Tax Exempt &
Government Entities

Tax Exempt Bonds (TEB) Phase I

Student Guide

ELMS course number 11204-002

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Course #11204-002 (8-2015): Tax Exempt Bonds (TEB) Phase I – Student Guide

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Lesson 2

Statutory Framework / Introduction to the Deskbook

Overview

Purpose

This lesson provides an overview of the structure of the Internal Revenue Code (Code or IRC), focusing on the principal IRC sections related to tax-advantaged bonds. After a brief review of legal research methods and resources, this lesson describes the statutory structure of relevant Code sections and an example of one analytical framework that the student might use in approaching the Code with respect to legal questions related to tax-advantaged bonds. The student will explore relevant Code sections in the Federal Taxation of Municipal Bonds Deskbook in order to identify the resources available in the Deskbook.

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Objectives

At the end of this lesson, you will be able to:

- List the Code sections specifically related to tax-advantaged bonds
- Name the subjects covered by each of the Code sections specifically related to tax-advantaged bonds
- Use the basic analytical framework for evaluating issues related to tax- advantaged bonds
- Use the Deskbook to find statutory language and citations to legislative history

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Section 1

Legal Research Review

Method

There are six steps in the tax research process. The six steps are: 1. determine the facts, 2. identify the issue or issues, 3. locate the applicable authorities, 4. analyze the authorities, 5. analyze the facts in reference to the applicable authorities, and 6. communicate your conclusions.

These six steps were discussed in Self-Study Course 4.

Authority: Sources of the Law

Primary authority is the law itself, such as statutes, cases, and regulations. Secondary authority is a description of the law, such as dictionaries, encyclopedias, practice materials, treatises, and law review articles. The law refers to more than the Internal Revenue Code. Notwithstanding its length, the Code does not provide detailed guidance. As a consequence, interpretations of the Code are necessary. There are both administrative and judicial interpretations. The term tax law as used by tax professionals encompasses all of these sources. It also includes committee reports issued by Congressional committees in the legislative process. These reports are very useful in determining the intent of the law, especially in interpreting new legislation that may have little or no judicial history or if the Treasury Department has not yet published regulations

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Getting Started

It is often helpful to start your research with the written materials you received in your IRS training. If the topic is not included in the written materials you received to date, the topic may be covered in training materials included on the Tax Exempt Bond Community page of the IRS website at www.irs.gov under the heading "Tax Exempt Bonds Forms, Publications, and Training Materials."

Another good starting point is the CD-ROM for the National Association of Bond Lawyers (NABL) Fundamentals of Municipal Bond Law. This seminar publication covers general municipal law, federal tax aspects of municipal bonds, securities laws, and professional responsibility.

The Internal Revenue Code (IRC or Code)

The IRC is Title 26 of the United States Code. The IRC is a statute, which can be changed by Congress. The IRC is interpreted by the Federal courts in judicial opinions, by the Treasury Department in Treasury Regulations, and in other administrative guidance published by the IRS. The IRC is constantly changing. Do not assume that any part of the statute remains the same as the last time you looked at it. Always check to be sure you are using the applicable version of the Code. Also, it is possible that the section of the Code you are dealing with has changed since the time the activities with which you are concerned occurred. You need to determine what the Code said, and what the law was, at the time of the events that are in question. Generally, unless otherwise provided, the applicable statute is the one in effect at the time the bonds were issued. Generally, the public law section that introduced the Code section into the Code (or sometimes the Code section itself) will have a provision relating to the effective date and applicability of the section. Thus, the Code is the first place to look for the answer to a tax law question.

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Example

You are examining a Build America Bond that was issued under § 54AA(g). Pursuant to that section, and § 6431, the issuer is entitled to receive directly from the Federal Government a credit payment equal to a percentage of the interest payable on the bond. The issuer has pledged the payments it expects to receive from the Federal Government to the payment of the debt service on the bonds.

You believe pledging payments received by the issuer directly from the Federal Government may be a partial federal guarantee of the bonds, which violates § 149(b). Section 149(b) provides that § 103(a) does not apply to a bond if the bond is federally guaranteed and that a bond is federally guaranteed if payment of debt service on the bond is guaranteed, even indirectly, in whole or in part by the United States.

The Code is the first place to look for the answer to your question regarding whether the bond is federally guaranteed and therefore not described in§ 103(a). You should look at the provisions of § 149(b), but before reaching your conclusion you should also look at § 54AA(d)(2)(A).

Has the issuer caused its bonds to fail to be described in § 103(a) by pledging the expected payments from the Federal Government to the payment of debt service in violation of § 149(b)? The Code answers your question.

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Other Tax Law Resources

Not every tax question can be answered by the literal language of the Code. At times the language of the Code is unavoidably ambiguous. Sometimes it is intentionally so, leaving the job of applying the law to a particular situation to those of us charged with doing so. When the literal language of the Code does not fully and finally answer a tax question, which occurs quite often, we look to the history of the Code section in question, the committee reports as they relate to that section and other legislative history, Treasury regulations, other IRS guidance, and the relationship of the section in question to other sections of the Code.

Section 2

Statutory Structure of Relevant IRC Sections

Structure of the Statute as it Relates to Tax-Advantaged Bonds

The IRC, itself a "title" of the United States Code, is divided into eleven subtitles, which are further divided into chapters, subchapters, parts, subparts, sections, subsections, paragraphs, subparagraphs, clauses, and subclauses.

The overall scheme of the statute as it concerns tax-advantaged bonds generally is as follows: Title 26 of the United States Code, referred to as the Internal Revenue Code, contains all matters concerned with taxation. Of the eleven subtitles within Title 26, subtitle A deals with income taxes. Chapter 1 of subtitle A sets out the law relating to normal taxes and surtaxes. Subchapter A of Chapter 1 is determination of tax liability. Part 1 of Chapter 1 deals with the tax on individuals, section 1 imposes a tax on all gross income. Subchapter B of Chapter 1 is computation of taxable income and
Part III of that subchapter lists items specifically excluded from gross income. Section 103 of Part III specifically excludes interest on state and local bonds from gross income.

Within the Code, the scheme for sections is as follows: for example, section 144(a)(12)(C)(ii)(II): 144 is the section; (a) is the subsection; (12) is the paragraph; (C) is the subparagraph; (ii) is the clause, and (II) is the subclause.

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Statutory Structure, Continued

§ 103 Stands Alone

Section 103 stands alone. The other sections of the IRC that concern tax-advantaged bonds do not immediately precede or follow § 103.

1986 Act

Section 103 stands alone because, as was mentioned in Self-Study Course 2, prior to the Tax Reform Act of 1986 (the "1986 Act"), all of the provisions related to tax-exempt bonds were contained in § 103. When the IRC of 1986 was drafted, instead of completely revising the IRC numbering system, Congress decided to place the new provisions related to tax-exempt bonds in their own part of the Code, Part IV of Subchapter B of Chapter 1 of Subtitle A of Title 26. See the graphic depiction of this location on the next page.

Other IRC Tax-Exempt Bond Provisions

Section 1394 authorized tax-exempt enterprise zone facility bonds in 1993 and empowerment zone facility bonds in 1997. Section 1400L authorized New York liberty Zone bonds in 2001 as relief after the terrorist attacks in New York City. Section 1400N(a) authorized qualified Gulf Opportunity zone bonds in the wake of Hurricane Katrina in 2005. Similar relief was provided in 2008 by authorizing the qualified Midwestern disaster bonds and qualified Hurricane Ike disaster area bonds. Section 1400U-3 authorized the recovery zone facility bonds in 2009.

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Tax Credit Bonds

At the time of the 1986 Act, tax-exempt bonds were the only type of tax-advantaged bond under the IRC. The provisions of § 1397E, authorizing the first tax credit bonds called qualified zone academy bonds were added in 1997. In 2005 the provisions of §§ 54 and 1400N(l) were added authorizing clean renewable energy bonds and Gulf tax credit bonds, respectively. In 2008 the provisions of §§ 54A through 54D were added and § 1397E was moved to § 54E authorizing qualified forestry conservation bonds, new clean renewable energy bonds, qualified energy conservation bonds and qualified zone academy bonds. Also in 2008, Midwestern tax credit bonds were authorized under section 1400N(l). Sections 54F, 54AA, and 1400U-2 were added in 2009 authorizing qualified school construction bonds, build America bonds, and recovery zone economic development bonds. In 2009 and 2010, under section 6431, Congress authorized tax credit to be received by issuers of certain tax credit bonds. Generally, other than the temporary relief provisions, tax credit bond provisions were placed, logically, in the part of the Code dealing with credits against tax, Part IV of Subchapter A of Chapter 1 of Subtitle A of Title 26.

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IRC Table of Contents; Principal IRC Sections Related to Tax-Advantaged Bonds

Title 26 – Internal Revenue Code

Subtitle A – Income Taxes

Chapter 1 – Normal Taxes and Surtaxes

Subchapter A – Determination of Tax Liability

Part IV – Credits Against Tax

Subpart H – Nonrefundable Credit to Holders of Clean Renewable Energy Bonds

Section 54 – Credit to holders of clean renewable energy bonds

Subpart I – Qualified tax credit bonds

Section 54A – Credit to holders of qualified tax credit bonds

Section 54B – Qualified forestry conservation bonds

Section 54C – New clean renewable energy bonds

Section 54D – Qualified energy conservation bonds

Section 54E – Qualified zone academy bonds

Section 54F – Qualified school construction bonds

Subpart J – Build America Bonds

Section 54AA – Build America bonds

Subchapter B – Computation of Taxable Income

Part III – Items Specifically Excluded From Gross Income

Section 103 – Interest on State and local bonds

Part IV - Tax Exemption Requirements for State and Local Bonds

Subpart A – Private activity bonds

Section 141 – Private activity bond; qualified bond

Section 142 – Exempt facility bond

Section 143 – Mortgage revenue bonds: qualified mortgage bond and qualified veterans' mortgage bond

Section 144

Subsection 144(a) – Qualified small issue bond

Subsection 144(b)– Qualified student loan bond

Subsection 144(c) – Qualified redevelopment bond

Section 145 – Qualified 501(c)(3) bond

Section 146 – Volume cap

Section 147 – Other requirements applicable to certain private activity bonds

Statutory Structure, Continued

IRC Table of Contents; Principal IRC Sections Related to Tax-Advantaged Bonds (continued)

Subpart B – Requirements applicable to all State and local bonds
Section 148 - Arbitrage
Section 149 – Bond must be registered to be tax exempt; other requirements
Subpart C – Definitions and special rules
Section 150 – Definitions and special rules
Subchapter U – Designation and treatment of empowerment zones, enterprise communities, and rural development investment areas
Part II – Tax-exempt facility bonds for empowerment zones and enterprise communities
Section 1394 – Tax-exempt enterprise facility bonds
Part IV – Incentives for education zones
Section 1397E – Credit to holders of qualified zone academy bonds
Subchapter W – District of Columbia enterprise zone
Section 1400A – Tax-exempt economic development bonds
Subchapter Y – Short-term regional benefits
Part I – Tax benefits for New York Liberty Zone
Section 1400L – Tax benefits for New York Liberty Zone
Part II – Tax benefits for GO zones
Section 1400N – Tax benefits for Gulf Opportunity zone
Part III –
Section 1400U-1 - Allocation of recovery zone bonds
Section 1400U-2 – Recovery zone economic development bonds
Section 1400U-3 – Recovery zone facility bonds

Section 3

Analytical Framework

Necessity

The need for a framework to analyze the statute is sufficiently important that it bears stating. In order to guide your analysis to the correct provision of the statute, you must start at the beginning of the analytical framework and follow it to the correct provision. If you start your analysis at the wrong place you may end up analyzing a provision that looks like it affects the facts of your case, but which does not apply to your case at all. Even experienced practitioners use an analytical framework when approaching the statute.

Decision Tree

The NABL Fundamentals of Municipal Bond Law text contains a Tax Inquiry Flowchart designed to assist the practitioner in identifying federal tax questions for tax-advantaged bond issues. You should print a copy of the flowchart and keep it handy. It operates as a “decision tree.” Start at the beginning with the questions of whether the issuer is valid and whether the debt is valid and follow the arrows in the direction that corresponds to the answers you give to the questions asked. When you reach the bottom of the page you will have identified the type of bond issue and some of the pertinent questions with which you are dealing. The flowchart is not itself an analytical framework. It is a tool that helps you in implementing the correct analytical framework.

Continued on next page

Analytical Framework, Continued

Basic Analytical Framework: Start with § 103(a)

The basic analytical framework is based on the provisions of the Code. Start at § 103(a) and ask a series of questions that arise from the text of the statute. Are you dealing with interest? Are you dealing with a bond? Is it a state or local bond? Take a careful look at § 103(a) and be certain you know what language of the statute these question relate to.

Next, §103(b)(1)

Now move on to § 103(b)(1). Is it a private activity bond? You need to look at § 141. If yes, is it a qualified private activity bond? You need to look at § 141(e). Is the bond of the type listed in § 141(e)(1)(A) through (G)? If so, you need to look at the following Code sections that correspond to the types of bonds listed in § 141(e)(1)(A) through (G):

- Exempt facility bond - § 142
- Qualified mortgage bond - § 143
- Qualified veterans' mortgage bond - § 143
- Qualified small issue bond - § 144(a)
- Qualified student loan bond - § 144(b)
- Qualified redevelopment bond - § 144(c)
- Qualified 501(c)(3) bond - § 145

That Leads to §141(e)(2) and §141(e)(3)

Now move on to § 141(e)(2). Does the bond you are looking at satisfy the requirements of § 146 relating to volume cap? The next question is based on § 141(e)(3). Does the bond you are looking at satisfy the requirements of each subsection of § 147?

Continued on next page

Analytical Framework, Continued

Analytical Framework Corresponds to Structure of the IRC

The questions you are asking and the analytical framework you are using follow the order of the numbered sections in the statute.

Move on to §103(b)(2) and § 103(b)(3)

Once you are done with questions that relate to § 103(b)(1), move to § 103(b)(2). Is the bond an arbitrage bond? You need to look at § 148. From there you move on to § 103(b)(3) and examine whether the requirements of § 149 are satisfied.

Only a Framework

The approach just outlined is only the framework for the analysis.

For each section mentioned, of course, there are many questions that must be asked and answered in order to determine whether the section affects your facts. The basic framework, however, starts with § 103.

Similarly, for other tax-exempt bonds, the basic analytical framework and starting point is the IRC section relating to those bonds, such as § 1394 for enterprise zone bonds, § 1400L for New York Liberty Zone bonds,
§ 1400N(a) for GO zone, Midwestern and Hurricane Ike bonds, and § 1400U-3 for recovery zone facility bonds.

Tax Credit Bonds: Same

For tax credit bonds you proceed in the same way. Start at the beginning of § 54, § 54A, B, C, D, E, or F, § 54AA, or § 1400U-2, as appropriate, and follow the terms of the statute from beginning to end just like you would with §103.

Section 4

Review of the Deskbook

About the Deskbook	The Deskbook, titled "Federal Taxation of Municipal Bonds Deskbook," is a compilation of primary sources of law on tax-advantaged bonds compiled and published by NABL.
Notes Following Each Section	Each Code section presented in the Deskbook is followed by notes relating to that section's statutory history; effective dates, transition rules, and noncodified provisions, cross-references, prior law, and legislative history.
Statutory History	The notes related to statutory history indicate the public law in which each section of the Code was contained as originally enacted and as subsequently amended.
Effective Dates, Transition rules and Noncodified Provisions	The United States Code is, as its name suggests, a codification of the law. There are provisions of the tax law that are not found in the United States Code version of the statute, such as effective date, applicability, and transitional provisions. Nevertheless, such noncodified provisions (i.e., "off- Code" provisions) are part of the statute and have equal dignity and controlling authority with the codified portions of the statute. Note [3] (Effective Dates, Transition Rules and Noncodified Provisions) following § 143 in your Deskbook is a good example.
Cross-References	"Cross-references," as used in the Deskbook, means cross-references to this section of the statute in other sections of the IRC and in other federal statutes. Note [4] (Cross-References) following § 103 is a good example.

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Prior Law

Prior law refers to the provisions of the Internal Revenue Code of 1954 (the "1954 Code"). Generally, the provisions of the 1954 Code apply to bonds issued prior to the effective date of the 1986 Act and to bonds that are subject to the transitional provisions of the 1986 Act. These notes are not helpful without a copy of Volume 5 of the Federal Taxation of Municipal Bonds series, to which the majority of agents and specialists in TEB do not have access.

Legislative History

Federal income tax legislation always originates in the House of Representatives. Hearings on the bill are held by the House Ways and Means Committee. When a bill is introduced in the House, a Committee Report is published that often states the reason the bill is being proposed. This reasoning establishes the legislative intent behind the final law. After the bill is approved by the House, it is considered by the Senate which also has a committee that holds hearings and prepares a report explaining changes made to the House bill, the Senate Finance Committee.

Later a Conference Committee resolves the differences between the House and Senate versions and issues its own report.

Each of these reports can be useful in clarifying the meaning of the language used in the statute. Citations to any applicable report relating to the legislation are included in Note [6] following each section of the Code.

Treasury Regulations

Each section of the Code that appears in the Deskbook is followed by applicable Treasury Regulations related to that section. As you learned in the Self-Study Course on tax law research, following the Code itself, the most important tax law research resource you have are the Treasury Regulations.

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Interpret Code; Types of Regulation

The regulations assist in interpreting the Code. The regulations often contain examples that assist in understanding the statutory language of the Code. The regulations are issued as proposed, temporary, and final. Some of the applicable regulations relate to the 1954 Code provisions and are applied to the extent that they are not inconsistent with the applicable provision of the 1986 Act.

Proposed Regulations

Proposed Regulations are issued to allow for suggestions and comments from the public. Although proposed regulations represent Treasury's official interpretation of the Code, they carry no more weight than the arguments the IRS would make in a court brief. Occasionally, to provide guidance and some certainty in an unsettled area of the law, Treasury may issue proposed regulations upon which, when the proposed regulations specifically so provide, issuers and other taxpayers may rely.

Temporary Regulations

Temporary Regulations are issued as a Treasury Decision with the purpose of having an immediate legal effect, but their effectiveness, generally, expires by force of law in 3 years after publication. Temporary regulations may be accompanied by corresponding proposed regulations and generally are followed by final regulations.

Final Regulations

Final Regulations are drafted after the public has had the opportunity to comment on the proposed version. Final Regulations are adopted by a Treasury Decision which contains a preamble or supplementary information discussing background, comments, and an explanation of provisions.

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Other Substantive IRC Sections in the Deskbook

In addition to the chapters in the Deskbook containing §§ 103 and 104 through 150, there are also chapters in the Deskbook containing the "tax credit sections" (§§ 54 through 54F and § 6431) and sections authorizing other miscellaneous tax-advantaged bonds (§§ 1391 through 1400U-3).

Indian Tribal Government Bonds

The Deskbook includes a separate chapter that contains § 7871 relating to bonds issued by Indian Tribal Governments, including Tribal Economic Development Bonds.

Issue Price and Marketability

Several Code sections that affect the issue price of bonds are included as are the Code provisions that are designed to control the volume of bond issuance through demand-side mechanisms that affect the marketability of bonds.

Transition Rules and Effective Dates

TEB examines questions over twenty years after the enactment of the 1986 Act regarding the meaning of the language in a transition rule from the 1986 Act. Although the enactment of the IRC of 1986 was decades ago, there likely will be questions from time to time that will be affected by one or more transition rules. The Deskbook contains the transition rules and effective dates for the 1986 Act under the heading of "1954 Code."

Revenue Rulings, Revenue Procedures, and Revenue Notices

The significant revenue rulings, revenue procedures, and revenue notices relating to tax-advantaged bonds are reproduced in the Deskbook.

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Using the Deskbook: Exercise 1

Assume that the current version of the IRC is applicable.

The bonds you are examining were issued by the City to finance a public park as part of an extensive park system all of which has been financed by bonds that purport to be tax-exempt bonds. The bond issue you are looking at was issued in the principal amount of $30,000,000 and is clearly not a qualified hospital bond. The bond issue you are looking at, when added to the principal amount of the other bonds issued for the park system within the three years prior to the date of issuance will exceed $150,000,000. Additionally, other capital expenditures made by the City on the park system during those three years and expected to be made during the three years following the date of issuance of the bonds you are examining will clearly exceed $40,000,000. You recall there is a provision in the Code that limits the amount of bonds other than hospital bonds to $150,000,000 and a provision limiting the aggregate face amount of qualified small issue bonds to $40,000,000.

Using the analytical framework discussed in this lesson, determine whether either of the $150,000,000 limitation or the capital expenditure limitation related to small issue bonds is applicable. Why or why not?

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Review of the Deskbook, Continued

Using the Deskbook: Exercise 2

Assume that the current version of the IRC is applicable.

You are looking at a bond issue that financed a terminal expansion and an additional runway at a county airport. The construction will likely take an extended period of time. How far in the analytical framework can you get before you need additional information? Why? What information do you need in order to get to at least the next major set of questions?

Using the Deskbook: Exercise 3

Assume that the current version of the IRC is applicable.

You have concluded that the bond issue you are looking at is a qualified hedging transaction pursuant to Regulations § 1.148-4(h). On that basis, should you jump to § 149(g) which describes the treatment of hedge bonds in order to determine whether the bonds in question are tax-exempt? Why or why not? Describe how the analytical framework discussed in this lesson would help you reach the correct answer to this question.

Summary

Review of Lesson 2

In this lesson you studied an overview of the structure of the Internal Revenue Code, which focused on the principal Code sections related to tax-advantaged bonds. You were introduced to an example of one analytical framework that you might use in approaching the Code with respect to legal questions related to tax-advantaged bonds. You explored relevant Code sections in the Deskbook in order to identify the resources available in the Deskbook.

Preview of Lesson 3

In Lesson 3 you will examine the important questions of whether the issuer is an eligible issuer of tax-advantaged bonds (valid issuer) and whether the debt has the characteristics necessary for it to be eligible to qualify as tax-advantaged debt (valid debt).

Entities that are qualified to issue tax-exempt bonds are:

- states and political subdivisions, and
- on behalf of issuers

In order to be tax-exempt, the debt must possess certain characteristics. The debt must:

- be valid under state law
- be an exercise of borrowing power
- result from an intent to make a loan
- be an obligation regardless of the source of repayment, and
- include payments treated as interest for federal tax purposes

Lesson 3 discusses all of these concepts.

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Lesson 3

Valid Issuer / Valid Debt

Overview

Purpose

The purpose of this lesson is to provide the student with a detailed examination of the legal analysis used to determine whether an entity is a valid issuer of tax-advantaged bonds and whether the obligation of an issuer is a valid debt for the purpose of tax-advantaged treatment by the Code.

Objectives

At the end of this lesson, you will be able to:

- List at least five types of entities that are eligible to issue tax-exempt debt
- Define the police power, the taxing power, and the eminent domain power and explain their significance in the field of tax-exempt bonds
- Identify the two types of "on behalf of issuers"
- Distinguish between the two types of "on behalf of issuers"
- Describe the characteristics an obligation must have in order to be eligible to be treated as debt for purposes of § 103

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Section 1

State or Political Subdivision

Interest Exclusion

Interest on any state or local bond is not included in gross income, except as provided under § 103(b):

- Nonqualified private activity bonds. A private activity bond must be qualified to be tax-exempt. See § 141(e).
- An arbitrage bond. The interest on a bond issued for the purpose of earning arbitrage is included in gross income. See § 148.
- Non-registered bonds, etc. Bonds must generally meet the requirements of § 149 to be tax-exempt.

State or Local Bond

"**State** or **local bond**" means an obligation of a State or **political subdivision** thereof. Section 103(c)(1).

The term "governmental unit" does not include the United States or any agency or instrumentality thereof. Section 150(a)(2).

District of Columbia and Territories

The District of Columbia (see Rev. Rul. 76-202, 1976-1 C.B. 26) and any possession of the United States (U.S. Virgin Islands, Puerto Rico, Northern Marianas Islands, Samoa, and Guam) are included as "**states**."

Section 2

Political Subdivisions

Definition

"Political subdivision" denotes any division of any state or local government unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. See Regulations § 1.103-1(b).

In determining whether an organization is a division of a state or local governmental unit, important considerations are the extent the organization is (1) controlled by state or local government unit, and (2) motivated by a wholly public purpose. See Rev. Rul. 83-131, 1983-2 C.B. 184.

Sovereign Powers

In *Commissioner* v. *Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945), the U.S. Court of Appeals for the Second Circuit identified three sovereign powers the presence or absence of which form the basis for determining whether an entity is a political subdivision:

- the power of eminent domain;
- the power to tax; and
- police power

The court in *Shamberg* stated that only part of the sovereign power of the governmental unit needs to be delegated to an issuer in order to qualify as a "political subdivision." However, if only an insubstantial amount of any or all sovereign powers are delegated, then the entity is not a political subdivision.

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Police Power

In Rev. Rul. 77-164, 1977-1 C.B. 20, a community development authority was held not to possess police power where it had only limited authority to adopt and enforce rules regarding use of community facilities and such authority was subordinate to the police power of the municipality in the event of conflict.

In *Philadelphia National Bank v. United States*, 666 F.2d 834 (1981), Temple University was held not to possess the police power by maintaining a campus police force authorized by state law to enforce only state laws but not university enacted rules or regulations. This was characterized by the court as "a minimal grant of police power" and as "limited authorization to exercise one small aspect of police power — one that has been delegated to private organizations as well." (See also Technical Advice Memorandum 8119061.) However, where a transit authority has the power to set rates, determine routes, and enforce its regulations by maintaining a security force, it is considered to possess police powers. See Rev. Rul. 73-563, 1973-2 C.B. 24.

Power to Tax

In Rev. Rul. 77-164, 1977-1 C.B. 20, the power to tax was not considered present where service and user fees assessed and collected by a community development authority were only for the benefit of property owners of the improvements, and not for the purposes of raising revenues for public or governmental purposes.

In *Philadelphia National Bank v. United States*, supra, Temple University did not possess the power to tax because it was a beneficiary of the state's taxing power through the appropriation of funds to the University.

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Eminent Domain

In Rev. Rul. 77-165, 1977-1 C.B. 21, only limited and specific delegations of the state's power of eminent domain (the power to take private property for public use) could be made to a state university under state law. The Service found that the right to exercise the power of eminent domain in specific projects designated by the legislature was not a substantial power of eminent domain. Lacking other substantial sovereign powers, the university was denied political subdivision status.

A similar result was reached in *Philadelphia National Bank v. United States*, supra. Here the state authority had to accept and implement Temple University's requests to condemn property. Temple was held not to possess the power of eminent domain.

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Facts and Circumstances are Important

In PLR 8630027, a proposed Development District with the power of eminent domain and power to tax was held not to be a qualified issuer of governmental obligations since it did not qualify as a political subdivision of a state. In that PLR, a for profit corporation proposed to petition a local municipality to establish a "Development District" that was coterminous with the acreage of land owned by the corporation. The Development District would be controlled by a five- member board of supervisors elected by the district landowners (which would be the corporation only). The Development District would possess the power to tax and the power of eminent domain but would not have police powers. The Development District's power of eminent domain would cover its district property (and other property subject to the approval of the county or municipality) for purposes relating solely to district roads and water and sewage management. The PLR determined that the Development District would not possess substantial powers of taxation or eminent domain to qualify as a political subdivision since the Development District (wholly controlled by the non-exempt corporation) would be delegated "no materially greater sovereign powers over the Development District land than the corporation inherently would have if the Development District were never created."

Section 3

On Behalf of Issuers

General Rule

An entity that fails to qualify as a political subdivision may be able to issue tax-exempt bonds "on behalf of" a state or local governmental unit as a "constituted authority" or as a "63-20 corporation." Constituted authorities are formed under state law and empowered to issue bonds on behalf of a state or political subdivision. 63-20 corporations are entities formed under applicable state nonprofit corporation law which comply with the requirements of Rev. Rul. 63-20.

“Constituted Authorities”

An obligation issued by or on behalf of any state or local governmental unit by a *constituted authority* empowered to issue such an obligation is the obligation of such a unit. See § 1.103-1(b)

There is no definition of “constituted authority” in either the Internal Revenue Code or the Regulations. However, Rev. Rul. 57-187, 1957-1 C.B. 65, holds that bonds are considered issued on behalf of a political subdivision of the state where certain conditions are met.

"Constituted Authorities" (continued)

Constituted authorities can issue tax-exempt bonds **on behalf of** a state or local government if the following criteria are met:

- the political subdivision has approved the creation of the issuer and the form of the issuer's certificate of incorporation;
- the board of directors of the issuer is elected by the governing body of the political subdivision and serves without compensation;
- the issuer's corporate powers include the power to acquire, improve, maintain, equip, and furnish projects; to lease such projects and collect rent; to sell and convey any and all of its property whenever the board of directors find such action to be in furtherance of the purposes for which it was organized; and to issue bonds for the purpose of carrying out any of its powers;
- all bonds are payable solely out of revenues and receipts derived from the leasing or sale of its projects;
- the political subdivision is not liable for the payment of principal or interest on any of the bonds;
- the issuer is exempt from all state taxation, and interest on bonds issued by the Board is exempt from state taxes;
- the issuer is a nonprofit corporation and no part of its net earnings may inure to the benefit of any private person; and
- upon dissolution of the issuer, the title to all property owned by it shall vest in and become the property of the political subdivision in which the issuer is located.

See Rev. Rul. 57-187, 1957-1 C.B. 65.

See also Rev. Rul. 60-248, 1960-2 C.B. 35; PLR 200307004.

"63-20 Corporations"

"63-20 corporations" are formed under state nonprofit law for purposes of issuing obligations **on behalf of** a political subdivision.

Under Rev. Rul. 63-20, obligations issued by a nonprofit corporation formed under the general nonprofit corporation law of a state will be considered issued 'on behalf of' a political subdivision, provided each of the following requirements is met:

- the corporation must engage in activities that are essentially public in nature;
- the corporation must be one that is created under the state's general non- profit corporation law (and is not organized for profit except to the extent of retiring indebtedness);
- the corporate income must not inure to any private person;
- the state or political subdivision thereof must have a beneficial interest in the corporation while the indebtedness remains outstanding;
- the state or political subdivision must obtain legal title to the property of the corporation with respect to which the indebtedness was incurred upon the retirement of such indebtedness; AND
- the state or political subdivision must approve both the corporation and the specific obligations to be issued by the corporation.

Rev. Rul. 63-20 is included in your Deskbook.

Continued on next page

On Behalf of Issuers, Continued

Intent of Operating Rules

Rev. Proc. 82-26, 1982-1 C.B. 476, gives examples of circumstances in which the criteria of Rev. Rul. 63-20, 1963-1 C.B. 24, will be deemed to have been met for purposes of obtaining an advance ruling (that obligations will be considered obligations of a state or a political subdivision) from the Service.

Section 2 of Rev. Proc. 82-26 provides as follows:

The operating rules of this revenue procedure are intended only to assist issuers of governmental obligations, and other parties with a material financial interest, in preparing ruling requests. The operating rules do not define, as a matter of law, the circumstances under which obligations to be issued by a nonprofit corporation will be considered issued on behalf of a governmental unit within the meaning of section 1.103-1(b) of the regulations. Thus, the operating rules are not to be used as tests for determining the taxability of bond interest.

Guidance v. Authority

Although Rev. Proc. 82-26 provides guidance as to the requirements for an "on-behalf of issuer," in determining whether an issuer qualifies under Rev. Rul. 63-20 and whether the interest on the bonds is excludable from gross income under § 103, the agent should look to, and cite, the requirements under Rev. Rul. 63-20.

Rev. Proc. 82-26 is included in your Deskbook.

Section 4

Other Issuers

Qualified Scholarship Funding Bonds

A qualified scholarship funding bond is treated as a state or local bond. Section 150(d).

To issue qualified scholarship funding bonds, the issuing corporation must be:

(1) A not-for-profit established exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965, and

(2) Organized at the request of the state or one or more political subdivisions thereof and required by corporate charter and bylaws, or required by state law, to devote any income (after payment of expenses, debt service, and the creation of reserves) to purchase additional student loan notes or pay over any income to the United States.

See § 150(d).

Continued on next page

Volunteer Fire Department

A bond of a volunteer fire department is treated as a bond of a political subdivision of a state if the following criteria are met.

(1) The department is a "qualified volunteer fire department" with respect to an area within the jurisdiction of the political subdivision.

(2) Ninety-five percent or more of the net proceeds of the bond issue are to be used for the acquisition, construction, reconstruction, or improvement of a firehouse (including land which is functionally related and subordinate thereto) or fire trucks to be used by such department.

(3) The qualified volunteer fire department is:
- organized and operated to provide firefighting or emergency medical services for persons in an area (within the jurisdiction of the political subdivision) that is not provided with any other firefighting service, and
- required (by written agreement) by the political subdivision to furnish firefighting services in such area.

(4) The requirements of §§ 147(f) (public approval) and 149(d) (advance refunding) are met.

See § 150(e).

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Other Issuers, Continued

Indian Tribal Governments Treated as States for Certain Purposes

An Indian tribal government shall be treated as a state for purposes of § 103 (relating to state and local bonds) if certain additional requirements are met.

See §§ 7871(a)(4) and (c) for the additional requirements.

Definitions

The term "Indian tribe" means any Indian tribe, band, nation, or other organized group or community that is recognized as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

See § 7871(c)(3)(E)(ii); Rev. Proc. 84-37, 1984-1 C.B. 513, modified by Rev. Proc. 86-17, 1986-1 C.B. 550; and Rev. Proc. 2008-55, 2008-39 I.R.B. 768.

Additional Requirements

See Phase II, Lesson 12 for special provisions relating to bonds issued by Indian tribal governments.

Section 5

Characteristics of Tax-Exempt Debt

Debt Must Be Valid Under State Law

Interest on the bonds issued by a state or local government is not excludable from gross income under § 103(a) if the bonds are invalid under state law.

Continued on next page

Obligation Must Be Debt Not Equity

The term "bond" means any obligation. Section 150(a)(1).

"Obligation means any valid evidence of indebtedness under general Federal income tax principles." Regulations § 1.150-1(b).

"The characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making this determination are:

(a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonable foreseeable future;

(b) whether holders of the instruments possess the right to enforce the payment of principal and interest;

(c) whether the rights of the holders of the instruments are subordinate to rights of general creditors;

(d) whether the instruments give the holders the right to participate in the management of the issuer;

(e) whether the issuer is thinly capitalized;

(f) whether there is identity between holders of the instruments and stockholders of the issuer;

Continued on next page

Obligation Must Be Debt Not Equity (continued)

(g) the label placed upon the instruments by the parties; and

(h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account."

Notice 94-47, 1994-1 C.B. 357.

Example

City, a political subdivision of State, issued revenue bonds to finance the construction of a manufacturing facility. The bonds satisfied the requirements for exemption under the applicable section of the Code. Subsequently, the Supreme Court of State held that under state law the bonds were not valid obligations of City because State's voter approval requirement for issuance of bonds had not been satisfied. Because the bonds were not valid obligations of City under state law, the bonds are not the obligation of a state or political subdivision for purposes of § 103(a). Therefore, interest on the bonds is not excludable from gross income. *See Rev. Rul. 87-116, 1987-2 C.B. 44.*

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Debt Must Be an Exercise of Borrowing Power

In order for an obligation to exist for purposes of § 103, it must be incurred in the exercise of the issuer’s borrowing power. *See United States Trust Co. v. Anderson*, 65 F.2d 575 (2d Cir. 1933).

Example

Taxpayer's property was taken by condemnation. State court awarded taxpayer an amount for the property plus interest. State's obligation to pay compensation for property taken for public purposes arises as a result of the exercise of eminent domain powers, not as a result of, or in the course of, State's exercise of borrowing power. Therefore, interest received by the taxpayer from the State as a result of property condemnation for public purposes is not exempt from income tax as interest on an "obligation" of a State or political subdivision thereof. *See Rev. Rul. 72-77, 1972-1 C.B. 28.*

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Debt Must Result from an Intent to Make a Loan

Interest on an obligation of a State or political subdivision is not excludable from gross income unless money was borrowed for its use with an obligation to repay.

See Rev. Rul. 74-113, 1974-1 C.B. 31.

Debt Must Be an Obligation Regardless of the Source of Repayment

A loan will be treated as an "obligation" for purposes of § 103 whether it is a general obligation of the political subdivision secured by its full faith and credit or whether repayment is restricted to revenues generated by the property purchased with the borrowed funds. The fact that the promise to repay bonds issued by a municipality was limited to the revenues to be derived from leasing the property financed with the bond proceeds did not cause interest on the bonds to be includable in gross income. It is not necessary that the obligation be a general one, pledging the general credit of the municipality or the use of its taxing power.

See Rev. Rul. 54-106, 1954-1 C.B. 28.

Substance Controls

The determination of whether a loan is made (whether debt constitutes an obligation) depends on the substance of a transaction rather than its form.

See Notice 94-47, 1994-1 C.B. 357.

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Interest on the Debt Must Be Interest for Federal Tax Purpose

Only "interest" on a municipal bond can be excluded from gross income by a bond purchaser.

The Supreme Court has defined interest as the amount one has contracted to pay for the use of borrowed money, and as the compensation paid for the use or forbearance of money.

See *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932) and also Rev. Rul. 69-188, 1969-1 C.B. 54.

Interest does not include separate charges made for investigating the prospective borrower and his security, closing costs of the loan and papers drawn in connection therewith, or fees paid to a third party for servicing and collecting a loan.

See Rev. Rul. 69-188, 1969-1 C.B. 54.

Insurance Proceeds as Tax-Exempt Interest

Defaulted interest paid by an independent insurance company pursuant to a bond insurance policy purchased by the issuer **(Rev. Rul. 72-134, 1972-1 C.B. 29)** or the underwriter **(Rev. Rul. 72-575, 1972-1 C.B. 74**) is excludable from the gross income of the bondholders.

Summary

Review

Section 103 provides the foundation for the income exclusion of interest of municipal bonds. Because the exclusion from income is a general provision, the exceptions become much more significant.

Entities that are qualified to issue tax-exempt bonds are:

- states and political subdivisions,
- on behalf of issuers,
- issuers of qualified scholarship funding bonds,
- volunteer fire departments, and
- Indian tribal governments.

In order to be tax-exempt, the debt must possess certain characteristics. The debt must:

- be valid under state law,
- be an exercise of borrowing power,
- result from an intent to make a loan,
- be an obligation regardless of the source of repayment, and
- interest on the debt must be interest for federal tax purposes.

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Lesson 4

Governmental Bonds

Overview

Purpose

This lesson explains how to distinguish a governmental bond from a private activity bond.

Objectives

After completing this lesson you will be able to:

Distinguish a governmental bond from a private activity bond

- Apply the following tests
  - private business use test
  - private security or payment test
  - private loan financing test
  - unrelated or disproportionate use test
- Explain the consequences, if any, for a bond that meets one or more of these tests

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Introduction

In General

Bonds issued by a State, territory, possession of the United States, the District of Columbia, or any political subdivision thereof ("State or local governments") are classified generally as either governmental bonds or private activity bonds.

Why is this important?

A bond may be issued by a State or local government as a governmental bond, but analysis of the use of proceeds or of the bond may reveal that the bond is actually a private activity bond. In addition, the State or local government may take a deliberate action after the issuance of the bond that may turn a governmental bond into a private activity bond. In either case, the issuer may lose all or a portion of the tax law benefits of the bond issue.

Definition of Government Bond

A governmental bond is an obligation of a State or local government that is issued to finance governmental purposes, meets the eligibility requirements for interest on the obligation to be excludable from the gross income of the owner of the obligation and is not a private activity bond.

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Definition of Private Activity Bond

Very generally, private activity bonds are obligations that benefit nongovernmental persons, such as private businesses, charitable organizations or individuals. Section 141 outlines the tests that, if met, make a bond a private activity bond.

A bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date that the issue will meet either the private:

- business tests (private business use test AND private security or payment test), OR
- loan financing test

Reasonable Expectations

The issuer's reasonable expectations must take into account events and actions over the entire stated term of an issue.

See Regulations § 1.141-2(d)(2).

Section I

Private Business Use Test

Overview

Contents

This section contains the following topics:

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Introduction

Private Business Use Rule

If **more than** 10 percent of the proceeds of the issue are to be used in a trade or business of a nongovernmental person, the issue meets the private business use test. Any activity carried on by a person other than a natural person is treated as a trade or business. If the private business use test is met and the private security or payment test (discussed in Section 3) is also met, the issue is an issue of private activity bonds. This section only discusses the private business use test.

See IRC § 141(a), (b)(1), and (b)(6); Regulations § 1.141-3(a)(1).

Private Business Users

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

See Regulations § 1.141-3(b).

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Direct and Indirect Uses

In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of bond proceeds.

A facility is treated as being used for a private business use if it is leased to a:

- nongovernmental person and subleased to a governmental person, or
- governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business.

The issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met.

See Regulations § 1.141-3(a)(2).

Leases

A lease of financed property to a nongovernmental person for use in a trade or business is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease.

Actual and Beneficial Uses

Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer.

See Regulations § 1.141-3(b)(1).

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Proceeds and Property

The use of bond proceeds includes the direct use of bond proceeds of the issue or use of the bond-financed property.

See Regulations § 1.141-3(a)(2).

Aggregate Use

The use of proceeds by **all** nongovernmental persons is aggregated to determine whether the private business use test is met.

See Regulations § 1.141-3(a)(3).

Output Contracts

Special rules for output contracts are in Regulations §§ 1.141-7 through 1.141-8. These rules apply to bonds sold on or after November 22, 2002.

See Treasury Decisions (T.D.) 8941 for the special rules found in Regulations § 1.141-7T as in effect from January 19, 2001, to November 21, 2002. See T.D. 8757 for the special rules in effect prior to January 19, 2001.

Basic Private Business Use Arrangements

Recall – Transferring Ownership of or Leasing Financed Property May Be Private Uses

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

Example 1 Ownership

State Alpha issues 20-year bonds to purchase the site for and construct and equip a building. Alpha then enters into an arrangement with Corporation Beta to sell the building to Beta on an installment basis while the bonds are outstanding.

The issue meets the private business use test because a nongovernmental person owns the financed facility.

Example 2 Lease

State Alpha issues 20-year bonds to purchase the site for and construct and equip a building. Alpha then enters into an arrangement with Corporation Beta whereby Alpha leases the factory to Beta for a 5- year term.

The issue meets the private business use test because a nongovernmental person is using 100% of the financed facility for 5 years resulting in 25% private business use over the measurement period. (See section entitled "Measurement of Private Business Use" below.)

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Example 3 Lease

City of Gamma issues bonds on behalf of Nonprofit Corporation Delta to finance the construction of a hospital. Delta will own legal title to the hospital. In addition, Delta will operate the hospital, but Delta is not treated as an agent of Gamma in its capacity as operator of the hospital. Gamma has certain rights to the hospital that establish that Gamma is properly treated as the owner of the property for federal income tax purposes. Gamma does not have rights, however, to directly control operation of the hospital while Delta owns legal title to it and operates it.

The issue meets the private business use test because the arrangement provides a nongovernmental person an interest in the financed facility that is comparable to a leasehold interest.

Management Contracts

Recall – A Management Contract of Financed Property May Be a Private Business Use

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- **a management or incentive payment contract**; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

See Regulations § 1.141-3(b).

General Rule

Generally, a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

See Regulations § 1.141-3(b)(4)(i); see also Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38 (Management Contract Guidelines) and amplified by Notice 2014-67, 2014-46 I.R.B. 822. Rev. Proc. 97-13 can be found in Federal Taxation of Municipal Bonds.

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Definition

A management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

See Regulations § 1.141-3(b)(4)(ii).

Treatment as Lessee

Further, a management contract with respect to financed property generally results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal tax purposes.

Arrangements not Treated as Net Profit Arrangements

(a) Generally, compensation under a management contract is not based on net profits if it is based on: (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee.

See Rev. Proc. 97-13, § 4.02(2).

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Permissible Arrangements

Section 5.03 of Rev. Proc. 97-13 provides permissible terms (safe harbors) that do not cause the management contract to result in private business use.

On October 24, 2014, the Internal Revenue Service issued Notice 2014-67, 2014-46 I.R.B. which created a new safe harbor for contracts with a term, including renewal options, of not more than five years. The big change is that such contract need *not be terminable* by the qualified user prior to the end of the term.

Notice 2014-67 applies to bonds issued on or after January 22, 2015, but also may be applied to bonds issued before January 22, 2015.

Notice 2014-67, created a new safe harbor for contracts with a term, including renewal options, of not more than five years. A major change is that such contracts need *not be terminable* by the qualified user prior to the end of the term.

Section 3.02 of Notice 2014-67 applies to contracts entered into, materially modified or extended on or after January 22, 2015, but may be applied to contracts entered into before that date.

Renewal Option

Under Rev. Proc. 97-13, if the service provider (manager) has a legally enforceable right to renew the contract, the contract has a renewal option.

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Certain Relationships

A management contract is not within the safe harbors of Rev. Proc. 97-13 if the service provider has a role or relationship with the qualified user (governmental person) to the extent that the relationship limits the ability of the qualified user to exercise its rights, including the right to terminate the contract. No such role or relationship is present if-

(a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

(b) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and

(c) The qualified user and the service provider under the contract are not related parties, as defined in Regulations § 1.150-1(b).

Compensation Arrangements - Hypothetical Set #1

County of Alpha uses proceeds of tax-exempt bonds to finance the construction of a courthouse. Alpha enters into a contract with Corporation Beta pursuant to which Beta is to manage the cafeteria located in the courthouse.

- The contract is a management contract and may result in private use depending on all the facts and circumstances.

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Compensation Terminology

What are the compensation terms of the management contract between Alpha and Beta?

What if the contract provides that Beta's compensation will equal 5 percent of the net profits of the cafeteria?

- The management contract is based on net profits.

What if the contract provides that Beta will receive 10 percent of the gross receipts of the cafeteria?

- The management contract is based only on gross receipts and not gross receipts and expenses from the facility.

What if Beta receives $2 for each meal served at the cafeteria?

- The management contract is based on a per-unit fee. See definition of "per-unit fee" in section 3.06 of Rev. Proc. 97-13 as modified by section 4.02 of Rev. Proc. 2001-39.

What if Beta's compensation will be $X per month?

- The management contract is based on a periodic fixed fee.

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Compensation Arrangements - Hypothetical Set #1

What if the contract is for a term of 15 years (including renewal options) and Beta's compensation will be (i) $X per month and (ii) 1 percent of gross receipts of the cafeteria during such month. The contract further provides that in no event will the amount received by Beta under clause (ii) be more than 5 percent of Beta's total compensation each month.

- The management contract does not result in private use because the management contract provides that <u>95 percent of Beta's compensation</u> <u>is a period fixed fee</u> and the term of the agreement is <u>15 years</u>. See section 5.03(1) of Rev. Proc. 97-13.

What if the contract is for a term of 7 years (including renewal options) and Beta's compensation will be (i) $X per month and (ii) 5 percent of gross receipts of the cafeteria during such month. The contract provides that in no event will the amount received by Beta under clause (ii) be more than 20 percent of Beta's total compensation each month.

- The management contract does not result in private use because the management contract provides that <u>80 percent</u> of Beta's compensation is a periodic fixed fee and the term of the agreement is for a term of less than <u>10 years</u>. See section 5.03(2) of Rev. Proc. 97-13.

What if the contract is for a term of 5 years (including all renewal options) terminable by Alpha after three years without penalty after reasonable notice and Beta's compensation for each month will be (i) $X per month and (ii) the lesser of 2 percent of gross revenues per month and $X dollars?

- The management contract does not result in private use because at least 50% of Beta's compensation is based on a periodic fixed fee, and the term of the agreement is <u>5 years and terminable by Alpha after</u> <u>three years without penalty</u>. See section 5.03(4) of Rev. Proc. 97-13.

Note: Under Notice 2014-67, the management contract above would not result in private use if <u>all</u> of the compensation for services is based on a periodic fixed fee even if the agreement is NOT terminable prior to the end of the term.

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Compensation Arrangements - Hypothetical Set #2

County of Gamma uses proceeds of tax-exempt bonds to finance the construction of a hospital.

What if Gamma enters into a management contract with Corporation Delta to manage its dialysis department for a term of 3 years, the contract is terminable by Gamma without penalty after 2 years and Delta will receive $10 from each payment that County receives from Medicare reimbursement for each patient using the dialysis department?

- The management contract does not result in private use because Delta's compensation is a per-unit fee and the term of the agreement (including renewal options) is 3 years and is terminable by Gamma without penalty after 2 years. The management contract meets the requirements of section 5.03(5) of Rev. Proc. 97-13.

Note: Under Notice 2014-67, the management contract above would not result in private use since all the compensation is a per-unit fee and the term of the agreement (including renewal options) is 3 years even if the agreement were NOT terminable prior to the end of the term.

What if the dialysis department is a new facility and the management contract provides that Delta will receive 25 percent of the gross revenues of the dialysis department for the first two years and Gamma may terminate the contract (after providing 60 days' notice) at the end of the first year without payment of any penalty to Delta?.

- The management contract does not result in private use because the facility is in its "startup" phase, Delta's compensation is based on a percentage of gross revenues, the term of the agreement (including renewal options) is 2 years and the contract is terminable by Gamma without penalty after 1 year after reasonable notice. The management contract meets the requirements of section 5.03(6) of Rev. Proc. 97-13.

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Compensation Arrangements - Hypothetical Set #3

Epsilon Hospital, a 501(c)(3) organization, uses proceeds of tax-exempt bonds to finance the construction of a hospital.

What if Epsilon enters into a contract with HMO pursuant to which HMO will send its patients to Epsilon and Epsilon will provide services to such patients? The contract provides that HMO will pay $100 per patient per month to Epsilon.

- The compensation is not considered to be based on a share of net profits because the compensation under the management contract is based on a capitation fee. See definition of capitation fee under section 3.02 of Rev. Proc. 97-13 as modified by section 4.01 of Rev. Proc. 2001-39.

What if Epsilon enters into a contract with Corporation Zeta pursuant to which Zeta is to manage the radiology department located in the hospital facility and the contract provides that Zeta will receive $100 at the end of Epsilon's fiscal year if the gross receipts of the radiology department increase by 5 percent during Epsilon's fiscal year?

- The productivity reward does not cause the compensation to be based on a share of net profits because the productivity reward is based on increase of gross receipts only. See section 5.02(3) of Rev. Proc. 97-13.

Note: Notice 2014-67 amplifies the percentage of revenue or expense productivity award provisions of section 5.02(3) of Rev. Proc. 97-13 to provide that the productivity award is not based on a share of net profits if the amount of the productivity award is 1) a stated dollar amount, 2) a periodic fixed fee, or 3) a tiered system of stated dollar amounts or periodic fixed fees based solely on the level of performance achieved with respect to the applicable measure. *What if* Epsilon enters into a contract with Zeta to manage the department, there are 6 members on the Board of Directors of Epsilon and Zeta is wholly owned by the chairperson of the Board of Directors of Epsilon and two doctors that serve on the Board?

- The management contract does not meet the safe harbor under section 5.04(2) of Rev. Proc. 97-13because more than 20% of the voting power of the Board of Directors of the Epsilon is vested in shareholders of the Zeta. Whether the management contract results in private use will depend on all the facts and circumstances.

Continued on next page

Compensation Arrangements - Hypothetical #4

City of Iota uses proceeds of bonds to finance an office building. The office building includes a cafeteria that is open to the general public.

What if Iota enters into a contract labeled "management contract" with Corporation Kappa to manage the cafeteria for a term of 10 years and Kappa receives all the receipts of the cafeteria and in turn gives $X per month to Iota? Kappa has complete discretion to manage the cafeteria without any input from Iota.

- Notwithstanding the contract's title, the contract is a lease and should not be analyzed under Rev. Proc. 97-13. See Regulations § 1.141-3(b)(3).

Arrangements That Are Not Management Contracts

Incidental Contract

A contact for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services) is **not** a management contact.

See Regulations § 1.141-3(b)(4)(iii)(A).

Hospital Admitting Privileges

The mere granting of admitting privileges by a hospital to a doctor is **not** a management contract, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area consistent with the size and nature of its facilities.

See Regulations § 1.141-3(b)(4)(iii)(B).

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Arrangements That Are Not Management Contracts, Continued

Operation of Public Utilities

A contract to provide for the operation of facilities that consists predominantly of public utility property is **not** a management contract if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

See Regulations § 1.141-3(b)(4)(iii)(C).

Service Providers

A contract to provide for services is not a management contract if the only compensation is reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

See Regulations § 1.141-3(b)(4)(iii)(D).

Research Agreements

***Recall* – Research Agreements May Create Private Use**

In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- **research contract**

See Regulations § 1.141-3(b).

Generally

An agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research based on all the facts and circumstances. Regulations § 1.141-3(b)(6)(ii).

An agreement by a nongovernmental person to sponsor research with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes. See Regulations § 1.141-3(b)(6)(ii).

See Rev. Proc. 2007-47, 2007-2 C.B. 108 (Research Agreements and Private Business Use Test), which can be found in Federal Taxation of Municipal Bonds.

Continued on next page

Basic Research

Any original investigation for the advancement of scientific knowledge not having a specific commercial objective is considered basic research. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research.

See section 3.01 of Rev. Proc. 2007-47.:

Corporate Sponsored Research

A research agreement relating to property used for basic research supported or sponsored by a sponsor does not result in private use if -

(i) any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use); and

(ii) the price paid for that use must be determined at the time the license or other resulting technology is available for use

The government entity is not required to permit persons other than the sponsor to use any license or other resulting technology. However, the price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.

See section 6.02 of Rev. Proc. 2007-47.

Continued on next page

Industry or Federally-Sponsored Research Agreements

A research agreement relating to property used pursuant to an industry-Federal Government research arrangement does not result in private use if -

(i) A single sponsor agrees, or multiple sponsors agree, to fund governmentally performed basic research;

(ii) The qualified user determines the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);

(iii)Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and

(iv) The sponsor or sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.

For purposes of (i) through (iv) above, the rights of the Federal Government and its agencies mandated by the Bayh-Dole Act does not result in private use if the license granted to any party other than the qualified user to use the product of the research is no more than a nonexclusive, royalty-free license.

See sections 6.03 and 6.04 of Rev. Proc. 2007-47.

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Research Agreements – Hypothetical Set

University of Upsilon, a university established under state law, finances the building housing its life sciences department with proceeds of tax-exempt bonds.

Assume that Upsilon and Corporation Chi enter into a research agreement whereby Chi sponsors research related into a particular bacteria and its effect on the human body. The agreement provides that any resulting technology from the research may be acquired by Chi at the end of the term of the research agreement at the fair market value when it is acquired.

- The research agreement does not result in private use of the bond-financed property by Chi. See section 6.02 of Rev. Proc. 2007-47.

Assume that Upsilon and Xi Association, a group of corporations that manufacture and sell drugs, enter into a research agreement whereby Xi provides a grant to the Upsilon to sponsor research related to a particular bacteria and its effect on the human body. The agreement provides that Upsilon will have control over the specific research to be performed and the Upsilon's professors and students will do the research. Further, any resulting technology (patent, etc.) from the research will be owned by Upsilon. Xi, or its members, will have a nonexclusive, royalty free license to use the resulting technology.

- The research agreement does not result in private use of the bond-financed property by Xi. See section 4.03 of Rev. Proc. 97-14.

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Research Agreements – Hypothetical Set (continued)

Assume that Upsilon and the National Institutes of Health (NIH), an agency of the U.S. Department of Health & Human Services, enter into a research agreement whereby NIH provides a grant to Upsilon to sponsor research related into a particular bacteria and its effect on the human body. The agreement provides that Upsilon will have control over the specific research to be performed and the Upsilon's professors and students will do the research. Further, any resulting technology (patent, etc.) from the research will be owned by Upsilon. NIH will have a nonexclusive, royalty free license to use the resulting technology. In addition, the agreement also provides that if Upsilon fails to make the product of the research available to the public on reasonable terms or if action is necessary to alleviate health or safety needs, NIH may grant a nonexclusive, royalty free license to a third party nongovernmental person to use the product of the research (march-in rights).

- The research agreement does not result in private use of the bond-financed property by NIH. See sections 6.03 and 6.04 of Rev. Proc. 2007-47.

Comparable Use

General

Any other arrangement that conveys special legal entitlements for beneficial use of the bond proceeds or financed property that are comparable to special legal entitlements of ownership, leases, management contracts, output contracts, or research agreements described above results in private business use.

See Regulations. § 1.141-3(b)(7)(i).

Priority Rights

An arrangement that conveys priority rights to the use or capacity of a facility is private business use.

See Regulations. § 1.141-3(b)(7)(i).

Economic Benefit -- Facilities Not Available for Use by the General Public

In the case of financed property that is not available for use by the general public, private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons. This is true even
if those nongovernmental persons have no special legal entitlement to use of the property.

See Regulations § 1.141-3(b)(7)(ii).

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Special Economic Benefit Test

In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including
one or more of the following factors, whether:

- the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person
- only a small number of nongovernmental persons receive the special economic benefit; AND
- the cost of the financed property is treated as depreciable by any nongovernmental person

See Regulations § 1.141-3(b)(7)(ii).

Use by the General Public

Public Use

Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

See Regulations § 1.141-3(c).

200 Day Use

Arrangements longer than 200 days are NOT treated as general public use.

See Regulations § 1.141-3(c)(3).

Priority Rights

In general, an arrangement that conveys priority rights to the use or capacity of a facility is NOT use on the same basis as the general public. Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. This includes different rates for different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable.

See Regulations. § 1.141-3(c)

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General Public Use – Hypothetical Set #1

State of Psi issues bonds to purchase land and construct a hotel for use by the general public (that is, tourists, visitors, and business travelers). The bond documents provide that Psi will own and operate the project for the term of the bonds. Psi will not enter into a lease or license with any user for use of rooms for a period longer than 200 days (although users may actually use rooms for consecutive periods in excess of 200 days). Psi charges the same rates to business travelers as to other guests.

- Use of the hotel by hotel guests who are traveling in connection with trades or businesses of nongovernmental persons is not a private business use of the hotel by these persons, because the hotel is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

Assume that Psi enters into an agreement with Corporation Tau having a term of 5 years that provides Tau the use of 10 percent of rooms for its corporate clients and employees.

- The 10 percent of the property reserved for the Tau is used in its trade or business is therefore considered to be private business use.

See Regulations § 1.141-3(c)(3).

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Other Actual or Beneficial Use – Hypothetical #2

Corporation Lambda and City of Mu enter into a plan to finance the construction of a parking lot adjacent to Lambda's factory. Pursuant to the plan, Lambda conveys the site for the parking lot to Mu for a nominal amount, subject to a covenant running with the land that the property be used
only for a parking lot. In addition, Mu agrees that Lambda will have the right to approve rates charged by Mu for use of the parking lot. Mu issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied.

- There is private business use of the parking lot. A nongovernmental person has special legal entitlements for beneficial use of the parking lot that are comparable to an ownership interest.

See Regulations § 1.141-3(b)(7)(i) and Example 5 of Regulations § 1.141-3(f).

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Other Actual or Beneficial Use – Hypothetical #3

Pi Authority, a political subdivision, owns and operates a hydroelectric generation plant and related facilities. Pursuant to a take or pay contract, Pi sells 15 percent of the output of the plant to Corporation Rho, an investor- owned utility. Rho is treated as a private business user of the plant. Under the license issued to Pi for operation of the plant, Pi is required by federal regulations to construct and operate various facilities for the preservation of fish and for public recreation. Pi issues its obligations to finance the fish preservation and public recreation facilities. Rho has no special legal entitlements for beneficial use of the financed facilities. The fish preservation facilities are functionally related to the operation of the plant. The recreation facilities are available to natural persons on a short-term basis according to generally applicable and uniformly applied rates. The recreation facilities are treated as used by the general public. Rho's use is not treated as private business use of the recreation facilities because Rho has no special legal entitlements for beneficial use of the recreation facilities. The fish preservation facilities are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business.

- Under all of the facts and circumstances (including the functional relationship of the fish preservation facilities to property used in Rho's trade or business), Rho derives a special economic benefit from the fish preservation facilities. Therefore, Rho's private business use may be established solely on the basis of that special economic benefit, and Rho's use of the fish preservation facilities is treated as private business use.

Other Exceptions

Agents

Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person is not private business use.

See Regulations § 1.141-3(d)(1).

Use Incidental to Financing

Use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. For example, bond trustees, servicers, and guarantors are generally not treated as private business users.

See Regulations § 1.141-3(d)(2).

Certain 100 Day Arrangements

Use by a nongovernmental person is not private business use if the:

- term of use under the arrangement, including all renewal options, is less than 100 days;
- arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and
- property is not financed for the principal purpose of providing that property for use by that nongovernmental person.

See Regulations § 1.141-3(d)(3)(i).

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50 Day Use

Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if the:

- term of use, including all renewal options, is not longer than 50 days;
- arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value; and
- property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

Temporary Use by Developers

Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the--

- issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and property benefited by that improvement, and to transfer the improvement to a governmental person, and
- improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed

See Regulations § 1.141-3(d)(4).

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Incidental Use

Incidental use of a financed facility is disregarded to the extent that such use does not exceed 2.5 percent of the proceeds of the issue. A use of a facility by a nongovernmental person is incidental if:

- **Except for vending machines, pay telephones, kiosks, and similar uses,** the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers
- The non-possessory use is not functionally related to any other use of the facility by the same person (other than a different non-possessory use); AND
- All non-possessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility

See Regulations § 1.141-3(d)(5).

Qualified Improvements

Proceeds that provide a governmental owned improvement to a governmental owned building (including land functionally related and subordinate to the building) are not used for a private business use if:

- The building was placed in service more than one year before the construction or acquisition of the improvement is begun
- The improvement is not exclusively for any private business use
- No portion of the improved building or any payments in respect of the improved building are taken into account under § 141(b)(2)(A) (the private security test); AND
- No more than 15 percent of the improved building is used for a private business use

See Regulations § 1.141-3(d)(6).

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Other Exceptions, Continued

Exceptions to the Private Business Use Rule - Hypothetical

Authority Eta, a political subdivision, uses all of the proceeds of its tax exempt bonds to construct a prison. Eta contracts with Federal Agency Theta to house federal prisoners on a space-available, first-come, first-served basis, pursuant to which Theta will be charged approximately the same amount for each prisoner as other persons that enter into similar transfer agreements. It is reasonably expected that other persons will enter into similar agreements.
The term of the use under the contract is not longer than 100 days, and Theta has no right to renew, although Eta reasonably expects to renew the contract indefinitely. The prison is not financed for a principal purpose of providing the prison for use by Theta. It is reasonably expected that during the term of the bonds, more than 10 percent of the prisoners at the prison will be federal prisoners.

- Theta's use of the facility is not general public use because this type of use (leasing space for prisoners) is not available for use on the same basis by natural persons not engaged in a trade or business. The issue does not meet the private business use test, however, because the lease is not longer than 100 days.

See Regulations § 1.141-3(d)(3)(i) and Example 15 under Regulations §1.141-3(f).

Measurement of Private Business Use

General Rule

In general, the private business use of proceeds is allocated to property under § 1.141-6. The amount of private business use of property is determined according to the average percentage of private business use of that property during the measurement period.

See Regulations § 1.141-3(g)(1). (Proposed regulations published September 26, 2006, address the allocation of proceeds to property, including mixed-use property. These rules are intended to be applied prospectively from a date after final regulations are published.)

Measurement Period – General Rules

Generally, the measurement period of property financed by an issue begins on the **later** of the:

- issue date of that issue, OR
- date the property is placed in service

The measurement period ends on the **earlier** of the:

- last date of the reasonably expected economic life of the property, OR
- latest maturity date of any bond of the issue financing the property
  - (determined without regard to any optional redemption dates)

See Regulations § 1.141-3(g)(2)(i).

Example: On June 1, 2000, County issues bonds to construct an office building for its own use. The construction is completed on August 15, 2003, and the building is placed in service on such date. The reasonably expected life of the building is 40 years and the latest maturity date of any bond of the issue is June 1, 2030. The measurement period for the office building begins on August 15, 2003, and ends on June 1, 2030.

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Measurement Period When Refunding

For short-term obligations that the issuer reasonably expects to refund (such as bond anticipation notes), the measurement period is based on the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates).

See Regulations § 1.141-3(g)(2)(ii).

Example: On June 1, 2000, County issues bond anticipation notes to finance the construction of an office building. The construction is completed on August 15, 2003, and the building is placed in service on such date. On September 1, 2003, County issues bonds to refund the BANs. The reasonably expected life of the building is 40 years and the latest maturity date of bond issue is June 1, 2030. The measurement period for the office building begins on August 15, 2003, and ends on June 1, 2030.

Use Resulting from Ownership

The amount of private business use resulting from ownership by a nongovernmental person is the greatest percentage of private business use in any one-year period.

See Regulations § 1.141-3(g)(2)(iv).

Anti-Abuse Rule

The Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any one-year period, if an issuer establishes the term of an issue for a period that is longer than is reasonably necessary for the governmental purposes of the issue for a principal purpose of increasing the permitted amount of private business use.

See Regulations § 1.141-3(g)(2)(v).

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Determining Average Use

The average percentage of private business use is the average of the percentages of private business use during the one-year periods within the measurement period. The percentage of private business use during any one-year period is determined by comparing the amount of private business use during the year to the total amount of all use (private business use and government use) during the year.

See Regulations § 1.141-3(g)(3) and (4)(i).

Use at Different Times

For a facility in which actual governmental use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. Periods of nonuse are disregarded when computing percentage use.

For example, the average amount of private business use of a stadium generally is based on the total number of days the stadium is actually used for events.

See Regulations § 1.141-3(g)(4)(ii).

Simultaneous Use

In general, for a facility in which governmental and private business use occur simultaneously, the facility is treated as having private business use. For example, a governmental owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use.

If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility.

For example, the average amount of private business use of a garage with unassigned spaces is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

See Regulations § 1.141-3(g)(4)(iii).

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Discrete Portion

Measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility. A discrete portion is a portion of a facility that consists of
any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls partitions, or other physical barriers are examples of a discrete portion.

See Regulations § 1.141-3(g)(4)(iv); § 1.141-1(b).

Fair Market Value

If the private business use is reasonably expected to have a greater fair market value than the government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use

See Regulations § 1.141-3(g)(4)(v).

Common Areas

The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of a facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit. Common areas are portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

See Regulations § 1.141-3(g)(5) and § 1.141-1(b).

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Neutral Costs

Proceeds that are used to pay costs of issuance, invested in a reserve or replacement fund, or paid as fees for a qualified guarantee or a qualified hedge must be allocated ratably among the other purposes for which the proceeds are used.

See Regulations § 1.141-3(g)(6).

Commencement of Measurement of Private Business Use

Generally, private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if the issuer enters into an arrangement for private business use a substantial period (at least 10% of the measurement period) before the right to actual private business use commences and the arrangement transfers ownership or is an arrangement for long-term use, private business use commences on the date the arrangement is entered into.

See Regulations § 1.141-3(g)(7).

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Private Business Use Allocations – Hypothetical #1

City of Kappa issues bonds and uses all of the proceeds to construct a stadium. Kappa enters into a long-term contract with a professional sports team Lambda under which Lambda will use the stadium 20 times during the year. This use will occur on nights and weekends. Kappa reasonably expects that the stadium will be used more than 180 other days each year, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of Lambda's uses when compared to the other uses of the stadium, taking into account the payments that Lambda is reasonably expected to make for its use.

- Assuming no other private business use, the issue does not meet the private business use test because not more than 10 percent of the use of the facility is for a private business use.

See Example 2 under Regulations § 1.141-3(g)(8).

Private Business Use Allocations – Hypothetical #2

City of Heta issues bonds to finance the construction of an airport terminal. Eighty percent of the leasable space of the terminal will be leased to private air carriers. The remaining 20 percent of the leasable space will be used, for the term of the bonds, by Heta for its administrative purposes.

- The common areas of the terminal, including waiting areas, lobbies, and hallways are treated as 80 percent used by the air carriers for purposes of the private business use test.

See Regulations § 1.141-3(g)(5) and Example 3 under Regulations § 1.141-3(g)(8).

Section II

Private Security or Payment Test

Overview

The private security or payment test is the second of the private business tests. If the private security or payment test **and** the private business use test described in Section I above are satisfied, a bond will be a private activity bond.

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Introduction

Private Security or Payment Test

Except as otherwise provided in § 141(b), an issue meets the private security or payment test if the payment of the principal of, or the interest on, more
than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly:

(i) secured by an interest in:

- property used or to be used for a private business use, or
- payments in respect of such property, OR

(ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Measurement of Private Security and Security

Present Value

In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

See Regulations § 1.141-4(b)(2(i).

Debt Service

Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. Debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of § 148(f).

See Regulations § 1.141-4(b)(ii).

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Measurement of Private Payment and Security – Hypothetical Set #1

City Alpha issues general obligation bonds with proceeds of $10 million to finance a 5-story office building. The bonds bear interest at a variable rate that is recomputed monthly according to an index that reflects current market yields. The yield that the interest index would produce on the issue date is 6 percent. Alpha leases 1 floor of the office building to Corporation Beta, a nongovernmental person, for the term of the bonds.

- Under all of the facts and circumstances, Beta is treated as using more than 10 percent of the proceeds. Using the 6 percent yield as the discount rate, Alpha reasonably expects on the issue date that the present value of lease payments to be made by Beta will be 8 percent of the present value of the total debt service on the bonds. After the issue date of the bonds, interest rates decline significantly, so that the yield on the bonds over their entire term is 4 percent. Using this actual 4 percent yield as the discount rate, the present value of lease payments made by Beta is 12 percent of the present value of the actual total debt service on the bonds. The bonds are not private activity bonds because Alpha reasonably expected on the issue date that the bonds would not meet the private security or payment test and because Alpha did not take any subsequent deliberate action to meet the private security or payment test.

See Example 3(i) under Regulations § 1.141-4(g).

Assume that 5 years after the issue date Alpha leases a second floor to Corporation S, a nongovernmental person, under a long-term lease.

- Because Alpha has taken a deliberate action, the present value of the lease payments must be computed. On the date this lease is entered into, Alpha reasonably expects that the yield on the bonds over their entire term will be 5.5 percent, based on actual interest rates to date and the then-current rate on the variable fixed bonds. Alpha uses this 5.5 percent yield as the discount rate. Using this 5.5 percent yield as the discount rate, as a percentage of the present value of the debt service on the bonds, the present value of the lease payments made by S is 3 percent. The bonds are private activity bonds because the present value of the aggregate private payments from Beta and S is greater than 10 percent of the present value of debt service.

See Example 3(ii) under Regulations § 1.141-4(g).

Private Payments for Use

Direct and Indirect

Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person.

See Regulations § 1.141-4(c)(2)(i)(A).

Not to Exceed Actual Use

Payments are taken into account only to the extent that they are made for the period of time that proceeds are used for a private business use.

Payments cannot exceed the percentage of private use. Thus if 7 percent of the proceeds of an issue is used by a person over the measurement period, payments with respect to the property financed with those proceeds are taken into account as private payments only to the extent that the present value of those payments does not exceed the present value of 7 percent of the debt service on the issue.

See Regulations § 1.141-4(c)(2)(i)(B).

Payments in Respect of Property

Private payments include payments made with respect to property financed with bond proceeds, even if such payments are not made by the private business user of bond proceeds. However, such payments are not taken into account if they are reasonably allocable to other property being used by the person making the payment.

See Regulations § 1.141-4(c)(2)(i)(A).

Payments for Operating Expenses

Payments for a use of proceeds do not include the portion of any payment properly allocable to the payment of ordinary and necessary expenses directly attributable to the operation and maintenance of the financed property used by the payer.

See Regulations § 1.141-4(c)(2)(i)(C).

Continued on next page

Payments for Overhead

General overhead and administrative expenses are not directly attributable to operations and maintenance, so payment attributable to these expenses are included as payments for use.

See Regulations § 1.141-4(c)(2)(i)(C).

Refinanced Debt Service

If the debt service on a bond issue is paid with proceeds of a refunding issue, the bond issue meets the private security or payment test if (and to the same extent that) the refunding issue meets the private security or payment test.

See Regulations § 1.141-4(c)(2)(ii).

Private Payments for Use – Hypothetical #1

Gamma Authority, a political subdivision of a state, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. Under all of the facts and circumstances, the private business use test will be met with respect to each issue that will be used for the rehabilitation and construction of buildings that will be leased or sold to nongovernmental persons for use in their trades or businesses. Nongovernmental persons will make payments for these sales and leases. There is no limitation either on the number of issues or the aggregate amount of bonds that may be outstanding. No group of bondholders has any legal claim prior to any other bondholders
or creditors with respect to specific revenues of Gamma, and there is no arrangement whereby revenues from a particular project are paid into a trust
or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by Gamma to pay the principal of, and the interest on, each issue.

- Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements. The payments relating to these leases and sales are taken into account as private payments to determine whether each issue of bonds meets the private security or payment test.

See Example 2 of Regulations § 1.141-4(g).

Continued on next page

Private Payments for Use – Hypothetical #2

In order to further public safety, City of Epsilon issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by Epsilon on the customers of the utility.

- Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Epsilon by the utility company for the undergrounding are, however, taken into account as private payments.

See Example 4 of Regulations § 1.141-4(g).

Private Payments for Use – Hypothetical #3

City of Zeta issues general obligation bonds to finance the renovation of a hospital that it owns. The hospital is operated for Zeta by Eta, a nongovernmental person, under a management contract that results in private business use under Regulations § 1.141-3. Zeta will use the revenues from the hospital (after the required payments to Eta and the payment of operation and maintenance expenses) to pay the debt service on the bonds.

- The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

See Regulations § 1.141-4(c)(2)(i)(A) and Example 5 of Regulations § 1.141-4(g).

Allocation of Payments

Generally

Private payments for the use of property are allocated to the source or different sources of funding of property. The allocation to the source or different sources of funding is based on all of the facts and circumstances. In general, a private payment for the use of property is allocated to a source of funding based upon the nexus between the payment and both the financed property and the source of funding. For this purpose, different sources of funding may include different tax-exempt issues, taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

See Regulations § 1.141-4(c)(3)(i).

Discrete Property

Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.

See Regulations § 1.141-4(c)(3)(ii).

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Allocation among Two or More Sources

Generally, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property.

If an issuer has not retained records of amounts expended on the property (for example, records of costs of a building that was built 30 years before the allocation), an issuer may use reasonable estimates of those expenditures. For this purpose, costs of issuance and other similar neutral costs are allocated ratably among expenditures in the same manner as in Regulations § 1.141-3(g)(6).

A payment for the use of property may be allocated to two or more issues that finance property according to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if that allocation reasonably reflects the economic substance of the arrangement. In general, allocations of payments according to relative debt service reasonably reflect the economic substance of the arrangement if the maturity of the bonds reasonably corresponds to the reasonably expected economic life of the property and debt service payments on the bonds are approximately level from year to year.

See Regulations § 1.141-4(c)(3)(iii).

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Payments Made in Connection with Issuance of Bonds

A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue.

Whether an arrangement is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances. An arrangement is ordinarily treated as entered into in connection with the issuance of an issue if the:

(i) issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and

(ii) amount of payments reflects all or a portion of debt service on the issue.

See Regulations § 1.141-4(c)(3)(iv).

Allocation to Equity

A private payment for the use of property may be allocated to equity before payments are allocated to an issue only if:

(i). Not later than 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to Regulations § 1.150-2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and

(ii). The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

Continued on next page

Allocation of Payments – Hypothetical #1

City Z purchases property for $1,250,000 using $1,000,000 of proceeds of its tax increment bonds and $250,000 of other revenues that are in its redevelopment fund. Within 60 days of the date of purchase, Z declared its intent to sell the property pursuant to a redevelopment plan and to use that amount to reimburse its redevelopment fund. The bonds are secured only by the incremental property taxes attributable to the increase in value of the property from the planned redevelopment of the property. Within 18 months after the issue date, Z sells the financed property to Developer M for
$250,000, which Z uses to reimburse the redevelopment fund. The property that M uses is financed both with the proceeds of the bonds and Z's redevelopment fund. The payments by M are properly allocable to the costs of property financed with the amounts in Z's redevelopment fund.

See Example 7 of Regulations § 1.141-4(g).

Allocation of Payments – Hypothetical #2

In 1997, City L issues bonds with proceeds of $8 million to finance the acquisition of a building. In 2002, L spends $2 million of its general revenues to improve the heating system and roof of the building. At that time, L enters into a 10-year lease with Corporation M for the building providing for annual payments of $1 million to L. The lease payments are at fair market value, and the lease payments do not otherwise have a significant nexus to either the
issue or to the expenditure of general revenues. Eighty percent of each lease payment is allocated to the issue and is taken into account under the private payment test because each lease payment is properly allocated to the sources of funding in a manner that reasonably corresponds to the relative amounts of the sources of funding that are expended on the building.

See Example 8 of Regulations § 1.141-4(g).

Private Security Test

General Rule

Property used or to be used for a private business use and payments in respect of the property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds.

See Regulations § 1.141-4(d)(4).

Security Taken into Account

The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with proceeds to the extent it is provided (directly or indirectly) by a user of proceeds of the issue.

See Regulations § 1.141-4(d)(2).

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Private Security Test, Continued

Payments in Respect of Property

The payments taken into account as private security are payments in respect of property used or to be used for a private business use. To determine the amount of payments treated as payments in respect of property used or to be used for a private business use, generally, the same rules as for private payments apply.

Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

See Regulations § 1.141-4(d)(5).

Allocation of Security

In general, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.

See Regulations § 1.141-3(d)(6).

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Private Security Test – Hypothetical #1

County of Theta issues certificates of participation in a lease of a building that Theta owns and covenants to appropriate annual payments for the lease. A portion of each payment is specified as interest. More than 10 percent of the building is used for private business use. None of the proceeds of the obligations are used with respect to the building. Theta uses the proceeds of the obligations to make a grant to Corporation Iota for the construction of a factory that Iota will own. Iota makes no payments to Theta, directly or indirectly, for its use of proceeds, and Iota has no relationship to the users of the leased building. If Theta defaults under the lease, the trustee for the holders of the certificates of participation has a limited right of repossession under which the trustee may not foreclose but may lease the property to a new tenant at fair market value.

- The obligations are secured by an interest in property used for a private business use. However, because the property is not provided by a private business user and is not financed property, the obligations do not meet the private security or payment test.

See Example 9 of Regulations § 1.141-4(g).

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Private Security Test – Hypothetical #2

Iota Park District issues $10 million of bonds and uses proceeds of the issue to purchase a building to be used as a recreation center. As security for the bonds, Iota grants a mortgage on the recreation center financed with bond proceeds to the bond indenture trustee. Iota enters into a management contract with Corporation Kappa, a for-profit corporation, to operate the recreation facility. The management contract results in 100% private business use of the recreation center under Regulations § 1.141-3. The fair market value of the recreation center is $10 million.

- The mortgage on the recreation center is treated as private security since a portion of the security for debt service on the bonds is property used (directly or indirectly) in a private business use by Kappa, a for-profit corporation..

See Regulations § 1.141-4(d)(4).

- The present value of the recreation center is compared to the present value of the debt service to be paid over the term of the issue in order to determine if there is private security. For purposes of determining the present value of debt service that is secured by property, the property is valued at the fair market value as of the first date on which the property secures bonds of the issue.

See Regulations § 1.141-4(b)(2).

- On the date of issuance, the present value of the fair market value of the recreation center is $10 million. If the present value of debt service on the bonds is $10 million, there is 100% private business use and 100% private security. The bonds are taxable private activity bonds

Generally Applicable Taxes

General Rule

For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use).

See Regulations § 1.141-4(e)(1).

Definition

With respect to bonds sold on or after October 24, 2008, unless the transition rule described below applies, a generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes or public purposes.

A transition rule applies to certain refunding bonds and projects substantially in progress as of October 19, 2006. Under the transition rule, a generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes.

See Regulations §§ 1.141-4(e)(2) and 1.141-15(k).

Uniform Tax Rate

A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.

See Regulations § 1.141-4(e)(2).

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Special Charges

A special charge is not a generally applicable tax.

With respect to bonds sold on or after October 24, 2008, unless the transition rule described below applies, a special charge includes a payment for a special privilege granted or regulatory function (for example, a license fee), a service rendered (for example, a sanitation services fee), a use of property (for example, rent), or a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons based on benefits received from the capital improvements financed with the assessment.

A transition rule applies to certain refunding bonds and projects substantially in progress as of October 19, 2006. Under the transition rule a special charge is a payment for a special privilege granted or service rendered. Special assessments paid by property owners benefitting from financial improvements are not generally applicable taxes.

See Regulations §§ 1.141-4(e)(3) and 1.141-15(k).

Impermissible Agreements

The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection an agreement:

- to be personally liable on a tax that does not generally impose personal liability
- to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls
- regarding the minimum market value of property subject to property tax; AND
- not to challenge or seek deferral of the tax

See Regulations § 1.141-4(e)(4)(ii).

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Permissible Agreements

The following are examples of agreements that do not cause a tax to fail to have a generally applicable manner of determination and collection:

- an agreement to use a grant for specified purposes (whether or not that agreement is secured)
- a representation regarding the expected value of the property following the improvement
- an agreement to insure the property and, if damaged, to restore the property
- a right of a grantor to rescind the grant if property taxes are not paid; AND
- an agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose

See Regulations § 1.141-4(e)(4)(iii).

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Payments in Lieu of Taxes

With respect to bonds sold on or after October 24, 2008, unless the transition rule described below applies, a tax equivalency payment and any other payment in lieu of a tax ("PILOT") is treated as a generally applicable tax if all of the following requirements are met, the PILOT is:

- not greater than the amount imposed by statute for a generally applicable tax that would otherwise apply in each year.
- commensurate with the amount imposed by a statute for a generally applicable tax in each year. A PILOT generally is commensurate with a generally applicable tax only if it is equal to a fixed percentage of the generally applicable tax that would otherwise apply in each year or it reflects a fixed adjustment to the generally applicable tax that would otherwise apply in each year. A PILOT based on a property tax does not fail to be commensurate with the property tax as a result of changes in the level of the percentage of or adjustment to that property tax for a reasonable phase-in period ending when the subject property is placed in service (as defined in Regulations §1.150-2(c)). A PILOT based on a property tax must take into account the current assessed value of the property for property tax purposes for each year in which the PILOT is paid and that assessed value must be determined in the same manner and with the same frequency as property subject to the property tax. A PILOT is not commensurate with a generally applicable tax, however, if the PILOT is set at a fixed dollar amount (for example, fixed debt service on a bond issue) that cannot vary with changes in the level of the generally applicable tax on which it is based.
- to be used for governmental or public purposes for which the generally applicable tax on which it is based may be used.
- not a special charge.

A transition rule applies to certain refunding bonds and projects substantially in progress as of October 19, 2006. Under the transition rule, a PILOT is treated as a generally applicable tax if the payment is:

- commensurate with and not greater than the amounts imposed by a statute for a tax of general application, AND
- designed for a public purpose and is not a special charge under the transition rule described in the section "Special Charges" above.

See Regulations §§ 1.141-4(e)(5) and 1.141-15(k).

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Generally Applicable Taxes - Hypotheticals

Authority Lambda issues bonds to finance the construction of a stadium. Under a long-term lease, Corporation Mu, a professional sports team, will use more than 10 percent of the stadium. Mu will not, however, make any payments for this private business use. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium. The portion of the ticket tax attributable to tickets purchased by persons attending Mu's events will, on a present value basis, exceed 10 percent of the present value of the debt service on Lambda's bonds.

- The bonds meet the private security or payment test. The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to Mu's events, the taxes are payments in respect of property used for a private business use.

See Example 11(i) of Regulations § 1.141-4(g).

Assume that the ticket tax is imposed by Lambda on tickets purchased for events at a number of large entertainment facilities within Lambda's jurisdiction (for example, other stadiums, arenas, and concert halls), some of which were not financed with tax-exempt bonds.

- The ticket tax is a generally applicable tax and therefore the revenues from this tax are not payments in respect of property used for a private business use. The receipt of the ticket tax does not cause the bonds to meet the private security or payment test.

See Example 11 (ii) of Regulations § 1.141-4(g).

Waste Remediation Bonds

Purpose

Section 1.141-4(f) applies to bonds issued to finance hazardous waste clean-up activities on privately owned land.

General Rule

Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated (cleaned up) or persons potentially responsible for disposing of hazardous waste on that site are not taken into account as private security. This provision applies only if the payments are made pursuant to either a:

- generally applicable state or local taxing statute; or
- state or local statute that regulates or restrains activities on an industry-wide basis of persons who are engaged in generating or handling hazardous waste or in refining, producing, or transporting petroleum,

provided that those payments do not represent, in substance, payment for the use of proceeds.

See Regulations § 1.141-4(f)(2).

Persons that are Private Users

The payments are not taken into account as private payments if payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds.

See Regulations § 1.141-4(f)(3) for additional requirements.

Section III

Private Loan Financing Test

General Rule

Bonds of an issue are private activity bonds if more than the lesser of five percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans (with certain exceptions) to persons other than governmental persons.

See § 141(c) and Regulations § 1.141-5(a).

Measurement Test

The amount actually loaned to a nongovernmental person is NOT discounted to reflect the present value of the loan repayments when determining whether the private loan financing test is met.

See Regulations § 1.141-5(b).

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Definition of Private Loan

Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this section.

In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed.

The determination of whether a loan is made depends on the substance of a transaction rather than its form.

See Regulations § 1.141-5(c)(1).

Nonpurpose Loans

A loan that is a nonpurpose investment does not cause the private loan- financing test to be met.

For example, proceeds invested in loans, such as obligations of the United States:

- during a temporary period,
- as part of a reasonably required reserve or replacement fund,
- as part of a refunding escrow, or
- as part of a minor portion

(as each of those terms are defined in Regulations § 1.148-1 or § 1.148-2) are generally not treated as loans under the private loan financing test.

See § 141(c) and Regulations § 1.141-5(c)(2)(i).

Prepayment Loans

A prepayment for property or services is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller.

See § 141(c)(2)(C) and Regulations § 1.141-5(c)(2)(ii) for limited exceptions.

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Tax Assessment Loans

A **tax assessment loan** is not a loan for purposes of the private loan financing test if certain requirements are met. A "tax assessment loan" arises when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies the following requirements:

- The tax or assessment must be an enforced contribution that is imposed and collected for the purpose of raising revenue to be used for a specific purpose (that is, to defray the capital cost of an improvement). The tax or assessment must be imposed pursuant to a state law of general application.
- The tax or assessment that must be imposed for one or more specific, essential governmental functions. See Regulations § 1.141-5(d)(4)(ii) for examples of essential governmental functions.
- Owners of both business and nonbusiness property benefiting from the financed improvements must be eligible, or required, to make deferred payments of the tax or assessment giving rise to tax assessment loan on an equal basis (the equal basis requirement).

See § 141(c)(2)(A) and Regulations § 1.141-5(d).

Turnkey Contracts

Turnkey contracts where the proceeds of a bond issue are loaned to a developer to be used to construct or rehabilitate a facility and the facility is conveyed to the municipality upon completion do not cause the private loan financing test to be met.

See Regulations § 1.141-5(e) Example 1

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Private Loan Financing Test – Hypothetical #1

City of Nu creates a special taxing district consisting of property owned by nongovernmental persons that requires environmental clean-up. Nu imposes a special tax on each parcel within the district in an amount that is related to the expected environmental clean-up costs of that parcel. The payment of the tax over a 20-year period is treated as a loan by the property owners for purposes of the private loan financing test. The special district issues bonds, acting on behalf of Nu, that are payable from the special tax levied within the district, and uses the proceeds to pay for the costs of environmental clean-up on the property within the district.

- The bonds meet the private loan financing test because more than 5 percent of the proceeds of the issue are loaned to nongovernmental persons. The issue does not meet the tax assessment loan exception because the improvements to property owned by a nongovernmental person are not an essential governmental function under § 141(c)(2).

See Example 2 of Regulations § 1.141-5(e).

In TAM 9250005, the Service held that City's tax increment bond, issued as a financial incentive for manufacturer to make improvements to its industrial facility, was a private activity bond. The tax was not a generally applicable tax because of impermissible agreements. Since the proceeds were not used for an essential governmental function, the bond also met the private loan financing test of § 141(c).

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Private Loan Financing Test – Hypothetical #2

State Agency Xi and federal agency Omicron will each contribute to rehabilitate a project owned by Xi. Omicron can only provide its funds through a contribution to Xi to be used to acquire the rehabilitated project on a turnkey basis from an approved developer. Under Omicron's turnkey program, the developer must own the project while it is rehabilitated. Xi issues its notes to provide funds for construction. A portion of the notes will be retired using the Omicron contribution, and the balance of the notes will be retired through the issuance by Xi of long-term bonds. Xi lends the proceeds of its notes to Developer B as construction financing and transfers title to B for a nominal amount. The conveyance is made on condition that B rehabilitate the property and reconvey it upon completion, with Xi retaining the right to force reconveyance if these conditions are not satisfied. B must name Xi as an additional insured on all insurance. Upon completion, B must transfer title to the project back to Xi at a set price, which price reflects B's costs and profit, not fair market value. Further, this price is adjusted downward to reflect any cost-underruns.

For purposes of § 141(c), this transaction does not involve a private loan. See Example 1 of Regulations § 1.141-5(e).

Section IV

Unrelated or Disproportionate Use Test

Overview

Contents

This section contains the following topics:

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Deliberate Actions	73

In General

General Rule

Under § 141(b)(3) (the unrelated or disproportionate use test), an issue meets the private business tests if the amount of private business use and private security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue. The test is applied as follows:

- First, determine whether a private business use is related to a government use
- Next, examine private business use that relates to the government use to determine whether it is disproportionate to that government use
- Then, aggregate all the unrelated use and disproportionate use financed with the proceeds of an issue to determine compliance with the unrelated or disproportionate use test
- If such uses exceed 5 percent, apply the private security or payment test to the payments and security related to such uses.

Unrelated Use

Whether a private business use is related to a government use financed with the proceeds of an issue is determined on a case-by-case basis, emphasizing the operational relationship between the government use and the private business use. In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.

See Regulations § 1.141-9(b)(1).

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Use for Same Purpose as Government Use

Use of a facility by a nongovernmental person for the same purpose as use by a governmental person is not treated as unrelated use if the government use is not insignificant. Similarly, a use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use does not result in unrelated use if the related use is not insignificant.

See Regulations § 1.141-9(b)(2).

Disproportion-ate Use

A private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use.

Unrelated or Disproportionate Use – Hypothetical #1

County of Pi issues $20 million principal amount of bonds and uses $18.1 million of the proceeds for construction of a new school building and $1.9 million of the proceeds for construction of a privately operated cafeteria in its administrative office building, which is located at a remote site. The cafeteria secures the bonds, in part.

- The $1.9 million of proceeds is unrelated to the government use (that is, school construction) financed with the bonds and exceeds five percent of $20 million. Thus, the issue meets the private business tests.

See Example 1 of Regulations § 1.141-9(e).

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Unrelated or Disproportionate Use – Hypothetical #2

County of Rho issues $20 million principal amount of bonds for the construction of a hospital with no private business use ($17 million); renovation of an office building with no private business use ($1 million); and construction of a garage that is entirely used for private business use ($2 million). The use of the garage is related to the use of the office building but not to the use of the hospital.

- The private business use of the garage results in $1 million of disproportionate use because the proceeds used for the garage ($2 million) exceed the proceeds used for the related government use ($1 million). The bonds are not private activity bonds, however, because the disproportionate use does not exceed five percent of the proceeds of the issue.

See Example 4 of Regulations § 1.141-9(e).

Deliberate Actions

Introduction

An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests (business use AND security or payment) or the private loan financing test to be met.

See Regulations § 1.141-2(d)(1).

Definition

Generally, a deliberate action is any action taken by the issuer that is within its control. An intent to violate the requirements of § 141 is not necessary for an action to be deliberate.

See Regulations 1.141-2(d)(3)(i).

Safe Harbor Exceptions

An action is not treated as deliberate if it:

- would be treated as an involuntary or compulsory conversion under§ 1033, OR
- is taken in response to a regulatory directive made by the federal government.

See Regulations § 1.141-2(d)(3)(ii).

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Timing

A deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

Remedial Actions

Regulations. § 1.141-12 provides certain remedial actions that an issuer can take to prevent a deliberate action with respect to property financed by an issue from causing that issue to meet the private business use test or the private loan financing test.

See Regulations § 1.141-2(f); see also Lesson 7 for a complete discussion of these rules.

Deliberate Actions – Hypotheticals

County owns and operates a hospital that was financed with proceeds of bonds the interest on which is excludable from gross income under § 103. On June 1, 2000, County enters into a purchase contract with Corporation, an organization described under § 501(c)(3) of the Code, to sell the hospital to Corporation. The purchase contract has no material contingencies. The settlement for the sale will not occur until October 1, 2000.

- The deliberate action occurred on June 1, 2000.

Assume that the purchase contract provides that the State's department of health must approve the transaction and Corporation must obtain a Certificate of Need. The purchase contract has material contingencies and thus the deliberate action does not occur when the contract is executed.

- Deliberate action will occur when all material contingencies have been removed or satisfied.

See Regulations § 1.141-2(e).

Section V

Effective Dates

In General	The effective dates of Regulations §§ 1.141-0 through 1.141-6(a), §§ 1.141-7 through 1.141-14 are more fully described in Regulations § 1.141-15.
Certain Short-Term Arrangements	See Regulations § 1.141-15(b)(2).
Certain Prepayments	See Regulations § 1.141-15(b)(3).
Refunding Bonds	See Regulations §§ 1.141-15(c), (g), and (j).
Retroactive Application of 1997 Regulations	See Regulations § 1.141-15(d), (e), (h), and (i).
Output Facilities	See Regulations § 1.141-15(f)-(i).
Generally Applicable Taxes and PILOTS	See Regulations § 1.141-15(k)(1) (in general). See Regulations § 1.141-15(k)(2)-(3) (transitional rules).
1986 Act	See sections 1311 and 1312 of the Tax Reform Act of 1986 for effective dates and transition rules for the 1986 Act.

Summary

Review of Lesson 4

A governmental bond is an obligation of a State or local government that is issued to finance governmental purposes, meets the eligibility requirements for interest on the obligation to be excludable from the gross income of the owner of the obligation, and is not a private activity bond.

In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property, pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract.

Except as otherwise provided in Regulations § 1.141-4, an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement directly or indirectly):

(i) secured by an interest in:

- property used or to be used for a private business use, or
- payments in respect of such property, OR

(ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Property used or to be used for a private business use and payments in respect of the property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds.

Continued on next page

Summary, Continued

Review of Lesson 4 (continued)

The payments taken into account as private security are payments in respect of property used or to be used for a private business use. To determine the amount of payments treated as payments in respect of property used or to be used for a private business use, generally, the same rules as for private payments apply.

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Lesson 5

Arbitrage and Rebate

Overview

Purpose

In the municipal bond context, arbitrage generally refers to the profit from borrowing funds in the tax-exempt market (through a bond issue) and investing them in the taxable market. Interest on a bond is not excludable from income for federal income tax purposes if the bond is an "arbitrage bond."

This lesson provides an introduction to the various concepts, statutory provisions, and regulations that restrict the earning of arbitrage on investments of proceeds of bonds.

Objectives

At the end of this lesson you will be able to:

- Define an "arbitrage bond"
- Determine if a bond is an arbitrage bond
- Locate the applicable statutory provisions and regulations for making the determination of whether a bond is an arbitrage bond

Continued on next page

Objectives
(continued)

- Describe the role of "reasonable expectations" and "intentional acts" in the context of arbitrage determinations
- For a fixed yield issue, describe the basic process for determining yield, and perform a yield calculation by determining issue price and calculating yield based on a set of payments
- Generally describe bond proceeds and the different types of funds in which bond proceeds are typically held
- Determine which funds are subject to arbitrage limitations
- Identify different classes of investments
- Perform an investment yield calculation by applying concepts to determine purchase prices of investments and calculating yield based on a set of payments and receipts for investments
- Locate the regulatory definition of "materially higher" applicable to different classes of investments
- Describe the effect of temporary periods on arbitrage determinations and identify applicable temporary periods
- Compare and contrast yield restriction requirements and arbitrage rebate requirements
- Summarize special rules applicable to arbitrage determinations for variable yield issues

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Section 1

Introduction

Overview

Purpose

This section presents general concepts relating to arbitrage (including the definition of an arbitrage bond) and provides the statutory and regulatory background related to arbitrage bonds.

Contents

This section contains the following topics:

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Summary & Background

Context: § 103

Interest on arbitrage bonds is not tax exempt. Section 103(a) provides that, except as provide in § 103(b), gross income does not include interest on any State or local bond. Section 103(b)(2) provides that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148).

Simple Concept

In the bond context, arbitrage generally refers to the profit from borrowing funds in the tax-exempt market (through a bond issue) and investing them in the taxable market. Generally, evaluating whether a bond is an arbitrage bond means determining whether the proceeds of the bonds have been invested to produce a return that exceeds the costs of the bonds. In its simplest application, this process involves determining a yield on the bonds and a yield on the investments and then comparing the two.

Complex Application

Although the concept can be described as a simple comparison between yields, in practice the evaluation of whether a bond is an arbitrage bond is complex. The complications arise from:

- Computational challenges of calculating yields in accordance with the Code and the Regulations
- Exceptions in the Code and the Regulations that in certain limited circumstances permit arbitrage to be earned and, in even more limited circumstances, to be retained

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Can you earn it?— Yield Restriction

Generally, bond proceeds cannot be invested at a yield that is materially higher than the bond yield. This concept is known as yield restriction. There are several exceptions that permit unrestricted investments during a certain temporary period.

Can you keep it?— Arbitrage Rebate

In many circumstances where arbitrage is permitted to be earned under an exception to the yield restriction rules, arbitrage rebate rules require the issuer to pay the arbitrage earnings to the Federal government in order to avoid having the bonds become arbitrage bonds.

Section 148 Arbitrage Bond Defined

Section 148(a) provides that for purposes of § 103, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of the issuance of the bond), to be used directly or indirectly to:

- acquire higher yielding investments; or
- replace funds which were used directly or indirectly to acquire higher yielding investments.

For purposes of this definition, a bond is treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue, of which such bond is a part, in such a manner.

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Applicable Law

Since the Tax Reform Act of 1986, the arbitrage and rebate rules have been set forth in § 148. Regulations promulgated under § 148, provide substantial guidance on the application of the arbitrage rules. Generally, this lesson presents arbitrage rules and concepts under current law, although in some instances important distinctions between current law and prior law or proposed law are noted. In making arbitrage determinations, it is essential to identify the applicable set of laws.

Prior to the Tax Reform Act, § 103(c) of the 1954 Code contained the arbitrage rules.

The rules relating to arbitrage have evolved over several decades. In their original form (1969), the rules prohibited arbitrage earnings (i.e., yield restriction) except in certain circumstances (exceptions to yield restriction). These rules have evolved over time to include a requirement that even in some circumstances where an exception to yield restriction applies, the arbitrage earnings must be paid by the issuer to the Federal government (rebate).

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Regulatory History

There have been numerous regulations issued regarding arbitrage and rebate rules. The following is a chronology of some of the regulations:

- 1979: Regulations §§ 1.103-13, 1.103-14 and 1.103-15 were issued. These regulations only address yield restriction issues.
- 1989: The first set of regulations under the 1986 Code was issued. These regulations generally address the rebate provisions of § 148.
- February 12, 1992: Regulations addressing certain provisions under § 148 were published. Two important provisions in these regulations dealt with construction issues and transferred proceeds.
- May 18, 1992: The Service republished regulations which combined the existing 1992 regulations and the 1989 regulations, as amended. These were issued as final and temporary regulations.
- November 4, 1992: The Service issued proposed regulations which included many of the provisions of the 1979 regulations, the final and temporary 1992 regulations, and the reimbursement regulations.
- June 30, 1993: Final regulations under § 148 were issued. These regulations are generally effective for bonds issued after June 30, 1993.
- May 9, 1997: The Service amended portions of the final regulations.
- November 13, 2014: In accordance with Regulation §1.148-3(i)(3)(i) an issuer must request a refund of an overpayment of rebate no later than the date that is two years after the final computation date for the issue to which the overpayment relates.

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Proposed Regulations

In 2007, proposed regulations making a number of discrete changes to the existing regulations were published (REG-106143-07, September 26, 2007). Certain more substantive changes, which are discussed in further detail in the preamble to the proposed regulations and which are fully set forth in the proposed regulations, include:

- Hedges based on taxable interest rates. The proposed regulations make revisions to accommodate certain hedges in which floating payments under the hedge are based on a taxable interest rate and to clarify that bonds covered by such a hedge are ineligible for treatment as fixed yield bonds under the special hedging rule in §1.148-4(h)(4).
- Joint bond yield authority. The proposed regulations remove the provision in the Existing Regulations that permits the IRS Commissioner to authorize a single yield computation on multiple bond issues.
- Electronic GIC bidding. The proposed regulations revise the bidding safe harbor for establishing the fair market value of guaranteed investment contracts (GICs) to accommodate electronic bidding.
- Refunds of overpayments of rebate. The proposed regulations clarify that the amount that an issuer is entitled to receive under a rebate refund claim is the excess of the total amount actually paid over the rebate amount.

Continued on next page

Summary & Background, Continued

Proposed Regulations (continued)

In 2013, proposed regulations making additional discrete changes to the existing regulations were published (REG-148659-07, September 16, 2007). Significant changes, which are discussed in further detail in the preamble to the proposed regulations and which are fully set forth in the proposed regulations, include:

- Working capital expenditures. The proposed regulations modify the safe harbors against creation of other replacement proceeds by shortening the safe harbor for short term working capital financings and adding a new one for longer term working capital financings. They also remove an existing restriction on financing a working capital reserve.

- Modification of qualified hedge. The proposed regulations simplify the rules for determining when a modification to a qualified hedge results in a deemed termination of that hedge.

In 2015, proposed regulations redefining issue price were published (REG-138526-14, June 24, 2015). As defined in the existing regulations, issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. The existing regulations define substantial amount as ten percent and apply a reasonable expectations standard (rather than a standard based on actual sales) for this purpose. The proposed regulations apply an actual sales standard and, as an alternative to the actual sales standard, permit an issuer to treat the initial offering price to the public as the issue price, provided certain requirements are met.

Advanced Concepts; Proceeds and Allocations

This lesson does not address advanced concepts related to arbitrage and rebate, including certain payments that adjust bond yield and the effective dates of the regulations discussed above. These concepts are addressed in TEB Basic Training Phase II Advanced Topics in Arbitrage. Additionally, material relating to treatment of bond proceeds and allocation of proceeds to expenditures is presented in another lesson in TEB Basic Training Phase I, and in some instances summarized in this lesson.

Section 2

General Arbitrage Concepts

Overview

Purpose

The purpose of this section is to outline the general concepts that are applied in the process of determining whether a bond is an arbitrage bond. Some of the outlined concepts are presented in greater detail in other sections of this lesson or in other lessons of TEB Basic Training.

Contents

This section contains the following topics:

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Acquiring Higher Yielding Investments	22
Reasonable Expectations and Intentional Acts	23
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Components of Arbitrage Determination

Section 148(a) provides the definition of the term "arbitrage bond." Under that definition, an arbitrage bond is any bond issued as part of issue any portion of the proceeds of which are reasonably expected (at the time of the issuance of the bond), to be used directly or indirectly to:

- acquire higher yielding investments; or
- replace funds which were used directly or indirectly to acquire higher yielding investments

For purposes of this definition, a bond is treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in such a manner.

Thus, the distinct components of making an arbitrage determination with respect to a bond are:

- Identify the issue of which the bond is a part
- Identify the proceeds of that issue
- Determine whether the issuer reasonably expected (at issuance) to use or subsequently intentionally used any portion of such proceeds to acquire higher yielding investments

The Bond Issue

General

Under § 148(a) the term "arbitrage bond" includes *any bond issued as part of issue* with impermissible arbitrage. Thus, arbitrage analysis is conducted at the issue level (rather than the bond level) and affects all bonds that are part of the issue.

Definition of Issue—Regulations § 1.150-1(c)

Regulations § 1.150-1(c) defines issue. Generally, the term issue means two or more bonds that are:

- Sold at substantially the same time (less than 15 days apart)
- Sold pursuant to the same plan of financing
- Payable from the same source of funds

Certain exceptions and special rules described in Regulations. § 1.150-1(c) may apply to particular bonds and issues.

Difference between Bonds and Issue

Each bond is a part of an issue. An issue typically contains many bonds. In evaluating compliance with various provisions of the Code relating to municipal bonds, it is important to understand whether the requirement applies on a bond-by-bond basis or to the entire issue of which a bond is a part.

Proceeds

General

Identifying impermissible arbitrage under § 148(a) with respect to a bond requires analysis of how the "*proceeds*" of the issue of which the bond is a part were invested. Therefore, to determine whether the bond issue complies with § 148, it is important to determine what is included under "proceeds" of the bond issue.

Proceeds are discussed in detail in lesson 6 of Phase I of TEB Basic Training and the description below is intended as background to facilitate learning of arbitrage concepts.

Definition

Proceeds are defined in various sections of the regulations as shown below:

Under current Regulations…	Proceeds include
§ 1.148-1(b)	any sale proceeds, investment proceeds, and transferred proceeds of an issue proceeds do not include amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under §1.148-2(d) or section 143(g) or to qualified administrative costs under §1.148-5(e).
Under prior Regulations	**Proceeds include**
§ 1.103-13(b)(2)	original proceeds and investment proceeds
§ 1.103-13(g)	amounts in a sinking fund

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Definition of Sale Proceeds

Under Regulations § 1.148-1(b), sale proceeds means any amounts actually or constructively received from the sale of an issue. This includes amounts paid as underwriter's discount or other compensation, and any accrued interest (other than pre-issuance accrued interest).

Sale proceeds also include any amounts received as a result of a sale of a right associated with the bond. The transfer of rights associated with the bond is discussed in Regulations § 1.148-4(b)(4) and are more fully described in TEB Basic Training Phase II Advanced Topics in Arbitrage lesson.

Definition of Investment Proceeds

Regulations § 1.148-1(b) defines investment proceeds as any amounts actually or constructively received from investing proceeds of an issue.

Definition of Transferred Proceeds – 1993 Regulations

Transferred proceeds are defined in § 1.148-9(b). When proceeds of a refunding issue are used to make principal payments on a prior issue, any unspent proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The unspent proceeds "transfer over" to the refunding issue based on a formula provided in Regulations § 1.148-9(b)(1).

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Applicable Regulations

Due to the various arbitrage regulations issued by the Service under § 148, an agent must determine the regulation applicable to the issue under audit so as to determine the amount and the date on which the transferred proceeds are "transferred" to the refunding issue.

See TEB Basic Training Phase III Refundings lesson for a further discussion of transferred proceeds and refundings.

Definition of Gross Proceeds

Although § 148(a) only refers to proceeds of the bond, Regulations § 1.148-2(a) provides that the direct or indirect investment of the "gross proceeds" of an issue in higher yielding investments causes the bonds of an issue to be arbitrage bonds.

Gross proceeds are defined in § 1.148-1(b) to include any proceeds and replacement proceeds of an issue.

Therefore, in determining whether the bonds are arbitrage bonds, the examining agent must determine whether, in addition to the proceeds, the bond issue has any replacement proceeds.

Continued on next page

Definition of Replacement Proceeds

Regulations § 1.148-1(c) defines replacement proceeds:

Amounts will be replacement proceeds only if there is a sufficiently direct nexus to the:

- bond issue; OR
- governmental purpose of the issue

To conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose.

The mere availability or preliminary earmarking of funds for a governmental purpose, however, does not establish a nexus to cause the amounts to be replacement proceeds.

If an issuer sets aside moneys to be used to pay debt service on the bonds on a particular date, such amounts are considered replacement proceeds of the bonds.

Replacement proceeds include, but are not limited to, sinking funds and pledged funds and other replacement proceeds described in §1.148-1(c)(4) to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue.

Sinking Fund

Regulations § 1.148-2(c)(2) provides that 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 debt service on the bonds.

Example 1

City X has certain bonds outstanding. City X sells some real property and the city council decides to set aside the proceeds of the sale of the real property to pay the debt service on the bonds. The proceeds of the sale of the real property are considered replacement proceeds and investments of such moneys must comply with § 148. (See also Rev. Rul. 79-134, 1979-1 C.B. 76; Rev. Rul. 80-13, 1980-1 C.B. 27.)

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Pledged Funds

A pledged fund is any amount that is directly or indirectly pledged to pay the principal of or interest on the bonds. A pledge by the issuer must provide reasonable assurance that such moneys will be available to pay the debt service on the bonds even if the issuer has financial difficulties. A party other than the issuer or conduit borrower may provide a pledge to secure the debt service on the bonds. A pledge to a guarantor of bonds is an indirect pledge to secure payment of principal or interest on the issue. (See Regulations § 1.148-1(c)(3)(i).)

Example 2

County X, a political subdivision of State Y will sell $50 million principal amount of bonds to finance the construction of a facility. State Y has surplus funds in the amount of $50 million which it will invest in treasury notes and pledge not to dispose of the notes while the bonds are outstanding. However, State Y does not reasonably expect to use the notes to pay debt service on the bonds. Because the notes are pledged as security for the bonds, the notes form a replacement fund for the bonds. (See Rev. Rul. 78-348, 1978-2 C.B. 95.)

Example 3

State A issued $1 million principal amount of bonds and lent the proceeds to Corporation B. Corporation B owns a federally insured mortgage note to be pledged as collateral for the bonds. The note has a materially higher yield than the yield on the bonds. There is reasonable assurance that the collateral will be available to pay debt service on the bonds. Accordingly, pledge of the mortgage note creates replacement proceeds. (See Rev. Rul. 78-348, 1978-2 C.B. 95.)

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Example 4

City Z issues $10 million principal amount of bonds and loans the proceeds to Corporation X to construct a facility. Corporation X enters into an agreement with Bank A, which will provide a letter of credit as security for the bonds. Corporation transferred $3 million to Bank A which Bank A sets aside in a separate account, which can only be used to pay any draws on the letter of credit. The $3 million in the special account is a pledged fund. (See also PLR 8844042.)

Negative Pledge

Under Regulations § 1.148-1(c)(3)(ii), a negative pledge is holding certain amounts pursuant to an agreement that such amounts will be maintained at a certain level for the benefit of the bondholders or a guarantor of the bonds. (See also PLR 8841027.) An amount is not treated as pledged however if the-

- Issuer or a substantial beneficiary may grant rights in the funds to a party that are superior to the rights of the bondholders or guarantor; OR
- Amounts do not exceed the reasonable needs for which they are maintained, the required level is tested no more frequently than every 6 months, AND the amounts may be spent without any substantial restrictions, other than the requirement to replenish the amounts by the next testing date.

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Other Replacement Proceeds

Replacement proceeds may arise if on the issue date, the issuer reasonably expects that:

- the bonds will be outstanding longer than reasonably necessary for the governmental purpose of the issue; AND
- there will be "available amounts" during the time that the bonds are outstanding longer than necessary

Available amounts are defined in § 1.148-6(d)(3)(iii).

A determination whether the issue will be outstanding longer than necessary is made under Regulations § 1.148-10.

The replacement proceeds are created at the beginning of each fiscal year in an amount equal to the available amounts.

Safe Harbor

Regulations § 1.148-1(c)(4)(B) includes safe harbor against creation of other replacement proceeds for the portions (if any) of an issue:

- used to finance restricted working capital;
- used to finance or refinance capital projects; OR
- that is a refunding issue

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Disposition Proceeds

Although this term is not used under § 148 or the regulations thereunder, the private activity bond rules dictate that disposition proceeds must also be analyzed under the arbitrage and rebate rules.

- Disposition proceeds are any amounts (including property such as an agreement to provide services) derived from the sale, exchange or other disposition of property (other than investments) financed with the proceeds of the issue.
- Regulations § 1.141-12(a)(4) provides that disposition proceeds must be treated as gross proceeds for purposes of § 148.

An agent examining a transaction where disposition proceeds may have resulted should analyze the transaction not only under §§ 141 and the regulations thereunder, but also under § 148 and regulations thereunder.

Subsequent Intentional Acts

Section 148(a) also provides that a bond will be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue to acquire higher yielding investments, or to replace funds which are used directly or indirectly to acquire higher yielding investments.

Accordingly, an issuer's reasonable expectations may not be sufficient to preserve the tax-exempt status of the bonds, if the issuer intentionally acts contrary to its expectations.

Acquiring Higher Yielding Investments

General

The computations applied to determine if a bond is an "arbitrage bond" under § 148(a) involves measuring whether any proceeds of the related bond issue were used to *acquire higher yielding investments* (or to replace funds which were used directly or indirectly to acquire higher yielding investments).

In other words, the process evaluates whether bond proceeds were invested at a yield in excess of the yield on the bonds.

A Simple Comparison

In theory, whether bond proceeds were used to acquire higher yielding investments is a simple matter of comparing the yield on the bonds to the yield on the investments that were acquired with the proceeds.

Complicated Determination

In practice, a few factors complicate the determination of whether bond proceeds were used to acquire higher yielding investments in a manner that does not comply with § 148(a):

- Various exceptions that permit the acquisition of higher yielding investments in certain circumstances
- The computations require access to and processing of substantial amounts of investment and payment data
- Evaluation of the reasonableness of the issuer's expectations at the time of issuance

Reasonable Expectations and Intentional Acts

General

Under § 148(a), arbitrage determinations are made based on the reasonable expectations of the issuer at the time of issuance of the bond. Unintentional post-issuance events that result in arbitrage earnings do not cause a bond to be an arbitrage bond (however, failure to pay rebate of arbitrage earnings caused by such events in accordance with arbitrage rebate rules may result in arbitrage bonds). Additionally intentional post-issuance actions that result in arbitrage earnings may result in arbitrage bonds.

Example: Qualification for temporary period exceptions to yield restriction (during which issuers can use bond proceeds to acquire higher yielding investments) based on expected timing of construction expenditures are based on reasonable expectations, and not on the actual timing of the expenditures.

Exception: Qualification for exceptions to arbitrage rebate requirements are generally based on the timing of the actual expenditure and not on the issuer's reasonable expectation at the time of issuance.

1993 Regulations—Certification Required

The 1993 regulations provide that an officer of the issuer responsible for issuing the bonds must in good faith certify the issuer's expectations as of the issue date. These certifications are generally included in the "tax certificate" or "arbitrage certificate" included in the bond transcript.

Under the regulations, the required certification is evidence of the issuer's expectations but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.

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Reasonable Expectations and Intentional Acts, Continued

What are "Reasonable Expectations?"

Regulations § 1.148-1(b) provides that an issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances.

Subsequent Intentional Acts

Section 148(a) also provides that a bond will be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue to acquire higher yielding investments, or to replace funds which are used directly or indirectly to acquire higher yielding investments.

Accordingly, an issuer's reasonable expectations may not be sufficient to preserve the tax-exempt status of the bonds, if the issuer intentionally acts contrary to its expectations.

Temporary Periods

General

Section 148(a) provides that use of bond proceeds to acquire higher yielding investments results in the bonds being arbitrage bonds. However, such investment of proceeds during a temporary period does not cause the bonds to be arbitrage bonds.

The length of the temporary period depends upon the purpose for which the bonds are issued or the type of proceeds. Temporary periods apply to both the proceeds and replacement proceeds of an issue. Temporary periods are discussed in section 6.

Yield Reduction Payments

General

In certain circumstances, an issuer may be able to invest bond proceeds in higher yielding investments in the absence of an applicable temporary period exception and avoid having the bonds be arbitrage bonds by making a yield reduction payment. Yield reduction payments are discussed in section 9.

Minor Portion

General

Bonds will not be treated as arbitrage bonds if an amount which is the lesser of:

- $100,000 or
- 5 percent of the proceeds of the issue

is invested at a yield which is materially higher than the yield on the bonds.

(See § 148(e) and Regulations § 1.148-2(g).)

Section 3

Bond Yield

Overview

Purpose

The purpose of this section is to enable the student to define economic return, issue price, and fixed and variable yield.

Contents

This section contains the following topics:

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Variable Yield Issues	37

Introduction & Basic Concepts

General

As discussed in the prior section, determining whether impermissible arbitrage has been earned on bond proceeds requires comparison of the yield on the bonds and the yield on the investments purchased with bond proceeds to determine if the proceeds have been used to acquire higher yielding investments.

Bond yield is a key component of this comparison and, thus, calculating bond yield is a core concept of this lesson.

For purposes of determining bond yield, there are two types of bond issues: fixed yield issues and variable yield issues. Under Regulations § 1.148-1(b), (i) fixed yield issue means any issue if each bond that is a part of the issue is a fixed yield bond and (ii) variable yield issue means any issue that is not a fixed yield issue.

Bond yield principles are similar for each type of issue, but calculation mechanics for variable yield issues reflect the need (not applicable to fixed yield issues) to measure variable yield at specific time intervals in order to meet yield restriction and rebate requirements.

Note: Generally, this lesson focuses on basic yield calculations. Certain advanced concepts are presented in Phase II of TEB Basic Training.

Yield—Concept

In the financial context, yield on an investment is the economic return to the investor.

Yield on an investment differs from the interest rate of the investment, although there is a relationship between interest rates and yield. In general, interest rates are used to calculate the amount of interest that is payable to an investor for an investment with a stated principal amount. On the other hand, calculation of yield requires measuring the amount that the investor paid for the investment and the timing and amount of actual principal and interest payments (note interest payment amounts are based on interest rates; this is the relationship between yield and interest rates) received by the investor. Thus, in addition to the interest rate, the return (or yield) to the investor depends upon the purchase price paid by the investor, the term of the investment, and the payment dates for principal and interest.

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Bond Yield—General Definition

Generally, as provided in Regulations § 1.148-4(b)(1)(i), for fixed yield issues, bond yield is the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue and amounts reasonably expected to be paid as fees for qualified guarantees on the issue, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price of the bonds of the issue as of the issue date.

In other words, yield is the discount rate that produces a present value equal to the issue price of all payments on the bonds when discounting such payments to the issue date.

In practice, this definition is adapted with adjustments and special rules applicable to characteristics of particular bonds, and also for variable yield issues.

Issue Price—Definition

For purposes of bond yield calculations in the arbitrage context, Regulations § 1.148-1(b) defines issue price as follows:

Issue price means, except as otherwise provided, issue price as defined in §§ 1273 and 1274. Generally, the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. Ten percent is a substantial amount. The issue price of bonds that are not substantially identical is determined separately.

The issue price of bonds for which a bona fide public offering is made is determined on the sale date based on reasonable expectations regarding the initial public offering price.

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Compounding Intervals

Yield is computed under the economic accrual method using any consistently applied compounding interval of not more than one year.

A short first compounding interval and a short last compounding interval may be used.

Financial Conventions

Reasonable, standard financial conventions may be used, such as the 30 days per month/360 days per year convention, as long as they are consistently applied.

Yield is expressed as an annual percentage rate that is calculated to at least four decimal places.

Regulations § 1.148-4(a).

Fixed Yield Issues

Fixed Yield Bond

According to Regulations § 1.148-1(b), a fixed yield bond is any bond whose yield is fixed and determinable on the date of issuance of the bond.

Fixed Yield Issue

According to Regulations § 1.148-1(b), a fixed yield issue is any issue if each bond that is part of that issue is a fixed yield bond.

Therefore, if the yield on any bond of the bond issue is not fixed on its issue date, then the issue is not a fixed yield issue.

Computation

Yield on a bond issue is calculated in accordance with Regulations § 1.148-4.

Regulations § 1.148-4(b) provides that yield on a fixed yield issue is the discount rate that results in the aggregate present value, as of the issue date, of all unconditionally payable payments over the life of the issue equaling the present value of the issue price as of that date.

Yield on a fixed yield issue is computed on the issue date and, except for certain specific circumstances discussed in Regulations §§ 1.148-4(b)(4) and 1.148-4(h), is not affected by subsequent events.

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Unconditional Payments

Regulations § 1.148-4(b) provides that in computing yield on a fixed yield issue, the unconditional payments may include the:

- principal payments (including call premiums on early retired bonds);
- interest payments;
- amounts paid, or expected to be paid, for a qualified guarantee; and
- amount paid, or expected to be paid, for a qualified hedging transaction

Note

This lesson provides an introduction into yield calculations and does not deal with qualified guarantees and qualified hedging transactions. Such concepts are discussed in TEB Basic Training Phase II Advanced Topics in Arbitrage.

Example 5

On January 1, 1994, City A issues an issue consisting of four identical fixed yield bonds. The total stated principal amount of the bonds is $20,000,000. The stated final maturity date of each bond is January 1, 2004. No bond is subject to redemption prior to maturity. Interest is payable on January 1 of each year at a rate of 6.0000% per annum on the outstanding principal amount. The aggregate issue price of the bonds is $20,060,000.

To compute the yield, each unconditional payments (in this case principal and interest) is treated as made on the date such payment is scheduled to be made. The yield is the discount rate at which the aggregate of the present value of each of these payments equals the issue price of the issue ($20,060,000).

Continued on next page

Example 5
(continued)

DATE	PRINCIPAL	INTEREST	PV (5.8731%)
1/1/1995		$1,200,000	$1,132,510
1/1/1996		1,200,000	1,068,816
1/1/1997		1,200,000	1,008,704
1/1/1998		1,200,000	951,973
1/1/1999		1,200,000	898,433
1/1/2000		1,200,000	847,903
1/1/2001		1,200,000	800,216
1/1/2002		1,200,000	755,210
1/1/2003		1,200,000	712,736
1/1/2004	$20,000,000	1,200,000	11,883,498
			20,060,000

The discount rate (compounded semiannually) at which the aggregate of the present value of all principal and interest payments equals the issue price is 5.8731%. The yield on the bond issue is therefore 5.8731%.

Bonds Subject to Mandatory or Contingent Early Redemption

According to Regulations § 1.148-4(b)(2), if a fixed yield issue is subject to mandatory or expected contingent early redemption, the yield is computed by assuming that the bonds will be redeemed on their reasonably expected early redemption date. In addition, it is assumed that the bonds will be redeemed at their value on the redemption date. Reasonable expectations are determined on the date of issue.

Continued on next page

Example 6

The facts are the same as in Example 5, except the bonds are subject to mandatory sinking fund redemption on January 1 of each year, beginning January 1, 2001. The bonds are redeemed at par plus accrued interest.

In computing the yield, the bonds are shown as redeemed in accordance with the mandatory redemption schedule.

DATE	PRINCIPAL	INTEREST	PV (5.8678%)
1/1/1995		$1,200,000	$1,132,569
1/1/1996		1,200,000	1,068,926
1/1/1997		1,200,000	1,008,860
1/1/1998		1,200,000	952,169
1/1/1999		1,200,000	898,664
1/1/2000		1,200,000	848,166
1/1/2001	$5,000,000	1,200,000	4,135,942
1/1/2002	5,000,000	900,000	3,714,650
1/1/2003	5,000,000	600,000	3,327,647
1/1/2004	5,000,000	300,000	2,972,407
			$20,060,000

The yield on the above issue of bonds is 5.8678% because that is the discount rate (compounded semiannually) at which the aggregate present values of the unconditional payments of principal and interest equals the issue price.

Continued on next page

Fixed Yield Issues, Continued

Note

The above examples present computations of yield on basic fixed yield issues.

If a fixed yield issue has any of the following characteristics, the computation of yield is more complicated and material discussed in TEB Basic Training Phase II will apply:

- substantially identical "deep-discount" bonds subject to mandatory early redemption (Regulations § 1.148-4(b)(2)(ii));
- issues which are subject to optional early redemption with a lower "yield-to-call" (call within 5 years of the issue date, premium bonds, and stepped coupon bonds) (Regulations § 1.148-4(b)(3));
- transfer of certain rights attached to the bond (Regulations § 1.148-4(b)(4)); or
- a qualified guarantee or qualified hedge

Variable Yield Issues

General

A variable yield issue is any bond issue that is not a fixed yield issue.

If the yield on any bond in the issue is not fixed and determinable on the date of issue, the bond issue is a variable yield issue.

The yield on a variable yield issue is computed separately for each computation period.

Computation Period

The computation period may be selected by the issuer and is the period between the computation dates.

Regulations § 1.148-3(e)(1) provides that an issuer may treat as computation dates:

- the last day of any bond year ending on or before the first required rebate payment date; and
- thereafter, the end of each bond year or the end of each fifth bond year

Once selected, the issuer may not change the computation dates after the first required rebate payment.

Computation Date

The computation date is each date on which the rebate amount for an issue is computed.

Example 7

The issue date for a variable yield issue is January 1, 1993. The issuer wants to determine yield on the bonds on January 1, 1994, when construction of the project is finished. The first computation period would be from January 1, 1993, the date of issue, to January 1, 1994, the first computation date. If the issuer decides to compute yield each bond year, the next computation period is between from January 1, 1994 to January 1, 1995.

Continued on next page

Variable Yield Issues, Continued

Computation of Yield

The yield on a variable yield issue is computed separately for each computation period.

According to Regulations § 1.148-4(c)(1), the yield for each computation period is the discount rate that, when used in computing the present value as of first day of the computation period of all the payments of principal and interest and fees for qualified guarantees 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 (or deemed issue price) of the bonds of the issue as of the first day of the computation period.

Payments Generally Included in the Yield Computation

Under Regulations § 1.148-4(c)(2), payments included in the yield computations are the following any amounts:

- actually paid for principal of the bond during the computation period;
- paid during the computation period for

  (i) interest accruing on the bond during such period,
  and
  (ii) interest accruing during the prior period that was included in the deemed issue price of the bond as accrued unpaid interest at the start of the current computation period; and
- properly allocable to fees for a qualified guarantee of the bond for the period
- properly allocable to a qualified hedge for the period

Actual Redemption

According to Regulations § 1.148-4(c)(2)(ii), if a bond is actually redeemed during a computation period, an amount equal to the greater of its value on the redemption date or the actual redemption price is included as a payment on the actual redemption date.

Continued on next page

Bonds Outstanding

According to Regulations § 1.148-4(c)(2)(iii), if a bond is outstanding at the end of a computation period, a payment equal to the bond's value is taken into account on the last day of the period. Generally, for a variable rate bond remarketed at par, the value is par plus accrued interest, according to Regulations § 1.148-4(e)(1).

Deemed Issue Price

According to Regulations § 1.148-4(c)(2)(iv), a bond outstanding at the end of a computation period is treated as if it were reissued on the next day for a deemed issue price at a value equal to its value on the day before.

Example 8

On January 1, 1994, City issues variable yield bonds in the principal amount of $1,000,000 at par (i.e., with an issue price of $1,000,000). The stated maturity date of the bonds is January 1, 2000. Actual principal and interest payments on the bonds prior to January 1, 1999 are set forth in the table below. From June 1, 1998 to January 1, 1999, $30,000 interest accrues on the bonds. On June 1, 1999, the issuer pays $65,000 in interest. On January 1, 2000, principal in the amount of $1,000,000 and interest in the amount of $38,000 is paid and the bonds are no longer outstanding.

First Computation Period. The issuer computes rebate on January 1, 1999 (timing of required rebate payments is discussed on another section of this lesson). The computation period for such computation date is from January 1, 1994 to January 1, 1999.

The issuer should include the following payments in the yield computation:

- The interest actually paid on June 1, 1994, 1995, 1996, 1997, and 1998.
- Because the issue is outstanding on January 1, 1999, the computation date, it is treated as redeemed on that date for purposes of calculating yield. The amount included on January 1, 1999, is its value ($1,000,000 plus accrued and unpaid interest of $30,000).

Continued on next page

Example 8
(continued)

DATE	PRINCIPAL	INTEREST	PV (5.44142%)
6/1/1994		30,000	29,336,36
6/1/1995		55,000	50,972.00
6/1/1996		57,000	50,064.26
6/1/1997		56,000	46,614.93
6/1/1998		45,000	35,500.42
1/1/1999	$1,000,000	30,000	787,512.03
			1,000,000

The yield on the issue during the first computation period is the discount rate at which the aggregate of the present value as of January 1, 1994 of all payments made during this period ($30,000, $55,000, $57,000, $56,000,
$45,000 and $1,030,000) equals the present value of the issue price of the issue ($1,000,000) on January 1, 1994. The bond yield for the first computation date is 5.44142%.

Second Computation Period. The bonds are treated as reissued on January 1, 1999 with a deemed issue price of $1,030,000. The payments included in the yield computation for this period include:

- Interest paid during the computation period ($65,000 on June 1, 1999 and $38,000 on January 1, 2000)
- Redemption price of the bonds on January 1, 2000 ($1,000,000)

Continued on next page

Example 8
(continued)

The yield on the issue during the second computation period is the discount rate at which the aggregate of the present value as of January 1, 1999 of all payments made during this period ($65,000, $38,000, and $1,000,000) equals the present value of the deemed issue price of the issue ($1,030,000) on January 1, 1999. The bond yield for the second computation date is 7.22364%.

DATE	PRINCIPAL	INTEREST	PV (7.22364%)
1/1/1999			
6/1/1999		65,000	63,106.24
1/1/2000	$1,000,000	38,000	966,893.76
			1,030,000.00

Note

This lesson includes yield computations for a basic variable yield bond issue and does not address fees for qualified guarantees or qualified hedges. For a discussion of these concepts see TEB Basic Training Phase II.

Section 4

Investment Yield and Investment Classes

Overview

Purpose

This section explains the general rules for calculating yield on investments of bond proceeds and defines the different investment classes (purpose investments, nonpurpose investments, and program investments).

General Rule

Regulations § 1.148-5(b)(1) provides that yield on investments is calculated in the same manner as the yield on bonds.

Generally, this means that the yield on an investment allocated to an issue is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue.

Thus, the yield on an investment allocated to an issue is the discount rate that, when used in computing the present value of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment.

Payments include amounts to be actually or constructively paid to acquire the investment, and receipts means amounts to be actually or constructively received from the investment, such as earnings and return of principal.

The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue.

Continued on next page

Class of Investments

Regulations § 1.148-5(b)(2) provides that for purposes of yield restriction rules, yield is computed separately for each class of investments. Each of the following is a separate class of investments:

a) Each category of yield restricted purpose investments and program investments that is subject to a different definition of materially higher under Regulations § 1.148-2(d)(2);

b) Yield restricted nonpurpose investments; and

c) All other nonpurpose investments

Purpose Investment

A purpose investment is an investment that is acquired to carry out the governmental purposes of the bond issue.

Example: Acquisition of a residential rental facility by a housing authority is a purpose investment.

Nonpurpose Investment

A nonpurpose investment is any investment property that is not considered a purpose investment.

Program Investments

A program investment is a purpose investment that is part of a governmental program and generally represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, or persons who provide housing and related facilities. Program investments include qualified student loans, single family mortgage loans, loans to 501(c)(3) organizations, and loans to persons who provide multifamily housing.

Continued on next page

Overview, Continued

Valuation of Investment

When calculating yield on the investments, the investments must be valued in accordance with Regulations § 1.148-5(d).

Note

This section does not address the valuation or computation of yield on investments. For a description of yield on investments, see TEB Basic Training Phase II.

Section 5

Yield Restriction Rules

Overview

Purpose This section explains basic yield restriction rules.

Continued on next page

Contents

This section contains the following topics:

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Investment Property	48
Materially Higher Yield	51

General

Section 148(a) prohibits use of bond proceeds to acquire “higher yielding investments.”

The policy behind the prohibition is to prevent municipal issuers from issuing tax-exempt debt bearing lower interest rates than taxable debt, and then investing the proceeds in taxable securities having a higher investment return.

In order to determine whether the investment of proceeds will result in the bond being an arbitrage bond, the agent must determine the “proceeds” of the bond and determine the “yield” on the bonds and the investments.

- Section 2 in this lesson contains a summary description of “proceeds” and another lesson in TEB Basic Training Phase I provides detailed explanation of “Proceeds & Allocations.”
- Section 3 in this lesson and TEB Basic Training Phase II present the computation of yield on fixed yield issues and variable yield issues.

Higher Yielding Investments

Definition

If the investment property acquired with the proceeds of the bond issue produces a yield which is "materially higher" than the yield on the bond issue, then the proceeds of the bond issue are used to acquire higher yielding investments.

To determine whether the bond is an arbitrage bond, there must first be a determination of whether investment property is acquired with the proceeds of the bond. If investment property is acquired with bond proceeds, then there must be a determination of whether the investment property produces a yield which is materially higher than the yield on the bonds.

Acquisition of investment property with proceeds of a bond, in and of itself, does not result in the bond being an arbitrage bond. A bond is an arbitrage bond only if the yield on the acquired investment property is materially higher than the yield on the bond.

Investment Property

Definition

Section 148(b)(2) provides that investment property generally includes any:

- security,
- obligation,
- annuity contract, or
- investment-type property, and
- in the case of bonds that are not private activity bonds, any residential rental property for family units which is not located in the jurisdiction of the issuer and which is not acquired to implement a court ordered or approved housing desegregation plan.

Continued on next page

Tax Exempt Bonds

Section 148(b)(3)(A) provides that although any security is investment property under § 148(b)(2), tax-exempt bonds are generally not treated as investment property. However, for purposes of bonds, other than specified private activity bonds defined in § 57(a)(5)(C), investment property includes specified private activity bonds defined in § 57(a)(5)(C).

Specified private activity bonds defined in § 57(a)(5)(C) are bonds, the interest income on which is subject to alternative minimum tax ("AMT bonds").

Investment Property

Bond Issue	Investments Acquired	
	AMT	Non-AMT
AMT	no	no
Non-AMT	yes	no

Accordingly, if proceeds of bonds that are not subject to the alternative minimum tax ("non-AMT bonds") are used to acquire AMT bonds, then the proceeds are used to acquire investment property. If proceeds of AMT bonds are used to acquire either AMT or non-AMT bonds, those investments are not considered investment property.

Continued on next page

Investment-Type Property

Investment-type property may include any property that is held principally as a passive vehicle for the production of income.

For this purpose, production of income includes any benefit based on the time value of money, including a benefit from making a prepayment.

Certain prepayments that do not give rise to investment-type property are described in Regulations § 1.148-1(e).

Example 9

City Y issues bonds for its governmental purposes and uses a portion of the bonds to prepay its electronic equipment maintenance contract for the next two years. Prepayment on substantially the same terms is made by persons similarly situated to City Y, which persons have not issued tax-exempt bonds. This prepayment is not an acquisition of investment-type property.

Materially Higher Yield

General Rule

According to Regulations § 1.148-2(d)(2)(i), if an investment purchased with proceeds of tax-exempt bonds produces a yield which exceeds one-eighth of one percent above the bond yield, the yield on the investment is materially higher than the yield on the bonds.

This general rule applies for both purpose investments and nonpurpose investments.

Exceptions to General Rule

Regulations § 1.148-2(d)(2) provides exceptions to the general rule for certain investments listed below:

TYPE OF INVESTMENT	MEANING OF MATERIALLY HIGHER
Refunding Escrow	one-thousandth of one percent
Replacement Proceeds	one-thousandth of one percent
Program Investments, other than student loans	one and one-half percent
Qualified Student Loans that are program investments	two percent
Qualified Mortgage Loans	one and one-eighth of one percent
Tax-exempt Obligations that are NOT considered investment property	there is no yield limitation

Section 6

Temporary Periods

Overview

Purpose

This section identifies temporary periods during which the use of bond proceeds to acquire higher yielding investments will not cause the bonds to be arbitrage bonds.

General Rule

Section 148(a) provides that use of bond proceeds to acquire higher yielding investments results in the bonds being arbitrage bonds. However, such investment of proceeds during an initial temporary period does not cause the bonds to be arbitrage bonds. (See also Regulations § 1.148-2(a).)

Under Regulations § 1.148-2(e), the length of the temporary period generally depends upon the purpose for which the bonds are issued or the type of proceeds. Temporary periods apply to both the proceeds and replacement proceeds of an issue.

Reasonable Expectations

Qualification for temporary period exceptions to yield restriction is generally based on the issuer's reasonable expectations regarding the expected timing of expenditures and not on the actual timing of expenditures.

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This section contains the following topics:

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Temporary Period for Other Proceeds	59

Capital Projects

General Rule

According to Regulations § 1.148-2(e)(2)(i), the net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to capital projects may be invested at an unrestricted yield for a 3-year temporary period.

The 3-year temporary period begins on the date of issuance of the bonds.

Reasonable Expectations

The 3-year temporary period only applies if, on the date of issuance, the issuer reasonably expects to meet the:

- expenditure test,
- time test, and
- due diligence test

These tests are applied separately to each conduit loan financed by the issue.

Expenditure Test

According to Regulations § 1.148-2(e)(2)(i)(A), the expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital project by the end of the 3-year temporary period.

Time Test

According to Regulations § 1.148-2(e)(2)(i)(B), the time test is met if the issuer incurs a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds on the capital project within 6 months of the date of issuance of the bonds.

A construction contract with a general contractor or a developer of the project or a purchase contract with the seller of the facility stating that the expenditure of proceeds will occur within six months is sufficient for this test.

Continued on next page

Due Diligence Test

According to Regulations § 1.148-2(e)(2)(i)(C), the due diligence test is met if the completion of the project and allocation of net sale proceeds to expenditures proceed with due diligence.

Net Sale Proceeds

Under Regulations § 1.148-1(b), net sale proceeds means sale proceeds less the portion of sale proceeds attributable to a reasonably required reserve or replacement fund and minor portion.

5-Year Temporary Period

The 3-year temporary period may be extended to 5 years in certain circumstances. In such case, the issuer and a licensed architect or engineer must certify that a period longer than 3 years is necessary to complete the capital project.

Certification

An officer of the issuer must certify the reasonable expectations of the issuer. The certification must state the facts and estimates that form the basis of the expectations.

Any intentional actions by the issuer or conduit borrower which are contrary to the reasonable expectations stated in the certification may result in the bond being an arbitrage bond. (See § 148(a) and Regulations §§ 1.148-2(b)(2) and (c).)

Mortgage Revenue Bonds

Qualified mortgage bonds and qualified veterans' mortgage bonds can qualify for the 3-year temporary period under the general rule provided in Regulations § 1.148-2(e)(2)(i).

Restricted Working Capital Expenditures

Definition

Restricted working capital expenditures are those subject to the rule in Regulations § 1.148-6(d)(3)(i). Proceeds of an issue may only be allocated to restricted working capital expenditures to the extent that such working capital expenditures exceed other amounts available to the issuer or conduit borrower as of the date of the allocation ("proceeds-spent-last rule").

General Rule

According to Regulations § 1.148-2(e)(3)(i), proceeds of a bond issue that are expected to be used for restricted working capital expenditures within 13 months of the date of issuance, may be invested without regard to yield restriction during those 13 months.

Exception for TRANs

According to Regulations § 1.148-2(e)(3)(ii), the 13-month temporary period for restricted working capital expenditures may be extended for tax and revenue anticipation notes ("TRANs") if:

- The TRANs are expected to be paid from tax revenues for a single fiscal year; and
- The TRANs will mature by the earlier of two years after the issue date or sixty days after the last date the tax payments are due

For TRANs meeting the above requirements, the temporary period is extended to the maturity date of the issue.

Continued on next page

Restricted Working Capital Expenditures, Continued

Exception for TRANS (continued)

Just as in any other bond issue, the reasonable expectations of the issuer as of the issue date are important to determine whether the bond issue qualifies for the 13-month or the extended temporary period.

The expectations of the issuer for its allocations to restricted working capital expenditures must be made in accordance with the proceeds-spent-last rule. The issuer must therefore expect that after spending all other amounts available to it for such expenditures, it will be able to spend proceeds of bonds or TRANs within the applicable temporary period.

Pooled Financings

Definition

Section 149(f)(6)(A) provides that a pooled financing is any bond issue the proceeds of which are reasonably expected, at the time of issuance, to be used to make loans to two or more unrelated borrowers.

See TEB Basic Training Phase III for additional description of pooled financings.

General Rule

Section 148(c)(2)(A) provides a 6-month temporary period while the proceeds are held by the issuer. Therefore, if the proceeds of a pooled financing issue are loaned to two or more borrowers for a qualified purpose, the proceeds may be invested by the issuer for up to 6 months without regard to yield limitation. (See also Regulations § 1.148-2(e)(4)(i).)

Exception for Construction Financing

If any portion of the proceeds of the pooled financing are used to make or finance loans for construction expenditures, the temporary period, while the proceeds are held by the issuer is increased to 2 years.

(See § 148(c)(2)(C) and Regulations § 1.148-2(e)(4)(iii).)

Temporary Period After Proceeds Loaned

According to Regulations § 1.148-2(e)(4)(i), the 6-month rule and the 2-year rule described above, only apply to the bond proceeds invested by the issuer prior to making loans. After the proceeds are loaned to a borrower, the temporary period depends upon the expected use of bond proceeds (such as, capital project, working capital expenditures, etc.)

Any otherwise available temporary period for proceeds held by a borrower is reduced by the period of time during which the proceeds were held by the issuer, before being loaned.

Continued on next page

Pooled Financings, Continued

Example 10

Authority X issues a bond issue which properly qualifies as a pooled financing. The temporary period for such financing would be 3 years under Regulations § 1.148-2(e). The proceeds are loaned to Conduit Borrower A, Conduit Borrower B, and Conduit Borrower C, within 3 months, 5 months, and 6 months, respectively, of the date of issuance of the bonds. Conduit Borrower A has an additional temporary period of 33 months, Conduit Borrower B has an additional temporary period of 31 months, and Conduit Borrower C has an additional temporary period of 30 months after the date such conduit borrower receives the proceeds of the bonds.

Loan Repayments

Proceeds received by the issuer as repayment of loans from the conduit borrowers may be used to make new loans. Such proceeds of repayments may be invested without regard to yield limitation for 3 months from the date of the repayments. (See § 148(c)(2)(B) and Regulations § 1.148-2(e)(4)(ii)(A).)

Mortgage Revenue Bonds

Section 148(c)(2)(D) provides that although qualified mortgage bonds and qualified veterans' mortgage bonds are pooled financings, the 6-month temporary period does not apply to them.

Qualified mortgage bonds and qualified veterans' mortgage bonds qualify for the 3-year temporary period under the general rule provided in Regulations § 1.148-2(e)(2)(i).

Temporary Period for Other Proceeds

Replacement Proceeds

According to Regulations § 1.148-2(e)(5)(i), replacement proceeds qualify for a 30-day temporary period from the date the proceeds are first treated as replacement proceeds.

Bona Fide Debt Service Fund

According to Regulations § 1.148-2(e)(5)(ii), amounts in a bona fide debt service fund qualify for a 13-month temporary period. If only a portion of the fund qualifies as a bona fide debt service fund, then such portion qualifies for the 13-month temporary period.

Investment Proceeds

According to Regulations § 1.148-2(e)(6), investment proceeds qualify for a 1-year temporary period from date of receipt.

Other Amounts

According to Regulations § 1.148-2(e)(7), gross proceeds not otherwise qualifying for a special temporary period exception under § 148(c) or Regulations § 1.148-2(e), qualify for a 30-day temporary period from date of receipt.

Section 7

Reasonably Required Reserve or Replacement Funds

Overview

Purpose

This section explains qualification requirements for a reasonably required reserve or replacement fund.

General Rule

Amounts held in a reasonably required reserve or replacement fund may be invested without regard to yield limitation.

(See § 148(d)(1) and Regulations § 1.148-2(f)(2)(i).)

Definition

According to Regulations § 1.148-2(f)(2)(ii), a reserve fund is a reasonably required reserve or replacement fund if it does not exceed the least of:

- 10 percent of the stated principal amount of the issue;
- Maximum annual debt service on the issue; or
- 125 percent of the average annual debt service on the issue

A reserve or replacement fund may be funded with moneys other than sale proceeds of the bond issue. Therefore, to determine whether the bond issue meets the yield restriction requirements, a determination must be made as to which funds constitute a reserve fund. Only the portion of the fund meeting the requirements stated above qualifies as a reasonably required reserve or replacement fund.

Special rules apply for bonds issued for more than a de minimis amount of discount or premium.

Continued on next page

Limitations on Use of Sale Proceeds

If sale proceeds in excess of 10 percent of the stated principal amount of the bond issue are used to fund a reserve or replacement fund, the bond issue consists of arbitrage bonds.

For the bonds to be arbitrage bonds, it is not necessary that the proceeds of the bonds in such a reserve fund be invested in higher yielding investments.

(See § 148(d)(2) and Regulations § 1.148-2(f)(1)).

Special rules apply for bonds issued for more than a de minimis amount of discount or premium.

Example 11

County A issues $10 million stated principal amount of bonds at par. It deposits $1 million of the sale proceeds into a reserve fund. County A has never issued bonds before and does not have a good credit rating. The bondholders require that County A deposit an additional $250,000 of its own moneys into the reserve fund. There are no other reserve funds established by County A as security for the bonds.

Maximum annual debt service on the bonds and 125 percent of the average annual debt service on the bonds both exceed $1m. Under the "least of" test described above, the maximum reasonably required reserve or replacement fund is $1 million ($10m stated principal amount x 10%). This amount may be invested without regard to yield limitation. County A may also deposit $250,000 of its own money in the reserve fund, however, such amount is not part of the reasonably required reserve or replacement fund and is subject to yield restriction

Example 12

Facts are the same as Example 11, except instead of using $1,000,000 of sale proceeds and $250,000 of its own moneys to fund the reserve, County A used $1,250,000 of sale proceeds to establish a reserve fund. Because County A used more than 10 percent of the stated principal amount of the bonds to establish a reserve fund, the bonds are arbitrage bonds. It does not matter whether County A invests any of this amount in investments which have a yield above the bond yield.

Section 8

Waivers Permitted

General Rule

Temporary Periods

On or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve fund.

Minor Portion

At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion.

(See Regulations § 1.148-2(h).)

Section 9

Coordination with Rebate Rules

Overview

General Rule

As stated in this lesson, bonds are arbitrage bonds if on the date of issuance the issuer reasonably expects to invest the proceeds in higher yielding investments.

However, during the temporary period the issuer or conduit borrower may invest proceeds in higher yielding investments.

Although any arbitrage earnings received by the issuer during the temporary period may not result in the bonds being arbitrage bonds, the issuer is generally not permitted to retain such arbitrage earnings.

Whether an issuer can retain the arbitrage earnings or whether it must rebate such earnings to the United States must be determined in each case. The rules regarding rebate are discussed in section 10.

Continued on next page

Rebate/Yield Reduction Payments

Generally, after any applicable temporary period, bond proceeds must be yield restricted. Yield restriction can be achieved in two ways— investment of proceeds:

- in securities that do not exceed the permitted yield; or
- above the permitted yield and making yield reduction payments. (Note that under Regulations § 1.148-5(c)(3), yield reduction payments may be made only for certain types of proceeds.)

Rebate and yield reduction payments are both recognized by the other. In other words, payment of rebate may be included in computing the yield on investments and vice versa. In many cases, making a rebate payment will also satisfy yield restriction requirements. It is possible, however, that a rebate payment will not fully satisfy yield restriction or even that no rebate payment at all is due, but a yield reduction payment is required. This concept is covered more fully in TEB Basic Training Phase II.

Summary

The rebate rules have the same basic purpose as yield restriction. Any arbitrage that is earned must be paid over to the United States unless an exception applies. There are two types of exceptions: the small issuer exception and the spending exceptions.

If none of the exceptions applies, then the amount of rebate due must be computed, which is a multi-step process.

Section 10

Rebate Concepts & Historical Perspective

Overview

Rebate in General

The rebate rules have the same basic purpose as yield restriction. They are designed to remove incentives for the issuance of arbitrage motivated bonds.

In general, the rebate rules require that arbitrage profits earned from investing proceeds of an issue in nonpurpose investments must be paid to the United States as rebate unless a specific exception to the rebate requirement applies
to the issue. Otherwise, the bonds will be arbitrage bonds.

Small issuer or spending exceptions may apply to exclude certain arbitrage profits from the rebate requirement. For example, an issuer that places certain proceeds of an issue in a project or construction fund may not be required to rebate arbitrage earned on the proceeds if the proceeds are expended in a timely fashion (as defined in the spending exceptions) on the project financed by the issue.

The payment of rebate is a requirement that must be met for interest on bonds to be excludable from gross income.

Historical Perspective

General

The first rebate requirements, enacted in 1980 and in 1984, applied only to mortgage revenue bonds and industrial development bonds. Major changes, however, were made in the Tax Reform Act of 1986. The 1986 Act contained a variety of restrictions on tax-exempt bonds, including tougher arbitrage rules under new § 148.

Code Changes— § 148(f)

Section § 148(f) extended the rebate rules to all categories of tax-exempt bonds.

Instead of the "reasonable expectation" standard, § 148(f) looks to actual investment of bond proceeds (i.e. what really happens, not just what the issuer predicts will happen).

The exceptions in the 1969 Act that permit unrestricted yield under certain conditions are generally retained by the 1986 Act, but investment earnings received are subject to the rebate rules of § 148(f).

Example 14

An issuer can fund a reasonably required reserve or replacement fund ("4-R Fund") that does not have to be yield restricted. The fund can earn arbitrage without causing the related bonds to be arbitrage bonds. The issuer, however, cannot keep the arbitrage earnings. They must be rebated unless an exception for rebate applies, or else the bonds will be arbitrage bonds.

Rebate Regulations

The first rebate regulations were issued in January 1985 as Regulations §1.103-15AT. These regulations applied a rebate requirement to certain types of industrial development bonds under former § 103(c)(6)(D) and are now of limited significance.

Continued on next page

1989 Temporary Regulations

Temporary regulations under § 148 were issued in May 1989. These regulations (which appeared at Regulations §§ 1.148-0T through 1.148-9T) focused on the new rebate requirement under § 148(f). For the most part, the
1979 arbitrage regulations continued to be effective and provided the rules for yield restriction. In some respects, however, the May 1989 regulations superseded the 1979 regulations.

The May 1989 regulations were strenuously criticized by State and local governments who viewed the regulations as:

- too complex,
- poorly organized,
- lacking guidance on fundamental issues, and
- overly detailed in their treatment of some obscure abusive transactions

Another criticism was that no real attempt was made to mesh the 1979 arbitrage regulations with the new rebate rules. This made the two sets of regulations somewhat difficult to read together. For example, the May 1989 regulations use certain newly defined terms that are not the same as the comparable terms under the 1979 regulations.

1991 Amendments

In response to these criticisms, simplifying amendments were issued in May 1991. This regulation (referred to as the “1991 bullet regulation”) was a “quick fix” of the worst problems with the May 1989 rebate regulations and was not a complete rewrite.

Continued on next page

1992 Proposed Regulations

In January 1992, proposed regulations were issued on rebate accounting rules, rebate spending exceptions and refunding rules. The accounting rules and the spending exceptions rules were new. The refunding rules significantly changed the rules under the May 1989 regulations.

In May 1992, the proposed regulations were finalized, along with the rest of the May 1989 temporary regulations, with some changes.

In November 1992, new proposed regulations were issued under § 148. These regulations were a complete rewrite and reorganization of the 1979 arbitrage regulations and the May 1992 rebate regulations.

1993 Final Regulations

The 1992 proposed regulations were finalized in June 1993.

The new regulations mesh the yield restriction and rebate rules, and are simpler and better organized than the old regulations.

The regulations achieve simplification in part by relying heavily on general anti-abuse rules.

The regulations have been changed and revised, in part, by temporary and final regulations issued in 1994 and 1997.

Continued on next page

2007 Proposed Regulations

In 2007, proposed regulations making a number of discrete changes to the existing regulations were published (REG-106143-07, September 26, 2007). Certain more substantive changes, which are discussed in further detail in the preamble to the proposed regulations and which are fully set forth in the proposed regulations, include:

- Hedges based on taxable interest rates. The proposed regulations make revisions to accommodate certain hedges in which floating payments under the hedge are based on a taxable interest rate and to clarify that bonds covered by such a hedge are ineligible for treatment as fixed yield bonds under the special hedging rule in §1.148-4(h)(4).

- Joint Bond Yield Authority. The proposed regulations remove the provision in the Existing Regulations that permits the IRS Commissioner to authorize a single yield computation on multiple bond issues.

- Electronic GIC Bidding. The proposed regulations revise the bidding safe harbor for establishing the fair market value of guaranteed investment contracts (GICs) to accommodate electronic bidding.

- Refunds of Overpayments of Rebate. The proposed regulations clarify that the amount that an issuer is entitled to receive under a rebate refund claim is the excess of the total amount actually paid over the rebate amount.

2013 Proposed Regulations

In 2013, proposed regulations making additional discrete changes to the existing regulations were published (REG-148659-07, September 16, 2007). Significant changes, which are discussed in further detail in the preamble to the proposed regulations and which are fully set forth in the proposed regulations, include:

- Working capital expenditures. The proposed regulations modify the safe harbors against creation of other replacement proceeds by shortening the safe harbor for short term working capital financings and adding a new one for longer term working capital financings. They also remove an existing restriction on financing a working capital reserve.
- Modification of qualified hedge. The proposed regulations simplify the rules for determining when a modification to a qualified hedge results in a deemed termination of that hedge.

2014 Regulatory Change

Under final regulations published November 13, 2014, an issuer has a deadline to file a rebate refund claim which is two years after the final computation date for the issue to which the overpayment relates.

2015 Proposed Regulations

In 2015, proposed regulations redefining issue price were published (REG-138526-14, June 24, 2015). As defined in the existing regulations, issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. The existing regulations define substantial amount as ten percent and apply a reasonable expectations standard (rather than a standard based on actual sales) for this purpose. The proposed regulations apply an actual sales standard and, as an alternative to the actual sales standard, permit an issuer to treat the initial offering price to the public as the issue price, provided certain requirements are met.

Section 11

General Arbitrage Rebate Rules

Overview

General Rule

Section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds.

Regulations § 1.148-3(a) provides that the arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

Regulations § 1.148-3(b) provides that as of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

Example 14

If an issue of bonds has a yield of 8 percent, and the proceeds of the issue are invested at a yield of 10 percent, the issuer must pay the 2 percent investment earnings, plus any additional earnings from investing that 2 percent, to the United States in order for the bonds to not be arbitrage bonds.

Continued on next page

Application of Rebate Rules

Compliance with the rebate rules can be analyzed through a series of steps as listed in the table below.

Step	Action
1	Determine compliance with small issuer exception.
2	Identify gross proceeds of the issue.
3	Identify the funds in which gross proceeds of the issue are held.
4	Identify gross proceeds of the issue not qualifying for an exception.
5	Determine computation and payment dates.
6	Calculate yield on the issue.
7	Identify the nonpurpose investments to which gross proceeds are allocated.
8	Create a schedule of the cash flows of the nonpurpose investments (payments for and receipts from nonpurpose investments).
9	Future value the cash flows using the yield of the issue.
10	Determine the sum of the future values of all the payments and the future value of all the receipts to determine the total rebate amount.
11	Confirm timely payment.

Exceptions to Rebate

There are two major types of exceptions to rebate:

- small issuer exception
- spending exceptions

In addition, the Code and the regulations provide certain additional exceptions to simplify computations.

Section 12 discusses the small issuer exception. Section 13 explains the spending exceptions. Section 14 discusses the bona fide debt service fund exception.

Section 12

Small Issuer Exception

Qualifications

Step One – Small Issuer Exception

The first step in determining compliance with the rebate requirements is to determine whether an issue qualifies for the small issuer exception.

General Rule

Under § 148(f)(4)(D), governmental bonds issued by a governmental unit that does not expect to issue more than $5 million of governmental bonds in that calendar year are excepted from the rebate requirements, but not yield restriction rules.

To Qualify

In order to qualify for the small issuer exception:

- the issuer must be a governmental unit with general taxing powers;
- no part of the issue can be a private activity bond;
- 95 percent or more of net proceeds are to be used for local governmental activities of the issuer or of governmental units located within the issuer's boundaries; and
- the issuer must either -
  - o reasonably expect, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during that calendar year will not exceed $5 million

    OR
  - o actually issue tax-exempt bonds (other than private activity bonds) during that calendar year the aggregate face amount of which does not exceed $5 million

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Size Limit

The $5 million size limit applies to the sum of the following:

- The issue to which the small issue exception applies;
- Previous issues of governmental bonds in the same calendar year;
- Issues of governmental bonds reasonably expected to be issued or actually issued in the same calendar year; and
- Issues by related entities that are subject to aggregation

Aggregation Rules

Regulations § 1.148-8(c)(2) sets forth the following aggregation rules for purposes of applying the $5 million size limitation:

- An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.
- Any bonds issued by an entity that is directly or indirectly controlled by the issuer (a "subordinate entity") is generally treated as issued by the issuer. There is, however, an exception in certain instances in which specific allocations of the bonds are made by the issuer.
- An entity formed or availed of to avoid the $5 million size limitation and all entities that would benefit from the avoidance are treated as one issuer.

Continued on next page

Qualifications, Continued

Special Rules for Refundings

Under § 148(f)(4)(D)(v), any portion of an issue issued to refund other bonds must also meet certain requirements with respect to length of maturity:

- the face amount of the refunding issue is no greater than $5M
- the refunded bonds met the small issuer exception
- the average maturity date of the refunding bonds is not later than the average maturity date of the bonds to be refunded by the issue; and no refunding bond has a maturity date which is later than 30 years after the date the original bond was issued

Current Refunding

Under § 148(f)(4)(D)(iii), a current refunding is not taken into account in determining the amount of bonds issued in the calendar year to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.

Special Limits for School Construction Bonds

The Taxpayer Relief Act of 1997 increased the $5 million limitation up to an additional $5 million for bonds issued to finance construction of public school facilities. This increased limit applies to bonds issued on or after January 1, 1998.

The Economic Growth and Tax Relief Reconciliation Act of 2001 increased the $5 million limitation up to an additional $10 million for bonds issued to finance construction of public school facilities. This increased limit applies to bonds issued on or after January 1, 2002.

For purposes of this exception, "construction" includes reconstruction and rehabilitation. (§ 148(f)(4)(C)(iv)).

Continued on next page

Example 15

On March 1, 2002, School District issues $12 million of bonds to construct a new high school. On August 1, 2002, School District issues $3 million of bonds to purchase school busses and computers. Both issues will qualify for the small issuer exception.

Example 16

The facts are the same as Example 16, however $4 million of bonds are issued for busses and computers. Neither issue qualifies for small issuer exception.

Example 17

In February 2002, School District issues $4 million of bonds to construct additions for an elementary school. School District may issue up to $5 million more in bonds in 2002 for non-public school construction items for both issues to qualify for the small issuer exception.

Yield Restriction Rules Still Applicable

An issue meeting the small issuer exception is exempt from the rebate requirement; however, the issue is still subject to the yield restriction rules.

An issue could meet the small issuer exception, but still be an arbitrage bond if, for example, the reserve fund is not properly sized or yield reduction payments are not made on a post-temporary period construction fund.

Continued on next page

Section 13

Spending Exceptions

Overview

Introduction

Spending exceptions may apply to except from the rebate requirement arbitrage earned on certain proceeds of an issue if the issuer spends the proceeds in accordance with prescribed 6-month, 18-month, or 2-year schedules. The spending exceptions sometimes apply only to a portion of an issue. For example, the spending exceptions generally don't apply to amounts held in a reasonably required reserve or replacement fund. Even if investment earnings on some proceeds are excepted from rebate, rebate may still be due on investment earnings on other proceeds. Thus, in the process of determining compliance with the rebate requirement, steps one and two shown below must be taken prior to applying the spending exceptions.

Contents

This section contains the following topics:

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18-Month Exception	81
Two-Year Construction Exception	84

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Step Two – Identify Gross Proceeds

Gross proceeds of an issue must be determined. Gross proceeds include any sales proceeds, investment proceeds, transferred proceeds, and replacement proceeds of the issue. These terms are defined in Regulations §§ 1.148-1(b) and (c) and 1.148-9.

Step Three – Identify Funds

The funds in which proceeds of an issue are held must be identified (e.g. project fund, reserve fund, debt service fund).

Step Four – Identify Gross Proceeds Not Excepted

Upon completing these steps, it must then be determined whether any gross proceeds of an issue are not excepted under the spending exception rules of Regulations § 1.148-7 or any other exception (e.g., bona fide debt service fund exception).

The rules of Regulations § 1.148-6(d) for allocating gross proceeds to expenditures are pertinent when applying the spending exceptions rules. Regulations § 1.148-6(d)(1)(ii) provides that an allocation of gross proceeds to an expenditure must involve a current outlay of cash for a governmental purpose of the issue.

When, in addition to bond proceeds, funds from other sources are being spent on a project, an issuer may have to determine which amounts are spent first for the project. Note in particular the rules in Regulations § 1.148-6(d)(3) that generally provide that, for working capital expenditures, bond proceeds are treated as being spent last.

Six-Month Exception

General Rule

Section 148(f)(4)(B) provides that an issue meets the rebate requirements if:

- The gross proceeds (as the term is modified for purposes of this exception) of the issue are allocated to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date; and
- The rebate requirement is met for amounts not required to be spent within the 6-month spending period (excluding earnings on a bona fide debt service fund).

Amounts Not Considered Gross Proceeds

For purposes of the six-month exception:

- Among other amounts, "gross proceeds" does not include:
  - Amounts in a bona fide debt service fund;
  - Amounts in a reasonably required reserve or replacement fund; or
  - Gross proceeds that arise after the 6-month period and that were not reasonably anticipated on the date of issuance. (See Regulations § 1.148-7(c)(3).)
- The rebate requirement must be met for (1) amounts in a reasonably required reserve or replacement fund, and (2) unanticipated gross proceeds arising after the six-month period, but not for earnings on a bona fide debt service fund. This is the case regardless of the fact that all of the gross proceeds of the issue (as defined for purposes of this exception) are spent within the initial six-month period.

Continued on next page

Six-Month Exception, Continued

Applicability

The exception applies to all types of bond issues (i.e., governmental, private activity, new money, and refunding).

Refundings

The only spending exception applicable to a refunding issue is the 6-month exception. For purposes of applying the 6-month exception to a refunding, proceeds of the prior issue do not become transferred proceeds of the refunding issue and need not be spent for the refunding issue to meet the 6-month exception. However, those proceeds are subject to rebate as transferred proceeds of the refunding issue, unless the prior proceeds also met an exception to rebate. Regulations § 1.148-7(b)(1).

Extension of Time Period

Section 148(f)(4)(B)(ii) provides that, for governmental bonds (except tax and revenue anticipation notes) and qualified 501(c)(3) bonds, the 6-month time period is extended to one year for an amount of gross proceeds that does not exceed 5 percent of the proceeds.

Prior to enactment of the Taxpayer Relief Act of 1997, this extension applied to the lessor of 5 percent of the proceeds or $100,000.

No De Minimis Exception

There is no de minimis exception (i.e. must spend all gross proceeds within required time period).

18-Month Exception

General Rule

Regulations § 1.148-7(d) provides that an issue meets the rebate requirement if:

- The gross proceeds (as the term is modified for purposes of this exception) of the issue are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule measured from the issue date:
  - At least 15 percent within 6 months (the 1st spending period)
  - At least 60 percent within 12 months (the 2nd spending period)
  - 100 percent within 18 months (the 3rd spending period);
- The rebate requirement is met for amounts not required to be spent within the 18-month spending period (excluding earnings on a bona fide debt service fund); and
- All the gross proceeds (as the term is modified for purposes of this exception) qualify for the 3-year temporary period with respect to bonds for capital projects. This means that the issue must reasonably expect to meet the expenditure test, the time test, and the due diligence test of the capital projects temporary period.

Continued on next page

Amounts Not Considered Gross Proceeds

For purposes of the 18-month exception, among other amounts, "gross proceeds" does not include:

- Amounts in a bona fide debt service fund;
- Amounts in a reasonably required reserve or replacement fund; or
- Gross proceeds that arise after the 18-month period and that were not reasonably anticipated on the date of issuance (e.g., insurance or lawsuit recoveries). (See Regulations §§ 1.148-7(c)(3) and 1.148-7(d)(3).)

These amounts are subject to the rebate requirement.

Investment Earnings

For the first two spending periods, the amount of investment proceeds included in computing gross proceeds is based on the issuer's reasonable expectations as of the issue date. For the third and final spending period, actual earnings are used to compute gross proceeds.

Reasonable Retainage

The 18-month time period is extended to 30 months (i.e., one additional year) for reasonable retainage. "Reasonable retainage" means an amount not to exceed 5 percent of net sale proceeds that is retained for reasonable business purposes relating to the property financed (e.g., retention to ensure compliance with a construction contract).

Continued on next page

De Minimis Rule

Regulations § 1.148-7(b)(4) provides that a failure to meet the requirements of the last spending period does not cause the issue to fail the spending exception if:

- the unspent proceeds do not exceed the lesser of:
  - 3 percent of the issue price, or
  - $250,000; and
- the issuer exercises due diligence to complete the project

Application to Multipurpose Issues

Under Regulations § 1.148-7(d)(4), the 18-month and 2-year exceptions may not be combined in the same issue. Only one of these exceptions may be used for a single issue. However, either the 18-month or 2-year exception may be combined with the 6-month exception.

No Retroactive Effect

Issuers cannot elect to apply the 18-month exception retroactively. It only applies to bonds issued on or after July 1, 1993.

Two-Year Construction Exception

General Rule

Section 148(f)(4)(C) provides that, in the case of a construction issue, the rebate requirements shall not apply to the available construction proceeds of such issue if the spending requirements are met in accordance with the following schedule:

- 10 percent of the available construction proceeds of the issue are allocated to expenditures for the governmental purposes of the issue within the 6 months beginning on the date the bonds are issued (the 1st spending period);
- 45 percent of such proceeds are allocated for such purposes within the1-year period beginning on such date (the 2nd spending period);
- 75 percent of such proceeds are allocated for such purposes within the18-month period beginning on such date (the 3rd spending period); and
- 100 percent of such proceeds are allocated for such purposes within the 2-year period beginning on such date (the 4th spending period).

Continued on next page

Construction Issue

An issue is a "construction issue" if:

- All of the bonds which are part of such issue are:
  - governmental bonds,
  - qualified 501(c)(3) bonds, or
  - private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization; and
- The issuer reasonably expects that at least 75 percent of the available construction proceeds of the construction issue will be used for construction expenditures with respect to property which is to be owned by a governmental unit or a 501(c)(3) organization.

Available Construction Proceeds

Section 148(f)(4)(C)(vi) provides that the term "available construction proceeds" generally means the amount equal to the issue price, plus certain earnings, minus proceeds deposited in a reasonably required reserve or replacement fund and proceeds used to finance issuance costs.

Earnings on the reserve fund are generally included in available construction proceeds until the earlier of the close of the two-year period or the date construction is substantially completed. After that point, earnings on the reserve fund are subject to rebate.

The issuer may, however, elect to exclude earnings on the reserve fund from available construction proceeds altogether. If this election is made, the reserve fund is subject to the rebate requirement from the date of issue.

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Construction Expenditures

Generally, construction expenditures include capital expenditures allocable to real property or constructed personal property, but not expenditures for acquisition of interests in land or other existing real property.

Turnkey contracts can qualify as long as the property has not been built or installed at the time the parties enter into the contract.

Constructed personal property means certain tangible personal property or specially developed computer software.

See Regulations § 1.148-7(g).

Reasonable Retainage

The two-year time period is extended to three years if all that remains as of the fourth spending period is reasonable retainage.

Reasonable retainage means an amount not to exceed five percent of available construction proceeds as of the end of the fourth spending period that is retained for reasonable business purposes relating to the property financed (e.g. retention to ensure compliance with a construction contract). Section 148(f)(4)(C)(iii).

De Minimis Rule

Regulations § 1.148-7(b)(4) provides that a failure to meet the requirements of the last spending period does not cause the issue to fail the spending exception if:

- the unspent proceeds do not exceed the lesser of:
  - 3 percent of the issue price, or
  - $250,000; and

- the issuer exercises due diligence to complete the project

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Bifurcation

Regulations § 1.148-7(j) provides that for purposes of applying this exception, the issuer may elect to treat the issue as two separate issues, as long as all construction expenditures are allocated to one of the issues (i.e., a construction issue and a non-construction issue) and certain conditions are met.

Penalty in Lieu of Rebate

An issuer of a construction issue may elect on or before the issue date to pay a "penalty in lieu of rebate" under the 2-year exception. (See §148(f)(4)(C)(vii).) The penalty amount is 1.5 percent of the amount by which an issue fails to meet the spending requirement as of any spending period. The penalty payment is in lieu of the obligation to pay the rebate amount on available construction proceeds upon failure to satisfy the spending requirements.

Section 14

Bona Fide Debt Service Fund Exception

Overview

Bona Fide Debt Service Exception

Section 148(f)(4)(A)(ii) provides that investment earnings on a bona fide debt service fund are excluded from rebate in certain cases.

Under Regulations § 1.148-1(b), a bona fide debt service fund is:

- used primarily to achieve a proper matching of revenues with debt service payments within each bond year and
- depleted at least once each bond year except for a reasonable carryover amount not to exceed the greater of (1) the earnings on the fund for the immediately preceding bond year or (2) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Under § 148(f)(4)(A)(ii), investment earnings on a bona fide debt service fund are exempt from the rebate requirement if the gross earnings on such fund for the bond year are less than $100,000.

The $100,000 earnings limitation may be ignored:

- For issues after July 1, 1993 with average annual debt service that is not in excess of $2,500,000 (Regulations § 1.148-3(k)); and
- For fixed rate governmental issues with an average maturity of at least 5 years (§ 148(f)(4)(A)(ii))

The 1997 Act provides that, in instances where the spending requirements of the two-year spending exception are met with respect to the available construction proceeds of a construction issue, earnings on a bona fide debt service fund will be excluded from rebate.

Section 15

Computing the Amount of Rebate Due

Overview

Introduction

If there are gross proceeds of an issue that do not qualify for an exception, steps five through ten should be taken for purposes of calculating rebate. Step eleven is the actual payment of rebate due. This section discusses these final steps, and includes examples of computing rebate.

Contents

This section contains the following topics:

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Computation and Payment Dates

General Rule

If there are gross proceeds of an issue that do not qualify for an exception, steps five through eleven should be taken for purposes of calculating and paying rebate. The general rule for the calculation of rebate set forth in §148(f)(2) and Regulations § 1.148-3 is that an issuer of bonds must pay to the Federal government an amount equal to the amount earned on all nonpurpose investments less the amount that would have been earned if the nonpurpose investments were invested at a rate equal to the yield on the bonds

Step Five – Computation and Payment Dates

According to Regulations §§ 1.148-3(e)(1) and 1.148-3(f), in order to calculate rebate, the computation and payment dates must first be determined. The general rule is that an issuer must compute rebate for successive 5-year intervals from the date of issue.

Computation Date and Period Defined

Computation date means each date on which the rebate amount for an issue is computed under Regulations § 1.148-3(e). Computation period means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date. Regulations §1.148-1(b).

Fixed Yield Issue

An issuer of a fixed yield issue may treat any date as a computation date. Regulations § 1.148-3(e)(1).

Variable Yield Issue

For a variable yield issue, an issuer may treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid as a computation date but may not change that treatment after the first payment date. After the first required payment date, an issuer must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date. Regulations § 1.148-3(e)(1).

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Final Computation Date

The date that an issue is discharged is generally the final computation date.

For an issue retired within three years of the issue date, the final computation date need not occur before the end of 8 months after the issue date or during the period in which the issuer reasonably expects that any of the spending exceptions will apply to the issue.

Rebate Installment Payment Date

Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. Regulations § 1.148-3(g).

Step Six – Yield Calculated

Bond yield is then determined. Yield is calculated the same way for rebate purpose as it is for yield restriction purposes. (See Regulations § 1.148-4(a).)

See Section 3 of this lesson for a discussion of calculating the bond yield.

Step Seven – Proceeds Allocated to Nonpurpose Investments

Next, proceeds of the issue must be allocated to nonpurpose investments.

Regulations § 1.148-6(a)(1) provides that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures.

Amounts are generally allocable to only one issue at a time as gross proceeds. (See Regulations § 1.148-6(b)(1).)

Amounts cease to be allocable to an issue as proceeds only when those amounts:

- are allocated to an expenditure for a governmental purpose;
- are allocated to transferred proceeds of another issue; or
- cease to be allocated to that issue at retirement of the issue or under the universal cap rule of Regulations § 1.148-6(b)(2).

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Step Seven – Proceeds Allocated to Nonpurpose Investments (continued)

Amounts cease to be allocated to an issue as replacement proceeds only when those amounts:

- are allocated to an expenditure for a governmental purpose;
- are no longer used in a manner that causes those amounts to be replacement proceeds of the issue; or
- cease to be allocated to that issue at retirement of the issue or the application of the universal cap rule.

Regulations § 1.148-6(c) provides that, upon purchase or sale of a nonpurpose investment, gross proceeds of an issue are not allocated to a payment for that nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of the nonpurpose investment as of the purchase or sale date.

Step Eight – Cash Flow Schedule Created

Next, a schedule of the cash flows of the nonpurpose investments must be made. The cash flows are shown as either negative (for payments) or positive (for receipts).

Information Sources

Information regarding the payments for and receipts of nonpurpose investments are normally obtained from the issuer or their trustee. Generally, not all the required information will be in the bond transcript, because the bond transcript includes documents as of the issue date and investments are typically made or repaid with investment earnings after such date.

Continued on next page

Payments

For purposes of creating a cash flow schedule, payments are:

- Amounts paid to acquire a nonpurpose investment;
- For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired or that becomes subject to the rebate requirement on a date after it is actually acquired, the value of the investment on that date;
- For a nonpurpose investment that was allocated to an issue at the end of the preceding computation period, the value of that investment at the beginning of the computation period;
- On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of$1,000; and
- Yield reduction payments on nonpurpose investments.

The size and number of the computation credits that should be included as payments will depend, in part, on which set of regulations applies. For instance, the 1993 regulations provide for a $1,000 computation credit as described above while the 1992 regulations provide for a computation date credit of $3,000 on each eligible computation date.

In 2007, proposed regulations provided for a cost-of-living adjustment to the computation credit for calendar years after 2007. The proposed regulations were published (REG-106143-07, September 26, 2007) and provide for permissive application of the cost-of-living adjustment for bond years ending on or after September 26, 2007.

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Receipts

For purpose of creating a cash flow schedule, receipts are:

- Amounts actually or constructively received from a nonpurpose investment, such as earnings and return of principal;
- For a nonpurpose investment that ceases to be allocated to an issue before its disposition or redemption date or that ceases to be subject to the rebate requirement on a date earlier than its disposition or redemption date, the value of that nonpurpose investment on that date; and
- For a nonpurpose investment that is held at the end of a computation period, the value of that investment at the end of that period.

Qualified Administrative Costs

Regulations § 1.148-5(e) provides that qualified administrative costs are taken into account in determining payments and receipts on nonpurpose investments. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. As such, qualified administrative costs decrease the yield on an investment and lower the rebate amount.

Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but NOT legal and accounting fees, recordkeeping, custody, and similar costs, and general overhead costs.

Step Nine – Payments and Receipts

Next, the cash flow created in the previous step is future valued to the computation date at the bond yield.

Future valuing provides for a mechanism which takes into account the time value of money when comparing amounts paid or received at different times.

Step Ten – Net Payments and Receipts

The future value of the payments and receipts are then netted against each other, and the net amount is the required rebate amount.

Payment of Rebate Due

Step Eleven – Timely Payment

The last step requires the timely payment of rebate.

Section 148(f)(3) requires that rebate be paid at least once every 5 years during the life of the bonds. The regulations, however, provide issuers with the flexibility to make earlier installment payments.

Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. The last rebate payment is due no later
than 60 days after the last bond is redeemed. Any rebate payment paid within the 60-day period may be treated as paid on the computation date to which it relates.

Except for the final payment, the amount of each required installment payment is at least 90 percent of the rebate amount as of that computation date, taking into account the future value of previous rebate payments.

An issuer is required to file Form 8038-T with its rebate payment.

An issuer that fails to pay rebate when required for a reason other than willful neglect may pay a penalty in lieu of loss of tax-exemption for interest on the bonds.

Penalty for Late Payments

For governmental and 501(c)(3) bonds, the penalty is 50 percent of the rebate amount not paid when required to be paid, plus interest on that amount. For other issues the penalty is 100 percent of the rebate amount, plus interest. Interest is computed at the underpayment rate under § 6621.

The penalty is automatically waived if the rebate amount plus interest is paid within 180 days of discovery of the failure unless:

- the issue is under examination; or
- the failure is due to willful neglect

(See Regulations § 1.148-3(h).)

Continued on next page

Recovery of Rebate Overpayment

Regulations § 1.148-3(i) provides that an issuer may recover an overpayment of rebate. There is an overpayment if the amount previously paid exceeds the sum of the rebate amount of the issue as of the most recent computation date plus any other amounts due (e.g. penalty in lieu of rebate) under § 148 as of the date the claim is made.

General Limitation: An overpayment can only be recovered if the recovery on the date it is first requested would not result in an additional rebate amount if that date were treated as a computation date.

Deadline for the Filing of Claims to Recover Overpayments: Regulations § 1.148-3(i)(3)(i) requires the filing of claims for recovery of overpayments of rebate to be filed no later than the date that is two years after the final computation date with respect to the issue, or two years from July 1, 2008 for an issue of bonds whose final computation date is on or before June 24, 2008.

Additional Limitation: Except for overpayments of penalty in lieu of rebate, an overpayment of less than $5,000 may not be recovered before the final computation date.

No interest is allowed on recoveries of an overpayment amount.

Section 16

Examples of Computing Rebate

Fixed Yield Issue

Example 18

On January 1, 1994, City A issues $49,000,000 of fixed yield bonds and invests all the sale proceeds. The bonds have a yield of 7% per annum (using semiannual compounding) and mature January 1, 2004. City A receives income from the investment of the bond proceeds and spends this income, as well as the sale proceeds themselves, for the governmental purpose of the issue according to the following schedule:

Date	Amount
2/1/94	$ 3,000,000
5/1/94	5,000,000
1/1/95	5,000,000
9/1/95	20,000,000
3/1/96	22,000,000

The total expenditures equals $55,000,000. This represents $49,000,000 of original proceeds plus $6,000,000 of investment proceeds. The significant amount of earnings indicates a high yield on the investment of the sale proceeds. The absence or presence of arbitrage profits is determined by the rebate calculation.

City A selects a bond year ending on January 1, so the first required computation date is 5 years from the issue date, on January 1, 1999. The rebate amount as of this date is computed by determining the future value of the receipts and the payments for the investments, using the same compounding interval used to compute the yield on the bond issue. The future value of these amounts, plus computation credits, as of January 1, 1999, is shown on the table on the following page.

Continued on next page

Example 18 (continued)

Date	Receipts (Payments)	FV (7%)
1/1/94	($49,000,000)	($69,119,339)[a]
2/1/94	3,000,000	4,207,602[b]
5/1/94	5,000,000	6,893,079
1/1/95	5,000,000	6,584,045
1/1/95	(1,000)	(1,317)[c]
9/1/95	20,000,000	25,155,464
1/1/96	(1,000)	(1,229)[c]
3/1/96	22,000,000	26,735,275
1/1/97	(1,000)	(1,148)[c]
Rebate amount (1/1/99)		$ 452,432

[a] This is the same as the amount that would be received on 1/1/99 if the proceeds from the sale of the bonds were invested at 7% per annum (the yield on the bonds) from 1/1/94 to 1/1/99.

[b] This amount (and the four following amounts) is what would be received if investment receipts (which are composed of both repayments of principal and interest from the investments) were invested at 7% per annum (the yield on the issue), compounded semiannually, from the date received through the date of the rebate calculation.

[c] Computation credit.

The amount of $69,119,339 is the future value of the $49,000,000 invested, assuming a yield on the investments equal to the yield on the bonds. The rebate determination involves measuring whether that amount, plus the future value of the computation credits, is greater than or less than the future value of receipts. If it is less, rebate is owed. Here, $69,119,339 plus $3,694 (the future value of the computation credits) equals $69,123,033. The aggregate future value of the receipts is $69,575,465. $69,575,465 minus $69,123,033 equals the rebate amount of $452,432.

City A files Form 8038-T and pays 90 percent of the rebate amount ($407,189) to the United States within 60 days of January 1, 1999.

Continued on next page

Example 18 (continued)

On January 1, 2004, City A redeems all the bonds, and thus this date is the final computation date. The future value of the receipts and payments as of this date is:

Date	Receipts (Payments)	FV (7%)
1/1/99	$452,432	$ 638,200
1/1/04	(1,000)	(1,000)
Rebate Amount (1/1/04)		$ 637,200

As of this computation date, the future value of the payment made on January1, 1999, is $574,380 and thus an additional rebate payment of $62,820 is due. This payment reflects the future value of the 10 percent unpaid portion, and thus would not be owed had the issuer paid the full rebate amount as of any prior computation date.

Variable Yield Issue

Example 19

On July 1, 1994, City B issues $30,000,000 of variable yield bonds and invests all of the sale proceeds. As of July 1, 1999, there are nonpurpose investments allocated to the issue. Prior to July 1, 1999, City B receives amounts from nonpurpose investments and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
08/01/94	$ 5,000,000
07/01/95	8,000,000
12/01/95	17,000,000
07/01/99	650,000

City B treats the last day of the fifth bond year (July 1, 1999) as a computation date. The yield on the variable yield issue during the first computation period is 6% per annum (using semiannual compounding). The value of the nonpurpose investments allocated to the issue as of July 1, 1999, is $3,000,000. The rebate amount as of July 1, 1999, is computed by determining the future value of the receipts and the payments for the nonpurpose investments, using the same conventions used to compute the yield on the bond issue. The future value of these amounts and of the computation date credits as of July 1, 1999, is:

Date	Receipts (Payments)	FV (6%)
07/01/94	($30,000,000)	($40,317,491)
08/01/94	5,000,000	6,686,560
07/01/95	(1,000)*	(1,267)
07/01/95	8,000,000	10,134,161
12/01/95	17,000,000	21,011,112
07/01/96	(1,000)*	(1,194)
07/01/97	(1,000)*	(1,126)
07/01/98	(1,000)*	(1,061)
07/01/99	650,000	650,000
07/01/99	3,000,000	3,000,000
07/01/99	(1,000)*	(1,000)

Rebate amount (7/01/1999) $1,158,694

*Payments include computation credits of $1,000. (See Regulations § 1.148-3(d)(1)((iv)).

Continued on next page

Example 19 (continued)

The future value of the initial $30,000,000 payment to acquire nonpurpose investments is $40,317,491. $40,317,491 plus $5,648 (the future value of the computation credits) equals $40,323,139. The aggregate future value of the receipts is $41,481,833. This amount includes the value of the nonpurpose investments held at the end of
the computation period ($3,000,000). $41,481,833 minus $40,323,139 equals the required rebate amount of $1,158,694.

City B pays 90 percent of the rebate amount ($1,042,825) to the United States within 60 days of July 1, 1999.

On July 1, 2004, City B redeems all of the bonds. Thus, the next computation date is July 1, 2004. On July 30, 1999, City B chose to compute rebate for periods following the first computation period by treating the end of each fifth bond year as a computation date. The yield during the second computation period is 5% per annum (using semiannual compounding). The computation of the rebate amount as of this date reflects the value of the nonpurpose investments allocated to the issue at the end of the prior computation period. On July 1, 2004, City B sells those nonpurpose investments for $3,925,000 and expends that amount for the governmental purpose of the issue.

As of July 1, 2004, the future value of the rebate amount computed as of July 1, 1999, and of all other payments and receipts is:

Date	Receipts (Payments)	FV (5%)
07/01/99	$1,158,694	$1,483,226
07/01/99	(3,000,000)	(3,840,254)
07/01/00	(1,000)	(1,218)
07/01/01	(1,000)	(1,160)
07/01/02	(1,000)	(1,104)
07/01/03	(1,000)	(1,051)
07/01/04	(2,000)*	(2,000)
07/01/04	3,925,000	3,925,000

Rebate Amount (07/1/2004) $1,561,439

Continued on next page

Variable Yield Issue, Continued

Example 19 (continued)

As of the July 1, 2004, the final computation date, the future value of the payment made on July 1, 1999, is $1,334,904 and thus an additional rebate payment of $226,535 is due.

* This payment includes computation credits of $1,000 for amounts allocated to gross proceeds of an issue subject to rebate and $1,000 for the final maturity. (See Regulations § 1.148-3(d)(1)(iv).)

Section 17

Yield Burning

Fair Market Value

Regulations §1.148-6(c)

Gross proceeds of an issue cannot be allocated to a payment for a nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of that nonpurpose investment. (See Regulations § 1.148-6(c).)

Yield burning is a concern in the arbitrage area. Issuers may lack incentive to invest at the highest possible yield if investment profits above the bond yield need to be paid over to the United States. Purchasing an investment for more than it is worth can be a way of transferring rebatable arbitrage profit to someone else.

This area should be looked at closely on examination to determine if fair market value was paid for investments.

The determination of the fair market value of investments is discussed in greater depth in TEB Basic Training Phase II and Phase III.

Summary

Review of Lesson 5 Regarding Arbitrage

Section 103(b)(2) provides that interest on a bond is not excludable from income for federal tax purposes if the bond is an arbitrage bond.

Section 148(a) provides that an arbitrage bond is any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of the issuance of the bond) to be used directly or indirectly to acquire higher yielding investments or to replace funds which were used to acquire higher yielding investments.

Additionally, a bond is an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the bonds as described above.

For purposes of § 148(a), "proceeds" generally include sale proceeds, investment proceeds, transferred proceeds, and replacement proceeds. In addition, according to Regulations § 1.141-12(a)(4) disposition proceeds must be treated as gross proceeds for purposes of § 148(a).

Yield on a bond issue is the economic return to the bondholders. A bond can have a fixed or a variable yield.

Yield on a fixed yield issue is the discount rate that results in the aggregate present value, as of the issue date, of all unconditionally payable payments over the life of the issue equaling the present value of the issue price as of that date.

Yield on a variable yield issue is computed separately for each computation period. The yield for each computation period is the discount rate at which the present value, as of the first day of the computation period, of all payments of principal and interest and qualified guarantees paid on the bond issue during that computation period, equals the present value of the issue price, as of the first day of the computation period.

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Review of Lesson 5 Regarding Arbitrage (continued)

Yield on investments is calculated in the same manner as the yield on the bonds. The yield on the investments is determined separately on each class of investments.

If the investment property acquired with the proceeds of the bond issue produces a yield which is "materially higher" than the yield on the issue, then the proceeds of the issue are used to acquire higher yielding investments. The definition of "materially higher" differs depending on the type of investment.

Section 148(c) and the accompanying regulations provide temporary periods during which the bond proceeds may be invested without yield restriction. The length of the temporary period generally depends upon the purpose for which the bonds are issued.

Although the arbitrage rules permit some proceeds to be invested without yield restriction, the issuer is generally not permitted to retain such arbitrage earnings. In some cases, the issuer can retain the arbitrage earnings, while in others the earnings must be rebated to the United States.

Review of Lesson 5 Regarding Rebate

Even if arbitrage can be earned under the yield restriction rules, it may be subject to rebate to the United States.

Although some of the rebate rules are similar to the yield restriction rules, the requirement to rebate arbitrage is separate from the requirement to restrict yield.

The rebate rules concentrate on actual cash flows rather than expected cash flows.

Before computing rebate, it must be determined whether any gross proceeds of the issue are excepted under any of the exceptions.

Rebate is computed using the future value method under the regulations.

Lesson 6

Proceeds and Allocations

Overview

Purpose

The applicable rules concerning tax-exempt bonds focus on the use and investment of the proceeds of the bonds. To determine whether the bond issue complies with § 103, it is important to determine what constitutes the "proceeds" (and net proceeds, gross proceeds and other variations of proceeds) of the bond issue. With the exception of "**net proceeds**," these concepts of "**proceeds**" are not defined in the Code. Definitions are found in various parts of the regulations. Sometimes the definitions are the same, but sometimes there are different definitions of the same term for different purposes. Some definitions apply for all purposes of §§ 141 through 150 while others apply on a more limited basis. The first three sections in this lesson will enable you to identify the various types of proceeds.

In determining compliance with the tax rules governing how the proceeds may be used or invested, it is necessary to measure and track the proceeds. Therefore, the Code and regulations contain various rules on the allocation of proceeds to investments and expenditures. There are also rules on the allocation of bonds to those proceeds and to the purposes to which the proceeds are allocated. The other sections of this lesson will enable you to determine if the allocation rules are being applied correctly by the issuer.

Continued on next page

Overview, Continued

Proceeds

Since the definition of proceeds is different for different purposes, the context in which the proceeds are being considered is critical. Consider:

Section 141 provides that a bond is a private activity bond if more than a specified amount of the "proceeds" of the bond are used:

- for a private business use and the private security or payment test is met,

  or

- to make or finance private loans or
- to acquire nongovernmental output property.

To be eligible for tax exemption as a qualified private activity bond, the "net proceeds" of the bond must be used in specified ways.

Section 148(a)(1) provides that a bond is an arbitrage bond if the "**proceeds**" of the bond are reasonably expected, at the time of issuance, to be invested in higher yielding investments. Section 148(f)(4)(B)(i) provides that a bond is to be treated as complying with the rebate requirement if the "**gross proceeds**" of the bond are spent within six months of the issue date.

Allocations

The allocation rules govern the manner in which an issuer may account for its use of proceeds of a bond issue. Allocations to investments are critical in determining compliance with yield restriction and rebate under § 148, as is the timing of allocations to expenditures. Allocations to types of expenditures are critical in determining compliance with many of the rules under §§ 141 to 150. When multiple sources of financing are used, appropriate allocations must be made from the sources. When a bond issue finances more than one activity, it may be important to allocate portions of the bond issue to the respective activities.

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Objectives

At the end of this lesson, you will be able to:

- Identify gross proceeds for arbitrage purposes, including sale proceeds, investment proceeds, transferred proceeds and replacement proceeds
- Describe proceeds and net proceeds in the context of the private activity bond tests and the exempt facility bond rules
- Identify and allocate bonds to a bond issue and to portions of a multi- purpose bond issue
- Apply the universal cap rule to a set of facts
- Allocate proceeds to capital expenditures and working capital expenditures
- Explain the general rules for proper reimbursement allocations

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Section 1

Proceeds of the Bonds Defined - § 148

Proceeds

Definition

Various “proceeds” are defined in the arbitrage regulations as shown below:

Under Regulations:	Type of “proceeds”:	Purpose:
§ 1.148-1(b)	gross proceeds sale proceeds investment proceeds transferred proceeds	Arbitrage and Rebate
§ 1.148-1(c)	replacement proceeds	Arbitrage and Rebate
§ 1.148-10(c)	excess gross proceeds	Arbitrage

Prior Definitions

Proceeds are defined in various sections of the withdrawn arbitrage regulations as shown below:

Under Regulations:	Proceeds include:	Purpose:
§ 1.103-13(b)(2)	original proceeds and investment proceeds	Arbitrage
§ 1.103-13(g)	amounts in a sinking fund (replacement proceeds)	Arbitrage
§ 1.103-14(e)	transferred proceeds	Arbitrage
§1.103-15	excess proceeds	Arbitrage

Continued on next page

Allowable Return on Purpose Investments Is Excluded

For purposes of defining "**proceeds**" for the arbitrage rules, Regulations § 1.148-1(b) provides that proceeds do not include amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under Regulations § 1.148-2(d) or § 143(g) or to qualified administrative costs recoverable under Regulations § 1.148-5(e).

Note

Other definitions of proceeds found in certain withdrawn regulations may be applicable to certain bond issues.

Sales Proceeds

Definition

Under Regulations § 1.148-1(b), "**sale proceeds**" means any amounts actually or constructively received from the sale of an issue. This includes amounts paid as underwriter's discount or other compensation, and any accrued interest (other than pre-issuance accrued interest).

Sale proceeds also include any amounts received as a result of a sale of a right associated with the bond. The transfer of rights associated with the bond is discussed in Regulations § 1.148-4(b)(4) and is more fully discussed in the Phase II, Lesson 2, Advanced Topics in Arbitrage text. In addition, a transfer of rights could result in a reissuance of the bonds, as described in the Phase III, Lesson 4, Reissuance text.

Sale proceeds (as well as issue price) will be adjusted to reflect amounts received or paid by the issuer in connection with the termination of an anticipatory hedge entered into before the issuance of bonds if the hedge was expected to be terminated in connection with the issuance. This is discussed in Regulations § 1.148-4(h)(5) and is more fully discussed in the Phase II, Lesson 2, Advanced Topics in Arbitrage text

Note

Due to the exclusion of pre-issuance accrued interest, the amount of sale proceeds will not always be equal to the issue price of the bonds.

Net Sales Proceeds

Definition

Regulations § 1.148-1(b) defines "**net sale proceeds**" as sale proceeds less the portion of sale proceeds invested in a reasonably required reserve or replacement fund under § 148(d) and as a part of a minor portion under § 148(e).

Investment Proceeds

Definition

Regulations § 1.148-1(b) defines "**investment proceeds**" as any amounts actually or constructively received from investing proceeds of an issue.

Because "**proceeds**," as defined under Regulations § 1.148-1(b), does not include replacement proceeds, investment earnings on replacement proceeds are not investment proceeds. For example, investment proceeds do **NOT** include investment earnings with respect to the investment of amounts treated as gross proceeds because they are in a debt service fund or other sinking fund. However, such earnings may constitute gross proceeds for independent reasons, as discussed below.

Prior Definitions

Regulations § 1.103-13(b)(2)(ii)(A) defines investment proceeds as amounts received by the issuer, such as interest and dividends, resulting from the investment of proceeds.

Regulations § 1.103-13(b)(2)(ii)(B) provides that investment proceeds do **NOT** include receipts from investment of amounts treated as proceeds because they are in a sinking fund.

Transferred Proceeds

Applicable Regulations

Due to the various arbitrage regulations issued by the Service under § 148, an agent must determine the regulation applicable to the issue under audit so as to determine the appropriate definition of "**transferred proceeds**".

Generally, these are unspent proceeds of a prior bond issue, which has been refunded. These unspent proceeds will transfer to the refunding bond and will no longer be proceeds of the prior issue. Utilizing the appropriate definition is critical in determining the amount and the date on which the transferred proceeds are "transferred" to the refunding issue.

1993 Regulations

Transferred proceeds are defined in Regulations § 1.148-9(b). When proceeds of a refunding issue are used to make principal payments on the refunded bonds, any unspent proceeds of the refunded issue become proceeds of the refunding issue. The unspent proceeds "transfer over" to the refunding issue in amounts based on a formula provided in Regulations § 1.148-9(b)(1).

1992 Regulations

Transferred proceeds are defined in § 1.148-11(c)(9) of the 1992 regulations. The definition is this section is similar to the definition in Regulations § 1.148-9(b). The formula for transfer amounts is also similar to the 1993 definition, and is found in § 1.148-11(d) of the 1992 regulations.

Continued on next page

Transferred Proceeds, Continued

1989 Regulations

Regulations § 1.148-8T(d)(8) defines transferred proceeds. "Transferred proceeds" means, with respect to a refunding issue, proceeds that have ceased to be proceeds of a refunded issue and are transferred proceeds of the refunding issue by reason of Regulations § 1.148-4T(e)(2) (including amounts actually or constructively received from investing such proceeds). The formula for transfer amounts under Regulations § 1.148-4T(e)(2) was quite different from prior and subsequent regulations, and used a "dollar for dollar" approach.

1979 Regulations

Regulations § 1.103-14(e)(2)(ii) defines transferred proceeds. The definition in this section is similar to the definition in Regulations. § 1.148-9(b), as is the formula for the transfer amounts.

Gross Proceeds

Definitions

Although § 148(a) only refers to proceeds of the bond, Regulations § 1.148-2(a) provides that the direct or indirect investment of the "**gross proceeds**" of an issue in higher yielding investments causes the bond issue to be an arbitrage bond.

"Gross proceeds" are referred to in § 148(f)(4)(B), and the term is defined in § 148(f)(6)(B):

> Except as otherwise provided by the Secretary, the gross proceeds of an issue include--(i) amounts received (including repayments of principal) as a result of investing the original proceeds of the issue, and (ii) amounts to be used to pay debt service on the issue.

Gross proceeds are defined in Regulations § 1.148-1(b) to include proceeds and replacement proceeds, which is broader than the definition in the statute, as it includes certain replacement proceeds that might not be intended to be used for debt service. This definition in Regulations § 1.148-1(b) is to be applied in determining compliance with the arbitrage and rebate rules

Application

In determining whether the bonds are arbitrage bonds, the examining agent must determine whether, in addition to the "proceeds" (sale proceeds, investment proceeds and transferred proceeds), the bond issue has any replacement proceeds.

Replacement Proceeds

Definition

Regulations § 1.148-1(c) defines **replacement proceeds:**

> Amounts are replacement proceeds of an issue if they have a sufficient direct nexus to:
> - the bond issue **or**
> - the governmental purpose of the issue
>
> to conclude that the amounts would have been used for the governmental purpose if the bonds were not used for such purpose.

For this purpose, payment of debt service is considered a governmental purpose of the issue. If an issuer sets aside moneys to be used to pay debt service on the bonds on a particular date, such amounts are considered replacement proceeds of the bonds.

The mere earmarking of funds for a governmental purpose, however, does not establish a nexus to cause the amounts to be replacement proceeds.

Replacement proceeds include, but are not limited to, sinking funds and pledged funds and certain "other replacement proceeds," in each case to the extent that such amounts are held by or derived from a substantial beneficiary of the issue. For this purpose a substantial beneficiary of an issue includes
the issuer and any related party to the issuer, and if the issuer is not a state, the state in which the issuer is located. A person is **not** a substantial beneficiary solely because they are a guarantor of the issue under a qualified guarantee.

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Sinking Fund

Regulations § 1.148-1(c)(2) provides that 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 debt service on the bonds.

Example 1

City X has certain bonds outstanding. City X sells some real property and the city council decides to set aside the proceeds of the sale of the real property to pay the debt service on the bonds. The proceeds from the sale of the real property are considered replacement proceeds and investments of such moneys, and rebate of earnings on such moneys, must comply with § 148.

See also Rev. Rul. 79-134, 1979-1 C.B. 76; Rev. Rul. 80-13, 1980-1 C.B. 27.

Pledged Funds

A pledged fund is any amount that is directly or indirectly pledged to pay the principal of or interest on the bonds. A pledge by the issuer must provide reasonable assurance that such moneys will be available to pay the debt service on the bonds even if the issuer has financial difficulties. A party other than the issuer or conduit borrower may provide a pledge to secure the debt service on the bonds. A pledge to a guarantor of bonds is an indirect pledge.

See Regulations § 1.148-1(c)(3)(i).

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Replacement Funds, Continued

Example 2

County X, a political subdivision of State Y will sell $50 million principal amount of bonds to finance the construction of a facility. State Y has surplus funds in the amount of $50 million which it will invest in U.S. Treasury notes and pledges not to dispose of the notes while the bonds are outstanding. However, State Y does not reasonably expect to use the notes to pay debt service on the bonds. Because the notes are pledged as security for the bonds, the notes form a pledged fund for the bonds.

See Rev. Rul. 78-348, 1978-2 CB 95.

Example 3

State A issued $1 million principal amount of bonds and lent the proceeds to Corporation B. Corporation B owns a federally insured mortgage note to be pledged as collateral for bonds. The note has a materially higher yield than the yield on the bonds. There is reasonable assurance that the collateral will be available to pay debt service on the bonds. Accordingly, pledge of the mortgage note creates replacement proceeds.

See Rev. Rul. 78-348, 1978-2 C.B. 95.

Example 4

City Z issues $10 million principal amount of bonds and loans the proceeds to Corporation X to construct a facility. Corporation X enters into an agreement with Bank A, which will provide a letter of credit as security for the bonds. Corporation transferred $3 million to Bank A which Bank A sets aside in a separate account, which can only be used to pay any draws on the letter of credit. The $3 million in the special account is a pledged fund.

See also PLR 8844042.

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Negative Pledge

Under Regulations § 1.148-1(c)(3)(ii), a negative pledge is holding certain amounts pursuant to an agreement for the benefit of the bondholders or a guarantor that such amounts, although not pledged, will be maintained at a certain level. **Such amounts will be replacement proceeds unless:**

- The issuer or a substantial beneficiary may grant rights in the funds to a party that are superior to the rights of the bondholders or guarantor; **or**
- The amounts do not exceed the reasonable needs for which they are maintained, the required level is tested no more frequently than every 6 months, **and** the amounts may be spent without substantial restrictions, other than the requirement to replenish the amounts by the next testing date.

See also PLR 8841027.

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Other Replacement Proceeds

Other replacement proceeds (Regulations § 1.148-1(c)(4)) may arise if on the issue date, the issuer reasonably expects that:

- the bonds will be outstanding longer than necessary for the governmental purpose; **and**

there will be "available amounts" during the time that the bonds are outstanding longer than necessary

Available amounts are defined in Regulations § 1.148-6(d)(3)(iii). Available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of the issue but 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 being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

A determination whether the issue will be outstanding longer than necessary is made under Regulations § 1.148-10, which discusses abusive arbitrage devices arising from, among other things, overburdening the tax-exempt market by issuing too many bonds, issuing bonds too early or allowing bonds to remain outstanding too long.

The replacement proceeds are created at the beginning of each fiscal year in an amount equal to the available amounts. Essentially, the available amounts are treated as if they are proceeds.

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Replacement Proceeds, Continued

Safe Harbor

Regulations § 1.148-1(c)(4)(B) provides safe harbors against creation of "other replacement proceeds" for the portions of an issue used for certain purposes, if certain criteria is met:

Purpose	Safe Harbor Criteria
Finance restricted working capital expenditures	Bonds outstanding no longer than two years
Financing or refinancing capital projects	Weighted average maturity of bonds not greater than 120% of average reasonable expected economic life of financed capital projects
Refunding of bonds	Weighted average maturity of bonds not greater than weighted average maturity of the prior bonds **and** the prior bond issue met one of the two preceding safe harbor criteria

Excess Gross Proceeds

Definition

Regulations § 1.148-10(c)(1) provides that advance refunding bonds utilize an abusive device and are arbitrage bonds if the issue has any excess gross proceeds.

"**Excess gross proceeds**" are defined in Regulations § 1.148-10(c)(2) as all gross proceeds of an advance refunding issue that exceed an amount equal to one percent of the sale proceeds of the issue, exclusive of gross proceeds allocable to:

(i) Payment of principal, interest, or call premium on the prior issue;

(ii) Payment of pre-issuance accrued interest on the refunding issue, and interest on the refunding issue that accrues for a period up to the completion date of any capital project for which the prior issue was issued, plus one year;

(iii) A reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund;

(iv) Payment of costs of issuance of the refunding issue;

(v) Payment of administrative costs allocable to repaying the prior issue, carrying and repaying the refunding issue, or investments of the refunding issue;

(vi) Transferred proceeds that will be used or maintained for the governmental purpose of the prior issue;

(vii) Interest on purpose investments;

(viii) Replacement proceeds in a sinking fund for the refunding issue

(ix) Qualified guarantee fees for the refunding issue or the prior issue; and

(x) Fees for a qualified hedge for the refunding issue.

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Excess Gross Proceeds, Continued

Application

To limit potential abuses in connection with advance refundings, the regulations limit the amount of gross proceeds permitted in connection with an advance refunding. Except for a de minimis amount equal to one percent of the sale proceeds of the issue, all gross proceeds of the advance refunding issue must fit within one of the 10 categories of permitted gross proceeds. Certain of the categories are described in terms of how the gross proceeds are applied, e.g., payment of costs of issuance. Other categories are based upon the reason the amounts constitute gross proceeds, e.g., replacement proceeds in a sinking fund for the refunding issue.

Disposition Proceeds

General

The term "**disposition proceeds**" is not used under § 148 or the related regulations. However, with respect to a change in use, Regulations § 1.141-12(a)(4) of the private activity bond regulations provides that disposition proceeds must be treated as gross proceeds for purposes of § 148 as a condition of the remedial action being effective for purposes of § 141.

Application

An agent examining a transaction where disposition proceeds may have resulted should analyze the transaction under § 141 and the related regulations, **and** should also analyze the treatment of disposition proceeds under § 148 and the related regulations.

Section 2

Proceeds of the Bonds Defined - § 141

Proceeds

Definition

Proceeds are defined in the regulations as shown below:

Under Regulations	Proceeds include	Purpose
§ 1.141-1(b)	• sale proceeds, other than those used to retire bonds of the issue but were not in a reasonably required reserve or replacement fund • investment proceeds during the construction period, net of rebate amounts • disposition proceeds in connection with change-in-use remediation permitted under Regulations § 1.141-12(e) • Commissioner may treat any replaced amounts as proceeds	Private activity bond tests

Sales Proceeds

Definition

Regulations § 1.141-1(a) incorporates the definition of "**sale proceeds**" from § 1.148-1(b) for purposes of applying the private activity bond regulations in §§ 1.141-0 through 1.141-16.

Under Regulations § 1.148-1(b), sale proceeds means any amounts actually or constructively received from the sale of an issue. This includes amounts paid as underwriter's discount or other compensation, and any accrued interest (other than pre-issuance accrued interest).

Sale proceeds also include any amounts received as a result of a sale of a right associated with the bond. The transfer of rights associated with the bond is discussed in Regulations § 1.148-4(b)(4).

Remember

Due to the exclusion of pre-issuance accrued interest, the amount of sale proceeds will not always be equal to the issue price of the bonds.

Investment Proceeds

Definition

Regulations § 1.141-1(a) incorporates the definition of "**investment proceeds**" from § 1.148-1(b) for purposes of applying the private activity bond rules in Regulations §§ 1.141-0 through 1.141-16. Regulations § 1.148-1(b) defines investment proceeds as any amounts actually or constructively received from investing proceeds of an issue.

Application

Proceeds for purposes of § 141 include any investment proceeds that accrue during the project period (net of rebate amounts attributable to the project period). Project period is defined in Regulations § 1.141-1(b) as the period beginning on the issue date and ending on the date that the project is placed in service.

Replaced Amounts

Definition

Replaced amounts are defined in Regulations § 1.141-1(b) as replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds. Regulations § 1.141-1(a) incorporates the definition of **"replacement proceeds"** from Regulations §1.148-1. Effectively, replaced amounts are other replacement proceeds as defined in Regulations § 1.148-1(c)(4).

Disposition Proceeds

General

If a change in use of property causes the bond issue that financed the property to meet the private activity bond tests under § 141, the issuer may be able to remedy the violation. The methods for such remedial action by the issuer focus on "**disposition proceeds**" that may arise from the change in use of the property.

Disposition proceeds occur when an issuer or conduit borrower sells, exchanges or otherwise disposes of all or a portion of a bond-financed facility and receives cash or other amounts (including property, such as an agreement to provide services) in return. The amounts received are the disposition proceeds.

See Regulations § 1.141-12(c).

Application

An agent examining a transaction where disposition proceeds may have resulted should analyze the transaction under § 141 and the related regulations **and** should also analyze the treatment of disposition proceeds under § 148 and the related regulations.

Section 3

Proceeds of the Bonds – Other Code Provisions

Proceeds

Use Tests

Proceeds and net proceeds are part of the use of proceeds tests of other Code provisions. Some of them are shown below:

Code Section	Test	Purpose
§ 142(a)	95% or more of the "**net proceeds**" of an issue	Exempt Facility Bonds
§ 143(a)(2)	all "**proceeds**" of such issue (exclusive of issuance costs and a reasonably required reserve) – referred to as lendable proceeds in Regulations § 6a.103A-2(b)(1)(i)	Mortgage Revenue Bonds
§ 144(a)	95% or more of the "**net proceeds**" of the issue	Qualified Small Issue Bonds
§ 144(b)	"**net proceeds**" of which are to be used	Qualified Student Loan Bonds
§ 144(c)	95% or more of the "**net proceeds**"	Qualified Redevelopment Bonds

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Use Tests
(continued)

Code Section	Test	Purpose
§ 145(a)	100% of the "**net proceeds**" used to finance property owned **and** 95% of the "**net proceeds**" used	Qualified 501(c)(3) Bond
§ 147(c)	25% or more of the "**net proceeds**"	Limit on Land Acquisition for Qualified Private Activity Bonds
§147(g)	2 % of the "**proceeds**"	Limit on Costs of Issuance for Qualified Private Activity Bonds
§149(f)(2)	30 % of the "**net proceed**s" 95 % of the "**net proceeds**"	Required Expectations As To Amount Used To Make Loans From Pooled Financing Issues Within One Year And Three Years

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Proceeds, Continued

Definition

Sections 142, 143, 144, 145, and 147 do not contain separate definitions of proceeds or net proceeds. Because bonds described in §§ 142, 143, 144, and 145 are described in § 141(e)(1), and § 147 is directly referred to in § 141(e)(3) related to qualified bonds, use of the definitions under § 141 would be applicable unless otherwise noted.

Note

Section 150 provides a definition of net proceeds but does not define proceeds.

Net Proceeds

Definitions

Sections 142, 143, 144,145, and 147 are in Subpart A of Part IV of Subchapter B of Chapter 1 of Subtitle A of the Code. Subpart C of Part IV contains § 150, which is entitled "Definitions and special rules."

Section 150 provides definitions for purposes of "this part", which means Part IV, including §§ 141 through 150.

Section 150(a)(3) defines net proceeds as the proceeds of an issue reduced by amounts in a reasonably required reserve or replacement fund. Because bonds described in §§ 142, 143, 144, and 145 are described in § 141(e)(1), and § 147 is directly referred to in § 141(e)(3) related to qualified bonds, use of the definitions related to "proceeds" found in § 141 would be applicable to determine the "proceeds" unless otherwise noted. Once the correct proceeds are determined the adjustment required by § 150(a)(3) is used to determine what is net proceeds.

Section 149(f)(2) defines net proceeds by reference to the definition in § 150, modified to exclude proceeds applied to costs of issuance and interest during the loan period.

Section 4

Allocations Generally

Overview of Allocation Rules

General Types of Allocations

Unless the use and investment of proceeds of an issue comply with §§ 141 through 150, the interest on the bonds of the issue will not be excludible from the bondholders' gross income. Such compliance often depends on the answers given to the following four general allocation questions:

1. Were the bonds of the bond issue properly identified and allocated to the issue?

2. Were the proceeds of the allocable bonds properly identified and allocated to the bond issue?

3. Were the proceeds properly allocated to expenditures and investments?

4. To what property, if any, were the proceeds allocated upon expenditure?

The Code and accompanying regulations provide issuers with detailed guidance for the proper allocation and accounting of bond proceeds. Currently, allocation rules are found primarily in Regulations § 1.148-6. These rules apply not only for arbitrage and rebate purposes but also for purposes of allocating proceeds to expenditures for § 141 purposes.

See Regulations § 1.141-6(a).

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Overview of Allocation Rules, Continued

General Types of Allocations (continued)

Note that most of the private activity bond tests allocation and accounting rules in Regulations § 1.141-6 are currently reserved. Proposed regulations were issued on September 26, 2006, to address, among other things, the question of what is the bond-financed property, or project, so that private business use of that property and, thus, of the proceeds can be determined.

Both Regulations §§ 1.141-6(a) and 1.148-6(a) generally provide that allocations to account for gross proceeds, investments, and expenditures of an issue may be made using any reasonable, consistently applied accounting method. Allocations under § 141 and § 148 must be consistent with each other.

Regulations § 1.148-6(a)(2) provides that an accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item.

Summary

The three basic types of allocations that must be made with respect to a bond issue are as follows:

1. allocating bonds to the issue;
2. allocating proceeds to bonds of the issue; and
3. allocating proceeds of the issue to expenditures (and property, if applicable) and investments

Failure to comply with the Code and applicable regulations with respect to allocations may result in the incorrect calculation of the required payment of rebate by the issuer or a determination that interest on the bonds is not tax-exempt. The rules that govern these allocations will be covered in the following sections.

Section 5

Allocations of Bonds to an Issue

General Rule

Introduction

Compliance with the tax-exempt bond rules cannot be determined unless, at the outset, all of the bonds of an issue are properly identified and allocated to the issue. Regulations § 1.150-1(c) provides the general rules for determining how bonds are allocated to a bond issue.

Definition - Issue

The term "**issue**" is defined in the regulation as two or more bonds that meet all of the following requirements:

- The bonds are sold at substantially the same time (bonds sold less than 15 days apart are treated as such).
- The bonds are sold pursuant to the same plan of financing. Factors to take into account in making this determination include the purposes for the bonds and the structure of the financing.
- The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor. *See Regulations § 1.150-1(c)(1).*

This definition is applicable to bonds issued after June 30, 1993, and is applicable for all purposes under §§ 103 and 141-150. (See Regulations §1.103-13(b)(10) and Rev. Rul. 81-216, 1981-2 C.B. 21, for the prior definition of the term "issue".)

Continued on next page

General Rule, Continued

Example 1

Series A bonds are sold on April 1, 2015, to finance the acquisition of land as a site for City A's future municipal water facility and are issued on April 25, 2015. Series B bonds are sold on April 8, 2015, to finance the construction of the water facility and are issued on May 15, 2015. Both Series A bonds and Series B bonds mature in twenty years and will be paid from water fees levied on City residents. The Series A bonds and Series B bonds should be identified as bonds of the same issue and allocated to that issue. The dates of the issuance of the bonds are not relevant.

Example 2

City A sold and issued Series A bonds on April 1, 2015, for the purpose of financing its operating expenses. The Series A bonds mature in six months. City A also sold its Series B bonds on April 1, 2015, which were issued on April 8, 2015, for the purpose of financing sewer improvements. The Series B bonds mature in 20 years. The Series A bonds and Series B bonds should not be identified as bonds of the same issue since the bonds are not part of the same plan of financing.

See Regulations § 1.150-1(c)(1)(ii).

Allocation of Taxable and Tax-Exempt Bonds

Regulations § 1.150-1(c)(2) provides that **taxable bonds** and **tax-exempt bonds** are not part of the same issue, regardless of their security or source of payment and the timing of their sales.

An allocation of tax-exempt bonds to a separate issue in a transaction (or series of related transactions) that includes taxable bonds may, however, result in the creation of an abusive arbitrage device or other abusive structure (e.g., structures involving windows or unreasonable allocations of bonds). *See, e.g., Regulations § 1.148-10(d), example 3.*

An allocation of tax-exempt bonds to a separate issue in a transaction (or series of related transactions) that includes taxable bonds may also result in the creation of an abusive structure transferring significant benefits of a tax-exempt financing in a manner that is inconsistent with the purposes of § 141. *See, e.g., Regulations § 1.141-14(b), examples 4, 5, 6.*

Permissive Exception

Bonds Financing Separate Purposes

Regulations § 1.150-1(c)(3) provides that bonds financing separate purposes may be allocated to, and treated as, separate issues.

- Examples of separate purposes include refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose.
- Each of these separate issues, when tested independently, must be comprised of tax-exempt bonds.

This permissive exception does **not** apply for purposes of §§ 141, 144(a), 148, 149(d), and 149(g). However, Regulations § 1.141-13(d)(1) provides separate authority for multi-purpose issue allocations for purposes of § 141.

Reasonable Allocation Method Required

Under Regulations § 1.150-1(c)(3), bonds must be allocated between each of the separate issues using a reasonable, consistently applied allocation method.

- An allocation is not reasonable if it achieves more favorable results under §§ 103 and 141 through 150 than could be achieved with actual separate issues.
- All allocations with respect to this permissive separate issues exception must be made in writing on or before the issue date.

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Permissive Exception, Continued

Practical Application

The permissive allocation rule of Regulations § 1.150-1(c)(3) does not permit separate testing of bonds of the same issue (under the general definition) for compliance with §§ 141, 144(a), 148, 149(d), and 149(g). Regulations § 1.141-13(d)(1) permits separate issue treatment for purposes of section 141. Thus, generally, bonds in one bond issue could consist of an issue of qualified private activity bonds and bonds that are tax-exempt governmental bonds. However, a single issue cannot comprise a qualified small issue bond under § 144(a) and a qualified exempt facility bond under § 142.. Finally, all the proceeds and bonds of an issue are generally analyzed together for purposes of complying with the arbitrage rules, including rebate, and the limits on advance refundings.

Certain specific rules under §§ 141, 148 and 149(d), or the applicable regulations, provide for separate issue treatment of bonds for specific purposes under such sections. For example, § 141(b)(9) provides that an issuer may elect to treat bonds as a separate qualified 501(c)(3) bond issue for purposes of the private business tests and the private loan test of § 141.

Regulations under §§ 148 and 149 provide for separate issue accounting for certain refunding purposes. Regulations § 1.141-13(d) requires similar and consistent accounting for separate testing of bonds under § 141. These rules will be considered in the following section.

Section 6

Multipurpose Issue Allocations

Introduction

Introduction

Multipurpose allocation rules may apply where the proceeds of the bonds in a single issue, as described in Section 5, are used to finance or refinance distinct and separate governmental purposes. Typically, these involve separate projects, separate refundings or a refunding and a new project.

Regulations § 1.148-9(h) applies to allocations of multipurpose issues, including allocations involving refunding purposes of the issue. Consistent allocations are required for allocations under Regulations §§ 1.141-13(d) and 1.150-1(c)(3).

Separate Purposes

What is a Separate Purpose?

Regulations § 1.148-9(h)(3)(i) provides that separate purposes of a multipurpose issue include:

- refunding a separate prior issue
- financing a separate purpose investment
- financing a construction issue (as defined in Regulations § 1.148-7(f))
- any clearly discrete governmental purpose reasonably expected to be financed by that issue

Capital Projects

Generally, capital projects that are (i) integrated or functionally related **and** (ii) qualify for the same initial temporary period under Regulations § 1.148-2(e)(2), are treated as having a single governmental purpose.

Example 1

City issues bonds and loans the proceeds to a qualified 501(c)(3) organization. The organization uses part of the funds to build an addition to a medical office building. The rest of the funds are used to build a parking lot adjacent to a hospital on the other side of City. Even though both projects qualify for the general three-year temporary period, they are not integrated or functionally related. Therefore, they are **not** treated as having a single governmental purpose.

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Refunding Issues

Regulations § 1.148-9(h)(3)(i) provides that the separate purposes of a refunding issue include the separate purposes of the prior issue, if any.

Financing Common Costs

Common costs of a multipurpose issue are not separate purposes.

Common costs include:

- issuance costs,
- accrued interest,
- capitalized interest on the issue,
- reserve or replacement fund,
- qualified guarantee fees, **and**
- similar costs properly allocable to the separate purposes of the issue

See Regulations § 1.148-9(h)(3)(ii).

Rules on Allocations of Multipurpose Issues

General Rule

As discussed above, the regulations permit allocation of portions of a bond issue among the issue's separate purposes. How are such allocations to be made?

Regulations § 1.148-9(h)(2)(i) provides generally that proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method.

An allocation is not reasonable if it achieves more favorable results under §§ 148 or 149(d) than could be achieved with actual separate issues.

An allocation may be made at any time, but once made may **not** be changed.

Allocations of Common Costs

Regulations § 1.148-9(h)(2)(ii) provides that a ratable allocation of common costs among the separate purposes of the multipurpose issue is generally reasonable.

Another method may be used if it more accurately reflects the economic benefit or burden of the costs.

Allocations of Bonds of a Multipurpose Issue

Introduction

If an issuer treats a bond issue as a multipurpose issue having separate purposes, the issuer must also allocate each bond in the bond issue to the separate purposes of the multipurpose issue.

Safe Harbor for Allocation of Bonds

Regulations § 1.148-9(h)(4)(i) provides that the portion of the bonds of a multipurpose issue allocated to a separate purpose must have an issue price that bears the same ratio to the aggregate issue price of the multipurpose issue as the portion of the sale proceeds of the multipurpose issue used for that separate purpose bears to the aggregate sale proceeds of the multipurpose issue.

Regulations § 1.148-9(h)(4)(ii) provides that this pro rata method of allocation based on the relative amount of sales proceeds will be considered to be a reasonable method of allocating the bonds of a multipurpose issue.

Allocation of Refunding Bonds

The rules with respect to allocations of bonds used to refund two or more prior issues are discussed in the Phase III, Lesson 3, Refundings text.

Safe Harbor for Allocation of Purpose Investments

Regulations § 1.148-9(h)(4)(iii) provides that an allocation of a portion of the bonds of a multipurpose issue to a particular purpose investment is generally reasonable if that purpose investment has principal and interest payments that reasonably coincide in time and amount to principal and interest payments on the bonds allocated to that purpose investment.

Example 2

Housing Authority X issues a $10,000,000 bond issue to finance qualified mortgage loans for owner-occupied residences under § 143. The Authority originates $5,000,000 of loans at 5 percent and six months later originates $5,000,000 of loans at 6.5 percent. A portion of the maturing bonds can be allocated to each purpose investment (loans) as long as the principal and interest payments of both coincide in time and amount.

Section 7

Allocation of Proceeds to Bond Issues

Overview

Introduction

Once bonds have been properly identified and allocated to an issue, proceeds of the bonds must be properly identified and allocated to the bonds of the issue. In order to complete this step, a basic understanding of the term "**proceeds**" and its related terms is necessary. This will provide an opportunity to review certain items from Sections 1, 2 and 3. Remember that the definition of "proceeds" provided in Regulations § 1.141-1 for qualification purposes is somewhat different from the definition provided in Regulations § 1.148-1(b) for arbitrage and rebate purposes.

One Issue Rule

The Rule

Gross proceeds are generally allocable to only one issue at a time. Regulations § 1.148-6(b)(1) provides that if amounts are simultaneously proceeds of one issue and replacement proceeds of another issue, those amounts are only allocable to the issue of which they are proceeds.

Example 1

City A issues bonds for water and sewer improvements and places 5% of the proceeds of the bonds in a reserve fund which is pledged to benefit the bonds and a prior bond issue. The amount deposited into the reserve fund constitutes sales proceeds of the new bonds. However, under the replacement proceeds definition of Regulations § 1.148-1(c), these pledged amounts also constitute gross proceeds of the prior bond issue. To prevent counting these proceeds twice, the one-issue rule provides that the amounts are allocable only to the new bond issue.

In effect, this rule provides that proceeds will not be allocated to two issues simultaneously for purposes of calculating arbitrage and rebate

Universal Cap Rule

General Rule

Regulations § 1.148-6(b)(2)(ii) provides an overall limitation on the amount of gross proceeds allocable to an issue. The general "universal cap" rule is that amounts that would otherwise be gross proceeds allocable to an issue are allocated to the issue only to the extent the value of non-purpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue.

The value of all outstanding bonds is referred to as the universal cap.

For purposes of the universal cap rule, gross proceeds allocable to cash, tax- exempt bonds that would be non-purpose investments (except for the specific exception provided for in § 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as non-purpose investments.

Non-purpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the non-purpose investments for purposes of the universal cap rule.

For purposes of the universal cap rule, the values of bonds and investments are determined under Regulations §§ 1.148-4(e) and 1.148-5(d) respectively. Valuation is discussed in the Phase II, Lesson 2, Advanced Topics in Arbitrage text.

Example 2

If the value of outstanding bonds is $20,000,000, the amount of non-purpose investments that may be allocated to the issue is limited to $20,000,000 (the universal cap).

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Universal Cap Deallocating Procedures

If the amount of nonpurpose investments exceeds the universal cap, Regulations § 1.148-6(b)(2)(iv) provides a rule for deallocating excess amounts. Specifically, that section provides that nonpurpose investments allocable to gross proceeds necessary to eliminate the excess amount cease to be allocated to the issue in the following order:

1. non-purpose investments allocable to replacement proceeds;
2. non-purpose investments allocable to transferred proceeds;
3. non-purpose investments allocable to sale proceeds and investment proceeds.

Example 3

City A issues bonds to build a sewer treatment plant and places the proceeds in a construction fund. City A also uses revenues to establish a reserve fund. Generally, the reserve fund would constitute replacement proceeds of the refunding issue. However, the universal cap prevents allocation of the replacement proceeds (the reserve fund) to the issue until sufficient original proceeds have been expended that such proceeds fall below the universal cap.

This rule is beneficial to the issuer when the proceeds of the reserve fund are invested at high yields.

Universal Cap Reallocations

Generally, amounts that cease to be allocated to an issue as a result of the application of the universal cap rule are only reallocated to another issue as replacement proceeds.

Regulations § 1.148-9(b)(3) provides a special rule for transferred proceeds. To the extent non-purpose investments allocable to transferred proceeds of a refunding issue exceed the universal cap for the refunding issue, the excess amount of transferred proceeds will be allocated back to the prior issue.

See Phase III, Lesson 3, Refundings text.

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Nonmandatory Application of Universal Cap Rule

Pursuant to Regulations § 1.148-6(b)(2)**,** if an issuer reasonably expects, as of the issue date, that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not apply on any date on which an issue actually has **all** of the following characteristics:

- No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve fund;
- The net proceeds of the issue either:
  - qualify for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings and
    were allocated to expenditures during an applicable temporary period; **or**
  - were deposited in a refunding escrow and expended as originally expected;
- The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;
- None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; **and**
- No proceeds of the issue are invested in qualified student loans or qualified mortgage loans.

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Universal Cap Rule, Continued

Universal Cap Determination Dates

Under Regulations § 1.148-6(b)(2)(iii), there are dates on which an issuer must determine whether application of the universal cap rules results in a reduction or reallocation of gross proceeds of an issue, unless the above "reasonable expectations" exception applies.

The general rule is that the amount of the universal cap and the value of the nonpurpose investments generally must be determined as of the first day of each bond year beginning with the first bond year that commences after the second anniversary of the issue date.

For refunding and refunded issues, there is a special rule that provides that the universal cap and values must be determined as of each date that proceeds of the refunded issue would become transferred proceeds of the refunding issue but for the universal cap rule and need not otherwise be determined in the bond year in which such a date occurs.

Otherwise, an issuer may generally apply the universal cap at any time.

Factors Indicating Possible Application of Universal Cap Rule

The following situations may result in the universal cap rule affecting the allocations of gross proceeds to an issue:

- Issuer fails to expend proceeds of an issue as expected.
- Bonds are rapidly retired from revenues.
- Toward the end of the term of an issue, non-purpose investments allocable to escrows and reserves of the issue are substantial.
- Endowment or other funds are pledged to pay debt service.

Allocating Disposition Proceeds

Allocation to an Issue

Although a proper expenditure for a capital asset will result in the reduction of the amount of proceeds of an issue, a change in use of bond-financed property resulting from a disposition will often generate cash or other assets.

Regulations § 1.141-12(c)(2) provides for the following result if the conditions to applying the remedial provisions of Regulations § 1.141-12(a) are met:

> After the date of the disposition, the proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds rather than the transferred property. If a disposition is made pursuant to an installment sale, the proceeds of the issue continue to be allocated to the transferred property. If an issue does not meet the requirements for remedial action... or the issuer does not take an appropriate remedial action, the proceeds of the issue are allocable to either the transferred property or the disposition proceeds, whichever allocation produces the greater amount of private business use and private security or payments

Universal Cap Not Applicable

Note that only the allocation rules under Regulations § 1.148-6(d) are made applicable to allocations for private activity testing. Thus, the universal cap rule, found in Regulations § 1.148-6(b), does not apply to the allocation described in the preceding paragraph. However, for purposes of complying with the requirement that the disposition proceeds be treated as gross proceeds for yield restriction and rebate, the universal cap rule would apply.

See Regulations § 1.141-12(i) for the rule limiting the amount of disposition proceeds for purposes of future compliance after the issuer has taken a remedial action to cure a change in use.

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Allocations among Sources

In situations where proceeds and other sources have financed property, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funding not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of those outstanding bonds. For this purpose, "principal amount" is the principal amount of plain par bonds and the present value of other bonds, and outstanding bonds do not include advance refunded bonds.

See Regulations § 1.141-12(c)(3).

Allocations to Non-qualified Bonds

Regulations § 1.141-12 provides for the allocation of a change in use to specified non-qualified bonds. The rules governing this allocation are covered in the next Phase I Lesson, Remedial Actions / Change in Use Rules.

Section 8

Allocations to Expenditures

Overview

Introduction

Once proceeds and bonds are identified and properly allocated to an issue, the allocable proceeds must be properly allocated to the governmental purpose of the issue or other permitted uses. Once these allocations have been verified, determinations can be made regarding whether or not the usage restrictions or qualification requirements of §§ 141 through 150 have been met.

This section covers the rules governing allocations to expenditures. The following section will cover allocations to investments.

General Rule

Generally, gross proceeds are allocated to an issue, and are subject to yield restriction and rebate rules, until an event occurs that allocates the proceeds away from the issue, or "deallocates" the proceeds.

Under the regulations, amounts cease to be proceeds of an issue when they are allocated to an expenditure for a governmental purpose such as the construction of a courthouse, roadway, etc.

Gross proceeds are not deallocated, however, when used to acquire a **non- purpose investment**. Such proceeds continue to be subject to yield restriction and rebate.

A payment of gross proceeds to a related party is not an expenditure. See Regulations § 1.150-1(b) for the definition of related party and Regulations § 1.150-1(e) for the definition of controlled group

Allocations to Expenditures – General Rules

Allocations to Purpose Investments

If the issuer expends gross proceeds for a **purpose investment**, such as a loan to a conduit borrower (another government entity or a private entity, such as a
501(c)(3) organization or owner of an exempt facility other than a governmental unit), then:

- the proceeds are not allocated to an expenditure for the governmental purpose of the issue until the conduit borrower actually spends the money, **and**
- even after such the expenditure by the conduit borrower, the proceeds remain allocated to the issue in the form of the purpose investment (for yield restriction purposes) until the sale, discharge, or other disposition of the purpose investment.

Note: The rule requiring expenditure of the proceeds by the conduit borrower before deallocation of the proceeds does **not** apply to purpose investments made with proceeds of a qualified mortgage bond or a qualified student loan bond issue. Rather, the proceeds are considered expended for the governmental purpose upon the acquisition of the mortgage loan or student loan. As with any purpose investment, the proceeds will continue to be allocated to the purpose investment (the mortgages or student loans) for yield restriction and other compliance purposes.

Allocations to Property

For purposes of testing the use of proceeds under § 141 with respect to private use, Regulations § 1.141-6(a) provides that "[f]or purposes of §§ 1.141-1 through 1.141-15, the provisions of § 1.148-6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under section 141 and section 148 must be consistent with each other."

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Allocation Methods

Often, an issuer will have several sources of funds available to finance a particular project. Sometimes it is critical for compliance purposes that a particular source be used for a particular expenditure, for instance to avoid violation of the private activity rules. The question then becomes how to properly allocate funds from the various sources to the expenditures.

Regulations § 1.148-6(d)(1)(i) provides that any of the following methods may be used to allocate funds from different sources to expenditures made for the same governmental purpose, if applied consistently:

1. Specific tracing. Specific tracing is the matching of bond proceeds to expenditures dollar for dollar and the most direct method of accounting for proceeds. With multiple sources, this would generally involve maintaining separate accounts for each source. The other methods may be used for commingled or separate accounts. Specific tracing is also the fall-back method of allocation. See below.
2. Gross proceeds spent first. This methodology is useful where the issuer has available funds that are not bond proceeds. This permits the issuer to spend the bond proceeds first, thereby reducing arbitrage and rebate liabilities. Compare this to the working capital expenditure rule discussed below.
3. First-in, first-out. Where there is more than one source, this method would permit the issuer to treat the proceeds of the first issue as first spent, the proceeds of the second issue next, and so on.
4. Ratable allocation method. For each expenditure the multiple sources of funds are accounted for as financing a portion of each expenditure in proportion to the relative amount of the total funds represented by each source.

Proceeds of an issue must be allocated using the specific tracing method if an issuer fails to maintain books and records sufficient to establish the accounting method for an issue.

See Regulations § 1.148-6(a)(3).

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Current Cash Outlays Requirement

Regardless of the accounting method, any allocation of gross proceeds to expenditure requires a current outlay of cash. The issuer must reasonably expect this outlay of cash to occur not later than five banking days after which the allocation of gross proceeds to expenditures is made.

See Regulations § 1.148-6(d)(1)(ii).

Timeframe Requirement

Regulations § 1.148-6(d)(1)(iii) provides that an issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of:

- the date the expenditure is paid; **or**
- the date that the project, if any, that is financed by the issue is placed in service.

The allocation must be made within 60 days after the fifth anniversary of the issue date or, if earlier, 60 days after the retirement of the issue.

Working Capital Expenditure Rules

General Rule

In keeping with the general policy of limiting the issuance of bonds until the proceeds are actually needed for a governmental purpose, the regulations create a restrictive allocation rule for working capital expenditures.

Working capital expenditures are defined in Regulations § 1.150-1(b) as any cost that is not a capital expenditure. Current operating expenses of a municipality are an example of working capital expenditures.

Regulations § 1.148-6(d)(3)(i) generally provides that proceeds of an issue may only be allocated to working capital under a "proceeds-spent-last" method. Under this rule, the issuer may only allocate proceeds to working capital expenditures to the extent that the working capital expenditures exceed “available amounts”. For this purpose, “proceeds” includes “other replacement proceeds”, described in Regulations § 1.148-1(c)(4).

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Available Amounts

"**Available amounts**" means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Available amounts for working capital expenditure purposes exclude the proceeds of the bond issue, but include cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party, if those amounts may be used for working capital expenditures of the type being financed by the issue,

(i) without a legislative or judicial action, **and**

(ii) without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

The following items are treated as unavailable:

- A reasonable working capital reserve. Such reasonable reserve, however, is not to exceed 5 percent of the actual working capital expenditures of the issuer in the preceding fiscal year.

- In determining "working capital expenditures of an issuer for a prior fiscal year," any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

- Certain qualified endowment funds of a 501(c)(3) organization. *See Regulations § 1.148-6(d)(3)(iii)(C).*

Note: For purposes of determining whether an issue meets the statutory safe harbor for expenditure of TRANs proceeds (§ 148(f)(4)(B)(iii)(II)), the phrase "aggregate available amount" in the definition of the cumulative cash flow deficit is to be treated as having the same meaning as "available amount," except that any reasonable working capital reserve is to be treated as available.

See Regulations § 1.148-6(d)(3)(iii)(D)

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Exceptions to the General Rule

Regulations § 1.148-6(d)(3)(ii) provides exceptions to the general rule that proceeds of an issue may only be allocated to working capital expenditures under a "proceeds-spent-last" method.

General de minimis exception. The general rule does not apply to expenditures to pay the following costs:

- Issuance costs.
- Qualified administrative costs.
- Fees for qualified guarantees or payments for a qualified hedge.
- Interest on the issue for a period beginning on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service.
- Amounts paid to the United States under the arbitrage provisions of §148: rebate payments, yield reduction payments, and penalty-in-lieu of rebate payments.
- Costs, other than those listed above, that do not exceed 5 percent of the sales proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses).
- Principal and interest on an issue paid from unexpected excess sale or investment proceeds.
- Principal and interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

Extraordinary items exception. The general rule typically does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues. If, however, an issuer or related party maintains a reserve for such items, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

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Exceptions to the General Rule (continued)

Exception for payment of principal and interest on prior issues. The general rule typically does not apply to expenditures for:

- payment of principal, interest, or redemption prices on a prior issue, and
- for a crossover refunding issue, payment of interest on the refunding issue

No Exception if Replacement Proceeds Created

The exceptions above do not apply if the allocation merely substitutes gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds.

Impact of Working Capital Expenditure Rule

Because gross proceeds remain allocable to the issue until other funds are unavailable, the proceeds remain subject to the arbitrage and rebate rules for a longer period of time. This limits the issuer's incentive to finance normal operating expenses with tax-exempt bonds while investing the proceeds of the bonds or other amounts on hand in higher yielding instruments.

Grant Expenditure Rule

Regulations § 1.148-6(d)(4) provides that gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made. Transfers of money or property to a transferee that is a related party to or agent of, the transferor are not considered grants.

Any amount of a bond-financed grant that is repaid to the grantor is treated as unspent proceeds of the issue as of the repayment date unless expended within 60 days of the repayment date.

Reimbursement Allocations

Definition

A reimbursement allocation is an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an expenditure that was originally paid from sources other than the bond proceeds (an original expenditure). A reimbursement bond is the portion of an issue allocated to reimburse such expenditure. *See Regulations § 1.150-2(c).*

Example

City A makes a declaration of intent to reimburse and spends $5,000,000 from its general funds on May 1, 2013, in connection with the construction of a courthouse. City A may issue $5,000,000 of bonds on January 1, 2014 and allocate the gross proceeds to the prior expenditure. If the reimbursement is proper, City A may invest the gross proceeds of the bonds without arbitrage consequences.

Reimbursement Allocation-Regulations §1.150.2

In allocating gross proceeds of reimbursement bonds, Regulations § 1.148-6(d)(5) states that the rules of Regulations § 1.150-2 apply. If the gross proceeds are used to reimburse a working capital expenditure, the rules of Regulations § 1.148-6(d)(3) also apply.

General Operating Rules for Reimbursement

Regulations § 1.150-2(d) provides the general operating rules for reimbursement allocations. Essentially, proceeds of a reimbursement bond will be treated as expended for the governmental purpose of the original expenditure on the date of the reimbursement allocation if the following three requirements are met:

1. Official intent.
2. The reimbursement period.
3. The nature of the expenditure.

Each requirement is discussed in further detail in Section 9

Private Business Tests Allocations (Proposed)

Introduction

As noted above, currently Regulations § 1.141-6 provides that the rules of Regulations § 1.148-6(d) apply for purposes of allocating proceeds of an issue to bond-financed property for purposes of compliance with the private activity rules of § 141. Proposed regulations issued on September 26, 2006, revise § 1.141-6 to expand on this premise.

Consistency Requirement

Under the proposed rules, consistency between allocations for arbitrage purposes and private use purposes are still required.

Proceeds

The proposed regulations provide rules for allocating bond proceeds and other sources of funds to mixed-use projects, and would permit certain reallocations over the private activity measurement period.

Payments

The proposed regulations also provide rules for allocating private payments between sources of funds for a project.

Effective Date

Issuers may not rely on the proposed rules.

Section 9

Reimbursement Allocations

Overview

Introduction

This section discusses the federal tax laws applicable to reimbursement allocations made from tax-exempt bond proceeds. These rules must be satisfied when an issuer allocates proceeds of an issue to reimburse itself for prior expenditures paid with funds other than bond proceeds. This section explains how to identify reimbursement allocations and apply the appropriate regulations.

What is a Reimbursement Bond?

A reimbursement bond is a tax-exempt bond the proceeds of which are allocated to prior expenditures originally paid from sources other than bond proceeds. A proper reimbursement allocation results in the proceeds being treated as spent for the governmental purpose of the original expenditures even though the actual moneys are used to replenish the funds originally used to pay the expenditures.

Example 1

County A intends to issue $1,000,000 in tax-exempt bonds to finance capital improvements to make a courthouse handicap accessible. The issuer intends to issue the bonds on June 1, 2014. On April 15, 2014, the issuer pays $100,000 for initial project construction expenditures out of its general funds. The bonds are issued on June 1, 2014 and the issuer allocates $100,000 of the proceeds to reimburse its general fund for the prior expenditures.

Applying the Appropriate Regulations

The rules applicable to reimbursement bonds have evolved over time through the issuance of several sets of regulations. Thus, it is important to determine the appropriate regulations to be applied during the course of examining an issue of reimbursement bonds.

Introduction

Why do we care?

In making a reimbursement allocation, the issuer seeks to treat the bond proceeds as spent for a governmental purpose that has already been funded. Therefore, a tracing of the proceeds will likely show that the proceeds are used to acquire investments yielding an amount materially higher than the yield of the reimbursement issue, or are spent on another purpose, which may or may not qualify under § 103. Thus, generally speaking, if the issue does not satisfy the applicable reimbursement rules, it will be deemed to be an issue of taxable arbitrage bonds, and might also be nonqualified private activity bonds.

Background

The current reimbursement regulations arose largely as a response to the potential abuse of arbitrage motivated reimbursement transactions. Essentially, an issuer could identify a bounty of old and cold governmental expenditures paid out of its general funds and then issue tax-exempt bonds to "reimburse" those funds. Since the tax-exempt proceeds would be deemed spent on those governmental purposes, the moneys could be freely invested or the purpose of generating arbitrage profits. Such arbitrage-motivated transactions were coined "pyramid bonds," reflecting the theoretical ability of modern day Egypt issuing bonds to reimburse itself for the costs incurred in constructing the pyramids.

This concept was illustrated in PLR 8923069, where the County Board of Commissioners decided to forego issuing tax-exempt bonds and self-financed the construction costs associated with expanding a jail facility. The County completed all but a small portion of the total project before proposing to issue tax-exempt bonds to finance the remaining construction and reimburse its capital improvement fund for the costs already incurred. The County represented its intention to invest all the moneys in its capital improvement fund (including the proposed bond proceeds) without regard to the arbitrage yield restriction and rebate requirements. The Service held that the County did not originally intend to finance the project with a reimbursement allocation, but rather that the substance of the transaction was to use over $20,000,000 of tax-exempt bond proceeds to earn arbitrage profits.

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General Rule

Regulations § 1.150-2(d) generally provides that a reimbursement allocation is treated as an expenditure of proceeds of a reimbursement bond for the governmental purpose of the original expenditure on the date of the reimbursement allocation if the following three requirements are satisfied. Failure to comply with the reimbursement rules results in the bond proceeds as having not been spent. Consequently arbitrage and rebate are applicable, and other qualification problems may be present.

- The issuer must timely adopt an **official intent** that the original expenditures will be reimbursed with proceeds of a debt obligation.
- The reimbursement allocation must be made within the **reimbursement period**.
- The original expenditures must be of a certain **nature.**

Definitions

Definitions

For purposes of applying these rules, Regulations § 1.150-2(c) provides several definitions, including the following:

"**Reimbursement bond**" means the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date.

"**Reimbursement allocation**" means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.

"**Issuer**" means:

- For any private activity bond (excluding a qualified 501(c)(3) bond, qualified student loan bond, qualified mortgage revenue bond, or qualified veterans' mortgage bond), the entity that actually issues the reimbursement bond.
- For any bond not described above, either the entity that actually issues the reimbursement bond or, to the extent that the reimbursement bond proceeds are to be loaned to a conduit borrower, that conduit borrower.

"**Original expenditure**" means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond.

Official Intent

General Rule

Regulations § 1.150-2(c) defines "**official intent**" as an issuer's declaration of intent to reimburse an original expenditure with proceeds of an obligation.

The official intent to reimburse an original expenditure must be properly and timely adopted in order for the issuer to make a valid reimbursement allocation. Otherwise, the allocation will be deemed invalid and the bond proceeds will be treated as unspent. Consequently, any investment of the proceeds would have to be yield restricted to prevent the issue from becoming an issue of arbitrage bonds.

The requirements for a proper and timely declaration of official intent are found in Regulations §§ 1.150-2(d)(1) and (e).

Who must adopt the Official Intent?

The general rule stated above provides that the official intent is declared by the "**issuer**." However, recall from the Definitions above that in Regulations
§ 1.150-2(c) the term "issuer" can include the conduit borrower of bond proceeds for reimbursement issues that consist of governmental bonds and certain types of qualified private activity bond issues.

As a result, an official intent may be adopted by either the issuer **or** conduit borrower for the following types of tax-exempt bond issues:

- Governmental bonds;
- Qualified 501(c)(3) bonds;
- Qualified student loan bonds;
- Qualified mortgage bonds;
- Qualified veterans' mortgage bonds; and
- Qualified volunteer fire department bonds.

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Who must adopt the Official Intent? (continued)

An official intent may be adopted **only** by the issuer for the following types of tax-exempt bond issues:

- All types of exempt facility bonds (including enterprise zone facility bonds);
- Qualified small issue bonds;
- Qualified redevelopment bonds; and
- Qualified scholarship funding bonds (note that the not-for-profit corporation using the bond proceeds actually issues the bonds).

When must an Official Intent to reimburse be Adopted?

Under Regulations § 1.150-2(d)(1), an issuer must timely adopt an official intent that an original expenditure will be reimbursed with the proceeds of a subsequent reimbursement bond issue.

This declaration of official intent must not be later than 60 days after payment of the original expenditure. Thus, if an issuer fails to adopt a proper official intent within 60 days of the date payment is made for the original expenditure from a source of the issuer's funds, the expenditure may not be reimbursed from an allocation of reimbursement bond proceeds.

Example 2

On March 1, 2014, School District uses moneys from its general fund to pay for $200,000 in capital expenditures on various school facilities. On May 20,2014, School Board adopts an official intent to reimburse those original expenditures. On June 15, 2014, School District issues $200,000 in bonds. On July 20, 2014, School District allocates the proceeds of the issue in accordance with the official intent and uses the $200,000 to acquire materially higher yielding investments. The reimbursement allocation is invalid due to an untimely declaration of official intent. Consequently, due to the proceeds being used in a manner violating the yield restriction rules, the entire $200,000 of proceeds are treated as arbitrage bonds.

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Form of Official Intent

Under Regulations § 1.150-2(e)(1), the official intent must be adopted in a reasonable form. Reasonable form includes the following:

- Issuer resolution;
- Action by a person authorized or designated to declare official intent on behalf of the issuer; or
- Specific legislative authorization for the issuance of obligations for a particular project.

Official intent will typically be adopted through passage of a resolution at an official meeting of the issuer or conduit borrower's governing body (*i.e.*, council or corporate board of directors), as applicable. Frequent issuers might designate an official (*e.g.*, the Treasurer) to indicate reimbursement intent at the time of expenditures.

Project Description

Under Regulations § 1.150-2(e)(2), the official intent must **both**:

- Provide a general description of the project for which the original expenditure is paid; **and**
- State the maximum principal amount of bonds expected to be issued for the project.

A project description is sufficient if it identifies the property or program encompassing the project (e.g., highway capital improvement program, hospital equipment acquisition, or school building renovation). With respect to fund accounting, the project description may identify, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., parks and recreation fund-recreational facility capital improvement program).

Deviations between the project described in the official intent and the actual project ultimately financed with reimbursement bonds are permitted, so long as the actual project is reasonably related in function to the described project.

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Example 3

City adopts a resolution evidencing an official intent to reimburse $100,000 in expenditures incurred during a capital improvement program for the city park. The resolution states that City expects that no more than $1,000,000 will be issued with respect to the project. City issues the reimbursement bonds and allocates $20,000 of the proceeds to the cost of purchasing new riding lawn mowers for park maintenance. This is a reasonable deviation in the project description since the lawn mowers are reasonably related in function to the capital improvement program for the park.

Example 4

The facts are the same as above, except City also allocates $60,000 of the proceeds of the reimbursement bonds to the cost of purchasing and outfitting a new police car to be used in patrolling an area encompassing the city park. This is not a reasonable deviation in the project description and the allocation of proceeds to this cost will not be recognized.

Reasonableness of Official Intent

On the date that an issuer declares its official intent to reimburse an original expenditure, the issuer must have a reasonable expectation that it will in fact reimburse that expenditure with proceeds of a reimbursement bond. *See Regulations § 1.150-2(e)(3).*

A declaration of official intent is **<u>not</u>** reasonable if it is made either simply as a matter of course or in a substantially excessive amount relative to the described project. Likewise, an historical pattern of failure to reimburse actual original expenditures covered by official intents generally is evidence of unreasonableness.

Note: An official intent declared pursuant to a specific legislative authorization is presumed to be reasonable. However, this presumption may be successfully rebutted based upon the facts and circumstances.

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Reasonable Expectations

For purposes of determining the reasonableness of an official intent, the definition of "reasonable expectations" provided in Regulations § 1.148-1(b) applies.

Under Regulations § 1.148-1(b), an issuer's expectations are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations, based on all the objective facts and circumstances.

Factors to be considered in determining whether expectations are reasonable include:

- The issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations;
- The level of inquiry by the issuer into factual matters; and
- The existence of enforceable covenants that require implementation of specific expectations

Reimbursement Period

General Rule

Under Regulations § 1.150-2(d)(2)(i), the reimbursement allocation must be made not later than 18 months after the later of:

- The date the original expenditure is paid; **or**
- The date the project is either placed in service or abandoned

However, in no event may the reimbursement allocation be made more than 3 years after the date the original expenditure is paid.

Example 5

On February 25, 2013, County paid $100,000 in original expenditures as part of a road improvement project. On March 10, 2013, County's Board of Commissioners adopted a valid official intent to reimburse expenditures incurred for that project. County completed the project on January 25, 2015. On July 1, 2015, County issued the reimbursement bonds and, on July 25, 2015, allocated $100,000 of the proceeds to the expenditures. The allocation was within the reimbursement period since it was made approximately 6 months after the date the road improvement project was completed. This is true even though the allocation occurred 29 months after the date the original expenditures were paid.

Example 6

Same facts as above, except County made the reimbursement allocation on March 1, 2016. Here, the allocation is not permitted because more than 3 years had passed since the date the original expenditures were paid. This is true even though the allocation was only a little over 13 months later than the date the road improvement project was completed.

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Special Rule for Small Issuers

An exception applies to the above general rule for reimbursement bonds that also satisfy the small issuer exception to rebate under § 148(f)(4)(D)(i). For such bonds, the "18 month" limitation is changed to "3 years" and the "3- year" maximum reimbursement period is disregarded.

See Regulations § 1.150-2(d)(2)(ii).

Special Rule for Long-Term Construction Projects

An exception applies to the above general rule for reimbursement bonds that finance certain long-term construction projects. For such bonds, the maximum reimbursement period is extended from "3 years" to "5 years."

This exception only applies to construction projects for which both the issuer and either a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project. *See Regulations § 1.150-2(d)(2)(iii).* Compare this to the similar rule in Regulations § 1.148-2(e)(2)(ii), which grants a 5-year construction temporary period in certain circumstances.

Nature of Expenditure

Allowable Purposes of Original Expenditure

Under Regulations § 1.150-2(d)(3), a reimbursement allocation is only permitted for the following types of expenditures:

- Capital expenditures
- Costs of issuance
- Certain extraordinary working capital expenditures incurred before issuance of the reimbursement bond (as described in Regulations § 1.148-6(d)(3)(ii)(B))
- Grants (as defined in Regulations § 1.148-6(d)(4))
- Qualified student loans (as described in § 144(b))
- Qualified mortgage loans (as described in § 143(a))
- Qualified veterans' mortgage loans (as described in § 143(b))

A reimbursement allocation is **not** permitted for any original expenditure other than those listed above.

Extraordinary Working Capital Expenditures

Extraordinary working capital expenditures are expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues. Examples of such expenditures include casualty losses or extraordinary legal judgments in amounts exceeding reasonable insurance coverage.

See Regulations § 1.148-6(d)(3)(ii)(B).

Exceptions to the General Rules

In General

Regulations § 1.150-2(f) provides 2 exceptions to the general requirements that the issuer adopt an official intent to reimburse the original expenditure under Regulations § 1.150-2(d)(1) and that the reimbursement allocation be made within the reimbursement period under Regulations § 1.150-2(d)(2). The 2 exceptions are the **de minimis exception** and the **preliminary expenditures exception**.

Note: The original expenditure must still meet the nature of expenditure requirement under Regulations § 1.150-2(d)(3).

De Minimis Exception

This exception applies for original expenditures in an amount not in excess of the lesser of $100,000 or 5 percent of the proceeds of the issue. In addition, this exception applies to “payment” of the costs of issuance of any bond.

Preliminary Expenditures Exception

This exception applies for preliminary expenditures up to an amount not in excess of 20 percent of the aggregate issue price of the issue(s) that finance or are reasonably expected to finance the project for which the preliminary expenditures were incurred.

Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to the commencement of acquisition, construction, or rehabilitation of a project. Preliminary expenditures may **not** consist of land acquisition, site preparation, and similar costs incident to commencement of construction.

Other Rules

Refunding Issue v. Reimbursement Issue

An issue must be analyzed as a refunding issue, and not a reimbursement issue, when the proceeds of the issue are allocated either to pay the principal or interest on an outstanding obligation or to reimburse an original expenditure already paid by another obligation. *See Regulations § 1.150-2(g)(1).*

In applying this principle, "obligation" means any valid evidence of indebtedness (tax-exempt or otherwise) under general Federal income tax principles. *See Regulations § 1.150-1(b).*

Example 7

City financed certain preliminary expenditures of a downtown sidewalk improvement program with a tax-exempt loan from the local bank. City then allocated proceeds from a subsequent tax-exempt bond issue to reimburse its general fund for these expenditures. This reimbursement allocation is invalid because the original expenditures were already financed by another obligation of City.

Example 8

Authority issued qualified 501(c)(3) bonds and loaned the proceeds to University, a 501(c)(3) organization. University used the proceeds to retire a taxable short-term loan which was undertaken to finance several capital projects. As a result of the accounting treatment used by University, the retirement of the loan with the bond proceeds created a deficit in the Current Fund which had to be "reimbursed." The Service held that the taxable loan was a "valid evidence of indebtedness and thus does constitute an 'obligation.'" Thus, since the bond proceeds were used to redeem the loan, the bonds were a refunding issue. *See TAM 9831003.*

Allocations made with the proceeds of a refunding issue are subject to the rules under Regulations § 1.148-9.

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Refunding of Reimbursement Bonds

In the case of a refunding issue where the prior issue consists (in whole or in part) of reimbursement bonds, the proceeds of the prior issue that were purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was valid under the applicable law in effect on the issue date of the prior issue.

See Regulations § 1.150-2(g)(2).

Example 9

In November 2014, Hospital, a 501(c)(3) organization, used a taxable loan to replenish its general fund for an expenditure it made in July 2014 to pay for land that it planned to use for an expansion. The board had authorized the expenditure in July, but had not specified any other accounting for payment for the land. In May 2015, Authority issues qualified 501(c)(3) bonds for Hospital to fund the expansion on the land. Included in the bond issue is an amount to pay off the taxable loan attributable to the land cost. Because the use of the taxable loan for the land was not made pursuant to an effective reimbursement allocation, the refinancing of the taxable loan will result in the general fund moneys from the taxable loan being considered as unspent proceeds of the taxable loan (and will therefore become unspent transferred proceeds of the bonds upon payment of the taxable loan).

Continued on next page

Anti-Abuse Rules

Two anti-abuse rules are provided under Regulations § 1.150-2(h).

1. Under the first anti-abuse rule, a reimbursement allocation is not to be treated as a permissible expenditure of proceeds if the allocation employs an abusive arbitrage device under Regulations § 1.148-10 to avoid the arbitrage restrictions or to avoid the restrictions under §§ 142 through 147.

2. Under the second anti-abuse rule, a purported reimbursement allocation is invalid if, within 1 year after the allocation, funds corresponding to the proceeds used for the reimbursement allocation are used in a manner that results in the creation of replacement proceeds of that issue or another issue. This rule does **<u>not</u>** apply to amounts deposited in a bona fide debt service fund. An example illustrating this rule is provided in Regulations

Effective Dates

In General

The general rules applicable to reimbursement bonds are found in Regulations § 1.150-2. These rules are applicable to reimbursement bonds issued after June 30, 1993 (the "1993 Regulations").

The 1993 Regulations replaced the prior rules, found in withdrawn Regulations § 1.103-18, which were effective for reimbursement bonds issued after March 2, 1992.

Prior to March 3, 1992, reimbursements were analyzed under Regulations § 1.103-8(a)(5). This "inducement resolution" requirement, applied directly to industrial development bonds, and was applied by analogy to other bonds.

Transitional Rules

Under Regulations § 1.150-2(j)(2)(i), an official intent is treated as satisfying the official intent requirements under §§ 1.150-2(d)(1) and (e) if the official intent was **either**:

- Declared prior to July 1, 1993, and satisfied the applicable provisions of Regulations § 1.103-8(a)(5) as in effect prior to that date; **or**
- Declared between January 27, 1992 and June 30, 1993, and satisfied the applicable provisions of withdrawn Regulations § 1.103-18 as in effect during that period.

Under Regulations § 1.150-2(j)(2)(ii), the requirements under Regulations § 1.103-8(a)(5) as found in T.D. 7199, 1972-2 C.B. 45, may be applied in lieu of the requirements under § 1.150-2 for any expenditures originally paid prior to August 15, 1993 that would have qualified for expenditure by reimbursement from the proceeds of a private activity bond under § 1.103-8(a)(5).

Prior Rules Under § 1.103-18

Effective Dates

This section discusses the rules under former Regulations § 1.103-18 which applied to reimbursement bonds issued before July 1, 1993, but after March 2, 1992.

See T.D. 8394, 1002-1 C.B. 21.

General Rules

Regulations § 1.103-18(c) provided the general rules for reimbursement allocations for governmental bonds, qualified 501(c)(3) bonds, and private activity bonds financing facilities owned by a governmental unit. This regulatory regime is similar to that found in Regulations § 1.150-2 of the 1993 Regulations.

Regulation § 1.103-18(d) provided that, with respect to reimbursement allocations for exempt facility bonds (other than those for facilities owned by governmental units) and qualified small issue bonds, the allocation is valid if the requirements under then Regulations § 1.103-8(a)(5) are satisfied and the anti-abuse rules under section 1.103-18(k) are not violated. The requirements under Regulations § 1.103-8(a)(5) are discussed on the last page of this section.

Definitions

Regulations § 1.103-18(e) provided definitions for the terms "**reimbursement bond**" and "**reimbursement allocation**." The rules are similar to the rules found in the 1993 Regulations.

Continued on next page

Prior Rules Under § 1.103-18, Continued

Other Rules

Regulations §§ 1.103-18(f), (g), (i) and (k) provided rules concerning the procedures for an issuer's declaration of an intention to reimburse an expenditure, the reasonableness of official intent, exceptions to the general rule, and anti-abuse rules.

Transitional Rules

Under Regulations § 1.103-18(l), certain transitional rules apply to allocations of reimbursement bonds issued after March 2, 1992, when either the expenditure is paid or the official intent is declared prior to March 3, 1992.

Prior Rules Under § 1.103-8(a)(5)

Effective Date

This section discusses the rules under former Regulations § 1.103-8(a)(5) which applied to reimbursement bonds issued before March 2, 1992.

Overview

The regulatory regime found in former Regulations § 1.103-8(a)(5) is significantly different than the subsequent reimbursement allocation regimes discussed earlier in this section. Former Regulations § 1.103-8(a)(5) is fundamentally a qualifying rule for exempt facility bonds and small issue industrial development bonds, so an improper reimbursement allocation of more than a minor amount results in the entire bond issue being nonqualified.

In comparison, the result of an improper reimbursement allocation under Regulations §§ 1.150-2 or 1.103-18 result in the proceeds allocated to such expenditures as not being spent and thus continue to be subject to the arbitrage and rebate rules, and may be spent in a manner that results in disqualification for tax-exemption.

Generally, the rule to be applied under Regulations § 1.103-8(a)(5) is dependent upon whether a bond resolution or similar official action was taken by the actual issuer prior to the commencement of the construction, reconstruction or acquisition of the facility being financed. For existing facilities acquired by the user, additional restrictions apply. These additional restrictions are similar to the rule found in Regulations § 1.142-4(c).

Section 10

Allocations of Investments

Overview

Introduction

Until proceeds are properly allocated to an expenditure, they will be invested (actually or constructively) to earn a return for the issuer. These investments made preceding the expenditure of the proceeds for the governmental purpose of the issue, referred to as "nonpurpose investments," may be acquired with multiple sources of funds. Once proceeds and bonds are identified and properly allocated to an issue, the allocable proceeds must be properly allocated to expenditures and investments. Once these allocations have been verified, determinations regarding whether or not the investment restrictions of § 148 have been met can be made.

This section covers the rules governing such allocations.

Commingled Funds

Special Rules for Allocations

As mentioned above, issuers frequently commingle gross proceeds of an issue with other funds. This is done to invest the funds more efficiently. Regulations § 1.148-6(e) imposes additional accounting rules for commingled funds:

- Under Regulations § 1.148-1(b), a commingled fund means any fund or account (other than an open-end regulated investment company) that contains both gross proceeds of an issue and amounts in excess of
  $25,000 that are not gross proceeds of the issue, if the amounts are invested and accounted for collectively without regard to source.

- Regulations § 1.148-6(e)(2) requires all payments and receipts with respect to investments in a commingled fund be allocated to each investor at the close of each fiscal period using a "consistently applied, reasonable ratable allocation method." The fiscal period must be a consistent fiscal period that does not exceed three months. The fiscal year is the calendar year unless the fund adopts another fiscal year.

- If a ratable allocation method is used to allocate expenditures from the commingled fund, the same ratable allocation method must be used to allocate payments and receipts on investments in the commingled fund.

- To illustrate, if the issuer commingles funds, it cannot simply allocate any lower yielding investments to the gross proceeds portion of the funds without allocating a ratable portion to the other sources of funds.

- For purposes of these rules, the term "investor" means each different source of funds. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, the fund is treated as having two investors.

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Safe Harbor Allocation Methods

Regulations § 1.148-6(e)(2)(ii) sets forth safe harbor ratable allocation methods for allocating items (e.g., expenditures, investments) in commingled funds in proportion to either-

1. The average daily balances of the amounts in the commingled fund from different investors during a fiscal period; or

2. The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.

Special Mark-to-Market Requirement for Internal Commingled Funds

Regulations § 1.148-6(e)(5) provides a special mark-to-market requirement for allocating to investors in an internal commingled fund their allocable portions.

- An internal commingled fund is a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund.

- The fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.

- The mark-to-market requirement does not apply to (1) a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer or (2) a commingled fund where the investments consist solely of obligations (i.e., debt rather than stock) and the remaining weighted average maturity of the investments does not exceed 18 months.

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Commingled Reserve Allocations

Regulations § 1.148-6(e)(6) defines a commingled reserve as a commingled fund that serves as a common reserve fund, replacement fund, or sinking fund for two or more issues. The regulation provides that, after making reasonable adjustments to account for proceeds allocated under the one-issue and universal cap rules, investments held by a commingled reserve must be allocated ratably among the issues served by the fund in accordance with one of the following methods:

1. The relative value of the bonds of the issues;

2. The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or

3. The relative original stated principal amounts of the outstanding issues.

An issuer must make such allocations as of a date at least every three years and as of each date that an issue first becomes secured by the commingled reserve. If relative original principal amounts are used to allocate, allocations must also be made on the retirement of any issue secured by the commingled reserve.

Section 11

History of Allocations under the Regulations

Introduction

Introduction

The current allocation and accounting regulations attempt to provide a workable approach to account for expenditures and investments and prevent abuses of the tax-exempt market. Many of the principles contained in Regulations § 1.148-6 originated in prior regulations. This section will trace the historical development of these principles.

1979 Regulations

Reasonable Allocation Methods

Section 1.103-13(f)(1) of the 1979 Regulations, T.D. 7627, 1979-2 C.B. 45, was an attempt to solve the specific problem of tracing the proceeds of bonds into acquired obligations. The term "acquired obligations" was defined as securities and obligations allocated to proceeds of an issue of governmental obligations during the period of time such issue is outstanding. *See Regulations § 1.103-13(b)(4)(i).*

- Specific tracing was viewed, however, as an administrative burden. The problem was most acute in cases where a municipality issued multiple bond issues and there was no requirement under local law or the bond indentures that the issuer separately account for the proceeds of each separate issue.
- Regulations § 1.103-13(f)(1) attempted to address the limitations of specific tracing. It provides that the governmental unit which issues numerous obligations or which commingles the proceeds of bonds with other revenues may allocate acquired obligations to the available proceeds of issued obligations using any reasonable method chosen by the issuer.

Limits on Reasonable Methods

Regulations § 1.103-13(f)(1) permitted issuers to make allocations "at any time and under any reasonable method," provided that such method of allocation satisfied the following requirements:

- all allocations had to be consistent with one another;
- obligations purchased with the original proceeds of a refunding issue had to be allocated to such proceeds;
- obligations not purchased with original proceeds of a refunding issue may not be allocated to such proceeds;
- obligations purchased with amounts treated as proceeds under the sinking fund rules of Regulations § 1.103-13(g) must be allocated to those proceeds; and
- if an obligation is allocated to two or more sources of funds, each receipt of principal or interest on the obligation must be allocated ratably among the several sources of funds.

1989 Regulations

Focus on Rebate Provisions

On May 15, 1989, the Service issued temporary regulations (the "1989 Regulations") interpreting the rebate provisions of § 148(f). *See T.D. 8252, 1989-1 C.B. 25.*

- In general, these regulations applied to governmental bonds issued after August 31, 1986, and to private activity bonds issued after December 31, 1985.
- Regulations § 1.148-4T(a) contained the general rule for the allocation and accounting of investments made with bond proceeds. Specifically, an investment was considered allocated to an issue for the period that:
  - begins on the date such gross proceeds are allocated to the issue and to the investment; and
  - ends on the date such gross proceeds cease to be allocated to the issue or to the investment.
- The 1989 Regulations also introduced the concept of the universal cap. The 1989 Regulations only applied this rule to refunding issues.
- Many of the definitions and rules relating to allocation and accounting were reserved in the 1989 Regulations. The Service amended the 1989 Regulations on April 25, 1991, 1991-1 C.B. 839

1992 Regulations

Introduction

On May 18, 1992, the Service published final regulations to replace the 1989 Regulations, T.D. 8418, 1992-1 C.B. 29 (the "1992 Regulations"). The 1992 Regulations were a modified version of three sets of proposed regulations published on January 30, 1992 (§ 1.148-4), and February 12, 1992 (§§ 1.148-6 and 1.148-11). The Service amended the 1992 Regulations on September 30 and October 5, 1992.

The 1992 Regulations addressed issues not fully covered by the 1989Regulations. The allocation and accounting rules found in § 1.148-4 of the 1992 Regulations are one such example.

As a result of the 1992 Regulations, § 1.103-13(f) of the 1979 Regulations was withdrawn.

Facts and Circumstances

Regulations § 1.148-4(a) provided that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds of an issue for purposes of §148.

The reasonableness of the accounting method was based on the facts and circumstances.

The 1992 Regulations essentially adopted the rule in the 1992 proposed regulations that required a current outlay of cash and a governmental purpose for any expenditure of gross proceeds. *See Regulations § 1.148-4(d)(1)(ii).*

Regulations § 1.148-4(a)(2) contained an anti-abuse provision for unreasonable accounting methods. That provision provided that an accounting method is not reasonable if it is employed as an artifice or device to avoid the arbitrage provisions.

Regulations § 1.148-4(a)(4) provided that an accounting method may be changed in order to improve the accuracy of the accounting of bond proceeds. The current regulations do not contain a similar provision.

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Universal Cap

Under Regulations § 1.148-4(b)(3), a universal cap was placed on the amount of nonpurpose investments that can be allocated to a particular issue.

- The limitation equaled the outstanding value of the issue. Regulations § 1.148-4(b)(3)(vii) also contained an anti-abuse rule that

Regulations § 1.148-4(b)(3)(vii) also contained an anti-abuse rule that prohibited issuers from allocating investments in such a manner as to avoid application of the universal cap

Current Regulations

1993 Arbitrage Regulations and Amendments

The 1993 Regulations were published on June 18, 1993, T.D. 8476. The 1993 Regulations provide the detailed allocation and accounting rules found in Regulations § 1.148-6. The § 1.148-6 regulations were corrected and amended on August 23, 1993, May 10, 1994, January 16, 1997, and again on May 9, 1997. The 1993 Regulations generally apply to bonds issued after June 30, 1993, with permissive retroactive application of the regulations, **in whole, but not in part**, to outstanding issues issued prior to July 1, 1993.

1997 Private Activity Bond Regulations and Amendments

Private activity bond regulations were published on January 16, 1997 (the "1997 PAB Regulations"). The 1997 PAB Regulations contain the allocation rules for the private activity bond tests, found in Regulations § 1.141-6. On September 26, 2006, significant proposed revisions to the allocation regulation were published. Issuers may **not** rely on the proposed revisions prior to publication of final regulations.

Summary

Review of Lesson 6

Proceeds" may have different meanings depending on the context. There are also many variations of the term "proceeds," such as net proceeds, gross proceeds, investment proceeds, etc. These terms may be broader or narrower than the relevant definition of proceeds that is applicable.

The three basic types of allocations that must be made with respect to a bond issue are as follows:

1. allocating bonds to the issue;

2. allocating proceeds to bonds of the issue; and

3. allocating proceeds of the issue to expenditures and investments.

Failure to comply with the Code and applicable regulations with respect to allocations may result in the payment of rebate by the issuer or a determination that interest on the bonds is not tax-exempt.

Preview of Lesson 7

In Lesson 7, you will examine situations where there has been a change in the original use of the proceeds. The lesson will cover the important question of whether the bonds continue to be eligible for tax exemption without further action. It will also describe various actions the issuer may take to retain the tax exemption for the bonds if inaction is not appropriate. Finally, the lesson will cover certain rules under Section 150(b) that may cause the loss of other tax benefits in addition to the loss of tax exemption when a change in use of the bond proceeds occurs.

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Lesson 7

Remedial Actions / Change in Use Rules

Overview

Introduction

When bonds are issued to finance a specific project, the parties involved in the transaction expect that all will go as planned. For example, when a county issues bonds to construct and equip a hospital, it may expect that it will be able to operate the hospital indefinitely. The county also may expect that the hospital will generate enough profit to cover the debt service on the bonds. Sometimes, however, projects don't work out as planned. Assume that after a few years, the county realizes that it cannot operate the hospital at a profit because of rising operating costs and inadequate management skills. It decides that its only option is to sell the hospital. The highest bidder turns out to be a for-profit hospital system. The sale of the hospital facility to a private business user would cause the bonds to meet the private business tests, resulting in the bonds being classified as private activity bonds. Would the interest on these bonds still be tax-exempt? In this case, they may be if certain requirements are met.

This lesson discusses post-issuance events and how they can affect the tax exempt status of the bonds.

Continued on next page

Objectives

After completing this lesson, you will be able to:

- Define and identify a deliberate action
- Explain the effect of a deliberate action on the tax-exempt status of bonds
- Determine if proper remedial action has taken place
- Determine if the §150(b) sanctions applies to a transaction
- Explain how the sanctions affect the owner and user of the tax-exempt bond-financed property.

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Typical Changes Which May Affect the Bond's Status

Typical transactions that may affect the status of tax-exempt bonds usually involve the sale, transfer, or lease of property financed with bond proceeds to another entity. Often this other entity is a private business user.

These types of transactions jeopardize the tax-exempt status of bonds because they may cause the bonds to meet the private business use and private security or payment tests of §141(a) long past the issue date. Even though the issuers did not expect to issue taxable bonds, these types of post-issuance events can cause the bonds to become taxable private activity bonds.

Effect of Change in Use

When a change in use occurs that causes the private business tests to be met, the bonds are considered to be taxable as **of the date of issuance,** unless an appropriate remedial action is taken. This is because the issuer took a deliberate action after the issue date which caused the bonds to be private activity bonds.

History

Until the early 1990's a bond's exemption from tax was based on the reasonable expectations of the issuer/borrower that the bond proceeds would not be used in a manner that would cause the bonds to become private activity bonds. A subsequent change to the use of the proceeds did not affect the tax exemption of the bonds per Revenue Ruling 77-416, 1977-2 C.B.34. Over time the IRS moved away from this position and formalized this point with Revenue Procedure 93-17, 1993-1 C.B. 507, which revoked Revenue Ruling 77-416. Revenue Procedure 93-17 imposed requirements that had to be met to preserve the tax exemption of the bonds when there was a change in use of a bond finance facility that caused the private business tests to be met. Also, the private activity the private activity bond regulations issued in 1997 provided that the private activity bond tests are to be applied on the basis of actual facts over the term of the bond issue.

See Exhibit 7-1 for specific applications and exceptions.

Continued on next page

Overview, Continued

Current Rules

This lesson will cover the current remedial action rules for governmental bonds and qualified 501(c)(3) bonds and the sanctions for private business use of qualified 501(c)(3) bonds that are generally effective for all such bonds issued on or after May 16, 1997. These rules are contained in Regulations §§ 1.141-12, 1.145-2, and 1.150-4.

Many of the rules may also be applied in whole, but not in part, to bonds that were issued before, but were still outstanding on May 16, 1997. (See Regulations §§ 1.141-15 and 1.141-16 for specific information.)

Section 1

Remedial Actions

Overview

Introduction

The phrase "change in use" is not defined in the statute or the regulations relating to state or local bonds. Generally, the phrase "change in use" is most often used to describe a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used as of the date of issue to a different use (or user) that causes the bonds to meet the private business tests or the private loan financing test. That is how this chapter will use the phrase. Some practitioners, however, will use this phrase even when the transaction does not cause the tests to be met.

The test for private activity bonds is based on the issuer's reasonable expectations on the issue date **and** subsequent deliberate actions of the issuer. Even though an issuer reasonably expects on the issue date to use the bond proceeds for a governmental purpose throughout the life of the bonds, obviously events will occur which are unexpected. These unexpected- though deliberate - actions affect the taxability of the interest on the bonds **from the issue date**, even though the events may occur much later.

The regulations provide for certain actions, which, if properly taken by issuers, will preserve the tax-exemption of the bonds starting from the issue date. This section explains these remedial actions and the other conditions which are also required.

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Overview, Continued

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Concept of Use

Use vs. User

The use of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for an activity of a nongovernmental person.

When speaking of "use," we tend to think of the actual use of the property rather than the user. For example, when you were reading the example about the county's hospital in the Overview to this lesson, you may not have thought that the sale of the hospital constituted a change in use, because the hospital would still be used as a hospital. However, you need to broaden your way of thinking about these rules. Instead of thinking only in terms of actual use of bond-financed property, think about the user of the property. Now when you review the example, does your position change? It should - because now we have a bond-financed hospital being used by a nongovernmental person.

Purpose

The private activity bond rules and the rules under § 150(b) work to limit the amount of tax-exempt subsidy being transferred to a nongovernmental person.

Who is a User?

A person can be a user of bond proceeds or a user of bond-financed property through both direct and indirect use.

A person can be treated as a user of bond proceeds or bond-financed property as a result of:

- ownership of property, or
- actual or beneficial use of property pursuant to a
  - lease,
  - management contract, or
  - an arrangement such as a take-or-pay or output contract

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Concept of Use, Continued

Management Contracts

Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-28 I.R.B. 38 and amplified by Notice 2014-67, 2014-46 I.R.B. 822, provides the conditions under which a management contract does not result in private business use under §141(b) and does not result in §145(a)(2)(B) being met.

Notice 2014-67 created a new safe harbor for contracts with a term, including renewal options, of not more than five years. The big change is that such contract need *not be terminable* by the qualified user prior to the end of the term.

Section 3.02 of Notice 2014-67,applies to contracts entered into, materially modified or extended on or after January 22, 2015, but may be applied to contracts entered into before that date.

Research Agreements

Rev. Proc. 2007-47, 2007-29 I.R.B. 108, provides the conditions under which a research agreement does not result in private business use under §141(b) and does not result in §145(a)(2)(B) being met.

Reasonable Expectations and Deliberate Action

Section 141 Revisited

According to Regulations §1.141-2(d)(1), an issue is an issue of private activity bonds if the issuer:

- **reasonably expects**, AS OF THE ISSUE DATE, that the issue will meet either the private business tests or the private loan financing test, OR
- takes a **deliberate action**, SUBSEQUENT TO THE ISSUE DATE, that causes the conditions of either the private business tests or the private loan financing test to be met

The term "issuer" includes the conduit borrower for this purpose . (See Regulations §§ 1.141-1(a) and 1.148-1(b) for definitions.)

Deliberate Action

Regulations §1.141-2(d)(3) defines a deliberate action as any action taken by the issuer that is within its control. The intent to violate the requirements of §141 is not necessary for an action to be deliberate

Example 1

City X issues bonds and lends the proceeds to Hospital Q to renovate its main
facility. Hospital Q reasonably expects that sometime in the future it will build
an entirely new facility, and sell the current one to a for-profit entity. But on the issue date, it does not know when this will happen.

Generally, these bonds are private activity bonds, because the issuer reasonably expects, ON THE ISSUE DATE that the bonds will eventually meet the private business tests. (We will see later, though, how the issuer can avoid this.)

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Example 2

County A issues bonds in the principal amount of $40M. The proceeds are loaned to an organization exempt under §501(c)(3) and are used to build the organization's main facility. On the issue date, A reasonably expects that the issue will not meet the private business tests or the private loan financing test as applied under §145. Subsequently, the organization engages in a series of transactions with for-profit subsidiaries, which result in revocation of the organization's tax-exempt status.

The organization has taken a deliberate action that affects the tax- exempt status of the bonds.

Safe Harbor Rules

Regulations §1.141-2(d)(3)(ii) provides for the following safe harbor exceptions from the definition of deliberate action:

- involuntary or compulsory conversions under § 1033, and
- actions taken in response to a regulatory directive made by the Federal Government

Example 3

City C issues bonds to finance the purchase of land. On the issue date, C reasonably expects that it will be the sole user of the land for the entire term of the bonds. Subsequently, the Federal Government acquires the land in a condemnation action. C sets aside the condemnation proceeds to pay debt service on the bonds but does not redeem the bonds on their first call date.

The bonds do not lose their tax-exempt status because C has not taken a deliberate action after the issue date.

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Exception for Mandatory Redemption Provision

Regulations § 1.141-2(d)(2)(ii) provides that actions reasonably expected, as of the issue date, to occur after the issue date and that cause the private business tests or the private loan financing test to be met, may be disregarded if

- the non-qualifying bonds are required to be redeemed within six months of the date of the action;
- as of the issue date the financed property will be used for a governmental purpose for a substantial period prior to the deliberate action;
- the issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that deliberate action; and
- the mandatory redemption of bonds meets all of the conditions for remedial action under §1.141-12(a).

Example 4

City C issues bonds to renovate an existing hospital that it currently owns. On the issue date, C reasonably expects that the hospital will be used for a governmental purpose for a substantial period. Also on the issue date, C plans to construct a new hospital but is uncertain about when this will occur. C reasonably expects that when the new hospital is placed in service, it will sell or lease the renovated hospital to a private hospital corporation. The bond documents require that the bonds must be redeemed within six months of the sale or lease of the renovated hospital (regardless of the amount actually received from the sale.) The bonds meet the reasonable expectations requirement of the private activity bond tests if the mandatory redemption of bonds meets all of the conditions of a remedial action under Regulations § 1.141-12(a).

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Reasonable Expectations and Deliberate Action, Continued

Special Rules Governmental Bonds Only	The regulations provide special rules as follows: (Note that these special rules apply only to governmental bonds and do not apply to 501(c)(3) bonds or other qualified private activity bonds.)
Regulations §	**Provides special rules relating to…**
1.141-2(d)(4)	dispositions of personal property in the ordinary course of an established governmental program
1.141-2(d)(5)	general obligation bond programs that finance a large number of separate purposes.

Remedial Actions

Introduction

Regulations § 1.141-12 provides for certain remedial actions that, if properly undertaken, will prevent a deliberate action from causing an issue to meet the private business tests or the private loan financing test.

Note: These actions do not remediate excess private security or payments, but since excess private business use will be cured, then the bonds will not be private activity bonds.

There are four possible remedial actions, and five conditions, which must be met before those actions, will apply.

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Required Conditions

With certain exceptions, the five conditions as provided by Regulations § 1.141-12(a) that are required to be met are:

1. The reasonable expectations test must be met;
2. The maturity cannot be unreasonably long;
3. The terms of the arrangement that satisfies the private business tests or private loan financing test must be bona fide, arm's length, and the new user must pay fair market value. (See Regulations § 1.141-12(f));
4. Disposition proceeds are treated as gross proceeds for arbitrage purposes; AND
5. Proceeds affected by the deliberate action are expended on a governmental purpose. (See Regulations § 1.141-12(d))

Condition # 1 Reasonable Expectations

In order to avail themselves of the remedial action provisions of Regulations §1.141-12, the issuer must have reasonably expected on the issue date that the issue would meet neither the private business tests nor the private loan financing test for the entire term of the bonds.

However, if the issuer reasonably expected on the issue date to take a deliberate action prior to the final maturity of the issue that would cause the private business tests or the private loan financing test to be met, the term of the bonds for applying the reasonable expectations test may be determined by taking into account a redemption provision if the provisions of the mandatory redemption exception of §1.141-2(d)(2)(ii)(A) through (C) applies to the bonds

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Condition # 2 Maturity

The second condition that must be met in order to use the remedial action provisions is that the bonds may not be outstanding longer than reasonably necessary for the governmental purpose of the issue.

This requirement is met if the weighted average maturity of the bonds of the issue is not greater than 120% of the average reasonably expected economic life of the property financed with the proceeds of the issue as of the issue date.

Condition # 3 Fair Market Value

The third condition that must be met in order to use the remedial provisions involves the concept of fair market value.

Except for a situation in which the remedial action provision of Regulations § 1.141-12(f) concerning the alternative use of the facility is used, the terms of any agreement that cause the private loan or the private business test to be met must be bona fide and arm's length. The new user must pay fair market value for the use of the bond financed property.

Condition # 4 Disposition Proceeds

The fourth condition that must be met in order to utilize the remedial provisions provides that the disposition proceeds must be treated as gross proceeds for arbitrage purposes.

This means that the disposition proceeds are subject to yield restrictions when necessary and the investment earnings are subject to the rebate provisions. The issuer can choose to treat the day that the disposition proceeds are received as the issue date of the bonds for the purpose of applying the temporary period rules and qualifying for a spending exception to rebate. Similarly, for the purpose of determining whether a spending exception is met, the issuer may disregard the disposition proceeds for expenditure exemptions met before receipt of the disposition proceeds.

Continued on next page

Condition # 5

The final condition that must be met in order to utilize the remedial provisions (except for the redemption or defeasance remedial action under Regulations § 1.141-12(d)) is that the proceeds of the issue that are affected by the deliberate action must have been expended on a governmental purpose before the date of the deliberate action.

Remedial Actions

If the conditions precedent to taking a remedial action are met, there are four possible remedial actions as provided by Regulations §§ 1.141-12(d), (e), (f), & (h):

1. Redemptions or defeasances of nonqualified bonds.
2. Alternate uses of disposition proceeds.
3. Alternate uses of affected facility.
4. Additional remedial actions provided by publication.

These actions are discussed below. Note that they do not apply in all cases.

Redemption or Defeasance of Nonqualified Bonds

Regulations § 1.141-12(d) provides that the requirements for this remedial action are met if all of the nonqualified bonds of the issue:

- are redeemed within 90 days of the deliberate action, or
- if not redeemed, then a defeasance escrow is established within 90 days of the deliberate action. (**The first call date cannot be more than 10.5 years from the date of issue. See § 1.141-12(d)(4).)**

Continued on next page

Example 5

On June 1, 2007, City C issues bonds with an issue price of $10M to finance the construction of a hospital building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C leases the building to Corporation P for 7 years. C uses other funds to immediately retire all of the bonds within 90 days of entering into the lease agreement. The five required conditions are also assumed to be met.

The transaction does not cause the bonds to be private activity bonds (retroactively or prospectively) because C has taken a remedial action, which prevents C's lease to P from being treated as a deliberate action causing private business tests to be met, so P's use is ignored.

Special Rule for Cash Received

Regulations § 1.141-12(d)(2) provides that if the disposition proceeds are exclusively cash, only a p**ro rata portion of the bonds needs to be redeemed or defeased** on the earliest call date. This is helpful in situations where the cash received is less than the amount due on the outstanding bonds.

Example 6

An issuer has $15M in bonds outstanding at the time of the sale of tax-exempt bond financed property to a private business. The disposition proceeds are $10M in cash.

Under the special rule, the issuer need only redeem $10M of the outstanding bonds within 90 days. Alternatively, if the first call date is beyond 90 days, the $10M is used to establish a defeasance escrow to redeem $10M of the bonds on the first call date.

None of the $15M in bonds is treated as privately used.

Continued on next page

Notice of Defeasance

Regulations § 1.141-12(d)(3) requires that the issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

Regulations § 1.150-5 provides that this notice must be filed with the Internal Revenue Service, 1111 Constitution Avenue NW, Attention: T:GE:TEB:O, Washington, DC 20224**.**

Alternate Use of Disposition Proceeds

Regulations § 1.141-12(e) provides that the requirements of this remedial action are met if the:

- deliberate action is a disposition exclusively for cash,
- issuer reasonably expects to expend the disposition proceeds within two years of the date of the deliberate action,
- disposition proceeds:
  - are treated as proceeds for purposes of §141,
  - are used in a manner that does not cause the issue to meet either the private business tests or the private loan test, AND
  - the issuer does not take any action subsequent to the deliberate action to cause either of the above tests to be met, AND
- any excess disposition proceeds are used for redemption or defeasance, in a manner described in Regulations § 1.141-12(d)

Continued on next page

Example 7

On June 1, 2007, County B issues bonds with a principal amount of $10M to finance the construction of a hospital building. On the issue date, B reasonably expects that it will be the only user of the building for the entire term of the bonds. Five years after the issue date, B sells the building to Corporation P for $5M, which is the fair market value of the building. B expects to use the $5M disposition proceeds for the construction of roads within two years of receipt. B treats these proceeds as proceeds for purposes of §141.

The bonds are not private activity bonds because B has taken appropriate remedial action. Note that the bonds are NOT redeemed.

Special Rule for Use by 501(c)(3) Organizations

In addition to the rule set forth above, if the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must be treated as reissued for purposes of §§ 141, 145, 147, 149, and 150 and must satisfy all of the applicable requirements for qualified 501(c)(3) bonds.

Continued on next page

Alternate Use of Facility

Regulations § 1.141-12(f) provides that the requirements for this remedial action are met if:

- The facility with respect to which the deliberate action occurs is used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization
- The nonqualified bonds:
  - are treated as reissued for purposes of §§ 55 through 59, 141, 142, 144 through 147, 149, and 150, AND
  - the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds,
- The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds, AND
- Disposition proceeds (other than those arising from an agreement to provide services) resulting from the deliberate action are:
  - used to pay debt service on the bonds on the next payment date, OR
  - are deposited (within 90 days of **receipt)** into an escrow that is yield restricted AND used to pay debt service on the bonds on the next available payment date.

Continued on next page

Example 8

County F issues bonds with an issue price of $10M to finance the construction of a health care center. Five years later, the county realized that the needs of the rural residents would be better served if the facility were operated by another organization. The county leased the facility to a 501(c)(3) organization for 30 years. The lease payments to be paid equal the debt service payments due on the bonds. Lease payments, as received, will be deposited into a yield-restricted escrow account and used to pay debt service on the bonds. At the expiration of the term, all assets revert to the authority, including any tenant improvements. The bonds are treated as reissued under the appropriate Code sections that apply to qualified 501(c)(3) bonds.

The actions taken meet all of the requirements for alternative use of a facility. The bonds are treated as qualified 501(c)(3) bonds beginning with the date of the lease. The bonds are NOT redeemed AND must meet the requirements for qualified 501(c)(3) bonds while outstanding.

Additional Remedial Actions Provided by Publication

Regulations § 1.141-12(h) provides that the Commissioner may provide for additional remedial actions through publication. Pursuant to this authority, the Internal Revenue Service released Rev. Proc. 97-15, 1997-1 C.B. 635, on February 3, 1997. Rev. Proc. 97-15 provides a program under which a request for a closing agreement can be made and can be found in your Deskbook.

Continued on next page

Provisions of Rev. Proc. 97-15 Closing Agreement

The Revenue Procedure permits an issuer to enter into a closing agreement to prevent interest on the bonds from:

- becoming taxable due to a deliberate action which causes the bonds to fail to meet certain requirements of sections 141-150, and
- being treated as a tax preference item in cases where the bonds were issued as governmental bonds but as a consequence of a remedial action taken by an issuer are qualified private activity bonds

Continued on next page

Required Issuer Actions

To prevent interest on governmental or 501(c)(3) bonds from being included in gross income, the following requirements must be met:

- The requirements of Regulations §§ 1.141-12, and 1.145-2 as applicable, relating to conditions for remedial action, AND

The issuer must:

- submit within 180 days of the subsequent action a proper request for a closing agreement which describes the subsequent action and explains computation of the proposed closing agreement amount,
- agree to redeem the bonds at the next call date,
- notify the bondholders that the bonds will be redeemed on the next redemption date and that if not redeemed then, the bonds will be nonqualified private activity bonds,
- not make any closing agreement payment from tax-exempt bond proceeds,
- sign a disclosure consent authorizing the Service to make certain documents relating to the agreement public if the bonds are not redeemed in accordance with the terms of the agreement, AND
- pay the full amount due upon execution of the closing agreement.

Effective Date

This revenue procedure is effective for bonds issued on or after May 16, 1997. Issuers may apply the revenue procedure to any bonds issued before May 16, 1997.

Continued on next page

Special Note Regarding Eligibility

A bond issue that is under an examination by the Service is NOT eligible for the program. An issue is under examination if the issuer of the bonds has been notified in writing by the Service that the issue has been selected for examination.

Example 9

County T issues bonds with a principal amount of $50M on June 1, 1995. The bond proceeds are loaned to a 501(c)(3) organization which uses the funds to construct a hospital wing. The first call date of the bonds is on June 1, 2007. During the course of an examination it was discovered that the exempt status of the 501(c)(3) organization was officially revoked in June 1997 due to inurement. Revocation of exempt status constitutes a deliberate action.

The closing agreement program is not available to the County because the organization's deliberate action was uncovered during an IRS examination.

Example 10

County X issues $75M bonds used to develop and operate a hospital facility Three years later, the county finds that operation of the facility is beyond its abilities. It decides to lease the facility to a private for-profit firm. Assume all of the conditions precedent to a remedial action are satisfied.

The County may request a closing agreement under the provisions of Rev. Proc. 97-15 to prevent the interest from being taxable.

Nonqualified Bonds

Introduction

The remedial action provisions provide a way to preserve the tax-exempt status of bonds based on post-issuance actions taken by the issuer. Certain of these provisions reference "nonqualified" bonds. Therefore, in order to ascertain whether the remedial action provisions were properly applied, an understanding of nonqualified bonds is essential.

Definition

Section 1.141-12(j) states the percentage of outstanding bonds that are nonqualified bonds equals the highest percentage of private business use in any 1-year period commencing with the deliberate action. All bonds allocable to private use are treated as nonqualified bonds, including the percentage permitted by the private activity bond tests.

Example 11

Governmental bonds are issued for $150 million. $7.5 million or 5% are used for private business purposes. Assume this use is level in each year of the measurement period. If $50 million of the proceeds were used to finance a building that was originally used for governmental purposes, and that building is subsequently sold to a private business, the nonqualified bonds would be the $50 million attributed to the building that was sold plus the $7.5 million attributed to the original private use or $57.5 million.

Allocation

Allocations to nonqualified bonds must be made on a pro rata basis; except for purposes of redemption or defeasance of nonqualified bonds, per the remedial action provision of Regulations § 1.141-12(j), an issuer may treat bonds with longer maturities as the nonqualified bonds.

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Proposed Regulation

Proposed regulations (REG-132483-03, 2003-2 C.B. 410, 68 FR 43059), published July 21, 2003 propose to amend the definition of nonqualified bonds in Regulations § 1.141-12, and modify the rules in Regulations § 1.141-12 pertaining to the allocation of nonqualified bonds.

Definition of Nonqualified Bond

These proposed regulations provide that the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business tests or private loan financing test, as applicable. For this purpose, the proposed regulations provide that the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the deliberate action.

Continued on next page

Example 12

In 2000, City G issued bonds with proceeds of $10 million to finance a courthouse. G uses $1 million of the proceeds for private business use and more than 10 percent of the debt service on the issue is secured by private security or payments. In 2004, in a bona fide and arm's length arrangement, G enters into a management contract with a nongovernmental person that results in private business use of 40 percent of the courthouse per year during the remaining term of the bonds. G immediately redeems the nonqualified bonds, or 44.44 percent of the outstanding bonds. This is the portion of the outstanding bonds that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test.

The amount of private business use is the greatest percentage of private business use in a one-year period commencing with the deliberate action. Thus, 10% original private use plus 40% new private use generated as a result of the management contract results in 50% private business use in the year of the deliberate action.

The amount of nonqualified bonds is computed by dividing the percentage of the facility used for a government use by the minimum amount of government use required and subtracting the resulting percentage from 100 percent.

50 % used for government use
÷
90% minimum government use required

----- (55.56%)

100% - 55.56% = 44.44% non qualified bonds calculated utilizing the proposed regulations.

Contrasting this calculation with the regulations as written, reveals that the nonqualified bonds would be 50% under the current regulations versus 44.44% under the proposed regulations

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Nonqualified Bonds, Continued

Allocation of Nonqualified Bonds

The second change envisioned by the proposed regulations would amend the provisions of Regulations §1.141-12 (relating to redemption or defeasance). Under the proposed regulations, allocations of nonqualified bonds must be made on a *pro rata* basis, except that an issuer redeeming or defeasing nonqualified bonds may treat any bonds of an issue as the nonqualified bonds so long as

(i) the remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (the determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer, is not greater than

(ii) the remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

Applicability of Proposed Regulations

The proposed regulations will apply to deliberate actions or failures to properly use proceeds, as applicable, that occur on or after the date of publication of final regulations in the Federal Register and may be applied by issuers to deliberate actions that occur on or after April 21, 2003 and before the date of publication of the final regulations in the Federal Register.

Exhibit 7-1 Applicability

The table below summarizes how the change of use provisions, apply to governmental and qualified 501(c)(3) bonds.

SUBJECT	REGULATIONS §	GOVT	QUALIFIED 501(c)(3)*
Deliberate action	**1.141-2(d)(3)**	YES	YES
Failure to properly use proceeds	**1.142-2(a)**	NO	NO
Special rules	**1.141-2 (d)(4) and (d)(5)**	YES	NO
Conditions for Remedial Action	**1.141-12(a)**	YES	YES
Redemption	**1.141-12(d)**	YES	YES
Redemption	**1.142-2(c)**	NO	NO
Dispositions of personal property	**1.142-2(c)(4)**	NO	NO
Dispositions for cash	**1.141-12(d)(2)**	YES	YES
Alt use-proceeds	**1.141-12(e)**	YES	YES
Special rule for 501(c)(3) orgs	**1.141-12(e)(2)**	NO	YES
Alt use-facility	**1.141-12(f)**	YES	YES
Nonqualified bonds	**1.141-12(j)(1)**	YES	YES
Nonqualified bonds	**1.142-2(e)**	NO	NO
Rev Proc 97-15	**1.141-12(h)**	YES	YES
NOTES:			***See modifications in § 1.145-2(b) and (c)(2).** **N/A to § 145(b), (c), (d).**

Section 2

Change-in-Use Sanctions

Overview

Introduction

As stated above, we generally use the phrase “change in use” to mean a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used as of the date of issue to a use that causes the private business tests or private loan financing test to be met. Section § 150(b) provides sanctions where proceeds of certain qualified private activity bonds are used for a non-qualified use. So, if there is a change to a nonqualifying use, these sanctions may apply.

The sanctions relates to the characterization of the use of the facility as unrelated trade or business income by a 501(c)(3) borrower and to the disallowance of the interest paid by the borrower of the bond proceeds to finance the facility.

Continued on next page

Example 12

On January 1, 1994, City X issues bonds in the principal amount of $50M. On that date, the bonds satisfied all of the requirements for tax-exempt qualified 501(c)(3) bonds under §§ 141 through 150. Hospital Y borrows the proceeds and uses them to finance construction and renovation of its facility, to fund a debt service reserve fund, and to pay costs of issuance. Five years later, the hospital proposes to enter into a partnership with a for-profit affiliate. Seven percent of the facility will be leased and operated by the partnership. The lease payments will be used to pay greater than 5 percent of the debt service on a portion of the bonds.

Absent appropriate remedial action under § 1.150-4, these bonds would become nonqualified private activity bonds on the date the hospital enters into an agreement with the partnership. The interest on the bonds would be taxable back to the issue date and § 150(b)(3) would apply, triggering the disallowance of the interest deduction to the 501(c)(3) borrower for the period beginning on the date the agreement was entered into and ending on the date such that the facility is not used in a nonqualified manner.

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Purpose

Section 150(b) affects the users of qualified 501(c)(3) bond financed facilities who fail to use the facilities for a qualifying purpose. These sanctions are generally separate and distinct from any retroactive or prospective loss of exemption of bond interest that may result if applicable Code requirements are not met.

The sanctions were enacted in response to the concern that the proper use of bond-financed facilities was generally under the control of the users of such facilities and that such users should bear responsibility for improper use of bond proceeds.

Effective Date

Section 150(b) was added to the Code in 1986, and generally applies to changes in use of bond-financed property occurring after August 15, 1986, with respect to financing provided after that date.

Applicability

The provisions of §§ 150(b) and (c) apply to:

- qualified 501(c)(3) bonds (§ 145)
- certain qualified private activity bonds, which will be covered in Phase II
- bonds financing facilities required to be owned by governmental units or 501(c)(3) organizations (§§ 145(a) and 142(b)(1))

These provisions do NOT apply to property financed with governmental bonds.

Qualified 501(c)(3) Bonds

General Rule

There are two provisions of § 150(b) that directly apply to qualified 501(c)(3) bonds - §150(b)(3) and § 150(b)(5).

1. Section 150(b)(3) applies when any portion of a facility that is financed with the proceeds of a 501(c)(3) bond is used in a trade or business of any person other than a 501(c)(3) organization or a government unit, but continues to be owned by a 501(c)(3) organization.
2. Section 150(b)(5) applies when facilities are required to be owned by a governmental unit or 501(c)(3) organization and is discussed later in the module.

Exception for *de minimis* nonqualified private use

Section 150(c)(1) provides an exception for purposes of subsection (b) that any use with respect to facilities financed with proceeds of an issue which are not required to be used for the exempt purpose of such an issue shall not be taken into account.

Sanctions

The results of § 150(b)(3) are twofold:

- The owner of the property (the 501(c)(3) organization) is treated as engaged in an unrelated trade or business with respect to the portion of the property used by a trade or business person, AND
- No deduction is allowed for interest on financing which accrues during the period that the property is so used.

The amount of income derived is equal at least to the fair rental value of the portion of the property so used.

Continued on next page

Example 13

Hospital Y enters into an agreement whereby approximately 15 percent of Hospital Y's facility will be leased to and managed by a for-profit corporation. The entire facility was financed with tax-exempt bonds. No proceeds were used for costs of issuance.

Section 145(a)(2)(B) provides that one of the requirements for qualified 501(c)(3) bonds is that no more than 5 percent of the net proceeds is used for private business use. The sanctions under § 150(b) will apply only when the private business use exceeds 5 percent (see 150(c)(1)). In this example, 15 percent of the facility (and the bond proceeds) are treated as being used by the for-profit corporation. That percentage is not reduced by the 5 percent that may be used for non-exempt purposes under § 145(a). If the private use amounted to less than 5 percent, then the 150(b) penalties would not apply.

Effect of Remedial Action

Regulations § 1.150-4 provides generally that the rules of §§ 150(b)(3), 150(b)(5), and 150(c) **apply even if the issuer takes a remedial action described in Regulations § 1.145-2.**

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Qualified 501(c)(3) Bonds, Continued

Special Rules

Section 150(c) provides an exception and several special rules which relate to § 150(b). The special rules relate to:

- the treatment of amounts payable for the use of a facility that are not interest (such as leases), AND
- allocations where only a portion of a facility is used for private use **(see Regulations § 1.150-4(c)).**

Exceptions

The sanctions have limited application if the remedial action taken is:

- redemption within 90 days of the deliberate action under § 1.145-2,
- an alternative qualifying use of a bond-financed facility under Regulations § 1.145-2 and 1.141-12(f), OR
- an alternative use of disposition proceeds under Regulations § 1.145-2 or § 1.141-12(e)

(See Regulations § 1.150-4(b) for specific rules.)

Continued on next page

Example 14

County G issues bonds in the principal amount of $75M. The bond is issued as a qualified 501(c)(3) bond. L (a 501(c)(3) organization) borrows the proceeds and uses them to finance the construction and renovation of its hospital. Six years later, L enters into an agreement with Partnership M, a partnership of private physicians, to lease the oncology department of the hospital for a period of 10 years. The amount of the lease payments is equal to the fair rental value of that portion of the facility. Approximately 6 percent of the proceeds of the bonds are allocable to the renovations made to the property to be used by the partnership. The bonds cannot be redeemed within 90 days because the first call date is beyond that date. However, the bonds are defeased and a proper escrow account is established within 90 days.

In this situation, a remedial action has been taken that prevents the lease with Partnership M from being a deliberate action that causes the private business use test under § 145(a) to be met. However, defeasance does not prevent § 150(b)(3) from applying. **(See Regulations § 1.150-4(b)(2).)** Therefore, L is required to file Form 990-T for the period beginning on the date the agreement is signed and continuing until the private use ceases or the bonds are redeemed. In computing the amount of unrelated business taxable income shown on the return, L is not allowed a deduction for interest accruing on the loan from County G for the portion of the property used by the partnership.

Facilities Required to be Owned by Governmental Units or 501(c)(3) Organizations

General Rule

Section 150(b)(5) provides for a denial of interest deduction when property financed by tax-exempt private activity bonds is required to be owned by a governmental unit or a 501(c)(3) organization, and the owner is not a governmental unit or a 501(c)(3) organization.

Disallowance

The owner is denied a deduction for interest on the financing which accrues during the period:

Beginning on the date…	Ending on the date…
the property is not owned as required	the property is owned as required.

Example 15

County H issued bonds and loaned the proceeds to a 501(c)(3) organization to construct a nursing home. Five years after the nursing home had begun operation, the organization discovered financial difficulties, which precluded it from meeting the financial obligations of the bonds. The nursing home was sold to a private, unrelated operator of nursing home facilities. Terms of the sale called for the new operator to assume the 501(c)(3) organization's note to the County. Within 90 days of the sale, a defeasance escrow was established to redeem the bonds. The first call date was one year after the sale.

Although a redemption would qualify as a remedial action that would prevent the bonds from becoming nonqualified private activity bonds, the defeasance escrow is not an exception under Regulations § 1.150-4(b)(2). Therefore, the general rule of § 1.150-4(b)(1) applies. As a result, the new owner is denied a deduction for interest incurred on the assumption of the note until the loan is repaid, the bonds are redeemed, or the nursing home is sold. The amount of the denied deduction is limited to the amount of interest on the bonds.

Auditing Techniques

§ 150(b)(3)

Use by other than a 501(c)(3) organization or governmental unit that causes the private business use of the issue to exceed 5 percent will result in gross income for purposes of Unrelated Business Taxable Income ("**UBTI**") to the 501(c)(3) organization of at least the fair rental value of the use of bond-financed facility.

Interest deductions are denied on the portion of the bonds that will be used by a person other than a 501(c)(3) organization or governmental unit equal to the allocable amount of bond interest.

Audit Tips

During an examination, the agent should:

- review conduit borrower's records/facilities to determine non-§501(c)(3) use,
- analyze sources of revenue that would disclose use by others,
- analyze contracts and agreements that would disclose use by others,
- review in-house publications to uncover private activities, AND
- tour the facilities to identify any private use

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Example 16

Assume that you are examining a bond issue, the proceeds of which are used by a § 501(c)(3) membership organization ("sub"). The sub is controlled by a parent organization ("parent"), which is a § 501(c)(4) membership organization.

You reviewed the publications of each organization. These publications list the facilities available to the members of the sub and the parent. Your review disclosed that some of the facilities available to the parent's members are those that are owned by the sub and were financed with tax-exempt bonds.

This bond is potentially a nonqualified § 145 bond. If so, then the 501(c)(3) organization could be liable for UBIT on the fair rental value of the portion of the facility used by the parent.

The next page illustrates the financial aspects of this situation.

Continued on next page

Example 17

Remember that this use by the parent's members in addition to any other private business use of the proceeds (including costs of issuance paid with proceeds) must exceed 5 percent in order to cause a private use problem. Also remember that the private payment test must be met. Assume the following:

Fair rental value of entire facility	$200,000/annually
Portion used by parent's members	7 percent
Fair rental value of portion of facility used by parent's members	$ 14,000
Bond gross proceeds	$1,700,000
Bond interest rate	6.5 percent
Annual interest payment	$ 110,500
Bond term 20 years	
Lease payments made by sub:	
Principal portion	$ 85,000
Interest portion	110,500
UBIT:	
Gross income	$ 14,000
Operating/maintenance expense	< 3,500>
Specific deduction	< 1,000>
Taxable income	$ 9,500
Interest portion of lease payment for portion used by parent's members	$7,735 (110,500x.07)

Sub is not permitted to deduct the $7,735 from gross income. Note that if parent were paying rent, it would not be allowed to deduct such rent from its UBTI gross income, if any.

§ 150(b)(5)

Tax-exempt bond facilities owned or used by a § 501(c)(3) or governmental entity must be owned by such an entity or no interest deduction is allowed for the portion that is not so owned.

Continued on next page

Audit Tips

During an examination, the agent should review records of issuer/conduit borrower noting the following:

- depreciation schedule for dispositions,
- in-house publications for discussion of sales, etc,
- CPA reports for decrease in assets, notes for disposals or future dispositions, AND
- minute books for discussions of dispositions

Summary

Review of Lesson 7

Lesson 7 discussed the remedial action rules included in Regulations §§ 1.141-12 and 1.145-2 and the sanctions provided by §§150(b) and (c) and Regulations § 1.150-4.

Note that the sanctions of § 150(b) and (c) and the accompanying regulations apply to qualified 501(c)(3) bonds, while the other remedial action regulations apply to governmental bonds and qualified 501(c)(3) bonds.

The § 1.141-2(d)(1) regulations clearly state that the private business tests and the private loan financing test consider both the issuer's:

- reasonable expectations about the use of bond proceeds on the issue date, AND
- subsequent deliberate actions

These subsequent deliberate actions become very significant to us as examiners. Bond counsel renders an opinion on the tax status of the bonds on the issue date based on reasonable expectations. Even though these expectations may be quite reasonable on the issue date, circumstances frequently change, resulting in a situation which can suddenly affect the tax-exempt status of the bonds. Bond counsel is usually no longer involved in the bond issue, but the issue can be subject to an IRS examination. Upon arrival, the agent reviews the bond transcript noting the expected plans for the proceeds and also analyzes the subsequent use of the proceeds to determine if those plans actually were carried out. Sometimes it is determined that the use of the proceeds has changed in some way resulting in consideration of the change in use rules.

Continued on next page

Review of Lesson 7 (continued)

When a change in use occurs, it can result in the bond issue becoming a nonqualified issue retroactive to the issue date. Therefore, it becomes necessary for the examiner to verify that proper remedial action was taken in order to preserve the tax-exempt status of the bonds.

The regulations provide four alternative remedial actions that, if properly performed by the issuer, will prevent the private use or private loan financing test from being met. In addition to meeting all of the requirements of the specific remedial action, the issuer must also meet five required conditions. If accomplished correctly, then the subsequent action will not be a deliberate action causing the private use or loan financing test to be met.

The § 150(b) sanctions apply only to certain types of qualified private activity bonds. These sanctions apply whenever proceeds are used for a non-qualified use, but their effects can be limited by the remedial action that is taken.

Preview of Lesson 8

Lesson 8 covers § 149 provisions of the law. These requirements apply to all tax-exempt bonds. They include such things as registration and information reporting obligations, prohibitions against Federal guarantees and conditions for advance refunding bonds, pooled bonds and hedge bonds.

Because these rules affect all tax-exempt obligations, they are very significant.

Exercises

Exercise 1

City B issues bonds to finance the purchase of land. On the issue date, City B reasonably expects that the land will be used for governmental purposes throughout the life of the bonds. Three years later, City B decides that this land will not be suitable for its intended purposes and sells the land to an unrelated private developer at fair market value. The disposition proceeds are invested pending the first call date which is 2 years after the sale date. At this time, the City had no plans to begin another project. The debt service on the bonds continues to be paid out of the city's general fund.

Does the sale of the property constitute a deliberate action?

If the sale is a deliberate action, has the city taken proper remedial action to preserve the tax-exempt status of the bonds?

If not, what effect will the deliberate action have on the bonds?

Continued on next page

Exercise 2

On June 1, 2007, City C issues 30-year bonds with an issue price of $10M to finance the construction of a hospital building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C sells the building to Corporation Y for $5M. The fair market value of the building at the time of the sale is $6M. C uses all of the sale proceeds to immediately retire a pro rata portion of the bonds.

Has C met all of the requirements for proper remedial action?

Why or why not?

Continued on next page

Exercise 3

On June 1, 1987, County M issues $70M of 20-year bonds, the proceeds of which are used to build a county administration building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, County M reasonably expects that it will be the only user of the building for the entire term of the bonds. After 10 years, the county decides that the building is too small and agrees to sell it at fair market value to an unrelated non-governmental person. Part of the disposition proceeds are placed into a defeasance escrow account which will pay debt service on the bonds until redemption in 1999. The remainder of the proceeds is used to begin construction of a new administration building.

Has the county taken proper remedial action to prevent the bonds from becoming taxable? Explain your answer.

Is the county subject to the sanctions of § 150(b)? Why or why not?

Is the new owner subject to the sanctions of § 150(b)? Why or why not?

Continued on next page

Exercises, Continued

Exercise 4

On May 1, 2000, County K issues $40M bonds, the proceeds of which are loaned to Hospital L. The hospital uses the bond proceeds to construct an adjacent building. On the issue date, the bonds are qualified 501(c)(3) bonds. Upon examination by the Internal Revenue Service in August 2007, it is determined that over 5 percent of the building is used by commercial enterprises. This use causes the bonds to meet the private business tests. The leases for this unrelated use are dated January 1, 2007.

Are these bonds qualified 501(c)(3) bonds?

If not, what options are available for the county to preserve the tax-exempt status of the bonds?

Do the sanctions of § 150(b) apply to the hospital and the lessees?

If the rules apply, explain the effect the rules will have on the hospital and the lessees.

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Lesson 8

Section 149
Rules Applicable to All Tax-Exempt Bonds

Overview

Introduction

This lesson discusses all of the provisions of § 149. Both governmental and qualified private activity bonds are subject to these rules.

The Tax Reform Act of 1986 added § 149(a) through (e) to the Code with an effective date of August 15, 1986.

Subsequently, § 149(f) was added by the Technical and Miscellaneous Revenue Act of 1988 with an effective date of October 21, 1988.

Finally, § 149(g) was added by the Omnibus Budget Reconciliation Act of 1989 with an effective date of September 15, 1989.

Continued on next page

Overview, Continued

Introduction (continued)

Prior to being included in §149, these provisions were found in the Code as shown below:

Subject	IRC 1986	IRC 1954
Registration	149(a)	103(j)
Federally guaranteed bonds	149(b)	103(h)
Tax exempt only under this title	149(c)	103(m)
Advance refundings	149(d)	N/A
Information reporting	149(e)	103(l)
Pooled financing bonds	149(f)	N/A
Hedge bonds	149(g)	N/A

Continued on next page

Objectives

At the end of this lesson, you will be able to:

- Identify "registration-required" bonds and determine if registration- required bonds have been properly registered
- Determine if a bond is federally guaranteed and if the interest on a federally guaranteed bond is tax exempt
- Identify bonds whose interest is tax exempt by virtue of provisions other than § 103(a) of the Code
- Identify a refunding issue
- Apply the rules of § 149(d) to advance refunding issues
- Explain the information reporting requirements of bonds
- Identify a hedge bond and determine whether the interest on a hedge bond is tax exempt

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Overview, Continued

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This lesson contains the following topics:

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Section 1

Registration

Overview

Introduction

Section 149(a) provides which bonds must be registered in order for the interest to be tax exempt.

Contents

This section contain the following topics:

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Types of Systems for Registration	8

General Rules

Introduction

Section 149(a) requires that certain bonds be registered in order for the interest to be tax exempt. Section 149(a)(2) provides that the term "registration-required bond" means any bond other than a bond which -

- is not of a type offered to the public, or
- has a maturity (at issue) of not more than one year, or
- is described in section 163(f)(2)(B)

Example

County A issued twenty-year bonds to finance the construction of a sanitary sewer system. The Federal Housing Administration agreed to purchase the bonds. The bonds were transferable by the owner upon presentation and surrender. Even though these bonds were not offered to the public for sale, they are typical of bonds that are offered to the public, and therefore must be registered to be tax exempt.

Continued on next page

General Rules, Continued

Legislative History

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), most bonds were "bearer bonds." The interest on bearer bonds was paid to whoever held the bonds. Each bond came with coupons that were redeemable for the interest. Because there was no requirement to account for who received the interest payments, the IRS was unable to determine the recipients of the interest income. Even though the requirements of TEFRA were directed primarily towards taxable bonds, the amendment also applies to bonds described in §103. Congress included the registration requirements in TEFRA in order to:

- limit the number of bearer bonds that were issued, and to
- help ensure compliance with the federal income tax laws, and to
- prevent bonds from being transferred to another party without the knowledge of the bond trustee

---

Registration Requirement Upheld by Supreme Court

In *South Carolina* v. *Baker*, 485 U.S. 505, 108 S. Ct. 1355 (1988), South Carolina objected to the Federal Government's restrictions concerning registration of municipal securities. The Supreme Court, however, upheld the TEFRA provisions regarding the registration requirement.

Types of Systems for Registration

Registered Form

Treasury Regulations § 5f.103-1(c) provides two acceptable systems for the registration of tax-exempt obligations. These two systems can be described as the:

- certificate system, and
- book entry system

Under the **certificate system**, the obligation is registered with the issuer or its agent, as to both principal and any stated interest. A certificate evidencing the right to such principal and interest is issued to the holder.

The obligation may be transferred when the current holder surrenders the obligation to the issuer, who then either:

- reissues the old instrument to the new holder, OR
- redeems the old instrument and issues a new instrument to the new holder

In a **book entry system** the ownership of the bond is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation. The right to principal and interest on a bond may be transferred only through a book entry system maintained by the issuer (or its agent).

Obligations that do not meet either of these requirements are considered to be in bearer form. However, terms can be changed during the life of the bonds to meet the requirements of a book entry system, and the bonds will be considered to be in registered form from that point on.

Continued on next page

Types of Systems for Registration, Continued

Book-Entry System vs. Certificate System

Figure 8-1 presents the mechanics of both the book-entry system and the certificate system of bond issuance. It also illustrates the similarities and differences between the two systems.

A description of the system used usually appears in every Official Statement.

Continued on next page

Types of Systems for Registration, Continued

Figure 8-1

Comparison of the Book-Entry System with the Certificate System of Bond Issuance		
Component	**Book-Entry System**	**Certificate System**
Printing	Issuer prints one bond for each maturity (for example, $22,000,000 term bond @ 5% maturing on 7/1/2024).	Issuer prints one bond of a certain denomination for each maturity (for example, 4,400 term bonds worth $5,000 each).
Delivery	One day before closing, bond counsel delivers bonds to the Trustee who delivers them to Depository Trust Company ("DTC").	One day before closing, bond counsel delivers bonds to underwriter.
Closing	Financing is closed when issuer receives purchase price from bondholders and DTC receives the bonds.	Financing is closed when underwriter has delivered purchase price to issuer and underwriter receives the bonds.
Ownership	Purchaser's name is recorded in a register kept by the registrar, usually the trustee.	Purchaser receives a certificate (bond) with his name on it, showing that he is the registered owner. Purchaser's name is recorded in a register kept by the registrar, usually the trustee.
Payments	Purchaser receives interest and principal payments according to bond provisions, and registrar notes the payments in the bond register.	Purchaser receives interest and principal payments according to bond provisions, and registrar notes the payments in the bond register.
Trading	If original purchaser trades (sells) the bond, registrar changes the name of the bondholder in the register.	If traded, the seller surrenders the certificate. The registrar either: • changes the name of the owner on the bond, or • cancels the surrendered bond, and issues a new bond to the new owner with his name on it

Section 2

Federally Guaranteed Bonds

Overview

Introduction

Section 149(b)(1) provides that the interest on bonds which are federally guaranteed is not tax exempt.

Continued on next page

Overview, Continued

Contents

This section contains the following topics:

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General Rules

Legislative History

Section 622 of the Deficit Reduction Act of 1984 amended § 103(h) of the 1954 Code to, in general, eliminate the tax exemption for interest on bonds where a substantial portion of the issue was deposited in federally insured deposits or accounts, or where the bonds were guaranteed directly or indirectly by the Federal Government. (House Rep. No. 98-432, Part 2, March 5, 1984, pages 1689 and 1690.)

This legislation was enacted in order to eliminate the advantage provided when a state or local bond is federally guaranteed. Without this provision these investments would be more attractive than either taxable municipal securities or other state and local bonds lacking federal guarantees. They would receive the benefit of the guarantee of the Federal Government plus the federal tax exemption of a state or local obligation.

When Are Bonds Federally Guaranteed?

Section 149(b)(2) provides that bonds are federally guaranteed if:

- The payment of the principal or interest is guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
- The payment of the principal or interest is otherwise indirectly guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
- Five percent or more of the bond proceeds are either:
  - o Used to make loans, and the principal and interest payments on the loans are guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
  - o Invested (directly or indirectly) in federally insured deposits or accounts

Continued on next page

General Rules, Continued

Federally Insured Deposits or Accounts

Section 149(b)(4)(B) defines "federally insured deposits or accounts" as those deposits or accounts in a financial institution to the extent such deposits or accounts are insured under Federal law by the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation (since abolished), the National Credit Union Administration, or any similar federally chartered corporation.

Instrumentalities

Statutory Definition

Section 149(b)(4)(A) states that any entity with statutory authority to borrow from the United States will be considered to be an instrumentality of the United States. However, the District of Columbia and possessions of the United States will only be considered to be instrumentalities with respect to the following types of bonds:

- exempt facility bonds,
- qualified small issue bonds,
- qualified student loan bonds

Possessions of the United States include the U.S.Virgin Islands, Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico.

Instrumentality Guidance

For guidance on the definition of "instrumentality" see Rev. Rul. 57-128, 1957-1 CB 311 which discusses state and local instrumentalities.

Continued on next page

Instrumentality Guidance

In determining whether or not the organization is an instrumentality of the United States ("U.S."), the following factors should be considered:

- whether the organization is used for a governmental purpose and performs or assists in the performance of a governmental function;
- whether performance of its function is on behalf of one or more states or political subdivisions;
- whether any private interests are involved, or the state or political governmental subdivision involved has the powers and interests of an owner;
- whether control and supervision is vested in a public authority;
- whether authorization is necessary for the creation or use of the organization ;
- the degree of financial autonomy and the source of the organization's operating expenses

Exceptions to the General Rule

Introduction

Interest on bonds described below are still tax exempt, even though they are federally guaranteed.

Exceptions for Certain Federal Insurance Programs

Guarantees by the following federal programs are permitted by § 149(b)(3)(A):

- Federal Housing Administration,
- Veterans' Administration,
- Federal National Mortgage Association,
- Federal Home Loan Mortgage Corporation,
- Government National Mortgage Association,
- any guarantee of student loans and any guarantee by the Student Loan
- Marketing Association to finance student loans,
- any guarantee by the Bonneville Power Authority, pursuant to Northwest Power Act, as in effect as of the date of enactment of the Tax
- Reform Act of 1984, or
- Subject to § 149(b)(3)(E), any guarantee by a Federal home loan bank made in connection with the original issuance of a bond during July 30, 2008 and ending December 31, 2010 (or as may be extended).

Continued on next page

Exceptions to the General Rule , Continued

Exceptions for Certain Investments of Bond Proceeds

Section 149(b)(3)(B) provides that certain bond proceeds may be invested in federally guaranteed deposits or accounts as follows:

- proceeds invested during the initial temporary period,
- investments of a bona fide debt service fund,
- investments of a reserve which meets the requirements of § 148(d), investments in U.S. Treasury bonds; or
- other investments permitted under regulations

The regulations provide that the following investments made after June 30, 1993, may be federally guaranteed:

- pursuant to Treas. Reg. § 1.149(b)-1(b)(2) any investment held in a refunding escrow as defined in § 1.148-1, or
- pursuant to Treasury Regulations § 1.149(b)-1(b)(1), investments in obligations issued pursuant to § 21 B(d)(3) of the Federal Home Loan Bank Act, as amended by § 511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision

Continued on next page

Example

State K issues bonds in the principal amount of $5MM, depositing the funds as follows:

- $500,000 Reserve Fund
- $50,000 Bona Fide Debt Service Fund
- $4,450,000 Project Fund

All of the funds are invested in government securities, except for the project fund. The project fund proceeds are deposited into a bank's money market account. The proceeds invested in the reserve and debt service funds are federally guaranteed, but meet the exceptions of § 149(b)(3)(B)(ii) and (iii), so the bond interest is tax-exempt.

The project fund, even though insured by the FDIC, meets the exception of § 149(b)(3)(B)(i), but only during the temporary period as provided by Treas. Reg. § 1.148-2(e)(1). At the end of the temporary period the funds remaining in this account would be considered to be federally guaranteed and thus could affect the tax-exemption of the bond interest.

Exceptions for Housing Programs

Section 149(b)(3)(C) provides that the prohibition of a federal guarantee for tax exempt bonds does not apply to the following, unless the proceeds of the bonds are deposited into federally insured deposits or accounts:

- private activity bonds for qualified residential rental projects or housing program obligations under § 11(b) of the United States Housing Act of 1937,
- qualified mortgage bonds issued pursuant to § 143(a),
- qualified veterans' mortgage bonds issued pursuant to § 143(b)

Continued on next page

Exceptions to the General Rule , Continued

Exceptions for Loans to, or Guarantees by, Financial Institutions

Section 149(b)(3)(D) provides that, except as provided in § 149(b)(2)(B)(ii), a bond which is issued as part of an issue shall not be treated as federally guaranteed merely because the proceeds are used to make loans to a financial institution or there is a guarantee by a financial institution unless such guarantee constitutes a federally insured deposit or account.

In *FDIC* v. *Philadelphia Gear Corp.*, 476 U.S. 426 (1986), the Court determined that a standby letter of credit issued by a bank whose deposits were insured by the FDIC did not constitute an FDIC-insured deposit.

Other Exceptions

Notice 88-54, 1988-1 C.B. 539, provides that capitalization grants awarded by the EPA through its State Water Pollution Control Revolving Fund Program under Title VI of the Water Quality Act of 1987 would not constitute a federal guarantee.

Notice 88-114, 1988-2 C.B. 449, provides that bonds that are insured, reinsured, or guaranteed by the Connie Lee Insurance Company, a wholly owned subsidiary of the College Construction Loan Insurance Association, would not be considered to be federally guaranteed.

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Section 3

Tax Exemption Derived Only Under This Title

General Rules

Introduction

Section 149(c)(1) provides that with certain exceptions, interest on bonds is exempt from federal tax only if the exemption is provided by the Code, even though an exemption may be provided by another federal statute.

Legislative History

Prior to the Deficit Reduction Act of 1984 ("DRA 1984"), there were two types of tax-exempt bonds on the market those whose exemption was derived

- directly from § 103(a), and
- from other federal statutes, such as obligations of the:
  - Federal Home Loan Bank,
  - Federal Savings and Loan Association, and
  - Central Bank of Cooperative

Those bonds whose exemption was derived from § 103(a) were required to comply with all of the provisions of § 103, while bonds whose exemption was derived from other federal statutes were not subject to the provisions of § 103

The DRA 1984 changed this, requiring generally, that all tax-exempt bonds comply with the provisions of § 103, regardless of the source of their tax-exemption.

Continued on next page

Bonds Issued Before 1984

Generally, bonds issued before 1984 whose exemption is derived from statutes other than the Code continue to be treated as bonds described in § 103(a), without having to comply with present §§ 141-150.

Bonds Issued After 1983

Section 149(c)(2)(B) provides generally that bonds issued after 1983 will NOT
be considered to be tax exempt under §103(a) unless they comply with present §§ 141-150.

Exceptions are provided for the following bonds:

1. Section 149(c)(2)(C)(i) provides for any bond issued pursuant to Northwest Power Act, as in effect on July 18, 1984,
2. Section 149(c)(2)(C)(ii) provides for any bond issued pursuant to § 608(a)(6)(A) of Public Law 97-468, as in effect on the date of the enactment of Tax Reform Act of 1986 ("TRA 1986"), pertaining to the transfer of the Alaska Railroad from federal to state control,
3. Section 149(c)(2)(C)(iii) provides for any bond issued before June 19, 1984, under § 11(b) of the United States Housing Act of 1937.

Continued on next page

General Rules, Continued

Example

County C issues bonds pursuant to § 11(b) of the U.S. Housing Act on June 1, 1992. These bonds must meet all of the provisions of §§ 141-150 in order for the interest on the bonds to be tax-exempt because they were issued after June 19, 1984.

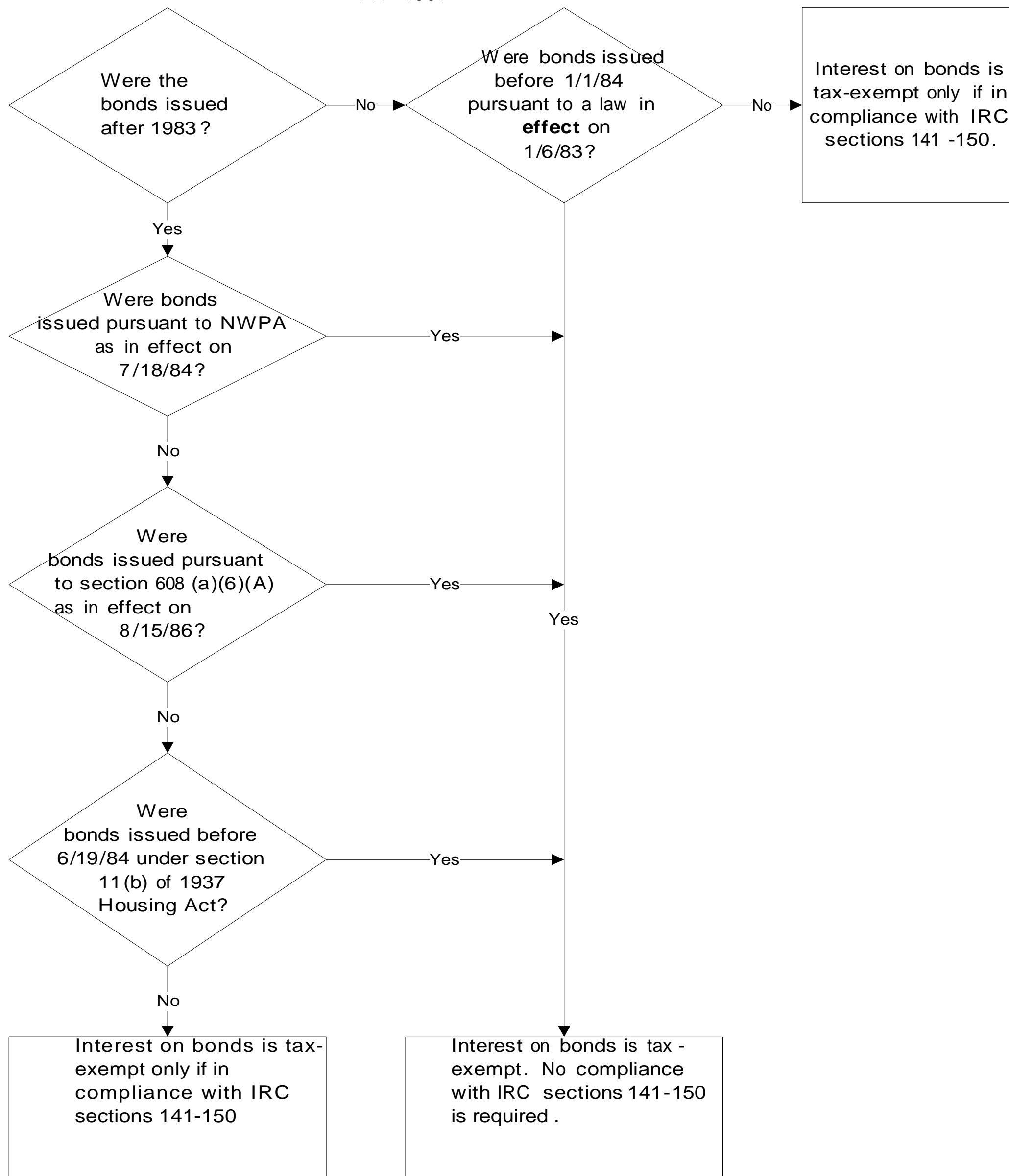
Flowchart

Bonds whose exemption is derived from a statute other than § 103 are required to file an information return, Form 8038 series. Refer to **Figure 8-2** below to determine if the bonds are subject to the provisions of §§ 141-150.

Continued on next page

General Rules, Continued

FIGURE 8-2: DETERMINING WHETHER OR NOT BONDS WHOSE EXEMPTION IS DERIVED FROM **STATUTES OTHER THAN IRC SECTION 103(a)** MUST COMPLY WITH SECTIONS 141 -150.



Section 4

Advance Refundings

Overview

Introduction

Section 149(d) provides that the interest paid on bonds that are not properly advance refunded is not tax-exempt. Advance refundings can be complicated and can present problems, particularly where arbitrage is concerned. For this reason, a complete discussion of them has been reserved for Phase II of this course.

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Prohibited Uses and Limitations on the Number of Advance Refundings

Private Activity Bonds

Section 149(d)(2) prohibits issuing advance refunding bonds for private activity bonds, except for Qualified 501(c)(3) Bonds. Private activity bonds may be advance refunded only with taxable refunding bonds.

Governmental and Qualified 501(3)(c) Bonds

Section 149(d)(3) provides limitations on the number of times a bond may be advance refunded, as shown in the table below.

Limitations

If the original Bond is issued…	Then it can be advance refunded…
Before 1986	Twice
Before 1986 and it was already advance refunded two or more times before March 15, 1986	Once
After 1985	Once

Continued on next page

Prohibited Uses and Limitations on the Number of Advance Refundings, Continued

Example

In 1996, City C had bonds outstanding that were originally issued in 1975. These bonds were advance refunded in 1978, 1981, and 1985. Because these bonds were issued before 1986, and because they were advance refunded at least twice prior to March 15, 1986, the original issue can be advance refunded only one more time. Section 149(d)(6)(B) treats all advance refundings before1986 as one refunding.

Example

In 1996, City A has outstanding bonds that were originally issued in 1986 and have never been advance refunded. Assume that the bonds are advance refunded in 1997, and the 1986 bonds are retired in 1999. Because the bonds were issued after 1985 they may only be refunded once. Because the original issue was advance refunded in 1997, there may not be another advance refunding of the issue.

First Call Date Requirement

Sections 149(d)(3)(A)(ii) and (iii) provide that if the advance refunding results in present value debt service savings (determined without regard to administrative expenses) to the issuer, then the prior bonds must be called as shown in the table below:

If the original bond is issued…	Then the prior bond must be redeemed not later than…
Before 1986	The earliest date on which the bond may be redeemed: • At par, or • At a premium of 3% or less.
After 1985	The earliest date on which the bond may be redeemed.

Continued on next page

Prohibited Uses and Limitations on the Number of Advance Refundings, Continued

Example

In the example above, City A's bonds would have to be called on the earliest call date if:

- there is present value debt service savings for the issuer, **and**
- if the issuer expects to treat the advance refunding as a tax-exempt issue

Abusive Transactions Prohibited

Section 149(d)(4) provides that the interest on an advance refunding issue will not be excluded from gross income under §103(a) if a device is employed in connection with the issuance of the advance refunding issue to obtain a material financial advantage. The material financial advantage is based on arbitrage concepts under § 148, and does not include savings attributable to lower interest rates.

Treasury Regulations § 1.149(d)-1(b) provides that an advance refunding issue violates § 149(d)(4) if:

- the issue violates any of the anti-abuse rules under Treasury
    - Regulations § 1.148-10,
- if issued after August 31, 1986, the issue fails to meet the rebate requirements under Treasury Regulations § 1.148-3, or
- the proceeds of the issue are invested in a certain type of escrow that contains both non-purpose investments and tax-exempt obligations (See§ 1.149(d)-1(b)(3))

Section 5

Information Reporting Requirements

Overview

Introduction

Section 149(e) provides specific reporting requirements for tax exempt issues.

The interest on bonds which do not meet the reporting requirements will not be tax exempt.

Although § 149(e) generally applies to bonds issued after August 15, 1986, the regulations apply to bonds issued after December 31, 1986. Rules for bonds issued after December 31, 1982 and before December 31, 1986 are covered under § 103(1) of the 1954 Code and Treasury Regulations § 5f.103-3.

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Overview, Continued

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IRS Has Authority to Designate Information Reporting Requirements

A bond will not be considered to be tax exempt under § 103(a) unless such bond satisfies the information reporting requirements under § 149(e)(2), which requires the issuer to submit not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary of the Treasury may prescribe with respect to any portion of the statement) a statement containing the information described in §149(e)(2). Section 149(e)(3) gives the Secretary authority to grant an extension of time for such filing if the failure to file in a timely fashion is not due to willful neglect.

Regulations

Treasury Regulations § 1.149(e)-1 (a) provides that interest on a bond is included in gross income unless certain information with respect to the issue of which the bond is a part is reported to the IRS.

Continued on next page

Who Must File

The issuer is required to file a "completed reporting form prescribed for this purpose" for all tax exempt issues issued after December 31, 1986.Since the regulations specifically require a prescribed form, no letters or issuer-designed forms are permitted.

Prior to December 31, 1986, § 103(l) of the 1954 Code only required issuers of the following types of bonds to file information returns:

- industrial development bonds (known as "private activity bonds" after TRA 1986),
- those used to finance loans to individuals for educational expenses,
- those used by § 501(c)(3) organizations

These reporting requirements also apply to most bond issuances discussed in Section 3, whose tax exemption is derived from non-Code provisions.

Required Forms

Forms 8038 Series

The table below shows the appropriate forms to be filed by issuers of tax exempt bonds:

Form Number	Purpose of Form
8038	Information return for all qualified private activity bonds.
8038-G	Information return for all governmental issues with an issue price of $100,000 or more.
8038-GC	Information return for all governmental issues with an issue price of less than $100,000.
8038-B	Information return for Issuers of Build America Bonds (Tax Credit/Direct Pay) and Recovery Zone Economic Development Bonds .
8038-TC	Information Return for Issuers of qualified tax credit bonds.

Continued on next page

Required Forms, Continued

What Does "Completed" Mean?

Treas. Reg. § 1.149(e)-1(d)(1) describes when an information reporting form will be considered to be "completed." The issuer must make a good faith effort to complete the form (taking into account the instructions to the form). The completed form must be prepared on the basis of available information and reasonable expectations as of the date of issue, except for consolidated returns. Consolidated returns should be completed based on information readily available to the issuer at the close of the year, supplemented by good faith estimates.

Special Requirements for Form 8038

Treas. Reg. § 1.149(e)-1(b)(2) requires issuers of private activity bonds subject to the volume cap to attach a copy of the certification by a state official which states that the bonds meet the volume cap requirements of § 146.

Form 8038-GC Options

An issuer has two options when reporting several issues of less than $100,000 that were issued during a calendar year. The issuer may file a:

- separate Form 8038-GC for each issue with an issue price of less than $100,000, or
- consolidated return which includes all issues with issue prices of less than $100,000.

Exceptions

A separate Form 8038-GC must be filed for those issues for which the issuer has elected to pay a penalty in lieu of rebating arbitrage.

The separate return option is not available for issues issued prior to January 1, 1992.

Continued on next page

Required Forms, Continued

Example

County X issues the following bonds during the calendar year ending December 31, 1996:

- $2,000,000 for sewer line repairs,
- $6,000,000 qualified hospital bonds,
- $95,000 for transportation repairs,
- $90,000 for new police cars,
- $92,000 for construction of city hall annex

The County has elected to pay the penalty in lieu of rebate for the $92,000 construction bonds.

County X must file the following forms regarding the bond issues:

Bond Issue	Required Form
$2,000,000 for sewer line repairs	8038-G
$6,000,000 for qualified hospital bonds	8038
$92,000 for construction of city hall annex	8038-GC (separate)

County X then has the option to file a separate Form 8038-GC for each of the remaining two issues or it can file a consolidated form 8038-GC which includes both issues.

Filing Dates

Filing Dates: 8038, 8038-G, 8038-GC, 8038-B and 8038-TC

Forms 8038, 8038-G, 8038-GC, 8038-B and 8038-TC filed for a single issue are due by the 15th day of the second calendar month following the close of the calendar quarter in which the bonds were issued.

Consolidated Forms 8038-GC are due by February 15th of the calendar year following the year in which the bonds were issued.

The table below provides a quick reference for determining the filing due dates of Forms 8038, 8038-G, 8038-GC, 8038-B and 8038-TC (see Form 8038 Series due date column). Please note that consolidated 8038-GCs have a different due date.

Month of Issuance	Quarter Ending Date	Form 8038 Series Due Date	Due Date 8038-GC (Consolidated returns only)
January February March	**03-31**	**05-15**	**02-15**
April May June	**06-30**	**08-15**	**02-15**
July August September	**09-30**	**11-15**	**02-15**
October November December	**12-31**	**02-15**	**02-15**

Continued on next page

Filing Dates, Continued

Filing Extensions for Forms 8038, F8038-G, 8038-GC, 8038-B and 8038-TC

Revenue Procedure 2002-48, 2002-37 IRB 531 describes the steps that should be taken to obtain an extension to file Forms 8038, 8038-G, 8038-GC, 8038-B or 8038-TC after the filing date has passed. While there are no provisions which allow for a request for an extension prior to the filing date, an issuer may request that the IRS make a determination that the failure to file timely was not due to willful neglect. If granted, then the information reporting requirements are considered to be met, and the interest on the bonds is tax exempt. If the Service is unable to grant the request, then the reporting requirements would not be satisfied and the interest on the bonds would not be excludable from gross income.

Special Extension for Bonds Issued from January 1-June 30, 1992

Information returns for bonds issued between January 1 and June 30, 1992 received an extended filing date to November 16, 1992.

Where to File

All returns are filed with the Ogden Service Center.

Penalties for Failure to File

None of the penalties provided by §§ 6652, 6721, or 6723 apply to the information returns required by § 149(e)(2). Thus, the only sanction for delinquent filings would be that the interest on the bonds would not be excludable from gross income.

Section 6

Treatment of Certain Pooled Financing Bonds

Overview

What are Pooled Financing Bonds?

Section 149(f)(6) provides that for purposes of this subsection "pooled financing bond" means any bond issued as part of an issue more than $5,000,000 of the proceeds of which are reasonably expected (at the time of issuance) to be used (or are intentionally used) directly or indirectly to make or finance loans to two or more ultimate borrowers. IF bonds are subject to the volume cap limitations of § 146 or §143(l)(3) applies to such issue, they are excepted from this definition.

How Pooled Financing Bonds are Used

A pooled financing arrangement occurs when a state or local government issues bonds and subsequently loans the proceeds to multiple borrowers. The borrowers may be governmental or private entities.

Pooled financings occur for various reasons. Municipalities or conduit borrowers may not have a sufficient credit rating to borrow on their own, or they may find that consolidating loans with other borrowers lowers the cost of borrowing. Rather than issuing several smaller bond issues an issuer will agree to issue one large issuance, and subsequently lend the proceeds to several municipalities or other conduit borrowers.

Continued on next page

Section 149(f) in General

Section 149(f) provides that the interest on a pooled financing bond will NOT be tax exempt unless it meets four specific requirements the:

1. Reasonable expectation requirement,
2. Cost of issuance payment requirements,
3. Written loan commitment requirement, and
4. Redemption requirement.

There are no regulations to accompany this section. (For more information on Pooled Bonds see – CITE IN OTHER MATERIAL).

Specific Applicability

The provisions of § 149(f) do not apply to all pooled financing bonds. Generally, they apply only to those issues not subject to the volume cap ceiling on private activity bonds generally, governmental or 501(c)(3).

Continued on next page

Legislative History

Section 149(f) was enacted to curb the following abuses by governmental issuers:

- Issuing bonds without immediate need for the funds,
- Issuing bonds without written commitments from potential borrowers to use the funds for governmental purposes,
- Issuing bonds for the sole purpose of "locking in" current low interest rates, OR
- Allowing bonds to remain outstanding longer than necessary.

Section 7

Hedge Bonds

Overview

General Rule

Section 149(g) provides that the interest on hedge bonds will not be tax exempt unless certain requirements are met. The regulations which accompany this section generally apply to bonds issued after June 30, 1993.

Contents

This section contains the following topics:

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Interest on a Hedge Bond Can Still be Tax Exempt	34

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Legislative History

Prior to § 149(g), municipalities could issue bonds when interest rates were low, even though there was not an immediate need for financing. They were "hedging" against the risk that interest rates would increase in future years. Congress viewed this practice as a drain on the federal treasury because the bonds were outstanding longer than necessary. The hedge bond rules were enacted to ensure that bond issues were reasonably sized and timely issued.

Hedge Bonds versus Hedged Bonds

There are two terms that are similar, but have different meanings. These differences must be clarified.

Hedge bonds, as defined in § 149(g), refer to bonds which are taxable bonds because they have failed to meet certain requirements regarding the investment and spending of proceeds.

Hedged bonds, as defined in Regulations § 1.148-4(h), refer to bonds where the issuer has entered into a hedge transaction which is used to compute bond yield. A hedge transaction is a contract entered into to modify the interest rate risk, such as a swap or a cap.

The following discussion is in regard to hedge bonds as defined in § 149(g). There will be a discussion of hedged bonds as defined in Regulations § 1.148-4(h) in Phase II of this course.

Hedge Bond Requirements

What is a Hedge Bond?

To avoid being a hedge bond, a bond must meet BOTH of the following tests:

1. The issuer must reasonably expect to spend at least 85 percent of spendable proceeds for the governmental purposes of the issue within 3 years of the issuance date; AND
2. 50 percent or less of the proceeds are invested in non-purpose investments having a substantially guaranteed yield for four years or more.

If either of these tests is NOT met, then the bonds are hedge bonds.

Reasonable Expectations

Treasury Regulations § 1.149(g)-1(a) states that "reasonable expectations" has the same meaning as set forth in Treasury Regulations § 1.148-1, along with the modification described in § 149(f)(2)(B). Section 149(f)(2)(B) concerns pooled financing issues, and provides that expectations regarding changes in interest rates and tax laws cannot be considered when determining whether expectations are reasonable.

What Are Spendable Proceeds?

The term "spendable proceeds," is defined in Treas. Reg. § 1.149(g)-1(a) as "net sale proceeds" as defined in Treas. Reg. § 1.148-1. Net sale proceeds are sale proceeds, and any amounts actually or constructively received from the sale of an issue, including amounts used for underwriter's discount and accrued interest, other than preissuance accrued interest less proceeds placed into a reasonable required reserve and replacement fund and as part of a minor portion under § 148(e). Net sale proceeds include but are not limited to, amounts derived from the sale of a right that is associated with a bond described in Treas. Reg. § 1.148-4(b)(4).

Non-purpose Investments

Non-purpose investments are investments in securities, bank deposits, or other investments which have nothing to do with the purpose of the issue. Guaranteed yields may result from any type of investment. Some examples are guaranteed investment contracts, government securities, or other bonds.

Exception to the General Rule

Exception to Hedge Bond Status

Section 149(g)(3)(B) provides that a bond which otherwise meets the definition of a hedge bond will not be considered a hedge bond if:

- 95 percent of the net proceeds are invested in tax-exempt bonds that are not subject to the Alternative Minimum Tax under § 57,
- amounts in a bona fide debt service fund, and
- amounts held for not more than 30 days pending reinvestment or bond redemption

This test is based on **actual** investments, and not the issuer's expectations.

Definition of "Net Proceeds"

Proceeds is defined in Treasury Regulations § 1.148-1(b) as any sale proceeds, investment proceeds, and transferred proceeds of an issue. Net sale proceeds are defined in Treasury Regulations § 1.148-1(b).

Continued on next page

Bonds Subject to the Alternative Minimum Tax ("AMT Bonds")

"AMT bonds" are those bonds which are considered tax preference items under
§ 57. Those items included in § 57 are subject to the Alternative Minimum Tax of § 55.

Generally, AMT bonds are private activity bonds issued after August 7, 1986, except for:

- qualified 501(c)(3) bonds,
- certain housing bonds, and
- refunding bonds, if the original bond was issued before August 8, 1986

Therefore, non-AMT bonds would be:

- 501(c)(3) bonds,
- certain housing bonds,
- certain refunding issues, AND
- • governmental bonds

Note: ARRA provided certain temporary relief from AMT on tax-exempt interest.

Interest on a Hedge Bond Can still be Tax-Exempt

Two Tests

Section 149(g)(1) provides that if a bond meets the definition of a hedge bond, the interest will be considered to be tax exempt if the bond meets two requirements:

1. Five-year reasonable expectations test described below, and
2. Cost of issuance payment requirements

5-Year Reasonable Expectation Test

Section 149(g)(2) provides that a hedge bond will not be tax-exempt unless the issuer reasonably expects to meet the spending requirements set forth in the table below:

Percentage of Spendable Proceeds	Time Period within which to be spent
10%	1 year
30%	2 years
60%	3 years
85%	5 years

Cost of Issuance Payment Requirements

The cost of issuance payment requirements for purposes of § 149(g) are met with respect to an issue if -

- at least 95 percent of the reasonably expected legal and underwriting costs associated with the issue are paid not later than the 180th day after the date of issuance, AND
- the payment of legal and underwriting costs are NOT contingent

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Interest on a Hedge Bond Can still be Tax-Exempt, Continued

Example

City X plans to issue a $59 million bond issue at 6% on January1, 1994. The proceeds will be used to build a qualified multi-purpose recreational complex. The City is in the process of purchasing the land from several landowners. The negotiations are not complete and are expected to continue for several months. Because the land purchases are not final, architectural plans are also not complete. As a result, on January 1, 1994, the issuance date, the City cannot reasonably expect to substantially finish the project within three years. However, because the city expects to have made significant progress on the project within five years, the bonds are issued anyway. Financial data regarding the issue is as follows:

Proceeds from sale	**$59,000,000 (includes underwriters discount)**
Accrued interest	$ 330,000
Gross proceeds	$59,330,000
Deposit to reserve	$(5,900,000)
Spendable proceeds	$53,430,000
Issuance costs paid by January 31, 1994	$1,135,327

In order to meet the 5-year reasonable expectations test of § 149(g)(2), the City must reasonably expect to spend the proceeds according to the following schedule:

Percentage of Spendable Proceeds	**Amount to be Spent**	**Date**
10%	$5,343,000*	December 31, 1994
30%	$16,029,000	December 31, 1995
60%	$32,058,000	December 31, 1996
85%	$45,415,500	December 31, 1998

Because City X reasonably expects to spend the amounts shown above, and the cost of issuance payment tests were met, the interest on the bonds will be tax exempt, even though the bonds are still considered to be hedge bonds

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Interest on a Hedge Bond Can still be Tax-Exempt, Continued

Additional Notes about This Section

There is no effect on the bond's status if the actual disbursements do not meet the above spending schedule unless the circumstances surrounding the actual events cast doubt on the reasonable expectations on the issuance date.

The allocation and accounting rules of Treasury Regulations § 1.148-6 apply to expenditures for purposes of § 149(g). There is an exception for certain expenditures which create replacement proceeds. See Treasury Regulations § 1.149(g)-1(b).

Section 149(g)(4)(A) provides that issuers of construction projects which are expected to take longer than five years may request a ruling regarding hedge bond status. The issuer must reasonably expect that the spendable proceeds will be spent over a reasonable construction period, which is specified in the request.

Summary

Review of Lesson 8

Lesson 8 discussed the various provisions of § 149. All tax-exempt municipal bonds are subject to these provisions.

Section 149(a) requires that most tax-exempt municipal bonds be registered. The regulations provide that issuers can use either the certificate or the book- entry system of registration.

Section 149(b) provides that tax-exempt municipal bonds cannot be federally guaranteed. There are many exceptions to this general rule.

Section 149(c) provides that all tax-exempt bonds must comply with § 103, even though tax-exempt status is provided under another federal statute. Most bonds issued after 1983, therefore, must comply with §§ 141-150.

Section149(d) provides the rules for advance refundings. Advance refundings are bonds issued to refund prior bonds, when the proceeds are held more than90 days in advance of the maturity or call date of the refunded bonds. In a current refunding, the proceeds of refunding bonds are used to repay prior bonds within 90 days of issuance of the refunding bonds.

Section 149(e) provides for the information reporting requirements of municipal bonds. Issuers are required to file one of a series of Forms 8038 when the bonds are issued. Form 8038-T is required to be filed when an issuer makes yield reduction or rebate payments, or is paying an arbitrage penalty.

Section 149(f) provides the rules for pooled financings. These are bonds the proceeds of which are loaned to two or more borrowers.

Continued on next page

Summary, Continued

Review of Lesson 8 (continued)

Section 149(g) provides the rules for hedge bonds. Hedge bonds are bonds which are issued prior to the need for financing. The interest on a hedge bond may or may not be tax-exempt, depending on the circumstances.

Preview of Lesson 9

Lesson 9 discusses the special rules contained in § 150 and provides you with cross-references to enable you to find these topics elsewhere in the training materials.

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Lesson 9

Section 150 – Definitions and Special Rules

Overview

Introduction

Section 150 contains definitions and various special rules. This module focuses primarily on the definitions contained in § 150(a). However, this Module will also set forth the special rules contained in § 150 and provide you with cross-references to enable you to find these topics elsewhere in the training materials.

Objectives

At the end of this lesson, you will be able to:

- Apply the definitions found in § 150(a) to various tax-exempt bond transactions
- Identify the various subject matters contained in § 150

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Contents

This lesson contains the following topics:

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Section 1

Definitions Contained in § 150(a)

Introduction

Section 150(a) and the accompanying regulations contain certain definitions that are necessary for purposes of applying the provisions contained in §§ 103 and 141 through 150 and related regulations to tax-exempt bond financings.

Definitions in § 150(a)

Section 150(a) lists 5 basic definitions which are at the heart of many tax-exempt transactions. These are listed below and summarized for your convenience. In addition, § 150(a)(5) provides that property is treated as owned by a governmental unit if it is owned on behalf of that unit

Section	Defined Term	Definition Summary
150(a)(1)	Bond	Any obligation
150(a)(2)	Governmental unit	Does not include the US government or any agency or instrumentality of US.
150(a)(3)	Net Proceeds	The proceeds of a bond issue defined in Regulations § 1.148-1(b) minus a reasonably required reserve or replacement fund.
150(a)(4)	501(c)(3) organization	Any organization described in § 501(c)(3) and exempt from tax under § 501(a).
150(a)(6)	Tax-exempt bonds	Interest on such bonds is excluded from gross income.

Continued on next page

Definitions Contained in § 150(a), Continued

Significance of § 150(a)(2)

Section 150(a)(2) provides that the term "governmental unit" does not include the United States or any agency or instrumentality thereof.

As you recall, § 103(a) states that generally gross income does not include interest on any "State or local bond". Section 103(c) defines “State or local bond” to mean an obligation of a State or political subdivision thereof. Regulations § 1.103-1(a) interprets that section and refers to States and political subdivisions collectively as state or local governmental units.

This definition is also important when distinguishing between a governmental and private activity bond, as discussed in Phase I Lesson 11 and Phase II Lesson 4. As a result of the definition in § 150(a)(2) use and ownership by the Federal government is treated as private business use.

Section 2

Definitions Contained in Regulations § 1.150-1

Overview

Definitions in Regulations § 1.150

Regulations § 1.150-1 lists additional basic definitions which are at the heart of many tax-exempt transactions. Except as otherwise provided, the definitions in Regulations § 1.150-1 apply for all purposes of §§ 103 and 141 through 150 and are applicable to bonds issued after June 30, 1993, to which Regulations §§ 1.148-1 through 1.148-11 apply

General Definitions

What are Issuance Costs?

The issuer incurs certain costs in connection with issuing the bonds.

The costs include fees for individual services, such as:

- counsel to various parties,
- underwriter,
- financial advisor,
- trustee, and
- rating agencies

Costs also include direct out-of-pocket expenses, such as:

- printing fees for the offering document,
- engineering and feasibility studies, and
- guarantee fees other than qualified guarantees

Cost of issuance is defined in Regulations § 1.150-1(b).

Note: Section 147(g) provides restrictions on costs of issuance for certain types of bonds.

What is a Pooled Financing issue?

Regulations § 1.150-1(b) defines “pooled financing issue” to mean an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to financed a single capital project.

Pooled financing bonds and the applicable requirements are covered in great detail in Phase III, Lesson 5.

Continued on next page

What are Governmental Bonds?

Regulations § 1.150-1(b) provides that "governmental bond" means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds. The same section of the Regulations defines a tax-exempt bond to mean any bond the interest on which is excludable from gross income under § 103(a).

The Code does not mention governmental bonds, but it does refer to private activity bonds. The private business tests and the private loan financing test of § 141 are used to distinguish between governmental and private activity bonds.

What is Working Capital?

Regulations § 1.150-1(b) defines the term working capital expenditures as any cost that is not a capital expenditure and further states that current operating expenses generally are working capital expenditures.

Continued on next page

General Definitions, Continued

Other Definitions

Regulations § 1.150-1(b) includes other definitions, which are not discussed in detail here. Those terms are listed below:

Term	Definition
Bond	Any obligation of a State or political subdivision thereof under § 103(c)(1).
Bond Documents	Bond indenture or resolution, transcript of proceedings, and any related documents.
Conduit Borrower	The obligor on a purpose investment.
Conduit Financing	An issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.
Conduit Loan	A purpose investment as defined in Regulations § 1.148-1.
Issue Date	**In reference to an issue**—The first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. **In reference to a bond**—the date on which the issuer receives the purchase price in exchange for that bond. **Note:** in no event is the Issue Date earlier than the first day that interest begins to accrue on the bond or bonds for Federal income tax purposes.
Obligation	Any valid evidence of indebtedness under general Federal income tax principles.
Private Activity Bond	A private activity bond as defined in § 141.
Qualified Mortgage Loan	A mortgage loan with respect to an owner-occupied residence acquired with the proceeds of an obligation described in §§ 143(a)(1) or 143(b).
Qualified Student Loan	A student loan acquired with the proceeds of an obligation described in § 144(b)(1).
Related Party	**In reference to a governmental unit or a 501(c)(3) organization—** any member of the same controlled group. **In reference to any other person**—a related person as defined in § 144(a)(3).
Taxable Bond	Any obligation the interest on which is not excludable from gross income under § 103.

Definition of Issue

What is an Issue?

Regulations § 1.150-1(c) provides that two or more bonds are generally part of the same issue if they are:

- sold at substantially the same time (within 15 days);
- sold pursuant to the same plan of financing; and
- reasonably expected to be paid from substantially the same source of funds.

Taxable and tax-exempt bonds are not part of the same issue.

Definition of Refunding

What is a Refunding?

Regulations § 1.150-1(d)(1) provides that a **refunding issue** means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (prior issue) including the following costs or similar costs if properly allocable to that refunding issue:

- issuance costs,
- accrued interest,
- capitalized interest on the refunding issue, or
- a reserve or replacement fund

Regulations § 1.150-1(d)(2) describes certain situations which are **NOT** refundings. These include:

- payments of certain interest,
- issues with certain different obligors,
- certain refundings of conduit financing issues, AND
- certain integrated transactions in connection with asset acquisitions

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Definition of Refunding, Continued

What is a Refunding? (continued)

Regulations § 1.150-1(d)(2)(ii)(A) provides that an issue is NOT a refunding issue to the extent that the obligor of one issue is neither:

- the obligor of the other issue, NOR
- a related party to the obligor of the other issue.

An obligor for this purpose means the actual issuer, except for the portion of an issue properly allocable to a purpose investment, when it means the conduit borrower.

Regulations § 1.150-1(d)(2)(i) provides that an issue is NOT a refunding issue if the only principal and interest that is paid with proceeds of the issue (without regard to the multipurpose issue rules of Regulations § 1.148-9(h) is interest on another issue that:

- Accrues on the other issue during a one-year period including the issue date of the issue that finances the interest;
- Is a capital expenditure, or
- Is a working capital expenditure to which the de minimis rule of Regulations § 1.148-6(d)(3)(ii)(a) applies.

Refunding bonds are covered in great detail in Phase III, Lesson 3.

Section 3

Change in Use Rules - § 150(b) and (c)

Overview

Generally, we use the phrase "change in use" to mean a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used, as of the date of issue. Sections 150(b) and 150(c) contain special rules regarding situations where proceeds of certain qualified private activity bonds are used for a non-qualified use. These special rules generally deny the conduit borrower a deduction for the interest on the loan financed by the issue. Regulations § 1.150-4 provides remedial actions that may be taken to avoid these sanctions. Other regulations provide remedial actions that, if properly taken by issuers, will preserve tax-exemption of the bonds starting from the issuance date.

Content and Cross Reference

Sections 150(b) and 150(c) contain provisions applicable when proceeds of a tax-exempt bond issue are used for a non-qualified use. A full discussion of this topic, including the remedial actions, is in Phase II. Please see Lesson 10.

Section 4

Qualified Scholarship Funding Bonds - § 150(d)

Qualified Scholarship Bonds

A qualified scholarship funding bond is treated as a State or local bond. To issue qualified scholarship funding bonds, the issuing corporation must satisfy the following criteria:

(1) The corporation must be a not-for-profit established exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965, AND

(2) The corporation must be organized at the request of the State or one or more political subdivisions thereof and required by corporate charter and bylaws, or required by state law, to devote any income (after payment of expenses, debt service, and the creation of reserves) to purchase additional student loan notes or pay over any income to the United States.

See § 150(d).

Content and Cross Reference

Qualified scholarship funding bonds and the related qualifications are covered in depth in Phase II. Please see Lesson 9 for a full discussion of this topic.

Section 5

Qualified Volunteer Fire Department Bonds - § 150(e)

Qualified Volunteer Fire Department

A bond of a volunteer fire department is treated as a bond of a political subdivision of a state if the following criteria are met:

(1) The department is a "qualified volunteer fire department" with respect to an area within the jurisdiction of the political subdivision.

(2) Ninety-five percent or more of the net proceeds of the bond issue are used for the acquisition, construction, reconstruction, or improvement of a fire house (including land which is functionally related and subordinate thereto) or fire trucks to be used by such department.

(3) The requirements of §§ 147(f) (public approval) and 149(d) (advance refunding) are met.

A "qualified volunteer fire department" with respect to a political subdivisions is any organization:

- organized and operated to provide emergency medical services for persons in an area (within the jurisdiction of the political subdivision) which generally is not provided with any other firefighting service, and
- which is required (by written agreement) by the political subdivision to furnish firefighting services in such area.

See § 150(e).

Content and Cross Reference

Section 150(e) outlines the requirements for a volunteer fire department to be "qualified" and its bonds to be treated as bonds of a political subdivision. Phase II covers this topic in more detail. Please see Lesson 15 for a full discussion of this topic.

Summary

Review of Lesson 9	Lesson 9 discussed the subject matter pertaining to § 150 with particular focus on the definitions contained in § 150(a) and Regulations § 1.150-1. Other subject matter contained in § 150 such as “change in use”, qualified scholarship funding bonds, and qualified volunteer fire department bonds also were discussed and a cross reference to other lessons in the training materials was provided.
Preview of Lesson 10	Lesson 10 begins the discussion of build America bonds.

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Lesson 10

Build America Bonds

Overview

Purpose

This lesson introduces the student to build America bonds ("Build America Bonds") authorized by § 54AA.

Objectives

At the end of this lesson, you will be able to:

- Identify the general requirements for and characteristics of all Build America Bonds
- Differentiate Build America Bonds (Direct Pay) from Build America Bonds (Tax Credit) and Recovery Zone Economic Development Bonds

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Overview, Continued

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Section 1

Introduction

Statute

The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009) (enacted February 17, 2009) ("ARRA"), added Section 54AA to the Code, which authorized state and local governments to issue "build America bonds" ("Build America Bonds") in lieu of issuing traditional tax-exempt obligations from February 17, 2009 through December 31, 2010.

Why is this important?

State and local governments borrowed more than $181 billion through the issuance of 2,275 separate issues of Build America Bonds by December 31, 2010. Issues of Build America Bonds will be outstanding for decades after 2010. In addition, Congress may authorize Build America Bonds to be issued in the future.

Definition

A Build America Bond is a federally taxable state or local governmental bond (excluding a private activity bond under § 141) that meets the following requirements:

(1) the interest on such bond would be (but for Section 54AA) excludable from gross income under § 103;
(2) the bond is issued before January 1, 2011; and
(3) the issuer makes an irrevocable election to have § 54AA apply to the bond.

See § 54AA(d).

Taxable Interest

Unlike traditional tax-exempt obligations, interest on Build America Bonds is federally taxable to bondholders. State and local governmental issuers that choose to issue federally taxable Build America Bonds instead of tax-exempt bonds are allowed federal subsidies for a portion of their borrowing costs. The subsidies take the form of either tax credits provided to holders of the bonds ("Build America Bonds (Tax Credit)") or refundable tax credits paid directly to state and local governmental issuers of the bonds ("Build America Bonds (Direct Payment)").

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Limited Period for Issuance of Build America Bonds

ARRA only authorized the issuance of Build America Bonds during the period commencing on February 17, 2009 (the effective date of ARRA) through December 31, 2010.

For bonds that were structured as a "draw-down" loan under Treas. Reg. § 1.150-1(c)(4)(i) or a commercial paper program under Treas. Reg. § 1.150-1(c)(4)(ii), only those draws or commercial paper that were funded before January 1, 2011 and for which interest began to accrue for Federal income tax purposes before January 1, 2011 may qualify as Build America Bonds. See § 4 of Notice 2010-81, 2010-50 I.R.B 825, November 23, 2010.

Irrevocable Election

An issuer of Build America Bonds must make the irrevocable election required by §§ 54AA(d) or (g) to issue such bonds as Build America Bonds on the issuer's books and records on or before the issue date of the bonds. See § 4 of Notice 2009-26, 2009-16 I.R.B. 833, April 3, 2009.

Not Federally Guaranteed

For purposes of the restrictions against federal guarantees of tax-exempt bonds under § 149(b), a Build America Bond is not treated as federally guaranteed by reason of the credit allowed under § 54AA(a) or § 6431. See § 54AA(d)(2)(A).

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De Minimis Premium Limitation

Build America Bonds must be issued with not more than a de minimis amount (determined under rules similar to the rules of § 1273(a)(3)) of premium over the stated principal amount of the bonds. For purposes of applying this limitation on bond premium, the definition of "issue price" applicable to tax- exempt bonds under Treas. Reg. § 1.148-1(b) applies. Section 1273(a)(3) and§ 1.1273-1(d) provide rules for determining a de minimis amount for a bond, which generally means .25 percent of the stated redemption price at maturity of the bond multiplied by the number of complete years from the bond's issue date to its maturity date. In addition, the rules in Treas. Reg. § 1.163-13(e)(3) (relating to an issuer's determination of bond issuance premium in certain circumstances) will apply to determine a bond's payment schedule and maturity date. Under Treas. Reg. § 1.163-13(e)(3)(i), in the case of a bond subject to certain contingencies, the rules in Treas. Reg. § 1.1272-1(c) (other than § 1.1272-1(c)(3) (relating to mandatory sinking funds)) will apply to determine the bond's payment schedule and maturity date. See § 6.2 of Notice 2010-35, 2010-19 I.R.B. 660, April 26, 2010.

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De Minimis Premium Limitation - Hypotheticals

County of Alpha issued a 17 year Build America Bond at a premium. How much premium over the stated principal amount of the bond was permissible?

What if the bond is callable by the County at par after 10 years?

- The County will be treated as if it called the bond on the first call date if calling the bond on the first call date would produce the lowest yield on the bond. If so, the County would determine if the premium is de minimis based on a 10-year maturity date rather than a 17-year maturity date (10 years times .25% equals 2.5% of permissible premium).

What if the bond is callable by the County at any time under a "make whole" call option, which requires the County to pay a call premium in an amount that preserves the bond's original yield to maturity?

- The County's exercise of that call option generally will not produce a lower yield and the call option will be disregarded in determining whether the bond premium is de minimis (17 years times .25% equals 4.25% of permissible premium).

See § 6.2 of Notice 2010-35

Information Reporting

To satisfy the information reporting requirements of § 149(e), issuers of Build America Bonds were originally required to report information about their Build America Bonds on IRS Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations* regardless of whether the issue price was less than $100,000. On its release, issuers of Build America Bonds were required to file IRS Form 8038-B, *Information Return for Build America Bonds and Recovery Zone Economic Development Bonds.*

Section 2

Build America Bonds (Direct Pay)

In General

Build America Bonds (Direct Payment) provide a Federal subsidy through a refundable tax credit paid directly to state or local governmental issuers by the Treasury Department and the IRS under § 6431 in lieu of any credit otherwise allowable to bondholders under § 54AA, in an amount equal to 35 percent of the total coupon interest payable to investors in the bonds. The amount of refundable credit that an issuer may claim with respect to a Build America Bond (Direct Payment) is determined by multiplying the interest payment that is payable by the issuer on an interest payment date (i.e., the bond coupon interest payment) by 35 percent. See § 2.3 of Notice 2009-26.

Original Issue Discount

Original issue discount is not treated as a payment of interest for purposes of calculating the refundable credit. See § 2.3 of Notice 2009-26.

Pre-issuance Accrued Interest

Pre-issuance accrued interest, which is the portion of the stated interest on any Build America Bonds (Direct Payment) paid by the issuer that is allocable to interest accrued prior to the issue date of the bond (as defined in § 1.150-1(b)), is not taken into account for purposes of determining refundable credit payments under § 6431. See § 6.5 of Notice 2010-35.

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Eligible Uses of Proceeds

The eligible uses of proceeds for Build America Bonds (Direct Payment) are more limited than the permissible uses of proceeds for Build America Bonds (Tax Credit) and for tax-exempt bonds generally. Build America Bonds (Direct Payment) must be issued to finance governmental purposes for which tax-exempt governmental bonds (excluding private activity bonds under § 141) could be issued under § 103. In addition, pursuant to § 54AA(g)(2) each Build America Bond (Direct Payment) must be a "qualified bond." A qualified bond means any Build America Bond issued as part of an issue if 100% of the excess of available project proceeds (defined in § 54A(e)(4) as the sale proceeds of an issue less not more than two percent of such proceeds used to pay issuance costs plus investment proceeds thereon) over the amounts in a reasonably required reserve fund are to be used to finance capital expenditures (as defined in Treas. Reg. § 1.150-1(b)), as contrasted with working capital expenditures. See § 2.3 of Notice 2009-26. Build America Bonds may not be used to refinanced capital expenditures in a refunding issue (as defined by Treas. Reg. 1.50-1)

Reasonably Required Reserve

In determining a reasonably required reserve fund for purposes of § 54AA(g), the rules under § 148(d)(2) apply to Build America Bonds (Direct Payment). Generally, an issue of Build America Bonds (Direct Payment) will be arbitrage bonds if the amount of the sale proceeds of the issue that is part of any reserve or replacement fund exceeds 10 percent of the proceeds. As such, the interest on such Build America Bonds (Direct Payment) could not be Federally tax-exempt under § 103 and thus, such bonds would not be qualified bonds for purposes of § 54AA(g). See § 2.3 of Notice 2009-26.

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Reimbursable Expenditures

An eligible financing of capital expenditures includes a reimbursement of capital expenditures under the reimbursement rules contained in Treas. Reg. § 1.150-2. Similarly, Build America Bonds (Direct Payment) may be used to reimburse otherwise-eligible capital expenditures under Treas. Reg. § 1.150-2 that were paid or incurred after the effective date of ARRA and that were financed originally with temporary short-term financing issued after February 17, 2009, and such reimbursement will not be treated as a refunding issue under Treas. Reg. § 1.150-1(d) or § 1.150-2(g). See § 2.3 of Notice 2009-26.

Overpayments of Tax

In general, the refundable credits paid to issuers with respect to Build America Bonds (Direct Payment) under § 6431 are payments that are treated as overpayments of tax for Federal tax purposes. Rules relating to overpayments of tax, such as credits against liabilities in respect of an internal revenue tax and offsets under § 6402, interest on overpayments of tax under § 6611, and limitations on credits or refunds of overpayments of tax under § 6511 apply to credit payments with respect to Build America Bonds (Direct Payment). See § 3.3 of Notice 2009-26.

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Refundable Credit Procedures

In general, the Secretary will pay an issuer the refundable credits due to the issuer with respect to interest on fixed rate Build America Bonds (Direct Payment) upon receipt of the issuer's timely filed Form 8038-CP *Return for Credit Payments to Issuers of Qualified Bonds* requesting payment of the credit. Section 6431 provides that the Secretary must make the payment on a contemporaneous basis with the applicable interest payment date. The ARRA Conference Report indicates that the payment by the Secretary may be made either in advance or as a reimbursement. See § 2.3 of Notice 2009-26.

For fixed rate Build America Bonds (Direct Payment), the due date for an issuer to file a Form 8038-CP is the 45th day before the applicable interest payment date with respect to the bonds. However, Form 8038-CP may not be filed earlier than the 90th day before the related interest payment date. See § 3.1(b) of Notice 2009-26.

For variable rate Build America Bonds (Direct Payment), upon receipt of a timely filed Form 8038-CP requesting payment of the credit, such amount will be paid quarterly on a reimbursement basis for interest paid by the issuer during the quarter, including the interest payment date with respect to which the return requesting payment relates. For variable rate Build America Bonds (Direct Payment) the due date for an issuer to file a Form 8038-CP is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested. See § 3.1(c) of Notice 2009-26

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Bond Yield

For purposes of the arbitrage investment restrictions under § 148, the yield on Build America Bonds (Direct Payment) is reduced by the credit allowed. Issuers should calculate the yield on Build America Bonds (Direct Payment) for purposes of the arbitrage rules by applying the rules contained in § 148 and the regulations thereunder, but by reducing the amount of interest paid on the bond by the amount of credit payments received pursuant to Section 6431. See § 2.3 of Notice 2009-26.

Section 3

Build America Bonds (Tax Credit)

In General

Build America Bonds (Tax Credit) provide a Federal subsidy through Federal tax credits to investors in the bonds in an amount equal to 35 percent of the total coupon interest payable by the issuer on such bonds.

Eligible Uses of Proceeds

Build America Bonds (Tax Credit) may be issued to finance any governmental purpose for which tax-exempt governmental bonds (excluding private activity bonds under § 141) could be issued under § 103 and must comply with all requirements applicable to the issuance of tax-exempt governmental bonds. Accordingly, Build America Bonds (Tax Credit) may be issued to finance the same kinds of expenditures (e.g., capital expenditures and working capital expenditures) and may involve the same kinds of financings (e.g., original new money financings, current refundings, and one advance refunding) as tax-exempt governmental bonds. Build America Bonds (Tax Credit) may not be issued for any purposes for which tax-exempt governmental bonds may not be issued under § 103 (e.g., prohibited second advance refunding issues or pension annuity issues). See § 2.2 of Notice 2009-26.

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Tax Credits

Section 54AA(a) provides that if a taxpayer holds a Build America Bond (Tax Credit) on one or more interest payment dates of the bond during any taxable year, there shall be allowed as a credit against the tax imposed by chapter 1 for the taxable year an amount equal to the sum of the credits determined under Section 54AA(b) with respect to such dates. Section 54AA(b) provides that the amount of the credit determined with respect to any interest payment date for a Build America Bond (Tax Credit) is 35 percent of the amount of interest payable by the issuer with respect to such date. An "interest payment date" is any date on which the bondholder is entitled to a payment of interest on such bond. The tax credit that a taxpayer may claim with respect to a Build America Bond (Tax Credit) is determined by multiplying the interest payment that a bondholder is entitled to receive from the issuer (i.e., the bond coupon interest payment) by 35 percent.

Effect of Sequestration on State and Local Govt Filers

Pursuant to the requirements of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, refund payments to certain state and local government filers claiming refundable credits under section 6431 of the Internal Revenue Code applicable to certain qualified bonds are subject to sequestration. This means that refund payments processed on or after October 1, 2013 and on or before September 30, 2014 will be reduced by the fiscal year 2014 sequestration rate of 7.2 percent and refund payments processed on or after October 1, 2014 and on or before September 30, 2015 will be reduced by the fiscal year 2015 sequestration rate of 7.3 percent irrespective of when the amounts claimed by an issuer on any Form 8038-CP was filed with the IRS. The sequestration reduction rate will be applied unless and until a law is enacted that cancels or otherwise impacts the sequester, at which time the sequestration reduction rate is subject to change. These reductions apply to Build America Bonds, Qualified School Construction Bonds, Qualified Zone Academy Bonds, New Clean Renewable Energy Bonds, and Qualified Energy Conservation Bonds for which the issuer elected to receive a direct credit subsidy pursuant to section 6431.

Continued on next page

Limitations and Carryforward Allowance

Section 54AA(1) provides that the credit allowed for any taxable year shall not exceed the excess of (1) the sum of the regular tax liability (as defined in § 26(b)) plus the tax imposed by § 55, over (2) the sum of the credits allowable under part IV of subchapter A of chapter 1 (other than subpart C and subpart J). Section 54AA(c)(2) provides that if the credit allowable under § 54AA(a) exceeds the limitation imposed by § 54AA(c)(1) for such taxable year, such excess shall be carried to the succeeding taxable year and added to the credit allowable under § 54AA(a) for such taxable year (determined before the application of § 54AA(c)(1) for such succeeding taxable year). Unused credit may be carried forward to succeeding taxable years.

Stripping Credits

Under § 54AA(f)(2), rules similar to the rules of § 54A(f), (g), (h), and (i) shall apply for purposes of the credit allowed under § 54AA(a). Section 54A authorized the Treasury Department to promulgate regulations to allow for "stripping," which is the separation of the ownership of the bonds and the associated tax credits under principles based on § 1286.

Bond Yield

Section 54AA(d)(2)(B) provides that for purposes of applying the arbitrage restrictions under § 148, the yield on a Build America Bond (Tax Credit) shall be determined without regard to the credit allowed under § 54AA(a). Accordingly, issuers should calculate the yield on Build America Bonds (Tax Credit) for purposes of the arbitrage rules by applying the rules contained in § 148 and the regulations thereunder without an adjustment for the tax credit taken by bondholders.

Section 4

Recovery Zone Economic Development Bonds

In General

Section 1400U-2 provides for another type of Build America Bonds known as "Recovery Zone Economic Development Bonds." Recovery Zone Economic Development Bonds are treated as a qualified bond for purposes of § 6431 and provide a deeper Federal subsidy in an amount equal to 45 percent of the total coupon interest. All Recovery Zone Economic Development Bonds are "Direct Payment" bonds.

Similarities to Build America Bonds (Direct Payment)

Recovery Zone Economic Development Bonds under § 1400U-2 are a third type of Build America Bonds. Recovery Zone Economic Development Bonds are comparable to Build America Bonds (Direct Payment), except that they provide for a deeper Federal subsidy through a refundable tax credit paid to State or local governmental issuers in an amount equal to 45 percent (rather than 35 percent) of the total coupon interest payable to investors in the bonds and they have different program requirements regarding eligible uses of proceeds for qualified economic development purposes within recovery zones, as described further below.

Volume Cap

An issuer of Recovery Zone Economic Development Bonds was required to receive an allocation of volume cap in order to issue the bonds. Under § 1400U-1, the annual national recovery zone economic development bond volume cap limitation was $10,000,000,000. The volume cap allocated among the States and counties and large municipalities within the States was based on relative declines in employment in 2008 and more fully described in Notice 2009-50.

Continued on next page

Recovery Zone Economic Develop Bonds, Continued

Eligible Uses of Proceeds

Under Section 1400U-2, each Recovery Zone Economic Development Bond must meet the following requirements: (1) the bond is a Build America Bond; (2) the bond must have been issued after February 17, 2009 and before January 1, 2011; (3) 100% of the excess of (i) the available project proceeds (as defined in Section 54A to mean sale proceeds of such issue less not more than two percent of such proceeds used to pay issuance costs plus investment proceeds thereon), over (ii) the amounts in a reasonably required reserve fund (within the meaning of Section 150(a)(3)) with respect to such issue, are to be used for one or more "qualified economic development purposes" (as defined in Section 1400U-2(c)); and (4) the issuer must designate such bond as a Recovery Zone Economic Development Bond.

Qualified Economic Development Purposes

Under § 1400U-2(c), "qualified economic development purposes" are expenditures for purposes of promoting development or other economic activity in a "recovery zone," including — (1) capital expenditures paid or incurred with respect to property located in such recovery zone, (2) expenditures for public infrastructure and construction of public facilities, and (3) expenditures for job training and educational programs.

Recovery Zones

A "recovery zone" is (1) any area designated by the issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress, (2) any area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, and (3) any area for which a designation as an empowerment zone or renewal community is in effect. See § 1400U-1(b).

Summary

Review of Lesson 10

This purpose of this lesson was to introduce the student to Build America Bonds:

- All Build America Bonds, including Recovery Zone Economic Development Bonds, were issued between February 17, 2009 and December 31, 2010.
- Issuers of Build America Bonds (Direct Payment) are entitled to receive refundable credit payments directly from the Treasury Department equal to 35 percent of interest on such bonds.
- Proceeds of Build America Bonds (Direct Payment) may only be used to pay costs of issuance, to fund a reasonably required reserve and for capital expenditures.
- Holders of Build America Bonds (Tax Credit) are entitled to tax credits equal to 35 percent of the interest on such bonds, which credits may not exceed tax liability in a tax year, but unused credits may be carried forward to subsequent tax years.
- Proceeds of Build America Bonds (Tax Credit) may be used to pay any costs or for any purposes for which proceeds of tax-exempt governmental bonds may be used.
- Issuers of Recovery Zone Economic Development Bonds are entitled to receive refundable credit payments directly from the Treasury Department equal to 45 percent of interest on such bonds.
- Proceeds of Recovery Zone Economic Development Bonds may be used to pay costs of issuance, to fund a reasonably required reserve and for qualified economic development purposes within designated recovery zones.

Continued on next page

Preview of Lesson 11

Lesson 11 discusses private activity bonds as described in § 141. The term "private activity bonds" will be defined and the tests for distinguishing governmental bonds from private activity bonds will be explored. Additionally, lesson 11 will examine those private activity bonds used to finance certain activities that are considered by Congress to be "qualified" private activity bonds, thus permitting exclusion of the interest to holders of the bonds.

Lesson 11

Introduction to Qualified Private Activity Bonds

Overview

General Rule

Interest on State and local government bonds is taxable if the bonds are private activity bonds (bonds issued to finance private activities not specifically authorized by Congress) unless the bond is a qualified private activity bond provided for in the Code.

See §§ 103(b) and 149(c).

Objectives

At the end of this lesson, you will be able to:

- Define a qualified private activity bond
- Identify additional requirements applicable to qualified 501(c)(3) bonds that are not applicable to governmental bonds

Continued on next page

Scope of Lesson

The material in this lesson is tailored to the requirements for qualified 501(c)(3) bonds. For a more complete discussion of the rules applicable to other types of qualified private activity bonds see text for Phase II Lesson.

Contents

This lesson contains the following topics:

Topic	See Page
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Maturity Limitation	9
Prohibited Facilities	12
Public Approval Requirement	13
Restriction on Issuance Costs	18
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Background

Definition of Private Activity Bond

Very generally, private activity bonds are obligations that benefit nongovernmental persons, such as private businesses, charitable organizations or individuals. Section 141 outlines the tests that, if met, make a bond a private activity bond.

A bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date that the issue will meet either the:

- private business tests (private business use test AND private security or payment test),

  OR

- private loan financing test

Private Business Use-Rule

If **more than** 10 percent of the proceeds of the issue are to be used in a trade or business of a nongovernmental person, the issue meets the private business use test. Any activity carried on by a person other than a natural person is treated as a trade or business. If the private business use test is met and the private security or payment test (discussed below) is also met, the issue is an issue of private activity bonds.

See § 141(a), (b)(1), and (b)(6); Regulations § 1.141-3(a)(1).

Continued on next page

Background, Continued

Private Security or Payment Test

Except as otherwise provided in § 141(b), an issue meets the private security or payment test if the payment of the principal of, or the interest on, more
than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly:

(i) secured by an interest in:

- property used or to be used for a private business use, or
- payments in respect of such property, OR

(ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Private Loan Financing Test

Bonds of an issue are private activity bonds if more than the lesser of five percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons.

See § 141(c).

Reasonable Expectations or Deliberate Actions

A bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests (business use and security or payment) or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the private business tests or the private loan financing test to be met.

See Regulations 1.141-2(c).

Continued on next page

Background, Continued

501(c)(3) Bonds

Generally bonds issued to finance facilities for 501(c)(3) organizations are private activity bonds because the:

- facilities are to be used in the trade or business of a nongovernmental 501(c)(3) organizations, and
- bonds are secured by the financed facility or revenues derived from the financed facility

Audit Technique

An issuer filing Form 8038 Information Return for Tax-Exempt Private Activity Bond Issues is admitting that the bonds are private activity bonds. Accordingly, it is not necessary for the examining agent to do an independent determination under § 141 on whether or not the bonds are private activity bonds. The focus of the examination of a Form 8038 return is on whether the bonds are qualified private activity bonds.

Qualified Private Activity Bonds

Qualified Private Activity Bonds; § 103(a)

Recall that §103(a) provides that except as provided in § 103(b) gross income does not include interest on any State or local bond. Section 103(b) (1) provides that § 103(a) does not apply to, among other bonds, any private activity bond which is not a qualified bond.

Private activity bonds used to finance certain activities are considered by Congress to be qualified private activity bonds, thus permitting exclusion of the interest to holders of the bonds.

Definition

Section 141(e) defines the term "qualified bond."

The term "qualified bond" means any private activity bond if, in addition to satisfying the requirements for volume cap in § 146 and other requirements in § 147, such bond is:

- an exempt facility bond
- a qualified mortgage bond
- a qualified veterans' mortgage bond
- a qualified small issue bond
- a qualified student loan bond
- a qualified redevelopment bond, or
- a qualified 501(c)(3) bond

Other lessons provide an in-depth exploration of these bonds

Miscellaneous Code Sections

Several other sections of the Code provide that bonds are to be treated as if they were exempt facility bonds or small issue bonds and therefore will be qualified private activity bonds. See §§ 1394 and 1400A (Enterprise Zone Facility Bonds), § 1400L(d) (New York Liberty Bonds), § 1400N(a) (Gulf Opportunity Zone Bonds), and § 1400U-3 (Recovery Zone Facility Bonds), and § 7871(c) (Tribal manufacturing bonds).

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Qualified Private Activity Bonds, Continued

95% Test

An exempt facility bond, a small issue bond, and a redevelopment bond are not qualified bonds unless at least 95% of the net proceeds of the bonds are used to provide the type of facility described in the Code sections authorizing such bonds.

See §§ 142(a), 144(a), and 144(c).

Section 150(a)(3) defines “net proceeds” as the proceeds of an issue reduced by amount in a reasonably required reserve or replacement fund.

Volume Cap

Introduction

Generally, each state and US possession is limited to a maximum amount of qualified private activity bonds that can be issued on an annual basis. This amount is based on the state's population and is computed annually. The amount allocated to each state is called the "state ceiling." The amount of the state ceiling is then allocated among the qualified private activity bond issuers within a state. This allocation is called the issuing authority's volume cap.

Bonds issued in excess of an issuer's volume cap do not satisfy the requirements of § 146, and therefore, are NOT tax-exempt bonds.

Remember that generally only qualified private activity bonds are required to meet § 146. With one exception, governmental bonds are not required to receive an allocation of the volume cap.

Qualified 501(c)(3) bonds are not required to receive an allocation of volume cap. See § 146(g)(2).

Volume cap is covered in detail in Phase II Lesson 4.

Maturity Limitation

Introduction

To prevent bonds from remaining outstanding longer than necessary, § 147(b) limits the average length of maturity of certain qualified private activity bonds.

Statutory Provisions

Section 147(b) provides the rules regarding the maturity limitation. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(14) of the 1954 Code.

General Rule

Section 147(b)(1) provides that a private activity bond is not a qualified private activity bond if it is issued as part of an issue and the average maturity of the bonds issued as part of such issue EXCEEDS 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of such issue.

Special Rule for Pooled Financings of 501(c)(3) Organizations

Section 147(b)(4) provides that certain qualified 501(c)(3) pooled financings satisfy the maturity limitation if the conditions relating to use of proceeds, average maturity of loans, demand surveys, and timing of loans as set forth in § 147(b)(4)(B) are satisfied.

Special Rule for Healthcare Financings

Section 147(b)(5) provides that the maturity limitation does not apply to bonds that finance mortgage loans insured under "FHA 242" or a similar FHA program (as in effect on the date of enactment of the Tax Reform Act of 1986) where the mortgage loan term approved by FHA plus the maximum maturity of the debentures which could be issued by FHA in satisfaction of its obligations exceeds the term permitted under § 147(b)(1).

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Exception for Working Capital Financings

Regulations § 1.147(b)-1 provides that § 147(b) does not apply to bond proceeds used to finance working capital expenditures. Regulations §1.150-1(b) defines the term working capital expenditures as any cost that is not a capital expenditure and further states that generally current operating expenses are working capital expenditures.

(Remember that qualified 501(c)(3) bonds are the only qualified private activity bonds can be used to finance working capital expenditures.)

Determination of Average Maturity

Section 147(b)(2)(A) provides that the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of the entire issue.

Determination of Average Reasonably Expected Economic Life

Section 147(b)(2)(B) provides that the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

Determination Date

Section 147(b)(3)(A) provides that the reasonably expected economic life of any facility shall be determined as of the LATER OF the date on which the:

- bonds are issued, OR
- facility is placed in service (or expected to be placed in service).

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Maturity Limitation, Continued

Determination of Economic Life

The House Conference Report No. 97-760, at 519 (1982) provides that the economic life of assets is determined on a case-by-case basis. However, to provide guidance and certainty, the conferees intend that the administrative guidelines established for the useful lives used for depreciation prior to the ACRS system (i.e., the midpoint lives under the ADR system where applicable and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) may be used to establish the economic lives of assets. See also Rev. Proc. 87-56, 1987-2 CB 674. However, the taxpayer can issue bonds with maturities longer than these administrative guidelines would allow where the taxpayer can show, on the basis of the facts and circumstances that the economic life to the principal user or users of the assets for whom the bonds are issued is longer than the lives established by the administrative guidelines.

Treatment of Land

Section 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land.

When land is taken into account, it is treated as having an economic life of 30 years.

Prohibited Facilities

Statutory Provisions

Section 147(e) provides the rules regarding prohibited facilities. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(18) of the 1954 Code.

There are no regulations applicable to this rule.

Rule

Section 147(e) provides that a private activity bond shall not be a qualified bond if any portion of the proceeds of the issue is used to provide any of the following:

- Airplanes
- Skyboxes or other private luxury boxes
- Health club facilities
- Facilities primarily used for gambling
- Stores the principal business of which is the sale of alcoholic
- beverages for consumption off premises

Note that pursuant to § 147(h)(2), **§ 147(e) does not apply to qualified 501(c)(3) bonds that finance health club facilities**. Rev. Rul. 2003-116, 2003-2 C.B. 1083, held that a helicopter is not an "airplane" within the meaning of § 147(e).

Public Approval Requirement

Introduction

Section 147(f) provides the rules regarding the public approval requirement. Prior to the Tax Reform Act of 1986, these rules were in § 103(k) of the 1954Code.

Regulations § 5f.103-2 also contains rules that pertain to the public approval requirement. (See below regarding proposed regulations.)

Section 147(f) provides that a private activity bond shall not be a qualified bond unless such bond is part of an issue which has been approved by:

- the governmental unit which issued such bond, or on behalf of which such bond was issued, AND
- generally each governmental unit having jurisdiction over the area in which the facility financed by the proceeds of such bond is located.

Public approval by a governmental unit can be either by:

- an "applicable elected representative" of such governmental unit after a **public hearing** following **reasonable public notice** about the bond issuance, OR
- voter referendum of such governmental unit

This requirement is commonly known as the "TEFRA requirement" because it was originally added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Applicability

Section 147(f) applies to ALL qualified private activity bonds, without exception.

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Issuer Approval

Generally that approval must always be provided by the government issuer or governmental unit on whose behalf the bonds will be issued. However, if a governmental unit issues bonds on behalf of more than one governmental unit (e.g. an authority issuing bonds on behalf of multiple counties), any of such units may satisfy the issuer approval requirement.

See § 147(f)(2)(A)(i) and Regulations § 5f.103-2(c)(2).

Host Approval

Each governmental unit the geographic jurisdiction of which contains the facility to be financed by the issue must approve the issue. However, if the entire site of a facility to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of such units may provide host approval for the issue with respect to the facility.

The issuer approval may be treated as satisfying the host approval requirement if the governmental unit giving the issuer approval meets both the issuer and host approval requirements.

See § 147(f)(2)(A)(ii) and Regulations § 5f.103-2(c)(3).

Definition of Governmental Unit

Regulations § 5f.103-2(g)(1) provides that the term "governmental unit" has the same meaning as in § 1.103-1, which provides that a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

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Definition of Applicable Elected Representative

Section 147(f)(2)(E) and Regulations § 5F.103-2(e) provide that the term "applicable elected representative" means with respect to any governmental unit:

- its elected legislative body,
- its chief elected executive officer,
- if a State, its chief elected legal officer of the State's executive branch (e.g. Attorney General),

OR

- any other official elected by the voters of such unit and designated for purposes of this requirement by such unit's chief elected executive officer or by State or local law to approve issues for the unit

What is "Reasonable Public Notice"?

Regulations § 5f.103-2(g)(3) provides that reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the unit where a facility is to be located, of the proposed issue.

The notice must state the time and place for the hearing and generally be published no fewer than 14 days before the hearing.

The notice is presumed reasonably designed to inform residents if:

- except in the location of the facility, given in the same manner and locations required by the governmental unit under state law for notice of public meetings,
- published in one or more newspapers of general circulation, or announced by radio or television broadcast in the area AND
- published no fewer than 14 days before the hearing.

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Notice Must Contain Certain Information

Regulations § 5f.103-2(f)(2) provides that the notice of hearing and the approval must contain the following.

- A general, functional description of the type and use of the facility to be financed (*e.g.* ,10,000 square foot machine shop and hardware manufacturing plant, 400-room airport hotel building, dock facility for supertankers, convention center auditorium and sports arena with25,000 seating capacity, air and water pollution control facilities for oil refinery)
- The maximum aggregate face amount of obligations to be issued with respect to the facility
- The initial owner, operator, or manager of the facility
- The prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.

Inadequate Notice

Regulations § 5f.103-2(f)(2) provides that an approval will not be rendered invalid due to an **insubstantial deviation** from the information required in a notice. However, an approval or notice of hearing will not be considered adequate if any of the required information is unknown on the date of the approval or the date of the public notice.

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Public Approval Requirement, Continued

Public Hearing

Regulations § 5f.103-2(g)(2) provides generally that a public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the proposed issue of bonds and the location and nature of a proposed facility to be financed.

Refunding Bonds

No approval is necessary for current refunding bonds as long as:

- the original bond met the public approval requirements, and
- the average maturity date of the refunding issue is NOT later than that of the refunded bonds.

The public approval requirements of § 147(f) must be met by advance refundings.

Proposed Regulations

Proposed regulations (REG 128841-07, September 9, 2008) would create a new set of regulations under § 147(f) to update and supplement portions of the existing regulations. Except as otherwise provided in proposed regulation § 1.147(f)-1, the proposed regulations will apply to bonds that are sold on or after the date of publication of final regulations in the Federal Register and that are subject to § 147(f).

Restriction on Issuance Costs

Statutory & Regulatory Provisions

Section 147(g) provides the rules regarding costs of issuance. These rules were added to the Code by the Tax Reform Act of 1986.

Regulations § 1.150-1(b) provides a definition of issuance costs.

Rule

Section 147(g)(1) provides that a private activity bond shall not be a qualified bond if the issuance costs financed by the issue exceed 2 percent of the **proceeds** (NOT face amount) of the issue.

Applicability

Section 147(g) applies to all types of qualified private activity bonds.

Relationship with "95 Percent" Test

Generally, at least 95 percent of the net proceeds of qualified private activity bonds must be used for the qualified purposes of the issue. Amounts used to finance any costs of issuance are NOT treated as spent for the qualified purpose of the issue. Thus, the amount of proceeds allocated to issuance costs must also be allocated to the 5 percent permissible "bad use" portion of the net proceeds.

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Restriction on Issuance Costs, Continued

What are Issuance Costs?

Regulations § 1.150-1(b) includes the following costs as issuance costs:

- Underwriter's discount
- Counsel fees
- Financial advisory fees
- Rating agency fees
- Trustee fees
- Paying agent fees
- Bond registrar, certification, and authentication fees
- Accounting fees
- Printing costs for bonds and offering documents
- Public approval process costs
- Engineering and feasibility study costs
- Guarantee fees, other than for qualified guarantees
- And costs similar to the above.

Additional Issuance Costs

Section 147(g) does not prohibit an issuer from incurring issuance costs in excess of the 2 percent limitation. An issuer can always use other funds to pay for these excess issuance costs.

Summary

Review of Lesson 11

A private activity bond is any bond which meets the private:

- business use test and the private security or payment test,
  OR
- loan financing test

The interest on a private activity bond cannot be tax-exempt, unless the bond is a qualified bond.

Both the reasonable expectations of the issuer on the issuance date and subsequent deliberate actions of the issuer are considered when determining if the private activity bond tests are met.

Qualified 501(c)(3) bonds are not required to receive an allocation of volume cap but are subject to certain of the other requirements generally applicable to private activity bonds. Qualified 501(c)(3) bonds are subject to the maturity limitation, which limits the average maturity of bonds to no more than 120 percent of the average reasonably expected economic life of the facilities being financed. The general prohibition on financing certain facilities applies to qualified 501(c)(3) bonds, except that such bonds may finance health club facilities whereas other types of bonds cannot. Like all other private activity bonds (except certain current refundings) qualified 501(c)(3) bonds are subject to the public approval requirement. Costs of issuance financed with proceeds of qualified 501(c)(3) cannot exceed 2 percent of the proceeds.

Preview of Lesson 12

Lesson 12 discusses qualified 501(c)(3) bonds as described in § 145. The term “qualified hospital bond” will be defined and the test for determining whether non-hospital bonds meet the $150 million volume cap will be explored. Additionally, lesson 12 will explore whether bonds used for residential rental property are qualified 501(c)(3) bonds. The private activity bond rules of other Code sections which apply to qualified 501(c)(3) bonds will also be discussed.

Lesson 12

Section 145 – Qualified 501(c)(3) Bonds

Overview

Introduction

Lesson 12 begins the discussion of qualified 501(c)(3) bonds which is one type of qualified private activity bonds.

Purpose

This lesson provides a detailed overview of §145 requirements and a general understanding of Exempt Organization law pertaining to 501(c)(3) organizations.

Objectives

After completing this lesson you will be able to:

- Define a qualified 501(c)(3) bond as described in § 145
- Define an exempt organization and describe the exemption application process
- Describe the requirements of the private business use test
- Describe how unrelated trade or business activity affects the private business use test

Continued on next page

Overview, Continued

Objectives (continued)

- Identify the rules for the private payment and security test
- Define a qualified hospital bond
- Determine if non-hospital bonds meet the $150 million volume cap
- Determine if bonds used for residential rental property are qualified501(c)(3) bonds

Identify the private activity bond rules of other Code sections which apply to qualified 501(c)(3) bonds

Contents

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Introduction

Definition of Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds are private activity bonds issued under § 145 if:

(1) **all** property financed by the net proceeds of the bond issue is to be owned by an organization described in § 501(c)(3) (a "tax exempt organization") or a governmental unit, **and**
(2) such bond would not be a private activity if:
  (A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying §513(a), and
  (B) paragraphs (1) and (2) of § 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

Tax Exempt Organization

A tax exempt organization is exempt from Federal income tax under § 501(a). There are various types of tax-exempt organizations, but for purposes of this module, we will only discuss § 501(c)(3) organizations.

A 501(c)(3) organization is a corporation, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

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Exemption Process

In general, an organization that desires to be exempt from Federal income tax under § 501(c)(3) must file a Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. (There are exceptions for churches, integrated auxiliaries of churches, and organizations that normally have annual gross receipts of not more than $5,000.) The organization sends the completed application, with attachments, to the Internal Revenue Service. If the organization meets the requirements for exemption, it is issued a Determination Letter.

Filing Requirements

Generally, organizations described in § 501(c)(3) are required to file an annual information return, either Form 990, Form 990-EZ, or Form990-PF, along with certain schedules that may be required for their organization. Certain categories of organizations are excepted from filing Form 990 or Form 990-EZ, including churches and certain small organizations. Small organizations are not required to file Form 990 or Form 990-EZ if their gross receipts are normally $25,000 or less ($50,000 for tax years ending on or after December 31, 2010). For tax years beginning after December 31, 2006, however, these small organizations must submit an annual electronic notice using Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or 990-EZ. The e-Postcard can only be filed electronically; there is no paper version. Filing organizations with an outstanding tax-exempt bond issue in excess of

$100,000 as of the last day of the tax year that was issued after December 31, 2002, must file Schedule K (Form 990) Supplemental Information on Tax-Exempt Bonds.

In addition, an exempt organization must file Form 990-T if it has $1,000 or more of gross income from an unrelated trade or business during the year. In general, the tax is imposed on income from a regularly carried-on trade or business that is not substantially related to the organization's exempt purposes (See IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations).

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Filing Requirements (continued)

For tax years beginning after December 31, 2006, if an organization is required to file an annual information return or annual electronic notice and fails to do so for three consecutive years, the organization will automatically lose its tax-exempt status as of the filing due date of the third year. For the organization to have its tax-exempt status reinstated, it must apply (or reapply) for tax-exempt status and pay the appropriate user fee.

Loss of Exempt Status

A 501(c)(3) organization can automatically lose its exempt status for failure to file its annual information return or annual electronic notice for three consecutive years or as a result of an examination by the Exempt Organizations Division. It can also lose its exempt status due to a change in its stated purpose or dissolution. (When an exempt organization dissolves, its assets must be distributed for exempt purposes pursuant to Regulations § 1.501(c)(3)-1(b)(4).) Since the organization must be a 501(c)(3) organization to be a qualified user of a qualified 501(c)(3) bond, loss of the organization's tax exempt status adversely affects the outstanding bond issues and the change in use rules under § 150 apply. These rules will be discussed in a later lesson.

Continued on next page

Example 1

Make a Joyful Noise v. Commissioner, TCM 1989-4: An exempt organization organized to provide camps for elderly citizens and disadvantaged children conducted bingo games to raise funds. It lost its state bingo permit due to a change in state law. The organization then leased its premises to other organizations. Certain leases provided that lessees would operate bingo games and that the exempt organization would receive a portion of the gross receipts from those games. Almost all of the exempt organization's receipts were derived from these arrangements. The exempt organization never implemented its plans to operate the camp. The court held that the operation of regularly scheduled bingo games constituted a trade or business that was unrelated to its exempt purpose, that such activities were not insubstantial, and therefore, that the organization was not operated exclusively for its exempt purposes. Accordingly, its 501(c)(3) status was revoked.

§ 145 Statutory Provisions

The specific requirements for qualified 501(c)(3) bonds are provided in § 145.

Regulations § 1.145-2(a) provides that §§ 1.141-0 through 1.141-15 of the Regulations are applicable to bonds issued under § 145(a).

Other requirements applicable to qualified private activity bonds that are also applicable to qualified 501(c)(3) bonds are provided in §§ 147-150. Under §146(g)(2), qualified 501(c)(3) bonds are exempt from the volume cap requirements of § 146.

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Use of Proceeds

Under § 145(a), ALL of the net proceeds of qualified 501(c)(3) bonds (bond proceeds less amount in the reasonably required reserve fund) must be used to finance property owned by a:

- 501(c)(3) organization, *or*
- governmental unit.

Unlike exempt facility and small issue bonds, proceeds of qualified 501(c)(3) bonds may be used to pay working capital, as well as capital expenditures. Note though, that certain arbitrage rules specifically apply to bonds issued to finance working capital.

See Regulations §§ 1.148-1(c)(4), 1.148-2(e)(3), and 1.148-6(d)(3).

Borrower

The borrower of qualified 501(c)(3) bonds that is not a governmental unit must be an organization described in § 501(c)(3) and have a favorable determination letter from the Service, if required. The organization must maintain its exempt status as long as the bonds are outstanding.

TAM 200006049 dealt with bonds intended to be qualified 501(c)(3) bonds the proceeds of which were loaned to Organization. Prior to issuance of the bonds, Organization received a 501(c)(3) determination letter. Subsequently, Organization's tax-exempt status was revoked retroactive to the taxable year in which the bonds were issued as a result of deliberate actions of the Organization taken during that year. More than 3 years after the end of the taxable year in which the deliberate actions were taken that resulted in revocation of 501(c)(3) status, the bonds were canceled and taken off the market. The Service ruled that the interest on the bonds was includable in the gross income of the bondholders beginning with the date of issuance of the bonds and cancellation of the bonds did not prevent interest on the bonds from being includable in the gross income of the bondholders because, as a remedial action, the action was not timely taken.

Continued on next page

Introduction, Continued

Election Out

Section 145(e) provides that issuers may elect NOT to treat a bond issue as qualified 501(c)(3) bonds if the bond issue is an issue of exempt facility bonds or qualified redevelopment bonds to which § 146 applies.

Private Use

As with other types of qualified private activity bonds, qualified 501(c)(3) bonds already have some inherent private business use - that of the 501(c)(3) organization itself. It is this private business use that differentiates these bonds from governmental bonds. However, § 145 considers use by a 501(c)(3) organization in its **related** activities as a government use.

The next section discusses the private activity bond tests.

Private Activity Bond Tests

Block Label

The private activity bond tests of § 141 will be discussed in detail in Lesson 4 of the Phase II Training. In this lesson, we will briefly discuss these tests and how they impact §145 and 501(c)(3) bonds.

In general, in order for a bond to be a private activity bond, it must meet either the private:

- business use test and the private security or payment test (the "private business tests"), **OR**
- loan financing test.

See § 141(b) and (c).

Since over five percent of the proceeds would generally be loaned to the 501(c)(3) organization/conduit borrower, the private loan financing test would be met, making these bonds private activity bonds from the outset. Similarly, if the 501(c)(3) organization leases rather than owns the bond-financed facility, the private business tests will likely be met. Remember, though, that the interest on private activity bonds can still be tax-exempt, if the bonds meet the special rules for a specific type of **qualified** private activity bonds, including qualified 501(c)(3) bonds.

However, § 145(a)(2) provides that in order for bonds to be considered qualified 501(c)(3) bonds, the bonds must NOT be private activity bonds, applying the requirements of § 141 as specifically modified in § 145(a)(2).

Continued on next page

Introduction (continued)

When applying the private business tests and private loan financing test under § 145, a 501(c)(3) organization with regard to its activities that are not unrelated trade or business under § 513 is treated as a governmental unit. This means that use of the bond-financed facility by a 501(c)(3) organization in related activities is NOT considered private business use for purposes of 501(c)(3) bonds. Also, a loan to a 501(c)(3) organization for use in related activities is not a private loan for this purpose.

In addition, § 145(a)(2)(B) provides that **five percent** is substituted for the **ten percent** limit in § 141(b). Also **net proceeds** is substituted for **proceeds.**

Private Business Use Test

Because in many instances, the debt service on the bonds will be paid with private payments, to be qualified 501(c)(3) bonds, no more than five percent of the net proceeds of the bond issue may be used for any private business use. Use by any 501(c)(3) organization in an activity that is unrelated trade or business under § 513 is considered private business use. Further, for this purpose, use of proceeds for costs of issuance is private business use.

See Regulations § 1.145-2(c)(2).

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Examples

Examples of application of the private business use and unrelated trade or business use rules for purposes of the 5 percent limit:

Example 1: 501(c)(3) organization runs a rehabilitation center and leases 25% of its building to the local police department. Although the police department is a governmental person, leasing to a police department is unrelated to the exempt purpose of the 501(c)(3) organization and the unrelated use is counted toward the 5%.

Example 2: 501(c)(3) retirement facility that provides step care including critical care services leases office space to another 501(c)(3) organization that provides geriatric counseling services. The counseling services are related to the borrowing 501(c)(3)'s exempt purpose of running a retirement facility and to the second organization’s exempt purposes. None of the use is counted toward the 5%.

Example 3: 501(c)(3) retirement facility that provides step care including critical care services leases office space to another 501(c)(3) organization that tutors children ages 6-12. The 501(c)(3) organization's purpose of tutoring is unrelated to the borrowing 501(c)(3)'s exempt purpose of running a retirement facility. Leasing to that organization is unrelated use that is counted toward the 5%.

Example 4: 501(c)(3) retirement facility that provides step care including critical care services leases office space to a doctor who gives geriatric medical care. The geriatric medical care is related to the borrowing 501(c)(3)’s exempt purpose of running a retirement facility, but the doctor's use constitutes private business use. Thus, the lessee’s use is counted toward the 5%.

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Private Security or Payment Test

To be considered qualified 501(c)(3) bonds, no more than **five** percent of the payment of the debt service on the bonds may be directly or indirectly:

(A) secured by any interest in property used or to be used for a private

(B) business use, OR secured by payments in respect of such property, OR (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used in a private business.

The private security or payment test relates to the nature of the security for and the source of the payment of debt service on the bond issue. The security for, and payment of debt service on the bonds is determined from the terms of the bond documents and any underlying arrangements.

A bond issue will not be a qualified 501(c)(3) bond issue if both the private business use test *and* the private security *or* payment test are met.

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Definition of Proceeds

According to Regulations § 1.141-1(b), "proceeds" are defined as the sales proceeds of an issue (other than those sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund (4R fund)), investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period) and disposition proceeds as provided under Regulations § 1.141-12. The Commissioner may treat any replaced amounts as proceeds.

Note: The above definition of "proceeds" is to be distinguished from the definition of proceeds under Regulations § 1.148-1(b).

Assume that Charity A borrows $100M of bond proceeds from City B in order to build a hospital. The private business use test is calculated as follows:

Sales Proceeds	$ 100,000,000
Investment Earnings During Project Period	12,000,000
Rebate Amount During Project Period	(2,000,000)
Reserve Fund	(10,000,000)
Net Proceeds	100,000,000 x .05
	5,000,000 (can be used for "bad" costs)

If $2M (2 percent of $100M) is used for issuance costs, then the remaining "bad cost" is only $3M and that amount may be used for private business use.

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Definition of Proceeds (continued)

"Disposition proceeds" is defined under Regulations § 1.141-12(c)(1) as any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition of property (other than investments) financed with proceeds.

Regulations § 1.148-1(b) defines :

"Investment proceeds" as any amounts actually or constructively received from investing proceeds of an issue; and

"Sale proceeds" as any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriter's discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right associated with a bond (such as redemption rights, stripped coupons or tax credits) and amounts received on termination of certain hedges.

"Project Period" is defined in Regulations § 1.141-1(b) as the time from the issue date until the project is placed in service.

Definition of Net Proceeds

Section 150(a)(3) defines "net proceeds" as proceeds of an issue reduced by amounts deposited in a reasonable required reserve or replacement fund.

Working Capital

Issuers may finance working capital with qualified 501(c)(3) bond proceeds but such financing is subject to restrictions.

See Regulations § 1.148-6(d)(3) (proceeds-spent-last rule) and section entitled $150 Million Volume Cap for Non-Hospital Bonds below).

Continued on next page

Private Activity Bond Tests, Continued

Example 1

City X issues and sells $10 million principal amount of bonds at par. It loans the $10 million to Corporation Y, a 501(c)(3) organization, to be used to construct a nursing home. Corporation Y deposits $1 million in a reasonably required debt service reserve fund. Corporation Y earns investment proceeds of $1.5M during the project period and has negative arbitrage. Net proceeds are $10.5M.

Example 2

Same as the example above, except, Corporation Y uses $400,000 of the proceeds to construct an office building adjacent to the nursing home and sells the building to Partnership Z. Partnership Z will provide accounting services to Corporation Y. No portion of the proceeds of the bonds was used to pay costs of issuance. Although less than 5 percent of the net proceeds were spent on the office building, the bonds will not be qualified 501(c)(3) bonds because not **all** of the net proceeds were used to finance property **owned** by a 501(c)(3) organization or governmental entity.

Example 3

Same as Example 1, except, Corporation Y leases 3 percent of the space in the nursing home to Partnership Z for the entire term of the bonds. No portion of the proceeds was used to pay costs of issuance. The amount of bond proceeds used to construct this space was $425,000 (or 4% of net proceeds). Partnership Z will have its equipment and employees in this space and will provide accounting services to Corporation Y. Partnership Z will pay rent at fair market value and there is no relationship between Corporation Y and Partnership Z.

The use of the space by Partnership Z will not meet the private business use test because at least 95 percent of the net proceeds were used to finance a facility used by a 501(c)(3) organization. In addition, all of the net proceeds of the bonds were used to finance a facility owned by a 501(c)(3) organization. Therefore, the bonds will be qualified 501(c)(3) bonds.

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Use by General Public

Use of bond-financed facilities by private persons in their trade or business that is general public use is not private business use. To be considered use by the general public, the property must be reasonably available for use on the same basis by natural persons not engaged in a trade or business and the term of the arrangement cannot exceed 200 days. *See Regulations § 1.141-3(c).*

The rules regarding general public use are the same for qualified 501(c)(3) bonds as for governmental bonds and are more fully described in Lesson 4. *See also Regulations§ 1.141-3(c).*

Unrelated Trade or Business

Use of bond proceeds or bond-financed facilities by a 501(c)(3) organization in an unrelated trade or business activity is considered private business use. Any such unrelated use is counted against the permissible 5 percent of net proceeds private business use. *See § 145(a)(2)(A).*

Whether an activity is an unrelated trade or business activity is determined in accordance with § 513. It does not matter that the 501(c)(3) organization may or may not pay any unrelated business income tax on the activity.

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Definition

Unrelated trade or business activity means any trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption. *See § 513(a); Regulations § 1.513-1(a).* A 501(c)(3) organization that has $1,000 or more gross income from an unrelated trade or business must file Form 990-T.

The term trade or business generally includes any activity carried on for the production of income from selling goods or performing services. Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes. *See Regulations § 1.513-1(b).*

Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit. *Id.*

Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations. *See Regulations § 1.513-1(c).*

Determining whether a business activity is substantially related to the organization’s exempt purposes requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose. A trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related. *See Regulations § 1.513-1(d).*

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Definition (continued)

The use of a bond-financed property may be private business use for purposes of § 145 even when it is not used in unrelated business use under § 513. For example, in some cases the leasing of a medical office building connected to a hospital to physicians who are not employees of the hospital, but practice at the hospital, may not be an unrelated use under § 513. However, such use may be private business use for purposes of the 5 percent test.

Example 4

City X issues $12 million principal amount of bonds and loans the proceeds to Corporation A, a 501(c)(3) organization. Corporation A will use the proceeds to purchase an existing multi-family residential rental facility. Corporation A deposits $900,000 in a reasonably required reserve fund and uses $11,100,000 to acquire the facility. A portion of the facility has always been rented by City X and used to provide services to the residents of the community, including the facility. The use by City X is not unrelated to Corporations A's exempt purposes under § 513. City X will continue to rent this portion after Corporation A acquires the facility.

Because all of the net proceeds are used to acquire a facility owned by a 501(c)(3) organization and used by a 501(c)(3) organization and a governmental unit in activities that are not unrelated trade or business, the bonds are qualified 501(c)(3) bonds. The rental by City X will not disqualify the bonds.

Example 5

Authority X issues $15 million principal amount of bonds and loans the proceeds to Corporation M, a 501(c)(3) organization, to construct a clinic. After the clinic has been constructed, Corporation M realizes that it has too much space and rents 10 percent of the space in the clinic to a sole proprietor who will operate a pharmacy and a flower shop in the rented space. Even if the rental of the space by Corporation M is not considered an unrelated trade or business under IRC § 513, the bonds will not be qualified 501(c)(3) bonds. This is because more than 5% of the bond proceeds are used in a trade or business of a nongovernmental person.

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Example 6

Same as Example 5, except that Corporation M rents the space to Corporation Z, a 501(c)(3) organization. Corporation Z uses the space to train unemployed persons seeking employment. Assume that the rental to Corporation Z is considered an unrelated trade or business under § 513 with respect to Corporation M. Because Corporation Z is renting more than 5 percent of the bond-financed facility, the bonds will not be qualified 501(c)(3) bonds.

Management Service Contracts

A management contract with respect to bond-financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

See Regulations § 1.141-3(b)(4)(i).

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Definition

A management contract is a management, service or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility.

For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. *See Regulations § 1.141-3(b)(4)(ii).*

Certain arrangements generally are not treated as management contracts resulting in private business use. *See Regulations § 1.141-3(b)(4)(iii) and section 2.01(7) of Rev. Proc. 97-13, 1997-1 C.B. 632.*

On October 24, 2014, the Internal Revenue Service issued Notice 2014-67 which created a new safe harbor for contracts with a term, including renewal options, of not more than five years. The big change is that such contract need *not be terminable* by the qualified user prior to the end of the term.

Notice 2014-67 applies to bonds issued on or after January 22, 2015, but also may be applied to bonds issued before January 22, 2015.

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Safe Harbors

The IRS has provided safe harbors regarding management service contracts between a service provider and a qualified user (including a 501(c)(3) organization in its related activities) where the service is provided in connection with a bond-financed facility.

For management contracts executed, materially modified, or amended on or after May 16, 1997, the safe harbors are provided in Rev. Proc. 97-13, 1997-1 C.B. 632. Rev. Proc. 97-13 obsoleted Rev. Proc. 93-19, 1993-1 C.B. 526.

Rev. Proc. 2001-39, 2001-28, I.R.B. 38, modifies the definitions of capitation fee and per unit fee in Rev. Proc. 97-13 to permit automatic increases of those fees to certain objective external standards.

Notice 2014-67 also created a new safe harbor for contracts with a term, including renewal options, of not more than five years which does not need to be terminable by the qualified user prior to the end of the term.

Notice 2014-67 applies to bonds issued on or after January 22, 2015, but also may be applied to bonds issued before January 22, 2015.

Management contracts are discussed in detail in Phase II, Lesson 4, Private Activity Bonds.

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Research Agreements

Certain agreements with respect to bond-financed facilities under which a nongovernmental person sponsors research by a qualified user (including a 501(c)(3) organization in its related activities) may result in private business use. *See Regulations § 1.141-3(b)(6)*

Private business use occurs if the sponsor is treated as the lessee (with certain exceptions) or owner of the bond-financed property for federal income tax purposes.

Rev. Proc. 2007-47, 2007-29 I.R.B. 108, provides safe harbors for research agreements for any research agreement entered into, materially modified, or extended on or after June 26, 2007. Rev. Proc. 2007-47 modified and superseded Rev. Proc. 97-14, 1997-1 C.B. 634.

Mixed Use and Multipurpose Facilities

Mixed use or multipurpose facilities are facilities that have multiple users, such as a 501(c)(3) organization and a private business user.

A mixed use or multipurpose facility may be financed in part with qualified 501(c)(3) bonds. The portion that is bond financed must be owned and used by the 501(c)(3) organization or by a governmental unit in furtherance of the 501(c)(3) organization's purpose.

Continued on next page

Private Activity Bond Tests, Continued

Allocations

The portion used by the private business user must be financed by sources other than tax-exempt bond proceeds.

The allocations between the different uses of the facility must be made in proportion to the benefits derived, directly or indirectly, by the various users of the facility.

The allocations of the bond proceeds and other sources of funds, and the use of the facility by various parties, must be reasonable and consistently applied and allocations under §§ 141 and 148 must be consistent with each other.

On September 26, 2006, the IRS published Proposed Regulations, 2006-2 C.B. 808 (Reg. 140379-02; Reg. 142599-02) that would revise the § 1.141-6 allocation and accounting rules and Regulations § 1.145-2 to provide mixed use rules.

$150 Million Volume Cap for Non-Hospital Bonds

Introduction

Qualified 501(c)(3) bonds are NOT subject to the state volume limits of §146. However, § 145(b) limits the aggregate outstanding face amount of certain qualified 501(c)(3) bonds allocated to a 501(c)(3) organization, which is a test-period beneficiary, to $150 million.

If the bonds are qualified hospital bonds, this limit does NOT apply. Nor does it apply to bonds issued on or after August 5, 1997, as part of an issue 95 percent or more of the net proceeds of which are to finance capital expenditures incurred after August 5, 1997.

Non-Hospital and Qualified Hospital Bonds

Therefore, one determination to be made is whether the bonds are hospital or non-hospital bonds.

Non-Hospital Bonds

We refer to all qualified 501(c)(3) bonds that are not qualified hospital bonds as non-hospital bonds.

Qualified Hospital Bonds

A qualified hospital bonds means any bond issued as part of an issue at least 95 percent of the net proceeds of which are used with respect to a hospital.

See § 145(c).

Continued on next page

$150 Million Volume Cap for Non-Hospital Bonds, Continued

Definition of a Hospital

A hospital is a facility that:

- is accredited by the Joint Commission on Accreditation of Healthcare (JCAH), or is accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of the governmental unit are essentially equivalent to JCAH;
- is primarily used to provide, by or under the supervision of physicians, to in-patients diagnostic services and therapeutic services for medical diagnosis, treatment and care for the injured, disabled or sick persons (including those who are mentally ill);
- has a requirement that every patient be under the care and supervision of a physician; AND
- provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or a registered nurse on duty at all times.

Rest or nursing homes, day care centers, medical school facilities, research laboratories, and ambulatory care facilities (e.g. surgicenters) are NOT hospitals.

See H.R. Conf. Rep. No. 841, 99th Cong., 2d Session, at 725.

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Bonds Taken into Account for the $150 Million Limitation

Sections 145(b)(2)(B) and (C) provide that for purposes of applying the $150 million limitation to a test-period beneficiary, the aggregate outstanding amount of the following bonds is included any:

- qualified non-hospital bonds;
- bonds issued under the Internal Revenue Code of 1954, if (I) such bonds would have been industrial development bonds had the 1954 Code not treated 501(c)(3) organizations as exempt persons, and (II) such bonds were not exempt facility, industrial park, or small issue bonds under the 1954 Code.

A bond shall be taken into account only to the extent that the proceeds of the issue of which such bond is a part are not used with respect to a hospital. However, if 90% or more of the net proceeds of an issue are used with respect to a hospital, no bond which is part of such issue shall be taken into account.

Note: Special rules apply to refunding bonds. (See "Refunding Bonds" section below.)

Continued on next page

Example 7

Corporation X, a 501(c)(3) organization plans to borrow proceeds of $150 million principal amount of qualified 501(c)(3) bonds to construct a rehabilitation facility to be issued in June 1997. In 1994, Corporation X borrowed $75 million principal amount of bonds to construct a new wing of a hospital. In 1993, Corporation X borrowed $32 million principal amount of bonds to construct a retirement facility. In 1987, Corporation X borrowed $16 million principal amount of bonds to acquire three skilled-care nursing facilities. In 1985, Corporation X borrowed $20 million principal amount of bonds to acquire six nursing homes. All of the bonds are currently outstanding.

In determining the outstanding bonds to be taken into account for purposes of § 145(b)(2)(B), Corporation X will include the 1993 bonds, the 1987 bonds and the 1985 bonds, but not the 1994 bonds. Because these outstanding bonds total $68 million, the maximum Corporation X can borrow of the 1997 bonds is $82 million.

Bonds Taken into Account for the $150 Million Limitation

Section 145(b)(4) provides that rules similar to the rules of subparagraphs (C), (D), and (E) of § 144(a)(10) apply to this subsection.

Continued on next page

Test Period Beneficiary

A test-period beneficiary is any person who is:

- an owner, OR
- a principal user of the bond financed facilities at any time during the test-period.

See § 144(a)(10)(D)

Test Period

The test-period is a three-year period beginning on the later of the date the:

- financed facility is placed in service, OR
- bonds are issued.

See § 144(a)(10)(D).

Aggregation Rule

Section 144(a)(10)(E) provides that all persons who are related within the meaning of § 144(a)(3) are treated as one person. Section 144(a)(3) provides that a person is related to another person if: (A) the relationship between such persons would result in a disallowance of losses under §§ 267 or 707(b), or (B) such persons are members of the same controlled group of corporations (as defined in § 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein.

For example, a university and all related persons (as defined in § 267), including related entities engaged in unrelated trades or businesses, are treated as one person in determining whether they are principal users of bond-financed property.

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$150 Million Volume Cap for Non-Hospital Bonds, Continued

Common Management or Control

Further, § 145(b)(3) provides that for purposes of determining the $150 million limitation, two or more organizations under common management or control shall be treated as one organization. Any 501(c)(3) organization will be treated as related to another person if the two have (a) significant common purposes and substantial common membership, or (b) directly or indirectly, substantial common direction. For example, a local chapter of a national organization may be treated as related to the national organization.

In PLR 8822043, the Service found that a local corporation ("Local X") and a national council were not under common management and control for purposes of § 145(b)(3). County will issue bonds to finance improvements for Local X, a 501(c)(3) member of a national council, itself a 501(c)(3) entity that promotes worldwide fellowship with a particular religious worldview. The Service ruled that because Local X controls its own programs, has its own financial resources, cannot be dissolved by the national council, selects its own board and contributes less than one percent of its revenues to the national council, it is not under common management or control.

Bonds Allocated to Test Period Beneficiary

All owners of bond-financed facilities during the 3-year test period are allocated that portion of the issue that is equivalent to the portion of the facilities that they own. Additionally, all principal users of the facilities during the 3-year test period are allocated a portion of the face amount of the issue equivalent to that portion of the facility used by them. (In certain cases, this may result in all or part of an issue being allocated to more than one 501(c)(3) organization.) *See § 144(a)(10)(C).*

H.R. Rep. No. 426, 99th Cong., 1st Session, at 540, states that, once a portion of an issue is allocated to a 501(c)(3) organization, that allocation remains in effect as long as the bonds are outstanding. This is true even if the organization no longer owns or uses the property financed with the bonds. Similarly, the fact that a person stops being related to an owner or principal user of the property after an allocation is made does not alter the allocation to that person as long as the bonds are outstanding.

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Refunding Bonds

In determining whether the $150 million limitation has been exceeded, bonds that are redeemed by a later issue (other than advance refunding bonds) are not taken into account. *See IRC § 145(b)(2)(A)(ii).*

Transition Rules

Special rules apply to bonds that refund bonds issued prior to the effective date of Tax Reform Act of 1986 (the "1986 Act"). The $150 million limit was added by the 1986 Act. Section 145(b) does not apply to current refunding bonds (or a series of bonds) the proceeds of which are used exclusively to refund a tax-exempt bond to which that the limit did not apply if the:

- (1) amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds;
- (2)(a) weighted average maturity of the refunding bonds does not exceed 120 percent of the weighted average reasonably expected economic life of the facilities financed with the refunded bonds, or
- (2)(b) last-maturing bond in the refunding issue matures no later than 17 years after the issue date of the refunded bonds; **and**
- (3) net proceeds of the refunding bond are used to redeem the refunded bond within 90 days of the issuance of the refunding bond.

See § 1313(c)(2) and (3) of the 1986 Act.

However, even if the limit does not apply because of this special transition rule, such refunding bonds are counted as outstanding bonds for purposes of determining whether subsequent new money or advance refunding bonds may be issued.

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Transition Rules (continued)

Advance refunding bonds are counted in determining whether the $150 million limitation is exceeded. However, under § 1313(b)(3)(G) of the 1986 Act , one advance refunding after March 14, 1986, of a bond issued before January 1, 1986, is permitted even if this refunding results in the test-period beneficiary having more than $150 million of outstanding bonds allocated to it.

Again, however, such advance refunding bonds are counted as outstanding bonds for purposes of determining whether subsequent new money or advance refunding bonds may be issued.

Example 8

On April 7, 1991, Corporation Y, a 501(c)(3) organization, is a beneficiary of $120 million principal amount of non-hospital bonds. On this date, Corporation Y wants to borrow $60 million face amount of advance refunding bond proceeds to advance refund bonds issued on December 12, 1985. These advance refunding bonds will not be included in calculating the $150 million limitation allocated to Corporation Y.

Example 9

On August 15, 1987, Corporation Y borrows $20 million face amount of bonds to construct a nursing home. On May 10, 1992, Corporation Y wants to advance refund the 1987 bonds by borrowing $19.7 million face amount of bonds. The 1987 bonds and the 1992 refunding bonds will be included in the calculation of the $150 million limitation allocated to Corporation Y.

Loss of Tax Exemption

If an issue of qualified 501(c)(3) bonds causes the $150 million limitation to be exceeded, only the issue that causes the limitation to be exceeded is taxable.

If the $150 million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued.

Residential Rental Facilities

General Rule

Section 145(d)(1) provides that proceeds of qualified 501(c)(3) bonds may not be used, directly or indirectly, to finance residential rental property for family units.

Exceptions

Section 145(d)(2) excepts from the general rule the following scenarios if the:

- first use of the bond-financed facility is as a residential rental property for family units;
- facility is a qualified residential rental project, as defined in § 142(d); or
- bond financed property will be substantially rehabilitated beginning within the two-year period ending one year after the date of acquisition of the property.

First Use Rule

Section 145(d)(3)(A) permits residential rental facilities to be treated as if the first use of it is residential rental even if that were not the case if:

- the first use of the facility was pursuant to taxable financing;
- at the time of the taxable financing there was reasonable expectation that the taxable financing would be replaced with tax-exempt bonds; and
- the taxable financing is replaced with tax-exempt financing within a reasonable period after the taxable financing is provided.

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Special Rule Regarding First Use

In addition to the above, § 145(d)(3)(B) provides that if, at the time of the first use of the property, there was no operating state or local program permitting use of tax-exempt bonds to finance a residential rental facility, the first time a property is financed with tax-exempt bonds is treated as first use of the property.

Example 10

In 1987, Corporation X, a 501(c)(3) organization, wanted to acquire an existing residential rental project located in County A. County A's local ordinance prohibited use of tax-exempt bonds to finance residential rental units. Corporation X acquired the facility with a taxable loan from a bank. In 1990, County A realized the increased need for low-income housing in its jurisdiction and amended its ordinance to permit issuance of tax-exempt bonds and established a housing authority to issue such bonds.

In 1991, Corporation X requested the housing authority to issue tax-exempt bonds, the proceeds of which were to be used to refinance the bank loan by Corporation X.

Although Corporation X already owned the facility and has been operating it, the use by Corporation X will be considered first use of the facility for purposes of the 1991 tax-exempt bonds.

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Example 10 (continued)

In PLR 9516027, the Service ruled that based on the facts and circumstances, the taxable interim construction financing qualified under § 145(d). After City gave preliminary approval for future issuance of bonds for 501(c)(3) corporation's project, Bank provided Corporation with a two-year taxable construction loan. City, later that year, issued the bonds and deposited the proceeds into an escrow account to be held by the bond trustee until certain conditions were met. Subsequently, the construction ran into difficulties, and as a result, the conditions for release of the escrow were not met and the bond trustee used the proceeds to redeem the bonds. Bank extended and increased its loan. After the project was finally completed, Corporation proposed a new issue of tax-exempt bonds to replace the taxable loan. The Service ruled that, provided the bonds were sold within 90 days and issued within 120 days of the ruling, the new bonds would "represent a replacement of . . . taxable financing within a reasonable period" for purposes of determining whether the first use of property is pursuant to tax-exempt financing under § 145(d)(3).

Qualified Residential Rental Project

A bond issue may be a qualified 501(c)(3) bond issued to acquire a residential rental project, if the residential rental project meets the requirements for a "qualified residential rental project" under § 142(d).

Rev. Rul 98-47, 1998-2 C.B. 399, describes which components of a continuing care retirement community constitute a "qualified residential rental project" within the meaning of §§ 142(d) and 145(d).

Section 142(d) provides the requirements for qualified residential rental projects with respect to exempt facility bonds. These requirements will be described in Lesson 6 of Phase II Training.

Continued on next page

Substantial Rehabilitation

Rules similar to the rules under § 47(c)(1)(C) are used to determine if the project has been substantially rehabilitated.

To be considered substantially rehabilitated, § 47(c)(1)(C)(i) provides that the qualified rehabilitation expenditures during the specified two- year period must exceed the greater of the adjusted basis of the project and its structural components or $5,000. Section 47(c)(1)(C)(ii) does not apply, but the Secretary may extend the two-year period in § 47(c)(1)(C)(i) where appropriate due to circumstances not within the control of the owner.

Other Applicable Private Activity Bond Rules

Applicable Rules

The following private activity bond rules are applicable to qualified 501(c)(3) bonds. These rules are discussed in other modules of this text.

- Section 147(b)(1) places a limit on the average maturity of qualified 501(c)(3) bonds.
- Section 147(b)(4) provides special rules for qualified 501(c)(3) bonds, the proceeds of which are borrowed by two or more unrelated 501(c)(3) organizations or governmental units.
- Section 147(e) prohibits the use of qualified 501(c)(3) bonds to finance certain facilities—with the exception of health club facilities. *See § 147(h)(2).*
- The notice and public approval requirements of § 147(f) are applicable to qualified 501(c)(3) bonds.
- The limitation on costs of issuance under § 147(g) is applicable to qualified 501(c)(3) bonds.
- The arbitrage and rebate rules of § 148 apply to qualified 501(c)(3) bonds.
- Qualified 501(c)(3) bonds, like governmental bonds, may be advance refunded. Section 149(d) provides the rules regarding advance refundings.
- Certain other provisions of § 149 also apply to qualified501(c)(3) bonds.
- Section 150(b)(3) provides rules regarding the change in use of a facility financed with qualified 501(c)(3) bonds which continues to be owned by a 501(c)(3) organization after the change. Section 150(c) contains exceptions to the general rule in § 150(b)(3).

Summary

Review of Lesson 12

Lesson 12 completes the discussion of qualified 501(c)(3) bonds as described in § 145.

Regulations §§ 1.145-0 through 1.145-2 also provide rules for qualified 501(c)(3) bonds, but generally state that the private activity bond rules under Regulations §§1.141-0 through 141.15 apply to qualified 501(c)(3) bonds.

Specific requirements of qualified 501(c)(3) bonds are:

- All of the net proceeds must be used to finance property OWNED BY a 501(c)(3) organization or a governmental unit.
- Use by a 501(c)(3) organization in its related activities is treated as governmental use with respect to the private business tests.
- The bonds must NOT meet the private business use test AND the private security or payment test, using **five percent** instead of **ten percent** and **net proceeds** instead of **proceeds.**
- Use of bond proceeds or bond-financed facilities by a 501(c)(3) organization in an unrelated trade or business activity is considered private business use.
- Qualified 501(c)(3) bonds that are not qualified hospital bonds may be subject to a $150 million volume cap.
- With certain exceptions, the proceeds of qualified 501(c)(3) bonds may not be used to finance residential rental property for family units.

Qualified 501(c)(3) bonds are also subject to the general private activity bond rules provided by §§ 147 through 150.

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Lesson 13

Bank Qualified Bonds – Section 265

Overview

Introduction

Lesson 13 covers qualified tax-exempt obligations, also known as bank qualified bonds. This lesson is an overview of the requirements related to bank qualified bonds.

Objectives

At the end of this lesson, you will be able to:

- Define the general rules for interest expense disallowance on tax-exempt indebtedness
- Define the exception for qualified tax-exempt obligations
- Define the TEFRA rule related to qualified tax-exempt bonds
- Identify ARRA Provisions: Special rules for obligations issued during 2009 and 2010

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Overview, Continued

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Legislative History

Overview

As a general rule, a nonbank taxpayer cannot deduct expenses or interest incurred in connection with acquiring or carrying assets that produce tax-exempt interest. Historically, banks were not subject to these rules. As such, a bank could deduct interest and other expenses on indebtedness incurred in the ordinary course of business where the expenses were not directly related to the purchase of tax-exempt bonds.

Historical Background

The deduction of interest expense related to tax-exempt bonds was scaled back under § 291(a)(3) enacted, effective for tax years beginning after December 31, 1982. Section 291(a)(3) was enacted as part of "*The Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA)." This provision disallowed 15% of the "allowable" related interest expense for "financial institution preference items." The Tax Reform Act of 1984 increased the disallowance of the interest expense deduction as a tax preference item from 15 percent to 20 percent for municipal securities purchased after December31, 1982. The amount of the allowable related interest expense subject to the 20% deduction disallowance under § 291 is calculated based on a portion of the interest expense deduction claimed by a bank attributable to its investment in tax-exempt obligations.

The term "financial institution preference item" includes: "In the case of a financial institution which is a bank (as defined in section 585(a)(2)), the amount of interest on indebtedness incurred or continued to purchase or carry obligations acquired after December 31, 1982, and before August 8, 1986, the interest on which is exempt from taxes for the taxable year, to the extent that a deduction would (but for this paragraph or section 265(b)) be allowable with respect to such interest for such taxable year." See section 291(e)(1)(B)(i).

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Legislative History, Continued

Historical Background (continued)

The Tax Reform Act of 1986 expanded the 20% disallowance rules under § 291 by adding § 265 to the Code effective for tax years beginning after December 31, 1986. Section 265(a) provides in part that "no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax." The general rule under § 265(a)(2) is that 100 percent of a financial institution's interest expense allocable to tax exempt income on obligations acquired after August 7, 1986 is disallowed as a deduction. However, § 265(b)(3) provides an exception to this general for *qualified* tax exempt obligations. Moreover, qualified tax exempt obligations acquired after August 7, 1986 are treated as acquired by a financial institution on August 7, 1986 for purposes of applying§ 265(b)(2), allocation rules to determine the allowable amount of interest expense before any adjustments, and for applying § 291(e)(1)(B), the 20% disallowance of interest expense for financial institution preference items.

General Rules

Statutory Provisions

Section 265 provides the requirements for expenses and interest relating to tax exempt income:

(a) **General Rule:** No deduction shall be allowed for:

(1) **Expenses:** Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

(2) **Interest:** Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle.

- This is generally referred to as the carrying cost (i.e. the interest expense incurred to purchase or carry an inventory of municipal securities) of tax exempt bonds which financial institutions may not deduct.

Regulations

Treas. Reg. §§ 1.265-1 and -2 provide rules for expenses and interest relating to tax exempt income and -3 provides rules for non-deductibility of interest relating to exempt interest dividends.

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General Rules, Continued

Definition of Interest Expense

Section 265(b)(4)(A) defines interest expense as the aggregate amount allowable to the taxpayer as a deduction for interest for the taxable year (determined without regard to this subsection, section 264 and section 291). For purposes of the preceding sentence, the term "interest" includes amounts (whether or not designated as interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

Definition of Financial Institution

Section 265(b)(5) defines a "financial institution" as any person who:

- accepts deposits from the public in the ordinary course of such person's trade or business and is subject to Federal or State supervision as a financial institution, or
- is a corporation described in § 585(a)(2)

Financial Institutions and Interest Expense

General Rule

Section 265(b)(1) provides that in the case of a financial institution, no deduction shall be allowed for the portion of the taxpayer's interest expense which is allocable to tax-exempt interest.

This rule is designed to prevent taxpayers from excluding from taxable income the interest income earned on tax-exempt securities while at the same time deducting interest expense used to purchase the investments.

Section 265(b)(1) is effective for tax years ending after December 31, 1986.

Interest Expense Disallowance

Application of the interest expense rules to financial institutions:

- § 265(a)(2) disallows 100% of the interest expense incurred to carry or purchase tax exempt obligations.
- § 265(b)(3) excepts "qualified tax exempt obligations" also commonly known as "bank qualified obligations" from the 100% disallowance of§ 265(a)(2).
- § 265(b)(3) treats "qualified tax exempt obligations" issued after August 7, 1986 as issued on August 7, 1986 for purposes of §291(e)(1)(B), financial institution preference items.
- § 291(e)(1)(B) financial institution preference items are subject to §291(a)(3) 20% disallowance of tax exempt interest expense for obligations issued before August 8, 1986.
- § 291 applies to § 265(b)(3) bank qualified obligations to reduce the interest expense allowable to carry or acquire tax exempt obligations by 20%.

Interest Expense Disallowance

Pro Rata Allocation of Interest Expense of Financial Institutions to Tax-Exempt Interest

Section 265(b) applies generally to obligations acquired after August 7, 1986. This section provides the formula to determine the pro rata allocation of interest expense of a financial institution to tax exempt interest as a determination of the financial institution's interest expense deduction.

Section 265(b)(2) provides:

- that for purposes of paragraph (b)(1), the portion of the taxpayer's interest expense which is allocable to tax-exempt interest is an amount which bears the same ratio to such interest expense as—
  - the taxpayer's average adjusted bases (within the meaning of section 1016) of tax-exempt obligations acquired after August 7, 1986, bears to
  - (B) such average adjusted bases for all assets of the taxpayer

Exception for Certain Tax-Exempt Obligations

Introduction

Section 265(b)(3) provides an exception to the general rule disallowing a deduction for interest expense related to tax exempt obligations.

Note: The exception allows financial institutions to deduct interest expense subject to the pro rata allocation rules of § 265(b) and the limitation of § 291(a)(3).

Exception: Section 265(b)(3) provides that any "qualified tax exempt obligation" (QTEO) acquired after August 7, 1986, shall be treated for purposes of:

- Section 265(b)(2) relating to the pro rata allocation of interest expense of financial institutions to tax exempt interest and
- Section 291(e)(1)(B) related to interest on debt to carry tax exempt obligations as if the QTEO were acquired on August 7, 1986.

Generally, this means that the Code allows a financial institution to deduct 80 percent of the carrying cost of a qualified tax-exempt obligation.

Definition of Qualified Tax Exempt Obligation

Section 265(b)(3)(B) states that the term "qualified tax-exempt obligation" means a tax-exempt obligation (1) which is issued after August 7, 1986 by a qualified small issuer; (2) which is not a private activity bond and (3) which is not designated by the issuer for purposes of section 265

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Exception for Certain Tax-Exempt Obligations , Continued

Qualified Small Issuer

Section 265(b)(3)(C) defines a "qualified small issuer" as:

- with respect to an obligation issued during any calendar year, any issuer, if the reasonably anticipated amount of tax exempt obligations (other than certain obligations described in § 265(b)(3)(C)(ii) including certain current refunding obligations, private activity bonds other than qualified § 501(c)(3) bonds and other specified obligations) that will be issued by the issuer during such calendar year does not exceed $10,000,000.

- Section 265(b)(3)(D) addresses the limitations on the amount of obligations which may be designated for purposes of the $10,000,000 limitation.

Certain Bonds Not Treated as Private Activity Bonds

Section 265(b)(3)(B)(ii) states that certain bonds are not treated as private activity bonds.

For purposes of § 265(b)(3)(B), there shall not be treated as a private activity bond:

- any qualified § 501(c)(3) bond (as defined in section 145), or

- any obligation issued to refund (or which is part of a series of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in section 103(b)(2) as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) or a private loan bond (as defined in section 103(o)(2)(A), as so in effect, but without regard to any exemption from such definition other than section 103(o)(2)(A)).

Rules under TEFRA – § 291

Introduction

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) promulgated§ 291(a)(3) restricting the deductibility of interest expense for financial institutions that make tax exempt investments in bonds, securities or loans.

TEFRA Limitation Related to Interest Expense Deduction

Section 291(a)(3) provides that the amount allowable as a deduction with respect to any "financial institution preference item" shall be reduced by 20 percent.

Section 291(a)(3) disallows 20 percent of the related interest expense for qualified tax-exempt, bank qualified obligations. In other words, the Code allows banks to deduct 80 percent of the carrying cost of a qualified tax-exempt obligation.

Rata Allocation of Interest Expense of Financial Institutions to Tax-Exempt Interest

Section 291(e)(1)(B)(ii) applies generally to obligations acquired after December 31, 1982 and before August 8, 1986 and provides the formula to determine the pro rata allocation of interest expense of a financial institution to tax exempt interest as a determination of the financial institution's interest expense deduction.

Section 291(e)(1)(B)(ii) provides:

- Unless the taxpayer establishes otherwise, the amount determined under the aggregate amount allowable shall be an amount which bears the same ratio to the aggregate amount allowable (determined without regard to this section and section 265(b)) to the taxpayer as a deduction for interest for the taxable year as—
  - (A) the taxpayer's average adjusted bases (within the meaning of section 1016) of tax-exempt obligations acquired after August 7,
    1986, bears to
  - (B) such average adjusted bases for all assets of the taxpayer

Note: Although § 265(b)(3) treats all qualified tax exempt obligations as issued on August 7, 1986 subject to this allocation formula, it tracks the allocation formula set forth under § 265(b)(2).

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Formula: IRC Sections 265 and 291

Step 1: Average Adjusted Bases of Tax Exempt Obligations / Average Adjusted Bases of All Assets* = %

Step 2: % x YTD Interest Expense = Disallowed Interest Expense $

Step 3: $ x 20% § 291Rate = Disallowed Interest Expense § 281**

Note:
*Rev. Rul. 90-44: Book assets can be used to determine average. Adjusted bases of tax exempt obligations can be based on monthly ending balances. Adjusted bases of all assets held can be based on assets at the end of each quarter.
**Step 3 applies if the requirements of a "qualified tax exempt obligation" are met.
For financial reporting purposes the interest is reported, i.e., included in book income for GAAP. The 20 percent § 291 disallowance represents a permanent M-1 adjustment representing disallowed interest expense for tax purposes. A schedule M-1 adjustment will indicate the total amount of tax free interest received by the bank.

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Rules under TEFRA – § 291, Continued

Financial Institution Preference Item

Section 291(e)(1)(B)(iv) provides the following with respect to the term "financial institution preference item:"

- For application of this subparagraph to certain obligations issued after
  - August 7, 1986, see § 265 (b)(3).

- In other words, for obligations issued after August 7, 1986 §
  - 291(e)(1)(B)(iv) refers to the § 265(b) pro rata allocation of interest expense rules of financial institutions to tax exempt interest.

- Generally, for interest on debt to carry tax exempt obligations acquired after December 31, 1982, and before August 8, 1986, see §291(e)(1)(B).

Section 265 and 291 Interaction

Section 265 and 291 Applicable Dates

Interest Expense on Obligations Issued Before August 8, 1986:

- A financial institution can generally deduct interest expense incurred in the ordinary course of its business.
- Section 291(a)(3) provides that the amount of interest that a bank incurred to purchase and carry tax-exempt obligations was considered a tax preference item.
- Section 291(a)(3) provides that the allowable deduction for any financial institution preference item shall be reduced.
- The term financial institution preference item includes a financial institution's interest expense that is allocable to tax exempt obligations acquired after December 31, 1982, and before August8, 1986.
- The Tax Reform Act of 1984 increased the disallowance of the interest expense deduction (for preference items) from 15 percent to 20 percent for securities purchased after December 31, 1982.

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Section 265 and 291 Interaction , Continued

Section 265 and 291 Applicable Dates (continued)

Interest Expense on Obligations Issued After August 7, 1986:

- The Tax Reform Act of 1986 significantly changed the rules governing the tax exemption of interest for obligations issued after August 7, 1986.
- Section 265(b)(1) was added to the Code effective for years after December 31, 1986. This section provides in part that "no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest." In
- other words, 100 percent of a financial institutions interest expense allocable to tax-exempt income on obligations acquired after August 7, 1986 is not allowed as a deduction.
- Section 265(b)(2) and 291(e)(1)(B)(ii) both include references to the same allocation formula as setout in the pro rata allocation section. As a note § 291(e)(1)(B)(ii) gives reference to 265(b).
- Exception: § 265(b)(3) provides that the 100 percent disallowance rule (under paragraph (b)(2) of this section) does not apply to qualified tax-exempt bonds.

Interest Expense on Obligations Treated as Issued On August 7, 1986

- Section 265(b)(3) treats qualified tax exempt bonds for purposes of §§265(b)(2) and 291(e)(1)(B) as if they were acquired on August 7,1986.
- Section 291(a)(3) 20% disallowance of interest expense applies to qualified tax-exempt bonds issued before August 8, 1986.

Other Rules Generally

Aggregation of Issuers

Section 265(b)(3)(E)(i) provides that for purposes of a qualified small issuer under subparagraph (C) and the limitation on the amount of obligations under subparagraph (D), an issuer and all entities which issue obligations on behalf of such issuer shall be treated as one issuer.

Section 265(b)(E)(ii) and (iii) provide that all obligations issued by a subordinate entity shall, for purposes of applying subparagraphs (C) and (D) to each other entity to which such entity is subordinate; be treated as issued by such other entity and an entity formed to avoid the purposes of subparagraph (C) and (D) and all entities benefitting thereby shall be treated as one issuer.

Treatment of Composite Issues

Section 265(b)(3)(F) provides that in the case of an obligation which is issued as part of a direct or indirect composite issue, such obligation shall not be treated a a qualified tax exempt obligation unless (i) the requirements of this paragraph are met with respect to such composite issue (determined by treated such composite issue as a single issue) and (ii) the requirements of this paragraph are met with respect to each separate lot of obligations which are part of the issue (determined by treated each such separate lot as a separate issue).

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Other Rules Generally, Continued

Subsidiaries of a Financial Institution – Determination of Average Adjusted Basis

In *PSB Holdings, Inc.* v. *Commissioner*, the Court rejected the IRS's position that a bank is required under §§265(b) and 291 to include a non-bank subsidiary's tax-exempt obligations that were purchased and owned by the subsidiary in calculating the bank's average adjusted bases of tax-exempt obligations for purposes of determining the bank's interest expense disallowance.

Thus, a financial institution is not required to include the investments of its non-bank subsidiary in calculating its interest expense disallowance under § 265(b).

Note:
See PSB Holdings Inc. v Commissioner, 129 T.C. 131 (2007) , (treatment of investment bank subsidiaries under section 265 and 291) and Rev. Rul. 90-44, 1990-20 IRB 5, 1990-1 CB 54.

ARRA Provisions

Introduction

The American Recovery and Reinvestment Act of 2009 (ARRA) modified the provisions of the Internal Revenue Code of 1986, as amended, governing:

- a financial institution's disallowance of its interest expense deduction allocable to tax exempt obligations
- qualified tax exempt obligations and
- the application of the alternative minimum tax (AMT) to tax exempt interest

Interest Expense Deduction

Section 265(b)(7)(A) provides that tax exempt obligations issued during 2009 or 2010 and held by a financial institution, shall not be taken into account in determining the portion of the financial institution's interest expense subject to the pro rata interest expense deduction disallowance rule under § 265(b)(2)(A) (i.e. the numerator of the pro rata formula related to the average adjusted bases of tax exempt obligations).

Limitation: Section 265(b)(7)(B) provides that the amount of tax exempt obligations excluded in 2009 and 2010 will be limited to 2 percent of the average adjusted bases for all assets of the taxpayer under § 265(b)(2)(B) (i.e. the denominator of the pro rata allocation formula).

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Qualified Tax Exempt Obligations

Section 265(b)(3)(G):

- raised the $10,000,000 qualified small issuer limit to $30,000,000 for tax exempt obligations issued in 2009 or 2010
- provided that in the case of a qualified 501(c)(3) bond issued in 2009 or 2010, the 501(c)(3) organization for whose benefit such bond was issued is treated as the issuer for purposes of § 265(b)(3) of the Code. Section 265(b)(3)(G)(iii) provides that section 265(b)(3)(F) restrictions on composite issues shall not apply, and any obligation issued as a part of such issue shall be treated as a qualified tax exempt obligation if the requirements of the paragraph are met with respect to each qualified portion of the issue (determined by treating each qualified portion as a separate issue which is issued by the qualified borrower with respect to which such portion relates.)

Alternative Minimum Tax

The Act amended §56 of the Code to provide that for new money (non refunding) bonds issued in 2009 and 2010, the interest on private activity bonds will not be treated as a tax preference item for individual and corporate alternative minimum tax (AMT) and the interest on governmental bonds will not be an adjustment to current earnings for purposes of corporate AMT. The temporary relief provided by ARRA also applied to refunding of bonds issued beginning in 2004, provided the refunding bonds are issued before 2011. The relief does not apply to refundings of pre-2004 bonds.

Examination Techniques

Examination Techniques Relating to Bank Qualified Bonds

For further information regarding examination techniques related to bank qualified bonds, refer to the Department of Treasury IRS Training 3149-104 (05/2001) Catalog Number 89400K, MSSP Commercial Banking, Chapter 18.

Summary

Review of Lesson 13

This lesson discussed the requirements of bank qualified bonds. These bonds are subject to complex rules and the lesson is not intended to provide a comprehensive discussion of such rules, but rather an overview of relevant considerations.

Generally, the interest expense deduction related to tax exempt obligations are subject to the following rules:

- Section 265(a)(2) disallows a deduction for interest expense related to tax-exempt obligations.
- Section 265(b)(3) provides an exception to the rule that generally disallows the deduction for interest expense.
- Tax-exempt obligations must meet the requirements of a qualified tax- exempt bond for the exception to apply.
- Application of pro rata allocation of interest expense of financial institutions to tax-exempt interest formula to determine interest expense deductibility.
- Application of TEFRA limitation in determining interest expense deductibility.
- Application of ARRA provisions as related to the determination of interest expense deduction, qualified tax-exempt obligations, and alternative minimum tax.

Tax References

Section 265; Section 291; Treas. Reg. 1.265-1, -2 and -3; Rev. Rul. 90-44; PSB Holdings Inc. v Commissioner, 129 TC 131 (2007); Department of Treasury IRS Training 3149-104 (05/2001) Catalog Number 89400K

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