real property (other than expenditures to acquire any interest in land or other existing real property); *see* Section 1.148-7(g)(2) (turnkey contract);

b. constructed personal property (generally, tangible personal property built to an issuer's specifications, with several detailed requirements; *see* Section 1.148-7(g)(3)); or

c. specially developed computer software that is functionally related and subordinate to real property or constructed personal property; s*ee* Sections 1.148-7(g)(4) and 1.148-7(e)(3) (definitions of real property and tangible personal property).

4. ***Apportioning of Multipurpose Issues.***

The 1993 Final Regulations include detailed rules under which an issuer may divide a multipurpose issue into a refunding issue and a nonrefunding issue and may further divide the non-refunding portion of a multipurpose issue into two issues: a construction issue and a non-construction issue, in order for one of the issues to qualify for the two-year rule and, potentially, the other for another exception to rebate. Code § 148(f)(4)(C); Section 1.148-7(j).

5. ***Available Construction Proceeds.***

ACP is defined as the sum of (i) an amount equal to the issue price of the construction issue; (ii) earnings on amounts invested in a 4R Fund funded from other than bond proceeds; and

[92] Section 1.148-7(f)(1)(i) clarify the "to be used" language of the Code by providing that an issue will be a construction issue if, as of the issue date, the issuer reasonably expects that at least 75% of the ACP will be allocated to construction expenditures.

[93] See Part I, Section V.A above for the definition of capital expenditures.

(iii) earnings on (i) and (ii); minus (iv) the amount of the issue price on deposit in a 4R Fund; minus (v) the costs of issuance financed by the bond issue; and (vi) minus earnings on amounts in a 4R Fund after the earlier of the close of the two-year period or the date construction is substantially completed. Code § 148(f)(4)(C)(vi); Section 1.148-7(i)(1).[94] Earnings include earnings on any investment in tax-exempt bonds. Section 1.148-7(i)(1). Pre-issuance accrued interest and earnings thereon may be disregarded. *Id.* Amounts that are not gross proceeds because of application of the "universal cap" rules of Section 1.148-6(b)(2) are not ACP. *Id.*

6. ***Treatment of 4R Fund Earnings.***

Under the two-year rule, absent an election to the contrary by the issuer, investment earnings on amounts in a 4R Fund generally are not subject to rebate until the earlier of two years after the issue date and the date that construction is substantially complete, because those amounts are part of ACP. Instead, they are subject to the same spending schedule as other ACP of the issue. But after the earlier of the date construction is substantially completed or the end of the two-year period, those earnings become subject to rebate because they are no longer part of ACP. Code § 148(f)(4)(C)(vi)(II) and Section 1.148-7(h)(2).

The issuer may also elect to rebate any arbitrage on amounts in a 4R Fund from the issue date. Code § 148(f)(4)(C)(vi)(IV) and Section 1.148-7(h)(2). For example, this election may be desirable when the 4R Fund is net funded, so that earnings on the 4R Fund are to be retained in the fund (rather than expended for the governmental purpose of the issue) until the 4R Fund reaches its proper size. For purposes of determining compliance with the spending requirements for each of the first three spending periods, ACP includes future earnings that the issuer reasonably expects as of the issue date for the entire two-year period. Section 1.148-7(h)(3).

7. ***Spending Requirements.***

To utilize the two-year rule fully, ACP must be spent for the governmental purposes of the issue at least as fast as the following schedule: (i) 10% within the six-month period beginning on the date the bonds are issued; (ii) 45% within the one-year period beginning on the date the bonds are issued; (iii) 75% within the 18-month period beginning on the date the bonds are issued; and (iv) 100% within the two-year period beginning on the date the bonds are issued.

The 100% test at the end of the second year will be deemed met if no more than 5% of ACP is kept as a reasonable retainage, as defined below, and those proceeds are spent within the three-year period beginning on the issue date. Code § 148(f)(4)(C)(ii) and Section 1.148-7(e)(2). The 1993 Final Regulations define "reasonable retainage" as amounts withheld for reasonable business purposes, such as to ensure or promote compliance with the terms of one or more construction contracts (*e.g.*, "punch list" items), where amounts are not yet payable, or in which the issuer determines that an actual dispute exists regarding either completion of construction or payment. Section 1.148-7(h). In addition to the exception for reasonable retainage, the 1993 Final Regulations contain a *de minimis* rule for failures to meet the final (24 month) spending target. Under this rule, which may be used in conjunction with the 5% "reasonable retainage," a failure

[94] ACP do not include amounts received as payments on purpose investments, earnings on those amounts, or repayments of grants financed by the issue. Code § 148(f)(4)(C)(vi); Section 1.148-7(i).

to spend an amount that does not exceed the lesser of 3% of the issue price or $250,000 is disregarded if the issuer exercises due diligence to complete the project. Section 1.148-7(b)(4).

8. ***Special Rules for Refunding Bonds and Refunded Bonds.***

For purposes of the two-year rule only, the proceeds of the refunded issue never become transferred proceeds of the refunding issue, but rather retain their original characterization and temporary period (the latter for purposes of spend-down and election timing but not, in the case of advance refundings, for purposes of yield restriction). Any failure to pay a required penalty (discussed below) that results in loss of tax exemption relates both to the original bonds (to the extent within the statute of limits) and to all refunding bonds. Code § 148(f)(4)(C)(x). Transferred proceeds with respect to which either the 1.5% penalty or the 3 percent penalty has been paid are also not subject to rebate. Code § 148(f)(4)(C)(xiii)(III).

9. ***Penalty In Lieu of Rebate.***

a. *In General.*

If the issuer fails to meet the spending rules specified above, absent an election to the contrary, the issuer will be obligated to pay rebate in accordance with the general rules of Code § 148(f)(2). Code § 148(f)(4)(C)(i). The issuer is permitted, however, to elect to pay a penalty in lieu of rebate. Code § 148(f)(4)(C)(vii); Section 1.148-7(k). The election to pay this 1.5% penalty must be made by the issue date of the bonds and continues to apply unless terminated, all ACP are spent, or the final maturity of the issuer and any refunding issues is reached. Code §§ 148(f)(4)(C)(ix) and 148(f)(4)(C)(viii); Section 1.148-7(k)(1).

b. *Amount of Penalty.*

Code § 148(f)(4)(C)(vii) and the 1993 Final Regulations provide that the penalty equals 1.5% of the amount of missed or under-spent expenditures for each six months during the two-year period. For example, if bonds with ACP (aside from investment proceeds) of $10 million are issued, investment proceeds at the end of the first six months are $300,000, and investment proceeds for the remainder of the construction period are expected to be $900,000 (for a total of $11,200,000), 10% or ACP in the amount of $1,120,000 is required to be spent by the close of the first six-month period. If only $800,000 is spent by the end of the first six-month period, the penalty would be $4,800 (($1,120,000 – $800,000) x 1.5%). Any penalty must be paid to the IRS within the 90 days following the six-month period for which the penalty applies. Code § 148(f)(4)(C)(xvi).

Depending on interest rates and the amounts of unspent proceeds, the 1.5% penalty may be significantly more or less than any rebate that would be owed. Unless the running of the 1.5% penalty is tolled by payment of the 3 percent penalty described below, the penalty ceases to apply only after the bonds (including any refunding bonds) have been retired. Although the payment of interest is a governmental purpose constituting an expenditure for purposes of the two-year rule, the redemption or purchase of bonds is not, either for purposes of the expenditure rules or for purposes of the calculation of requisite penalties. Code § 148(f)(4)(C)(xii); Section 1.148-7(b)(3). In PLR 9526002, the IRS ruled in technical advice that the 1.5% penalty cannot be reduced even if construction delays are encountered that are caused by natural disasters outside of the control of

the issuer, and the penalty continues to accrue until the issuer elects to terminate the penalty as described below.

c. *Tolling the Penalty.*

The issuer may elect to toll the running of the 1.5% penalty by paying a separate three-percent penalty on unspent ACP. Code § 148(f)(4)(C)(viii); Section 1.148-7(k)(1). The issuer must elect to pay the 3 percent penalty not later than 90 days after the earlier of (i) expiration of the initial temporary period applicable to the bonds or (ii) substantial completion of all or a portion of the construction to be financed with the bonds. Code §§ 148(f)(4)(C)(viii)(I) and 148(f)(4)(C)(ix); Section 1.148-7(l)(1).

d. *Payment of Penalties.*

The 1.5% and 3 percent penalties are the exclusive alternatives to the payment of rebate automatically available to the issuer. Each penalty payment is subject to the rules relating to payment of rebate under Section 1.148-3(g). Failure to rebate or pay such penalties is subject to the rules of Sections 1.148-3(h)(1), (2), and (3).[95]

10. ***Application to Pooled Bonds.***

The ACP of pooled bonds that are construction issues automatically qualifies for the two-year rule. To facilitate the use of the two-year rule for the ACP of pooled bonds, Code § 148(c)(2) was amended by the 1989 Act to provide that, if pooled bonds are issued and part of the issue is used to make or finance loans for construction expenditures, that portion of the bonds is entitled to a two-year temporary period, in the hands of the pooled issuer, rather than six months as provided under prior law. Code § 148(c)(2)(C).

The 1993 Final Regulations provide that an issuer can elect, on or before the issue date, to apply the spending exceptions separately to each conduit loan. If this election is made, then (1) the spending requirements for a loan begin on the earlier of the date the loan is made or the first day following the one-year period beginning on the issue date of the pooled financing issue, ad (2) the rebate requirement (and none of the spending exceptions) apply to the gross proceeds of the issue before the date on which the spending requirements begin. Section 1.148-7(b)(6)(ii). If an issuer makes this election, it may make all elections under the two-year rule separately for each loan, Section 1.148-7(b)(6)(ii)(C), and may pay rebate with regard to some conduit loans and the 1.5% penalty for other conduit loans from the same pooled financing issue. The 1.5% penalty is computed separately for each conduit loan. Section 1.148-7(b)(6)(ii)(B).

As is the case with other construction issues, if a borrower in the pool fails to meet the expenditure requirements, the issuer must pay rebate in accordance with the general rules of Code

[95] *See* Sections 1.148-7(m) and 1.148-3(h)(4). In addition, Code § 148(f)(4)(C)(x) and the 1993 Final Regulations provide that failure to pay all or a portion of a penalty (not due to willful neglect) may be cured, with the consent of the Secretary of the Treasury, by payment of the deficiency, plus 50% of the deficiency, plus interest on the deficiency from the due date to the payment date at the Code § 6621 underpayment rate. This provision is analogous to Code § 148(f)(7), which pertains to failure to make required rebate payments. *See also* PLR 9405018 (safe harbor for late payments of rebate for an innocent failure to pay rebate applies to a failure to pay the in lieu of rebate penalty).

§ 148(f)(2), unless it has elected to pay the 1.5% penalty in lieu of rebate. This election must be made on or before the date the pooled bonds are issued and is irrevocable. A pooled issuer, however, may elect to terminate the 1.5% penalty for a loan rather than for the entire issue.

ISSUER / ISSUE EXCEPTIONS

E. Small Issuer Exception

1. *General.*

Code § 148(f)(4)(d) provides that no rebate is required with respect to bonds issued to finance governmental activities of certain small issuers (the "Small Issuer Exception"). The only regulatory guidance on this rebate exception is contained in Section 1.148-8. To be eligible for the small issuer exception, the following requirements must be met:

a. *General Taxing Power.*

The bonds must be issued by a governmental unit with general taxing powers, interpreted under Section 1.148-8(b) as the power to impose taxes of general applicability that, when collected, may be used for general purposes of the issuer. The taxing power may be limited to a specific tax, provided that its applicability is not limited to a small number of persons. The taxing power may be subject to procedural limits, such as voter approval requirements, but may not be contingent on approval by another governmental unit. Certain entities such as school districts, which can cause a tax to be collected on its behalf, should generally be treated as qualifying even if the amounts and types of taxes are somewhat limited by State law.

b. *No Private Activity Bonds; Use for Local Activities.*

No private activity bonds qualify under this exception. Code § 148(f)(4)(D)(i)(II). In addition, at least 95% of the net proceeds of the bond issue are "to be used" for the local governmental activities of the issuer or a governmental unit entirely within the jurisdiction of the issuer. Code § 148(f)(4)(D)(i)(III). This test is a reasonable expectations test with respect to the use of proceeds. It appears that a governmental unit contained within the jurisdiction of a larger unit may have difficulty in lending the proceeds to the larger unit and still qualifying as having met this jurisdictional test.

c. *$5,000,000 / $15,000,000 Limit.*

Under the small-issuer exception as first enacted, the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by the small issuer and all subordinate entities of the issuer during the calendar year of the issue is not reasonably expected to exceed $5,000,000. Code § 148(f)(4)(D)(i)(IV). The $5,000,000 has since been increased to $15,000,000 for public school construction bonds. *See* Section VIII.E.1.d below.

(i) For these purposes, the aggregation rule in Code § 148(f)(4)(D)(ii) and Section 1.148-8(c) treats an issuer and all subordinate entities, and an issuer and all entities that issue on behalf of the issuer, as one issuer. Referred to as an "upward attribution" or aggregation rule, this rule requires a review of the relationships an issuer has with other entities.

An issuer is subordinate to another governmental unit if it is directly or indirectly controlled by another entity within the meaning of Section 1.150-1(e).[96] Mere geographic inclusion of one entity within another does not create subordination if the smaller entity derives its powers independently from the larger entity and is not subject to significant control by the larger entity. On-behalf-of entities are presumably defined by the concepts contained in Rev. Rul. 57-187, 1957 1 C.B. 65 (Alabama industrial development board); Rev. Rul. 63-20, 1963 1 C.B. 24; Rev. Proc. 82-26, 1982 1 C.B. 476, *etc*. For application of these concepts, *see* PLR 8821008 (February 22, 1988).

(ii) Code § 148(f)(4)(D)(ii)(III) and Section 1.148-8(c)(2)(iii) require downward attribution when a smaller entity is formed, or availed of, to avoid aggregation. But the aggregation rule of Code § 148(f)(4)(D)(ii) and Section 1.148-8(c)(2)(ii)(B) permit certain allocations and activities, as follows:

(a) An issuer with general taxing powers may allocate irrevocably its $5,000,000 cap to a subordinate entity (including an on-behalf-of issuer); the allocation must bear a reasonable relationship to the benefit to the subordinate entity from the bond issue, taking into account the manner in which (1) proceeds are to be distributed; (2) debt service is to be paid; (3) the facility is to be owned; (4) the use or output of the facility is to be shared; and (5) the costs of operation and maintenance are to be shared; and

(b) An issuer with general taxing powers may issue bonds to make loans to other entities with general taxing powers that are not subordinate to the issuer without using any of the issuer's $5,000,000 cap (although it should use the borrower's cap).

d. *Bigger "Small Issue" Bonds for School Construction.*

The 1997 Act increased the $5,000,000 limit by the lesser of $5,000,000 or "so much of the aggregate face amount of the bonds as are attributable to financing the construction . . . of public school facilities" for bonds issued after 1997.[97] The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act")[98] replaced the "$5,000,000 school" amount with $10,000,000, effectively expanding the small issue rebate exception to $15 million (for public school construction issues). Code § 148(f)(4)(D)(vii). The amendments made by the 2001 Act applied to bonds issued after December 31, 2001, but did "not apply to taxable, plan or limit years beginning after December 31, 2010."[99] The amendments made by the 2001 Act were extended through the end of 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[100] and were finally made permanent by the American Taxpayer Relief Act of 2012. [101]

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[96] Section 1.148-8(c)(2)(ii). *See* Section 1.150-1(e) for control factors.
[97] Code § 148(f)(4)(D)(vii), added by section 223(a) of the 1997 Act.
[98] Pub. L. 107-16, section 421(a).
[99] Section 901 of the 2001 Act.
[100] Pub. L. 111-312, section 101.
[101] Pub. L. 112-240, section 101.

2. ***Refundings.***

Current refunding bonds are not taken into account in determining whether the new money portion of the issue or other issues exceed the $5,000,000 cap, but only to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds. Code § 148(f)(4)(D)(iii). Advance refunding bonds are fully included in calculating the $5,000,000 limit. The advance or current refunding bond itself is not eligible for the small issuer exception unless the aggregate face amount does not exceed $5,000,000, the refunded bonds qualified for the small issuer exception, the average maturity date of the refunding bonds is not later than the average maturity of the refunded bonds, and the maturity date of the refunding bond is not later than 30 years after original bond was issued. Code § 148(f)(4)(D)(v).

3. ***Pooled Bonds.***

Under Section 1.148-8(d), in the context of a pooled financing in which the borrower otherwise meets the small issuer exception, the small issuer exception will be available to the proceeds of the pooled issue in the hands of the small issuer borrower. The pooled financing may mix large and small issuers and treat each borrowing separately for purposes of available rebate exceptions. A loan to a conduit borrower qualifies for the small issuer exception, however, only if the bonds of the pooled financing are not private activity bonds, none of the loans to conduit borrowers are private activity bonds, and the loan to the conduit borrower meets all the requirements of the Small Issuer Exception. The issuer of the pooled financing issue is, however, subject to the rebate requirement for any unloaned gross proceeds.

4. ***TRANs.***

TRANs are eligible for this exception. *See* PLR 8740027 (July 7, 1987).

OTHER REBATE EXCEPTIONS

F. Bona Fide Debt Service Fund Exception

Amounts earned on a bona fide debt service fund are not taken into account in computing rebate if the gross earnings on the fund for a bond year are less than $100,000. For governmental bonds with an average maturity of at least five years and fixed interest rates during the term of the issue, the $100,000 limit is ignored, and all gross earnings on the fund are exempt from rebate.[102] In addition, an issue is treated as satisfying the $100,000 earnings limit if the average annual debt service does not exceed $2,500,000.[103] Private activity bonds (including qualified 501(c)(3) bonds) must observe the $100,000 earnings limit.

All bona fide debt service funds for a single bond issue are treated as a single fund. Conversely, a single fund serving two or more bond issues is treated as a series of separate funds. Section 1.148-6(e)(6) requires such a fund to be allocated ratably among the issuers in accordance with one of the following methods: (1) the relative values (determined in accordance with

[102] Code § 148(f)(4)(A)(ii).
[103] Section 1.148-3(k).

Section 1.148-4(e)) of the issues; (2) the remaining maximum annual debt service requirements of the issues; or (c) the original stated principal amounts of the issues.

G. Exception for Tax-Exempt Investments

Because the rebate requirement applies only to earnings on "nonpurpose investments," earnings on investments that are not nonpurpose investments are free from the rebate requirement. Code § 148(f)(6) defines the term "nonpurpose investment" as any investment property that is acquired with gross proceeds of an issue and that is not acquired in order to carry out the governmental purposes of the bond issue. Code § 148(b)(3) excludes any "eligible tax-exempt bond" (including an interest in a regulated investment company to the extent that at least 95% of the income to the holder of the investment is interest that is excludable from gross income under Code § 103(a)(i) and demand deposit SLGS)[104] from the definition of "investment property," and thus from the definition of "nonpurpose investment." But under Code § 148(b)(3)(b), "investment property" does include "specified private activity bonds" as defined in Code § 57(a)(5)(C) (any private activity bond other than a qualified 501(c)(3) bond, commonly referred to as an "AMT bond").

H. Exception for Purpose Investments.

The definition of "proceeds" under Section 1.148-1(b) states that an issuer's receipts from purpose investments under any of the permitted spreads found in Section 1.148-2(d) or for the recoupment of qualified administrative costs are not "proceeds" and, thus, are not subject to rebate. *See also*, PLR 8933045 (July 9, 1989). In a similar fashion, under Section 1.148-5(e)(3), administrative costs of purpose investments decrease the receipts from those investments. These amounts thus would also not be subject to rebate.

IX. RECOVERIES OF REBATE OVERPAYMENT

Under Section 1.148-3(i), issuers are entitled to recover any overpayment of rebate, defined as the excess of (1) the amount paid to the United States under Code § 148 over (2) the sum of the rebate amounts and yield reduction payments required to be paid on the date the recovery is requested. For recoveries of less than $5,000, recovery must wait until the after the final rebate computation date for the issue. In order to request a recovery, an issuer must file Form 8038-R with the IRS. An issuer is required to seek a recovery of rebate overpayment within two years of the final computation date for the issue to which the overpayment relates.

An example in the 2016 Final Regulations makes it clear that the "amount paid" means just the amount paid at that time, and not the future value of that payment on the computation date. *See* Example 2 in Section 1.148-3(j).

The IRS has concluded that an arbitrage rebate overpayment is a "sum" within the meaning of Code § 7422(a), which requires that administrative remedies be exhausted before a suit for recovery of a tax or penalty can be brought in court. *See* TAM 200750018. The IRS has not yet decided whether the future valuing of a rebate payment for purposes of computing a rebate

[104] Section 1.148-1(c)(4)(ii)(E).

overpayment constitutes the payment of statutory interest for purposes of the Code. *See* PLR 200512019.