

Module D

Reimbursements

Overview

Introduction This module 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 module 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, 2005. On April 15, 2005, the issuer pays \$100,000 for initial project construction expenditures out of its general funds. The bonds are issued on June 1, 2005 and the issuer allocates \$100,000 of the proceeds to reimburse its general fund for the prior expenditures.

Why do we Care? Reimbursement bond proceeds are treated as spent for the governmental purpose of the original expenditure. However, in reality, the proceeds may be used to acquire investments yielding an amount materially higher than the yield of the reimbursement issue. 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.

Objectives

At the end of this module, the student should be able to:

- Identify a reimbursement allocation.
 - Identify the appropriate regulations applicable to the reimbursement bonds.
 - Explain the general rules for proper reimbursement allocations.
- Explain the consequences of improper reimbursement allocations.
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Background

Historical Context

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 for 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.

Applying the Appropriate Regulations

The rules applicable to reimbursement bonds have evolved over time through the issuance of revised regulations. Thus, it is important to determine the appropriate regulations to be applied during the course of examining an issue of reimbursement bonds.

The current rules are found in Treas. Reg. section 1.150-2, which applies to bonds issued after June 30, 1993. For reimbursements bonds issued before June 30, 1993, but after March 2, 1992, the rules under withdrawn Treas. Reg. section 1.103-18 apply. For earlier issues, the rules under withdrawn Treas. Reg. section 1.103-8(a)(5) should be applied.

Section 1

General Rules

Introduction

Effective Date The general rules applicable to reimbursement bonds are found in Treas. Reg. section 1.150-2. These rules, which are applicable to reimbursement bonds issued after June 30, 1993, replaced the prior rules found in withdrawn Treas. Reg. section 1.103-18.

General Rule Treas. Reg. section 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 3 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.

- The issuer must timely adopt an **official intent** that the original expenditures will be reimbursed with tax-exempt bond proceeds.
 - The reimbursement allocation must be made within the **reimbursement period**.
 - The original expenditures must be of a certain **nature**.
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Definitions

Definitions

For purposes of applying these rules, Treas. Reg. section 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

Treas. Reg. section 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 artificial 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 Treas. Reg. section 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 provided in Treas. Reg. section 1.150-2(c) (see also page 5 of this Module) that 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.

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.

An official intent may ONLY be adopted 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).
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Official Intent, Continued

When must an Official Intent to reimburse be Adopted?

Under Treas. Reg. section 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, 2002, School District uses moneys from its general fund to pay for \$200,000 in capital expenditures on various school facilities. On May 20, 2002, School Board adopts an official intent to reimburse those original expenditures. On June 15, 2002, School District issues \$200,000 in bonds. On June 20, 2002, 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 artificial 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.

Form of Official Intent

Under Treas. Reg. section 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.

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Official Intent, Continued

Project Description

Under Treas. Reg. section 1.150-2(e)(2), the official intent must provide both:

- 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 is permitted so long as the actual project is reasonably related in function to the described project.

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

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 will invalidate the official intent.

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Official Intent, Continued

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 Treas. Reg. section 1.150-2(e)(3).**

A declaration of official intent is NOT 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 is evidence of unreasonableness.

For purposes of determining the reasonableness of an official intent, the definition of “reasonable expectations” provided in Treas. Reg. section 1.148-1(b) applies.

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.

Reasonable Expectations

Under Treas. Reg. section 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 covenants, enforceable by bondholders, that require implementation of specific expectations.
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Reimbursement Period

General Rule Under Treas. Reg. section 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, 2000, County paid \$100,000 in original expenditures as part of a road improvement project. On March 10, 2000, County's Board of Commissioners adopted a valid official intent to reimburse expenditures incurred for that project. County completed the project on January 25, 2002. On July 1, 2002, County issued the reimbursement bonds and, on July 25, 2002, 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, 2003. Here, the allocation was artificial because more than 3 years had past 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.

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 IRC section 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 Treas. Reg. section 1.150-2(d)(2)(ii).**

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Reimbursement Period, Continued

**Special Rule for
Long-Term
Construction
Projects**

An exception applies to the above general rule for reimbursement bonds that finance certain 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 Treas. Reg. section 1.150-2(d)(2)(iii).**

Nature of Expenditure

Allowable Purposes of Original Expenditure

Under Treas. Reg. section 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 Treas. Reg. section 1.148-6(d)(3)(ii)(B));
- Grants (as defined in Treas. Reg. section 1.148-6(d)(4));
- Qualified student loans (as described in IRC section 144(b));
- Qualified mortgage loans (as described in IRC section 143(a)); or
- Qualified veterans' mortgage loans (as described in IRC section 143(b)).

A reimbursement allocation is NOT permitted for any original expenditure other than that 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 Treas. Reg. section 1.148-6(d)(3)(ii)(B).**

Exceptions to the General Rules

In General

Treas. Reg. section 1.150-2(f) provides 2 exceptions to the general requirements that the issuer adopt an official intent to reimburse the original expenditure under section 1.150-2(d)(1) and that the reimbursement allocation be made within the reimbursement period under section 1.150-2(d)(2). The 2 exceptions are the **de minimis exception** and the **preliminary expenditures exception**.

The original expenditure must still meet the nature of expenditure requirement under Treas. Reg. section 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. This exception also applies to 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, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

Other Rules

**Refunding
Issue v.
Reimbursement
Issue**

An issue is a refunding issue, and not a reimbursement issue, when the proceeds 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 Treas. Reg. section 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 Treas. Reg. section 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 artificial 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 **Treas. Reg. section 1.148-9.**

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Other Rules, Continued

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 Treas. Reg. section 1.150-2(g)(2).**

Anti-Abuse Rules

Two anti-abuse rules are provided under Treas. Reg. section 1.150-2(h).

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 Treas. Reg. section 1.148-10 to avoid the arbitrage restrictions or if to avoid the restrictions under sections 142 through 147.

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 NOT apply to amounts deposited in a bona fide debt service fund. An example illustrating this rule is provided in Treas. Reg. section 1.150-2(h)(2)(ii).

Transitional Rules

Under Treas. Reg. section 1.150-2(j)(2)(i), an official intent is treated as satisfying the official intent requirements under sections 1.150-2(d)(1) and (e) if the official intent was:

- Declared prior to July 1, 1993, and satisfied the applicable provisions of withdrawn Treas. Reg. section 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 Treas. Reg. section 1.103-18 as in effect during that period.

Under Treas. Reg. section 1.150-2(j)(2)(ii), the requirements under withdrawn Treas. Reg. section 1.103-8(a)(5) may be applied in lieu of the requirements under section 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 section 1.103-8(a)(5).

Section 2

Prior Rules Under Section 1.103-18-

Overview

Effective Dates This section discusses the rules under withdrawn Treas. Reg. section 1.103-18 which apply to reimbursement bonds issued before June 30, 1993, but after March 2, 1992.

General Rules Treas. Reg. section 1.103-18(c) provides 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 Treas. Reg. section 1.150-2 (discussed in Section 1 of this module).

Under section 1.103-18(c)(2), a reimbursement allocation is treated as an expenditure of proceeds of the reimbursement bond on the date of the reimbursement allocation if 3 requirements are satisfied:

- The issuer adopts a **reasonable official intent** to reimburse the expenditures with proceeds of an issue on or before the date the expenditure is paid;
- The reimbursement allocation occurs within a **reimbursement period** ending not later than 1 year after the later of the date on which the expenditure is paid OR the date on which the property is placed in service; AND
- The expenditure to be reimbursed is a **capital expenditure** or the costs of issuing the reimbursement bond (See also Treas. Reg. section 1.103-18(h)).

Treas. Reg. section 1.103-18(d) provides that, with respect to reimbursement allocations for exempt facility bonds and qualified small issue bonds, the allocation is valid if the requirements under withdrawn Treas. Reg. section 1.103-8(a)(5) are satisfied and the anti-abuse rules under section 1.103-18(k) are not violated. The requirements under section 1.103-8(a)(5) are discussed in Section 3 of this module.

Definitions Treas. Reg. section 1.103-18(e) provides definitions for the terms “reimbursement bond” and “reimbursement allocation.”

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Overview, Continued

Declaration of Official Intent

Treas. Reg. section 1.103-18(f)(1) provides that, procedurally, an issuer may declare an intention to reimburse an expenditure if 4 requirements are satisfied:

- The issuer (or any person or entity designated by the issuer to declare official intent on behalf of the issuer) states that it reasonably expects to reimburse the expenditure with proceeds of debt to be incurred by the issuer;
- The statement of official intent specifically states that it is a declaration of official intent under this regulation section;
- The statement provides a general description of the project and the maximum anticipated debt as required under section 1.103-18(f)(2);
AND
- The written instrument evidencing official intent satisfies the public availability requirements under section 1.103-18(f)(3).

The requirements under Treas. Reg. section 1.103-18(f)(2) relating to the general functional description of the project and the maximum principal amount of reimbursement bonds expected to be issued is similar to the current rules under Treas. Reg. section 1.150-2(e)(2).

Under Treas. Reg. section 1.103-18(f)(3), the written instrument evidencing the issuer's declaration of official intent must be reasonably available for public inspection within a reasonable period of time after the declaration. Safe harbors for this requirement are provided if the issuer either:

- Makes the declaration available for public inspection at its main administrative office or other customary record-keeping location during the period beginning on the date 30 days after the declaration and ending on the issue date of the reimbursement bonds; OR
- Complies with applicable State or local sunshine laws governing public availability of records of official acts of the issuer.

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Overview, Continued

Reasonableness of Official Intent

Treas. Reg. section 1.103-18(g)(1) provides that a declaration of official intent to reimburse an expenditure is reasonable ONLY if, as of the date of the declaration:

- It is consistent with the budgetary and financial circumstances of the issuer; AND
- The issuer reasonably expects to reimburse the expenditure with proceeds of an issue.

Sections 1.103-18(g)(2) and (3) provide guidance on these 2 elements of reasonableness, including factors that are to be considered in the determination, which has similarities to the reasonableness standards of Treas. Reg. section 1.150-2(e)(3).

Exceptions to the General Rules

Treas. Reg. section 1.103-18(i) provides 3 exceptions to the general rules for reimbursement allocations under section 1.103-18.

Paragraph (1) of the section permits an issuer to timely declare an official intent within 45 days after the original expenditure is paid if the expenditure was not reasonably foreseeable at least 30 days prior to payment.

Paragraph (2) of the section provides that the official intent requirement does not apply to certain preliminary expenditures. This exception is similar to that found in Treas. Reg. section 1.150-2(f)(2).

Paragraph (3) of the section provides a safe harbor for satisfying the reimbursement period requirement for expenditures paid with respect to projects abandoned prior to completion.

Anti-Abuse Rules

Treas. Reg. section 1.103-18(k) provides 3 anti-abuse rules for reimbursement allocations as well as examples illustrating these rules.

Transitional Rules

Under Treas. Reg. section 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.

Section 3

Prior Rules Under Section 1.103-8(a)(5)

Overview

Effective Date This section discusses the rules under withdrawn Treas. Reg. section 1.103-8(a)(5) which apply to reimbursement bonds issued before March 2, 1992.

Introduction The regulatory regime found in withdrawn Treas. Reg. section 1.103-8(a)(5) is of a significantly different characteristic than the subsequent reimbursement allocation regimes discussed in sections 1 and 2 of this module. Namely, section 1.103-8(a)(5) is fundamentally a qualifying rule where an improper reimbursement allocation results in the entire bond issue being nonqualified. In comparison, the result of an improper reimbursement allocation under sections 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.

The significance of this distinction is that, if applicable, noncompliance with the provisions of section 1.103-8(a)(5) automatically results in the issue losing its tax-exempt status.

Generally, the rule to be applied under section 1.103-8(a)(5) is dependent upon whether the original use of the facility occurs before, on, or after the date of issue of the bonds. For existing facilities acquired by the user, original use begins on the acquisition date.
