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Notes from the Editor (on “Arbitrage Rebate”)

This issue of The Bond Lawyer contains particularly meaty discussions of federal tax law developments (final arbitrage regulations and new management contract rules, ably discussed in Mike Bailey’s Tax Microphone) and the first (and possibly last) tranche of issuer settlements under the SEC’s MCDC Initiative (examined with customary insight in Paul Maco’s Federal Securities Laws). Don’t be discouraged by my intervening musings, and skip ahead, if necessary, to be sure you read Mike’s and Paul’s pieces.

My own Notes this issue focus on uses of the words “arbitrage” and, more specifically, “arbitrage rebate.”

(You may remember that my quarterly Notes are inspired by William Safire, the late New York Times columnist and author of its weekly column, “On Language.” As a former speechwriter for Richard Nixon and confirmed conservative, Safire would have enjoyed this issue’s Notes, probably not for the style in which they are conveyed, but for their conclusion, for reasons that should soon become apparent.)

In deference to principles of federalism and comity, Congress has generally declined to tax interest received on obligations issued by or on behalf of state or local government. Nevertheless, Congress in its wisdom denied the exemption to any “arbitrage bond.” IRC §103(b)(2). An obligation is an “arbitrage” bond if proceeds of the issue of which it is a part are reasonably expected to be invested in or to replace higher yielding investments, except for a reasonable temporary period or as part of a reasonably required reserve fund or minor portion, or the issuer fails to make periodic payments to the US of any excess earnings from higher yielding nonpurpose investments. IRC § 148.

(I’m sure there is no truth, by the way, to the supposition that Congress enacted this requirement to boost revenue from its tax on alcoholic beverages. That might be a likely result if issuer officials computed and filed their own Forms 8038-T, but these are regularly outsourced to arbitrage rebate firms. An issuer filling out its own Form 8038-T would be like a self-administered mugging.)

The regulations refer to excess earnings from the investment of bond proceeds as “arbitrage” and to the required periodic payment of the excess to the US government as “rebate.” Treas. Reg. § 1.103-148-3(a). Are these proper uses of the words?

Webster’s Third New International Dictionary defines “arbitrage” as the “simultaneous purchase and sale of the same or equivalent security, commodity contract, insurance, or foreign exchange on the same or different markets in order to profit from price discrepancies.” According to Webster’s, the word is derived from the Middle English and Middle and Old French word “arbitrer,” meaning to render judgment, originally derived from the Latin word “arbitrari” (“think”) by adding “age” to the end. (In other words, the product of thought, which ordinarily is encouraged.) The Random House Dictionary of the English Language, 2nd ed. (unabridged), defines “arbitrage” in substantially the same way: “Finance: the simultaneous purchase and sale of the same securities, commodities, or foreign exchange in different markets to profit from unequal prices.”

Are rebatable excess earnings the product of “arbitrage”? They could be. If a very creditworthy state issuer were to issue $100 million of 5% bonds, set aside $15 million of proceeds for a project, immediately invest the remaining $85 million in 6% US treasury obligations of like duration, and use the interest earnings to pay all the interest expense on the bonds, it would have engaged in arbitrage within the common meaning of the term. It would have bought equivalent debt securities in one market (the taxable government securities market) and simultaneously sold substantially similar obligations in another market (the tax-exempt municipal bond market) to earn a profit. (I’m told that a substantially similar stadium financing proposal by a certain Western US city led to enactment of the original arbitrage restrictions. The story may be apocryphal, but if any of you old-timers can confirm or debunk the story, I would be very interested in knowing.)
But, of course, the arbitrage restrictions, and rebate requirements, reach many other investment transactions. For example, if a state issues long-term, fixed-rate bonds and a year later invests unspent proceeds in corporate commercial paper, any resulting excess earnings would be subject to the arbitrage rebate requirements, even though the transaction could not legitimately be described as “arbitrage” in common usage. It could not be described as “arbitrage” because the bonds and investments are dissimilar (long-term, fixed-rate governmental obligations vs. short-term corporate obligations), and the issuer’s purchase and sale are not even close to being simultaneous. In fact, except possibly when an issuer invests bond proceeds in laddered US treasury obligations at the time of issue, investment transactions that are subject to the arbitrage rebate requirement cannot be fairly described as “arbitrage,” consistent with common usage of that word.

Well, what about “rebate”? Does “arbitrage rebate” at least involve a fair use of the word “rebate”?

*Webster’s* defines rebate as follows: “a: a return of a portion of interest on a loan for a payment of the loan before its due date  b: a retroactive abatement, credit, discount, or refund (as from a wholesaler to a retailer) usu. as consideration for a specified volume of business.” Similarly, *Random House* defines “rebate” as “a return of part of the original payment for some service or merchandise; partial refund.” Finally, *Black’s Law Dictionary*, 10th ed., defines rebate as “1. A return of part of a payment, serving as a discount or reduction. 2. An amount of money that is paid back when someone has overpaid.”

May the required payment of “arbitrage” profits to the US government be fairly characterized as “rebate”? Well, the immediate problem with that use of the word is obvious: In order to have a “return” or “refund” or “pay-back” of funds to the US government, the funds must start there. Only when bond proceeds are invested in US treasury obligations is that the case, and even then the “arbitrage” profits would not have been paid by the US government if they resulted from a gain on sale of the treasury obligations to a civilian, rather than from an interest payment. (This reminds me of the pundits’ question, “Why do we call them ‘tax returns’ when so little of it does?”)

If not “arbitrage” and “rebate,” what could the transactions and payments have been named? “Excess profits” and “excess profits tax” would be candidates, but they conjure up memories of wartime excess profits taxes and an unsuccessful effort to impose an excess profits tax on oil companies in the early 1990s. In addition, the required payment of excess earnings is not a tax, since it is merely a condition of tax exemption, rather than a mandatory imposition. As a substitute for “arbitrage,” Congress might have referred to excess earnings as “godsend,” since they are often dependent on the vicissitudes of the debt market. (If arbitrage bonds had been called “godsend bonds,” would the IRS have encountered First Amendment problems in requiring “rebate” payments?) As a substitute for “rebate,” Congress might have chosen “tribute,” meaning “payment made periodically by one state or ruler to another, especially as a sign of dependence,” or “expropriation,” defined as “the act of a government in taking privately owned property, ostensibly to be used for purposes designed to benefit the overall public,” each according to that scholarly publication, *Investopedia*. Congress failed to do so for reasons that are perhaps too obvious.

So how did transactions that are not examples of arbitrage come to be described as “arbitrage,” and how did required payment of excess earnings come to be named “rebate”? Did Congress or the Treasury Department use a focus group to find words that make the Code provision more sympathetic? Expropriating profits that result from true arbitrage between taxable and tax-exempt markets is an understandably sympathetic exercise of Congressional authority. Expropriating profits is considerably less sympathetic if the profits result from rises in interest rates after bonds are issued, or from investments in obligations with more risk, rather than from arbitrage, especially when interest rates could just as easily have fallen with no resulting federal subsidy or hedge payment. We may never know how these terms came to be used. (If you do know, I’m sure we would all be interested in finding out through a letter to the editor in the next issue of *The Bond Lawyer*.)

We do know, though, that Congress is adept at assigning names to (and in) legislation that are intended to put it in its best light. See, e.g., from the 2013 session, Ammunition Management for More Obtainability Act of 2013 (AMMO), Congressional Hope for Uniform Recognition of Christian Heritage (CHURCH) Act of 2013, Formerly Owned Resources for Veterans to Express Thanks for Service Act of 2013 (FORVETS), Focused Reduction of Effluence and Stormwater Runoff Through Hydrofracking Environmental Regulation Act of 2013 (FRESH), Immigration and Naturalization Investment Ven-
tures for Engineering, Science, and Technology in America Act of 2013 (INVEST), Opportunity Kindling New Options for Career and Knowledge Seekers Act (Opportunity KNOCKS), Sequestration Tied to Member Pay (STOMP) Act of 2013, Strengthen and Unite Communities with Civics Education and English Development Act of 2013 (SUCCESS), and Support More Assets, Resources, and Technology on the Border Act of 2013 (SMART Borders Act). With this track record, should we be surprised?

If there are other words that you would like to see explored in future editions, please let me know. More importantly, if you would like (or at least be willing) to submit an article for publication in *The Bond Lawyer* and compete for the Carlson Prize, please contact me. In other words, if you have read this far, click here: fredric.weber@nortonrosefulbright.com.

*September 2016*
On August 24, 2016, the SEC announced that 71 issuers and obligated persons (“Respondent Issuers”) entered into settlement orders (the “Orders”) with the SEC for violations of federal securities laws in municipal bond offerings under the Municipalities Continuing Disclosure Cooperation (“MCDC”) Initiative.1 In accord with the terms of the MCDC Initiative, the Respondent Issuers settled without admitting or denying the findings and agreed to cease and desist from future violations, and no fines or civil penalties were assessed. Also consistent with the MCDC terms, each of the Respondent Issuers agreed to establish appropriate written policies, procedures, and training regarding continuing disclosure obligations as well as comply with their existing continuing disclosure undertakings, including updating past delinquent filings within 180 days; disclose the settlement in future offering documents for the next five years; certify in writing compliance with the undertakings; and cooperate with any subsequent investigations by the SEC. Together with the first Issuer settlement under the MCDC Initiative, In the Matter of Kings Canyon Unified School District,2 MCDC issuer settlements total 72, the same number of settlements reached under the program with underwriters (the “Underwriter Settlements”).3

Respondent Issuer Orders

The named Respondent Issuers are geographically diverse, with at least one party in each of 45 states. Out of the 50 states, only Arizona, Florida, Nevada, Oregon, and Rhode Island do not have a state or local entity or obligated person included among the respondents. The Orders do not include issuers or obligated persons from the District of Columbia, U.S. Virgin Islands, Puerto Rico, or Guam. Together with the States of Hawaii and Minnesota as well as several state transportation and housing authorities and a state university boards of trustees, the Respondent Issuers cover the spectrum of local government issuers in the United States. They include cities, counties, boroughs, townships, towns, park districts, school districts, parish school districts, sanitary districts, fire protection districts, city electric and water boards, boards of education, joint action power agencies, and airport authorities, as well as obligated persons, including hospitals, universities, health care systems, charter schools, and solid waste and recycling companies.

Violations identified in the Orders include findings that:

The Respondent’s official statements stated that the Respondent “has not failed to comply in any material respect with any of its previous continuing disclosure certificates … was false and/or misleading because although Respondent filed selected portions of the required fiscal year 2009 and 2010 annual financial information for these years, neither audited nor unaudited financial statements were included in these filings;”

“Respondent made a materially misleading statement and a material omission about its prior compliance with its earlier continuing disclosure agreement” in stating it “had filed some annual reports late, but failed to disclose that Respondent had not filed the annual financial statements that it had agreed to provide” for prior years and “misrepresented that these financial statements were contained in official statements that had been disseminated earlier,” and in a 2012 “final official statement [which] made no statement about compliance with Respondent’s prior continuing disclosure agreement and thereby failed to disclose that Respondent had not filed the annual financial statement that it had agreed to provide for fiscal year 2010 by the time of the offering, though due before.”

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5 https://www.sec.gov/litigation/admin/2016/33-10166.pdf

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“Respondent made materially false and misleading statements about its prior compliance with its earlier continuing disclosure agreements,” in two competitive offerings in 2013 in which the final official statements each read, in relevant part: “[t]he [Respondent] has complied in all material respects with its previous [undertakings] under [Rule 15c2-12]” when “Respondent filed its audited financial statements for fiscal years 2007 and 2008 late by approximately four months and five months, respectively” and “failed to provide within EMMA cross-references to its previously filed audited financial statements for fiscal years 2009 and 2011 and its annual financial information and operating data for fiscal years 2008 through 2011,”6 and

“Respondent made a materially false statement about its prior compliance” in stating it “has never failed to comply in all material respects with any previous undertakings with the provision of reports or notices or events” when Respondent “failed to file certain notices of defeasances prior to the offering, though due before, resulting in bonds … trading with significantly different credit structures for up to two years.”7

One Respondent, in addition to prior undisclosed late filings, was cited for failing to disclose the late filing, by 245 days, of its 2010 audited financial reports, “although [they had been] timely filed in the wrong location.”8 Notably, although Rule 15c2-12 does not require continuing disclosure undertakings to provide for quarterly financial reporting, one obligated person was cited for its silence on disclosure compliance and the resulting failure “to disclose that Respondent failed to file interim financial information for the second quarter of fiscal 2011, and operating data for fiscal 2010 and the second quarter of fiscal 2011” as well as “failure to file the required late notices for these events.”9 All violations among the 71 Orders relating to filing required annual financial information were accompanied by violations for failure to file the related failure to file notices or, in several instances, the late filing of such notices, once again emphasizing the importance of disclosing a failure to timely file such a notice in addition to the late filing of annual financial information itself.

At least two Orders found violations in private offerings (presumably exempt from Rule 15c2-12), where the Respondent Issuer entered into a continuing disclosure agreement to market the securities, but failed to disclose that it had materially breached a similar agreement in the last 5 years.10

Several of the Orders were based on undisclosed failures to link a timely filed Official Statement or annual financial information to the CUSIP for each outstanding security that benefited from an existing CDA,11 and others were based on failure to include some required content in the annual financial information,12 each of which may inform the diligence procedures that should be applied by underwriters, although the Orders are not addressed to them.

At least one Order found a violation for failing to disclose a late filing five years before the offering, even though late filings in the subsequent three years were disclosed, suggesting that a breach is “material” if it would have significance to an investor in the outstanding securities benefiting from the breached CDA, not (or not only) the investors to whom the new securities are offered.13

Many of the Respondent Issuer Orders listed violations in competitively bid offerings. Among the Underwriter Settlements, with respect to competitive offerings, in all orders save one, failures to disclose occurred in instances where the underwriter participated in a prior negotiated offering or in multiple competitive offerings of the same issuer, a rough dichotomy consistent with the Commission’s Interpretation of Municipal Underwriter Responsibilities.14 The guidance therein,

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14 See the Winter 2016 installment of this column at https://www.nabl.org/Portals/0/Newsroom/The_Bond_Lawyer_Winter_2016.pdf
relating to an underwriter's formation of a reasonable basis for belief, does not carry over to issuers' responsibilities for their offering documents, since as the entity charged with making filings with EMMA and the NRMSIRs, the Respondent Issuers would have known whether they had complied with their filing obligations.

The 71 Orders use different phrasing compared to the findings from the first issuer order under MCDC, Kings Canyon. In Kings Canyon, the Order finds: “The statement regarding compliance with prior continuing disclosure obligations contained in the “Continuing Disclosure” section of the Official Statement for the 2010 Offering was an untrue statement of a material fact. The Issuer should have known that this statement was untrue (emphasis added).” In the 71 subsequent Orders, the finding is modified to “knew or should have known,” in various formulations, as the following examples illustrate:

“Respondent knew or should have known that its failure to make any statement regarding its prior material noncompliance was an omission to state a material fact necessary in order to make the statements made about its continuing disclosure obligations, in light of the circumstances under which they were made, not misleading.”


Not too much should be made of this variation, however, as the “knew or should have known” formulation is embedded in §8A of the Securities Act of 1933 (the “Securities Act”), pursuant to which the Orders are issued and amounts to a negligence standard.

Contrast with Underwriter Settlements

Consistent with the MCDC Initiative, the terms of settlement were less onerous on the Respondent Issuers than on settling Underwriters. Each of the Respondent Issuers consented to the entry of its respective Order and, as noted above, agreed to, within 180 days, establish appropriate written policies, procedures, and training regarding continuing disclosure obligations; comply with existing continuing disclosure undertakings within 180 days, including updating past delinquent filings; disclose the settlement in future offering documents for the next five years; certify in writing compliance with the undertakings; and cooperate with any subsequent investigations by the SEC.

SEC. 8A. (a) AUTHORITY OF THE COMMISSION.—If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this title, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Emphasis added.

Statutory language “knew or should have known” sets a negligence standard. KPMG, LLP v. SEC, 289 F.3d 109, 120 (D.C. Cir. 2002).
For the Respondent Issuers, the Orders were issued pursuant to Section 8A of the Securities Act only, unlike in the Underwriter Settlements, the orders for which were also issued pursuant to Section 15(b) of the Securities Exchange Act of 1934 (the “Exchange Act”). With respect to the Respondent Issuers, proceeding under Section 8A alone made sense, since unlike the underwriters, they are not registered under the Exchange Act. For underwriters, however, it is a reminder that the Commission could have achieved the same result without use of the “willful” violation finding included in each of the 72 underwriter orders under the MCDC Initiative that, in turn, made each firm subject to “statutory disqualification.”22 The Commission did not choose this narrower path, although it has taken it before in settlements with securities firms, imposing cease and desist orders and sanctions solely under Section 8A of the Securities Act for violations of Securities Act sections 17(a)(2) and (3).23 What followed for underwriters is worth understanding.

Because the Commission chose to include “willful” violations in their orders, underwriters had to file a Membership Continuance Application (Form MC-400A) with FINRA within ten business days after receipt of a SD Notification Letter from FINRA’s Registration & Disclosure Department (which was issued after FINRA received the underwriter’s Order from the SEC) to initiate an eligibility proceeding if it wished to continue in FINRA membership or, more bluntly, stay in business. Form MC-400A requires firms to answer designated questions, provide a copy of the SEC’s order as well as a statement explaining why it should be permitted to continue in membership notwithstanding a statutory disqualification. If FINRA determines that approval of the application is warranted, FINRA is required to provide the SEC with notice of the approval of the firm’s application for continued membership. Should FINRA deny the application, FINRA is required to file a notice with the SEC of such denial. These details (and more) were helpfully provided by the FINRA staff in Frequently Asked Questions on FINRA’s Eligibility Proceedings for Firms Participating in the MCDC Initiative.24

It is worth pausing for a moment to look back and reflect upon the fact that, while extremely unlikely, this process did present the remote possibility that with a sufficient number of missteps along the way, firms constituting up to “96% of the municipal market share for municipal underwritings”25 might have become unable to continue membership in FINRA, that is, carry on their business. FINRA and its staff went to great effort in outreach, industry conference calls, and helpful instructive steps (of which the FAQs are only one), to assure this did not happen. SEC staff in the Division of Corporation Finance did the same with respect to the waivers that accompanied the underwriter orders.

Under the terms of the MCDC Initiative, Respondent Issuers are required establish appropriate written policies, procedures, and training regarding continuing disclosure obligations within 180 days, but unlike underwriters, do not need to hire independent consultants deemed “not unacceptable” to the SEC staff to conduct a review of their policies and procedures and adopt, with limited exceptions, the recommendations within 90 days. Nor did the Respondent Issuers pay any penalty, unlike underwriters, who paid civil penalties up to $500,000.

What Else is Ahead?

As of this writing, under the MCDC Initiative, the Commission has issued 72 orders with respect to issuers and obligated persons and 72 orders with respect to underwriters. In the case of underwriters, the Commission stated the underwriters covered “comprise 96 percent of the market share for municipal underwritings.”26 In the case of issuers and obligated persons, the Commission’s orders cover at least one issuer or obligated person in each of 45 states and include in the mix, states, state authorities, most forms of local government entities in the US and a good sampling of obligated persons. In the Orders, the Commission did not limit itself to description of a maximum of three examples of violations. Rather the Orders include as many as seven, together with clear descriptions of the vio-

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22 See Section 15(b)(4)(D) of the Exchange Act, incorporated by reference in 3(a)(39)(F) of the Exchange Act. Article III, Section 3(a) of FINRA’s By-Laws states that no firm can continue in membership with FINRA if it is subject to a statutory disqualification.
24 Available at: http://www.finra.org/industry/faq-eligibility-mcdc
lative statements or omissions. The Orders, combined with the Underwriter Settlements, seem to cover the municipal landscape and provide particularized guidance in a great variety of fact patterns.

There may be future settlements with issuers or obligated persons underway, but with all that the Commission has accomplished, it is fair to question whether there is any point to pursuing additional settlements under the MCDC Initiative. While some may hold a different view, the Commission has never pursued every potential violation with Javert-like intensity. It simply doesn't have the resources to do so in a market of 50,000-plus issuers and obligated persons, without acting to the detriment of other markets, as well as other segments of the municipal market. The Commission may also determine that, with regard to this particular topic, a better use of its resources would be to focus on issuers and obligated persons who did not self-report but were reported by underwriters, or individuals identified in patterns of potential misconduct. It may also conclude that it has gathered sufficient data to move from enforcement to support additional regulation or pursue legislation relating to continuing disclosure. We can only wait and see.

September 2016
Federal Tax Law: The Tax Microphone
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It’s been a busy quarter for tax-exempt bond officials at the Treasury Department and the IRS. Two major guidance projects have been published: Rev. Rul. 2016-44, which sets forth new safe harbors for management contracts, and new final regulations (which mostly concern arbitrage rules, but also include provisions concerning other rules). My view is that Treasury Department and IRS officials should be praised for these significant achievements and their hard work in completing these important projects.

New Management Contract Safe Harbors for Property Financed with Tax-Exempt Bonds

On August 22, 2016, the IRS released Rev. Proc. 2016-44, which provides new guidance on the treatment of management contracts for purposes of the restrictions on use of property financed with tax-exempt bonds. This published guidance provides for new safe harbors under which the IRS will not treat management contracts as giving rise to private business use.

The new guidance applies to tax-exempt bonds that are governmental bonds issued for the benefit of state and local governments and to qualified 501(c)(3) bonds issued for the benefit of section 501(c)(3) organizations. This guidance also applies to certain qualified tax credit bonds, such as Build America Bonds, that are subject to the same private business use rules. Although the guidance nominally refers to management contracts, it applies to most types of service contracts. The new guidance is a significant development for those types of bond issues.

Highlights

• The new guidance establishes new safe harbors that are in some ways much more liberal and flexible than the Rev. Proc. 97-13 safe harbors, but in other respects stricter.

• The new safe harbors reflect a reconceived framework and will replace the Rev. Proc. 97-13 safe harbors. Issuers and borrowers generally may continue to rely on the Rev. Proc. 97-13 safe harbors (including Notice 2014-67) for management contracts entered into before August 18, 2017, and certain extensions of those contracts pursuant to their term.

• The new safe harbors permit almost any type of variable or fixed compensation and abandon the Rev. Proc. 97-13 framework, which generally focused on term and fixed fee compensation and certain types of identified variable compensation.

• The new safe harbors accordingly rely more heavily on the rule that “net profits arrangements” are not permitted under the safe harbors, because there is otherwise more flexibility in compensation arrangements.

• The new guidance permits management contracts having a term up to 30 years, but retain a rule limiting the term to no more than 80 percent of the weighted economic life of the managed property.

• The new guidance establishes new safe harbor requirements relating to control of the managed property, bearing of net losses, risk of loss and consistency of tax positions.

• In general, the new safe harbors are more “principles-based,” and provide fewer bright lines, than the Rev. Proc. 97-13 safe harbors. Accordingly, more interpretive questions may arise than under the Rev. Proc. 97-13 safe harbors, particularly with respect to the new requirements. Also, issuers, borrowers and counsel may need to more frequently address whether a management contract may be treated as not resulting in private business use, where the contract does not meet all of the safe harbor requirements.
• Many management contracts that have been customarily treated as within the Rev. Proc. 97-13 safe harbors may not exactly meet the new safe harbors.

• In general, the new safe harbors may be particularly helpful for certain long-term management contracts for infrastructure. Certain shorter-term management contracts in particular, however, will be subject to new standards that may involve compliance burdens. The IRS appears to have already acknowledged these new compliance burdens by extending the transition period.

• Many issuers and borrowers may need to consider implementing new practices to review management contracts relating to tax-exempt bond financed property that are entered into, materially modified or in certain cases renewed after August 17, 2017.

**Description of the New Safe Harbors**

“Safe Harbor” Guidance. The new guidance provides for revised safe harbors in the form of a new revenue procedure. It does not change the substantive rules in the IRS regulations for when a management contract gives rise to private business use. Again, for this purpose a management contract refers to almost any kind of service contract. Accordingly, the new guidance would not properly be used adversely against issuers and borrowers by the IRS in examinations, but rather sets forth standards that are intended to provide a basis for conservative tax positions of issuers, borrowers and bond counsel. It remains to be seen, however, how IRS agents will actually apply the new safe harbors.

Immediate Permissive Application. The new guidance may be applied immediately to new or existing management contracts.

Relationship to IRS Rev. Proc. 97-13, as amended. The new guidance supersedes Rev. Proc. 97-13, including the portions of Notice 2014-67 that amend Rev. Proc. 97-13. Issuers and borrowers may continue to rely on Rev. Proc. 97-13, as amended, with respect to a management contract that is entered into before August 18, 2017, unless it is materially modified or in certain cases extended on or after that date. An additional effective date rule also grandfathers extensions of a management contract entered into before August 18, 2017, if the extension is pursuant to a “renewal option” provided in the contract. A renewal option is defined as a provision under which either party has a legally enforceable right to renew the contract. Accordingly, during a long transition period, an important consideration in reviewing certain management contract extensions may be whether the extension is pursuant to the terms of the contract.


The new guidance states that it is in response to public comments requesting more flexible safe harbors for management contracts having a term greater than five years. It states that it builds upon the amplifications in IRS Notice 2014-67 that provide for flexible safe harbors for contracts having a term up to five years.

Notably, however, the new guidance reframes and in many respects reconceives the safe harbors for management contracts. Although the new guidance responds to industry calls for more flexible safe harbors, one important question raised is whether certain management contracts that currently qualify for safe harbor treatment will no longer so qualify, as is discussed further below. The NABL public comments to the IRS requested additional safe harbors, not new safe harbors that displaced the existing ones; the IRS and Treasury Department did not adopt that approach.

Some in the profession have indicated that they were “dancing in their offices” when the new revenue procedure was released, because it is in some respects much more liberal and flexible than the prior safe harbors set forth in the amended Rev. Proc. 97-13. It is becoming increasingly evident, however, that the new safe harbors are not in all instances more favorable. The IRS and Treasury Department appear to have acknowledged that new problems may arise by extending the
transition period to August 18, 2017 (rather than the February 18, 2017 date set forth in the original release).

**Safe Harbor Framework Restated.** The new guidance states that it provides for a “more flexible and less formulaic approach toward variable compensation for longer-term management contracts” and “applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider.”

The new guidance provides a general safe harbor and another safe harbor for “eligible expense reimbursement arrangements.” The references in this description to the “new safe harbor” refer to the new general safe harbor when context requires.

**Term up to 30 Years Permitted.** If a management contract meets the other requirements for the new safe harbor, the term of the contract may have a term that is no greater than the lesser of 30 years or 80% of the “weighted average reasonably expected economic life of the managed property.” By comparison, existing Rev. Proc. 97-13 (as modified) establishes separate safe harbors for management contracts with terms not exceeding 5 years, 10 years, 15 years, and, in some cases, 20 years. The new safe harbor applies the 80% limit to contracts with any term, although Rev. Proc. 97-13 does not apply the 80% limit to contracts having a term not exceeding five years.

The Rev. Proc. 97-13 safe harbors also generally limit the term of longer-term contracts to not more than 80% of the useful life of the “financed property.” The reference to the “managed property” rather than the “financed property” possibly signals a helpful clarification, because the new safe harbor possibly can be read as focusing on the economic life of the property that is managed, and not the assets that are financed by a particular bond issue. Additional questions may be raised by new provisions that describe in more detail how and when the 80% limit is applied and identify the managed property that is tested under the rule.

**Variable and Fixed Compensation Permitted.** If a management contract meets the other requirements of the new safe harbor, almost any type of variable or fixed compensation is permitted. The Rev. Proc. 97-13 safe harbors for longer-term contracts are based on the extent to which compensation is fixed and for shorter-term contracts identify specific types of variable compensation. That framework, focusing on fixed fees and certain identified types of variable compensation, will no longer apply under Rev. Proc. 2016-44.

**No “Net Profits Arrangements.”** The new guidance relies more heavily on the rule in the IRS regulations that states that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation based, in whole or in part, on a share of net profits from the operation of the facility.

The new guidance provides an additional gloss on this continuing standard, which may or may not be helpful to issuers and borrowers.

The new guidance states that compensation to the service provider will not be treated as providing a share of net profits if “no element of the compensation takes into account, or is contingent upon, either the managed property’s net profits or both the managed property’s revenues or expenses for any fiscal period.” For this purpose, the elements of compensation are “the eligibility for, the amount of, and the timing of the payment of the compensation.”

In general, this appears to be a somewhat strict interpretation of the no-net-profits standard. Because a contract will not qualify for the safe harbor if the “eligibility for” or “timing of” a payment is based on a net profits standard, it appears that any trigger for a payment based on net profits will not qualify. By comparison, in a recently released private letter ruling (PLR 201622003), the IRS concluded that a hotel management contract did not give rise to private business use even though the contract provided for additional compensation triggered by a benchmark that was “a variant of net profits.” In that case, the IRS permitted favorable treatment of the contract, in part because the amount of the payment was not based on net profits.
Such a private letter ruling only applies to the specific issuer that requested it, and it is unclear whether its favorable conclusion would apply in view of the reframed standards of Rev. Proc. 2016-44. IRS officials have informally indicated, however, that there was no intent to reverse the result in PLR 201622003. The new rule concerning the “timing” of compensation could also raise issues for certain arrangements in which payment of compensation is subordinated.

The new guidance also states that “incentive compensation will not be treated as providing a share of net profits if the eligibility for incentive compensation is determined by the service provider’s performance in meeting one or more standards that measure quality of services, performance or productivity,” but only if the amount and timing of the payment meets the requirements set forth above.

In general, this reframed net profits standard will be one of the most important considerations in reviewing management contracts for private business use compliance. One important point, however, is it appears that the somewhat strict interpretation of the no-net-profits rule in the new guidance applies only for the purposes of the safe harbor, and is not necessarily an interpretation of the substantive rule in the IRS regulations for when a management contract necessarily results in private business use.

**No Bearing of Net Losses of the Managed Property.** The new guidance provides that a management contract will not meet the safe harbor if it, in substance, imposes on the service provider “the burden of bearing any share of net losses from the operation of the managed property.” For this purpose, an arrangement will not be treated as requiring the service provider to bear a share of net losses if: (1) the determination of the amount of the service provider’s compensation and the amount of any expenses paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property’s net losses or both the managed property’s revenues and expenses for any fiscal period; and (2) the timing of the payment of compensation is not contingent upon the managed property’s net losses.

The new guidance helpfully provides that, as an example, a service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property’s expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of this reduction.

This new requirement is not set forth in Rev. Proc. 97-13. It is framed in a manner similar to the provision concerning net profits arrangements.

**Control Over Use of the Managed Property.** Perhaps the core provision of the new guidance is a requirement that the qualified user “must exercise a significant degree of control over use of the managed property.” This new requirement is not set forth in the current Rev. Proc. 97-13, although certain provisions relating to control were set forth in prior management contract safe harbors.

The “qualified user” is the term used in the safe harbors for the State or local government or 501(c)(3) organization that uses the bond-financed property. The qualified user is usually the issuer or the borrower, and may include other users, such as affiliates.

The new guidance states that this control requirement is met if “the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and general nature and type of use of the managed property (for example, the type of services).” It is unclear whether the “significant degree of control” requirement may be established in other ways. For example, it is unclear whether a contract including most of this list of control rights, but not all, may still meet the safe harbor.

The new guidance provides some clarification of what is meant by certain of the listed control rights. As an example, a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital
expenditures described by functional purpose and specific amounts, and may show approval of dispositions of property in a similar manner. Further, a qualified user may show approval of rates charged for use by either expressly approving such rates (or the methodology for setting such rates) or by including in the contract a requirement that the service provider “charge rates that are reasonable and customary as specifically determined by an independent third party.”

These new control rights requirements, and in particular the requirement that the qualified user control rates, may raise many questions and require a change in practices for management contracts entered into, materially modified or in certain cases extended after February 17, 2017. For example, in the case of physician contracts for hospitals financed with tax-exempt bonds, many existing “separate billing” arrangements that have been treated as within the Rev. Proc. 97-13 safe harbors may not be within the new safe harbors, unless the contracts are reframed to reflect these new requirements.

**Risk of Loss of the Managed Property.** In order to meet the new safe harbor, the qualified user must bear the risk of loss of the managed property (for example, upon force majeure). This is another new requirement. A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing on the service provider a penalty for failure to operate the managed property in accordance with standards set forth in the management contract.

**No Inconsistent Tax Position.** Another new requirement is that the service provider must agree “that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property.” As an example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property. It appears that this express agreement will need to be included in contracts under the new safe harbor.

This new requirement is another provision that will likely require a change from currently prevailing practices for management contracts entered into, materially modified or in certain cases extended after February 17, 2017. Many existing contracts that are treated as within the Rev. Proc. 97-13 safe harbors do not contain such an express agreement. Specific agreements regarding tax treatment of the type required by the new safe harbor as a matter of prevailing practice may have been included in long-term management contracts, but have been less common in shorter-term contracts because the tax treatment has been regarded as implicit.

**No Circumstances Substantially Limiting Exercise of Rights.** The new guidance continues the general requirement in Rev. Proc. 97-13 that the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user’s ability to exercise its rights under the contract.

Like Rev. Proc. 97-13, the new guidance contains a “safe harbor within a safe harbor” for establishing that the service provider has no such role or relationship. This safe harbor continues the general approach of Rev. Proc. 97-13, but is in some respects stricter. The new guidance requires as a safe harbor that (1) no more than 20% of the governing body of the qualified user is vested in persons having a role with the service provider, and (2) the governing body of the qualified user not include the chief executive officer of the service provider (or a person with equivalent management responsibilities) or the chairperson (or equivalent executive) of the service provider’s governing body. For the purpose of this safe harbor, “service provider” now expressly includes related parties to the service provider.

Because the specific requirements concerning overlapping board members continue to be framed as a “safe harbor within a safe harbor,” it appears that issuers and borrowers could reasonably meet the substantive requirement based on other factors.

**Functionally Related and Subordinate Use.** The new guidance contains a new helpful provision relating to “functionally related and subordinate use.” Under this new rule, a service provider’s use of a project that is functionally related and subordinate to performance of its services under a management contract does not result in private business...
use, if the contract meets all of the requirements of the new guidance. An example is use of storage areas to store equipment used to perform activities under a management contract.

**Eligible Expense Reimbursement Arrangements.** A separate safe harbor is established for “eligible expense reimbursement arrangements.” An “eligible expense reimbursement arrangement” is defined as a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider. An eligible expense reimbursement arrangement does not result in private business use, regardless of whether the other requirements of the new guidance are met.

This separate safe harbor is an expansion of an exception set forth in the IRS regulations from private business use that previously applied only to management contracts for public utility property.

**Contracts Properly Characterized as Leases.** The new guidance recites a rule in the IRS regulations that provides that a lease generally results in private business use, and that any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease (even if the arrangement is in form a management contract). The new guidance further recites a provision in the IRS regulations to the effect that, in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including (1) the degree of control over the property that is exercised by the service provider; and (2) whether the service provider bears the risk of loss of the financed property.

The new guidance does not otherwise expressly address the question of when a management contract is properly characterized as a lease. As a practical matter, however, it would appear that any management contract meeting the new safe harbor should not ordinarily be subject to characterization as a lease, because many of the new requirements (including requirements relating to control and risk of loss) are also factors relevant to determining whether an arrangement is in substance a lease.

**Anti-Abuse Rules.** The new guidance does not override any of the provisions of the IRS regulations. Accordingly, it is important to continue to interpret the new guidance in the context of the IRS regulations. In particular, the anti-abuse rules in the IRS regulations provide that, in certain circumstances, an arrangement that directly or indirectly passes through to private persons the financial benefit of tax-exempt interest rates may result in private business use, even if the arrangement would not otherwise result in private business use under the regulations. Rev. Proc. 2016-44 does not address or discuss this anti-abuse rule. One possible view is that the new guidance in effect also provides a safe harbor from application of the anti-abuse rule. This anti-abuse rule may continue, however, to be an important consideration in the consideration of certain management contracts.

**What happened to section 1301(e)?** Section 1301(e) of the Tax Reform Act of 1986 included a statutory directive regarding the treatment of management contracts under the private business use rules:

The Secretary of the Treasury or his delegate shall modify the Secretary’s advance ruling guidelines relating to when use of property pursuant to a management contract is not considered a trade or business use by a private person for purposes of Section 141(a) of the Internal Revenue Code of 1986 to provide that use pursuant to a management contract generally shall not be treated as trade or business use as long as—

1. the term of such contract (including renewal options) does not exceed 5 years,
2. the exempt owner has the option to cancel such contract at the end of any 3-year period,
3. the manager under the contract is not compensated (in whole or in part) on the basis of a share of net profits, and
4. at least 50 percent of the annual compensation of the manager under such contract is based on a periodic fixed fee.
This statutory provision had been central to the development of published guidance relating to the treatment of management contracts under the private business use rules. Indeed, it served as the primary touchstone for the development of the particular safe harbors set forth in Rev. Proc. 97-13. The framework of Rev. Proc. 97-13 safe harbors based on term of the contract and type of compensation arrangement was in large part grounded on this statutory directive, and the particular safe harbor rules were in large part extrapolations of the stated five-year safe harbor.

The legislative history to the Tax Reform Act also expressly stated that Section 1301(e) was not intended to otherwise limit the Treasury Department’s authority to determine what constitutes (or what does not constitute) a use of bond proceeds.

One question is whether, or the extent to which, the safe harbor described in Section 1301(e) continues to survive. It is, after all, a statutory provision, not just a safe harbor set forth in a revenue procedure. Arguably, Section 1301(e) has greater formal authority than Rev. Proc. 2016-44, particularly because a revenue procedure is not a formal regulation subject to notice and comment and is not an interpretation of the substantive standard in the same manner as a regulation. Is it still possible, then, to separately rely on Section 1301(e), and to reasonably extrapolate from that statutory safe harbor, or is Section 1301(e) a dead letter?

**How the Treasury Department and the IRS responded to public comments.** Last year, NABL submitted detailed public comments on Rev. Proc. 97-13 setting forth recommendations for new safe harbors for contracts having a term longer than five years. Those comments recommended that the existing safe harbors be retained, and that additional safe harbors be adopted for longer-term contracts. In general, those comments recommended that such additional safe harbors focus on factors that distinguish service contracts from leases and partnerships for federal tax purposes, including control and risk of loss.

Rev. Proc. 2016-44 is largely responsive to those public comments, but not to the extent that it completely supersedes the existing safe harbors of Rev. Proc. 97-13.

Simplification, but at what practical cost? Those of us who devote a large part of our lives to reading and interpreting arcane federal tax regulations and published guidance generally appreciate as much as anyone the need for simplification. The complexity of some of the rules in the tax-exempt bond area is sometimes mindboggling, and likely also sometimes unnecessary. In that light, we need to applaud efforts to simplify the rules. One possible justification for the entirely new framework for management contracts is that it is simpler than the Rev. Proc. 97-13 approach. Gone are special rules for contracts with different terms. Gone are descriptions of various different sorts of compensation arrangements. Rev. Proc. 2016-44 in effect states “one size fits all” principles for evaluating all service contracts, regardless of term or type.

Although the approach of Rev. Proc. 2016-44 has a sort of elegance and simplicity of approach, it raises a number of practical problems. The most important is that the term of a contract is an important factor, perhaps one of the most important factors, in determining whether a contract has the potential to improperly transfer the benefits of tax-exempt financing. A two-year management contract is a much different animal from a 30-year management contract. The protections the IRS needs for a 30-year contract are much different than the protections needed for a two-year contract. Special exceptions and favorable treatment for shorter-term contracts are for good reason reflected in many places in the regulations dealing with private business use -- for example, in exceptions from private business use for output contracts with shorter terms. The main problem with Rev. Proc. 2016-44 is that it subjects shorter-term contracts to all the same requirements as even very long-term contracts. These new requirements include a rigorously stated rule pertaining to control and rules requiring particular contract provisions. Are all of those requirements really necessary for a one or two year contract? Put another way, isn’t the short term of a contract one of the most important factors for determining whether the qualified user has retained control of the financed facility?

**More public comments?** The new guidance does not request any further public comments. Public comments likely will be submitted, however, particularly in light of the reconceived nature of the new safe harbor and its many new requirements. The IRS has already very helpfully responded to initial informal comments by extending the transition period
an additional six months (from the original February 18, 2017 to August 18, 2017) Officials of the IRS and the Treasury Department will also certainly make many clarifying public statements before August 18, 2017.

New Final Regulations Providing Arbitrage (and Other) Guidance

On July 18, 2016 the United States Treasury Department and the Internal Revenue Service published final regulations concerning requirements for tax-exempt bonds. These final regulations mostly concern the rules relating to investments treated as financed with tax-exempt bonds (the so-called “arbitrage” rules), but also concern other rules, including the definition of “issue” and certain private business use rules. The final regulations are highly technical, and mostly provide refinements to existing rules that are intended to make them more user friendly.

The new final regulations follow up on proposed regulations published on September 26, 2007 and September 16, 2013. The proposed regulations finalize substantially all of the provisions set forth in the proposed regulations, except that they do not address controversial changes to the definition of “issue price” of tax-exempt bonds originally set forth in the 2013 proposed regulations. A partial withdrawal of the 2013 proposed regulations (concerning the definition of “issue price”) and new proposed regulations concerning the definition of “issue price” were published on June 24, 2015. Accordingly, the 2015 proposed regulations, concerning the “issue price” definition, remain outstanding.

The new final regulations generally apply to bonds sold on or after October 17, 2016. A number of special effective dates apply to particular provisions of the new regulations, however. Many of these special effective date rules refer to transactions or actions taken on or after October 17, 2016. Issuers are permitted to apply most, but not all, of the rules in the new final regulations to bonds sold before October 17, 2016, but generally only if those provisions are applied in whole and not in part.

Rules for valuation of investments

General. The arbitrage rules generally apply to investments that are treated as acquired with proceeds or replacement proceeds of a tax-exempt bond issue (“allocated to” a bond issue, in the terminology of the regulations). The rules for how investments are treated when they first become allocated to a bond issue, or cease to be so allocated, are technical but can have significant financial consequences. In particular, the existing regulations contain detailed rules for whether an investment needs to be revalued at its fair market value, or is not to be revalued (that is, treated as valued at its “present value”), when it is allocated to an issue after being acquired or ceases to be allocated to an issue before it matures or is disposed of.

The new final regulations clarify these investment valuation rules in ways that are mostly, but not in all respects, favorable to issuers.

The general rule in the regulations is that investments need to be valued at fair market value when they first become allocated to, or cease to be allocated to, a bond issue. A number of important exceptions to this mark-to-market rule apply, however. The new final regulations clarify these exceptions.

In general, the new final regulations serve to facilitate certain transactions that the IRS appears to view as customary and nonabusive. These customary transactions include tax-exempt and taxable refundings of tax-exempt bonds and reallocations of a parity reserve fund to different issues when one of the secured bond issues is retired. Accordingly, the new final regulations provide that investments do not need to be valued at fair market value when they become transferred proceeds of a refunding bond issue, provided that the first bond issue is tax-exempt. The new regulations also provide that investments do not need to be valued at fair market value when they cease to be allocated to one issue under the universal cap (that is, because it is entirely or mostly retired) and become allocated to another issue “as a result of a preexisting pledge of the investment to secure the other bond issue,” again provided that the first bond issue is tax-exempt.
The preamble to the final regulations acknowledges that this exception from the mark-to-market requirement can have financial benefits to the issuer. That is because an investment may have substantially increased in value between the date it is acquired and the date it ceases to be allocated to a tax-exempt bond issue. Permitting such an investment with unrealized gain to leave a tax-exempt bond issue without revaluation in effect can enable the issuer to avoid subjecting the unrealized economic gain to the arbitrage rebate and yield restriction rules. For that reason, the preamble indicates that this exception to the mark-to-market rule applies only in the two instances specified. Other transactions that may provide the issuer with a similar economic benefit do not generally qualify for the favorable rule.

It may be noted that the 2013 proposed regulations contained a similar rule for valuation of investments transferring to a refunding issue. Those proposed regulations appeared to have facilitated a number of subsequent taxable refundings of tax-exempt advance refunding bonds, because they indicated that the IRS generally took the view that a taxable refunding of a tax-exempt bond issue generally should not cause the refunded bond issue to fail to meet the arbitrage rules. The final regulations affirm this interpretation. The final regulations do not, however, provide any relief for transactions that might be viewed as having a similar financial effect, but are not as customary (for example, issuing taxable debt to “refund” defeased bonds).

**Purpose investments.** The final regulations also clarify that purpose investments are not subject to the general mark-to-market rule. Purpose investments in general are loans (such as loans to a conduit borrower) made to further the governmental purposes of a tax-exempt bond issue.

**SLGs.** The new regulations generally provide that, when an issuer is required to determine the fair market value of a SLG that it holds, the fair market value is the redemption value that could be received from the Bureau of Fiscal Service.

**More flexible rules for the “3-bid” safe harbor to establish fair market value of certain investments**

As a part of the IRS response to perceived abuses involving “yield burning”, the IRS published regulations in the 1990s setting forth detailed safe harbors, based on bona fide bidding procedures, for guaranteed investment contracts and yield restricted defeasance escrows. The detailed provisions of these safe harbors continue to be an important part of day-to-day practice. In response to public comments, the new regulations helpfully update these safe harbors by providing that the bid specifications may be in electronic form and may be disseminated by web site, as well as other means. The new regulations also clarify the rule in the existing regulations that no bidder may have a “last look” by permitting all bidders to have an equal opportunity for a “last look” to review bids.

**Revised rules for qualified hedges**

Since 1993, the arbitrage regulations have contained rules that permit certain interest rate hedges of tax-exempt bonds to be taken into account in determining bond yield for purposes of the arbitrage rules. These rules (the so-called “qualified hedge” rules) are highly technical, and have been revised previously. A large portion of the new final regulations makes revisions to these qualified hedge rules. In general, the revisions are intended to be helpful to issuers.

Part of the complexity in the arbitrage regulations dealing with qualified hedges is that the rules provide for two different levels of integration of the hedge and tax-exempt bonds. These two different levels of integration concern how hedged bonds fit within the general framework of the arbitrage regulations, which provide somewhat different rules for variable yield bond issues and fixed yield bond issues. In the base level, payments and receipts on the hedge are taken into account to compute yield on the hedged bonds (so-called “simple integration”), but the bond issue generally is treated as having a variable yield. In the second level, payments and receipts on a hedge relating to variable yield bonds are taken into account to make the bond issue be treated as a fixed yield bond issue (so-called “super integration”). The new final regulations mostly concern revisions to the rules for “simple integration,” but also include some changes to the rules for “super integration.”
Favorable rules for identification of qualified hedges. The arbitrage regulations generally provide that payments on an interest rate swap may be taken into account in determining bond yield only if the governmental issuer “identifies” the hedge as a qualified hedge. The prior final regulations required that this “identification” be made within 3 calendar days of the date the qualified hedge is entered into by binding contract. The new final regulations helpfully permit the identification to be made within 15 calendar days of the date the hedge is entered into.

In the case of a conduit bond issue, both the existing and new final regulations require the governmental issuer to make the identification (rather than the conduit borrower). Accordingly, the more flexible 15-day rule may be particularly helpful for identification of qualified hedges entered into by a conduit borrower, because it affords more time for coordinating the execution of a formal written identification by the governmental issuer.

Favorable rules relating to correspondence of hedge payments to interest payments on the hedged bonds. The existing regulations contain a number of requirements for qualified hedges that are basically intended to assure that the payments on the interest rate hedge reasonably correspond to interest payments on the bonds.

The final regulations provide that payments on a qualified hedge may qualify, even though up to 90 days from the date of corresponding interest payments on the hedged bonds.

The final regulations refine and generally make more flexible the rules for determining when a hedge based on a taxable interest index can be treated as a qualified hedge. The final regulations provide, however, that a hedge based on a taxable interest index generally may not be treated as a “superintegrated” qualified hedge of a tax-exempt bond issue, except in the case when the interest on the tax-exempt bond issue is itself based on a taxable interest index.

The final regulations clarify that “cost-of-funds” hedges may be qualified hedges.

Hedge provider certification requirements. The new final regulations provide that, in order to treat a hedge as a qualified hedge, the issuer must obtain a hedge provider’s certification containing several specific representations. The certification must provide that (1) the terms of the hedge were agreed to in a bona fide, arm’s-length transaction; (2) the hedge provider has not made, and does not reasonably expect to make, any payment to a third party for the benefit of the issuer in connection with the hedge, except for payments that the provider expressly identifies; and (3) amounts payable under the hedge do not include any payments for underwriting or other services unrelated to the hedge, except for any payment the provider expressly identifies. This required certification is less detailed than the certification that would have been required under the proposed regulations, which included a certification to the effect that the issuer’s rate on the hedge is comparable to the rate that would be paid by a comparably situated issuer of taxable debt. The new required certification generally appears to be consistent with commonplace industry practice.

Favorable rules for modifications of hedges. The new final regulations include favorable rules for modifications of qualified hedges. Under the new rules, a modification of a qualified hedge will not be treated as a deemed termination of the hedge if the modified hedge would meet the requirements for a qualified hedge, re-tested at the time of the modification. For the purpose of this retesting, the fair market value of the qualified hedge does not need to be retested. This new rule replaces more complicated rules in the existing regulations, including a rule that provides that a qualified hedge is deemed to be terminated if the issuer enters into an “offsetting hedge.” This new rule also replaces a rule stated in Notice 2008-41 which generally provided that a modification of a qualified hedge is not treated as a constructive termination if it would not affect the integrated yield of the bond issue by more than 0.25% per annum.

Favorable rules for refundings of hedged bonds. The new final regulations include a favorable rule that will make refundings of hedged bonds simpler in many cases. Under the new rule, a qualified hedge for the refunded bonds may continue to be treated as a qualified hedge for the refunding bonds, provided that the hedge would meet the requirements for a qualified hedge of the refunding bonds, re-tested at the time of the refunding. For the purpose of this retesting, the fair market value of the hedge does not need to be re-tested. For example, this new rule could simplify the tax treatment of
a qualified hedge for the refunded bonds in a case where the principal payments on the refunding bonds matched with the principal payments on the refunded bonds. In a case where the hedge does not meet all of the requirements for a qualified hedge for the refunding bonds, the hedge will be deemed to be terminated in the same manner as under the existing regulations.

Under the existing regulations, the rules for qualified hedges of refunded bonds often require a complicated analysis and process. Under the existing rules, a qualified hedge is always deemed to be terminated when the hedged bonds are redeemed. The hedge is then required to be valued at fair market value, which triggers a deemed hedge payment or receipt. That deemed payment then generally needs to be associated with the refunding bonds. In certain cases, the deemed fair market value portion of the hedge may then be treated as a qualified hedge of the refunding bonds. These steps under the existing regulations are generally more burdensome than under the new regulations, which do not require revaluation of the hedge.

Expanded rules for “yield reduction payments”

One aspect of the rules for investments of tax-exempt bond proceeds in the Internal Revenue Code (that is, the so-called “arbitrage rules”) of course is that two separate, but largely overlapping rules apply: (1) yield restriction rules and (2) rebate rules. The yield restriction rules generally prohibit investing tax-exempt bond proceeds at a yield higher than the bond yield, with a variety of exceptions; the rebate rules generally require investment profit to be paid to the IRS, in those instances where investment at a higher yield is permitted. Over the years, the regulations under the arbitrage rules have taken a number of limited steps towards effectively unifying these two rules, mostly by permitting “yield reduction payments” to be made to the IRS to accomplish yield restriction, in a manner similar to rebate payments. In general, the existing regulations permit yield reduction payments in a list of specific situations that the IRS appears to have identified as not likely to be susceptible to abuse. The new regulations add the following to the situations where yield reduction payments are permitted.

Nonpurpose investments when United States Treasury securities -- State and Local Government Series (“SLGs”) are not available. Yield restriction is often accomplished, particularly in the case of advance refundings, by the purchase of SLGs. From time to time, because of federal debt limit considerations, the “SLGs window” has been closed by the Bureau of the Fiscal Service. Yield reduction payments are now permitted in such situations, even for advance refundings.

Nonpurpose investments allocable to proceeds of certain variable yield advance refunding issues. The vast majority of advance refunding issues are fixed rate issues, in large part because of the need to ensure that the yield on an advance refunding escrow does not exceed the bond yield. Certain advance refundings, however, have been accomplished by the issuance of variable yield bonds hedged with an interest rate swap. These hedged advance refunding bonds are in financial result close to fixed rate bonds, but are still often treated as variable rate bonds under the arbitrage regulations (for example, because of use of a LIBOR-based swap not eligible for super integration). As a result, they have usually been accomplished with somewhat elaborate yield monitoring provisions, which can be unwieldy. The new regulations contain a detailed rule permitting yield reduction payments for such advance refunding issues, but generally only to the limited extent necessary to correct for the extent to which the hedge correspondence is not perfect.

Qualified mortgage loans and all student loans. The new regulations now permit issuers of qualified mortgage bonds and qualified student loan bonds to make yield reduction payments with respect to qualified mortgage loans and all types of student loans that are purpose investments of those types of bond issues. The preamble to the new regulations states that the purpose of this new rule is to address the particular administrative challenges resulting from the large number of such loans.

All of these new provisions permitting “yield reduction payments” are helpful and responsive to public comments. The list of the specific instances where yield reduction payments are permitted, however, has grown even longer and more complicated – and, to be fair, even more quirky – than before. A major step towards tax simplification would be to provide that yield reduction payments may be made to achieve yield restriction in any instance, except for transactions involving an
abusive arbitrage device. That change would substitute one sentence for several pages of complex rules (with traps for the unwary) in the arbitrage regulations. The rationale for not taking this step has become increasingly tenuous. Why, for example, should yield reduction payments be permitted for hedged variable rate advance refunding bonds but not for any other type of advance refunding bonds? Also, as was stated by the IRS in explaining the new rule for qualified mortgage loans and qualified student loans, a good reason to permit yield reduction payments is because the yield restriction rules are administratively challenging; that could be said for almost any application of the yield restriction rules.

Long-Term Working Capital Financings

The Internal Revenue Code does not prohibit tax-exempt bond financing of working capital for governmental and qualified 501(c)(3) bonds. To the contrary, certain provisions in section 148 expressly apply to working capital financings. Nonetheless, the arbitrage regulations restrict working capital financings in a number of ways. These restrictions include special rules for when bond proceeds may be treated as spent, when available amounts that are not directly derived from the bonds are treated as gross proceeds, and anti-abuse rules.

The regulations generally provide that available amounts must be treated as gross proceeds of the bonds if the bonds have a term longer than is reasonably necessary for the governmental purposes and the issuer reasonably expects that there will be available amounts during the period for which the bonds are to remain outstanding longer than is reasonably necessary. In other words, the arbitrage regulations basically take the view that an issuer ordinarily should not be able to obtain an investment benefit by investing expected surplus amounts during the term of a long-term working capital bond issue.

The new regulations provide a new, somewhat elaborate rule for how and when such available amounts are to be treated as gross proceeds of a long-term working capital bond issue. First, a special rule applies during the first five years after the issue date. During this period, the issuer is not required to treat available amounts as gross proceeds if on the issue date it does not reasonably expect that there will be such available amounts as of the first day of a fiscal year.

Beginning on the first testing year (which is further explained below) and each subsequent fiscal year, the issuer must determine the available amount as of the first day of each fiscal year (and subject that available amount to the arbitrage yield restriction and rebate rules). The issuer must apply that available amount to redeem or invest in tax-exempt bonds, generally within the first 90 days of the fiscal year. For this purpose, the new regulations permit an issuer to treat tax-exempt regulated investment company shares and Demand Deposit SLGs as tax-exempt bonds. The new regulations permit amounts that are invested not more than 30 days in a fiscal year to be treated as spent.

The new regulations also contain other specific rules for when such available amounts can be treated as spent and no longer tracked.

The new regulations generally follow the conceptual framework articulated in the first private letter ruling to address a long-term working capital financing after publication of the final arbitrage regulations in 1993. That private letter ruling (PLR 9424043) considered the treatment of long-term bonds issued by a district in financial distress. In that private letter ruling, the IRS agreed that available amounts during the term should not be treated as gross proceeds to the extent that the issuer reasonably expected that none would arise. The IRS would not accept such a representation, however, for a period of longer than five years after the issue date. The IRS took the position that projections of financial condition beyond a five-year threshold are generally insufficiently reliable to be reasonable.

That skepticism regarding very long-term financial projections is reflected in the new regulations, mostly in the definition of “testing year.” A testing year is the first fiscal year following the applicable temporary period in which an issuer reasonably expects to have available amounts. In no event, however, may the first day of the first testing year be later than five years after the issue date.
The volume of long-term working capital financings appears to ebb and wane, and generally to increase during periods of financial recession. For example, a considerable number of long-term working capital financings appear to have been issued in 2009 and 2010. Many of those financings contain provisions generally modelled on the position stated in IRS private letter rulings and remain outstanding. Presumably, if an issuer choose to do so, the new regulations may in effect be applied to most of those outstanding bonds, even if the covenants in the bond documents are not exactly the same.

**Other working capital financings**

The existing regulations contain a restriction against financing a working capital reserve with tax-exempt bonds. That provision in effect penalized issuers that have not previously maintained a reasonable working capital reserve. The new regulations helpfully remove that restriction.

The new regulations also recognize that special considerations apply to financing of extraordinary working capital expenditures, making a change to the anti-abuse rule.

Not as favorable is a rule that shortens the safe harbor bond maturity for most short-term working financings from two years to 13 months, although this change appears to be mostly technical.

**Look-through treatment of grants for most purposes**

The arbitrage regulations have long provided that tax-exempt bond proceeds used to make a grant are treated as spent when the grant is made. The arbitrage regulations (and other tax-exempt bond regulations) did not explain, however, how such a grant is otherwise treated. The new regulations provide that (except for the timing rule that proceeds are spent for arbitrage purposes when the grant is made), the character and nature of a grantee’s use of proceeds are taken into account in determining which rules are applicable and whether applicable requirements for the bond issue are met. As an example, the regulations state that the grantee’s use of proceeds determines whether the proceeds or used for capital projects or working capital.

This new rule generally is a clarification that appears to be consistent with prevailing practice. It is likely particularly of interest for issuers of certain large general obligation bonds (for example, states), where use of bond proceeds to make grants is fairly common. It clarifies, for example, that the question of whether proceeds are used for a private business use depends on how the grantee uses grant proceeds. It also clarifies the treatment of grants for purposes of temporary period rules and rules relating to whether the term of a financing is longer than reasonably necessary for its governmental purposes.

**Revised definition of “issue”**

The new regulations revise the definition of “issue,” which is mostly relevant for purposes of determining whether bonds sold at about the same time are a single issue or separate issues. In prior revisions to the arbitrage regulations, this rule has been the subject of some controversy and much public comment. This time, it appears that the changes were intended to be a technical clarification that different types of tax credit bonds are separate issues, such as Build America Bonds and other types of tax credit bonds.

The actual wording of this new provision, however, is quite broad, and possibly could have more consequential implications for certain types of bond issues. The new regulations literally provide that each type of tax-advantaged bond that has “a different structure for delivery of the tax benefit that reduces the issuer’s borrowing costs or different eligibility requirements” is treated as part of a different issue. Because “tax-advantaged bonds” includes a tax-exempt bond, one question raised by this new wording is whether exempt facility private activity bonds and governmental bonds are necessarily treated as separate issues. Another question raised is whether different types of exempt facility bonds (for example, exempt facility bonds for both sewage treatment and solid waste disposal facilities) are necessarily treated as separate issues. This type of question frequently arises, for example, in airport financings, where governmental and exempt facility bonds are issued at the same time pursuant
to the same plan of financing. It appears that this type of question may not have been contemplated by the drafters, but is a question that will require clarification.

Accordingly, the new definition of “issue” may be something of a “sleeper,” with greater importance than may appear on first impression.

*External commingled investment funds*

The arbitrage regulations provide for favorable treatment of certain external commingled investment funds by permitting more favorable treatment of the administrative costs of such funds. The new regulations contain a helpful clarification that additional small investors do not prevent this favorable treatment.

*Bond yield provisions*

The new regulations make a helpful change to the “yield-to-call” rule for computing bond yield. Under certain circumstances, yield must be determined by assuming that bonds are redeemed on an optional redemption date, rather than retired at maturity. Under the new regulations, the test for purposes of this rule focuses on the lowest yield of a particular bond, rather than the lowest yield of an issue. This is intended as a simplification.

*Rebate provisions*

The new regulations more formally state the longstanding IRS position that it does not have authority to pay interest on refunds of rebate payments. They also finalize a rule providing for an increased rebate computation credit.

*Anti-abuse rule*

The new regulations restate the rule providing the IRS with general anti-abuse authority. They do so to prevent confusion between this rule and the “economic substance” doctrine under general federal income tax principles. The rule now refers to the IRS authority “to reflect the economics of the transaction.” It is not clear whether this change has any practical significance. In any event, in the few instances where the IRS has seriously attempted to apply versions of this general rule, it appears not to have met with success. For example, in City of *Columbus v. Commissioner*, the United States Court of Appeals for the District of Columbia brushed aside in short order the IRS’s assertion of the general anti-abuse rule.

*Rev. Proc. 97-15 made obsolete*

In another change not focused on arbitrage, the new regulations make obsolete the original revenue procedure setting forth closing agreement terms for certain violations generally resulting from change of use of bond-financed property, Rev. Proc. 97-15. The preamble to the new regulations state that this action was taken because the voluntary closing agreement program established by IRS Notice 2008-31 is broader in scope than Rev. Proc. 97-15. This action might be viewed as merely as administrative clean-up by the IRS, but it could have some practical significance for how the Tax Exempt Bond program of the IRS functions. Rev. Proc. 97-15 set forth specific provisions for how to determine settlement amounts, while Notice 2008-31 contains no such specific provisions. Instead, the authority of Notice 2008-31 is mostly implemented through TEB Internal Revenue Manual provisions. Also, it should be noted that issuers were entitled to rely on the provisions of Rev. Proc. 97-15, but are not entitled to rely on Internal Revenue Manual settlement standards. Because TEB has taken the view that it was bound to follow the settlement standards in Rev. Proc. 97-15, it has been somewhat constrained in its flexibility. TEB may have more flexibility to fashion settlement standards, for better or worse, now that Rev. Proc. 97-15 is obsolete.
General impressions

The new arbitrage regulations generally achieve the goal of making certainly highly complex rules in the existing regulations more administrable for issuers and borrowers. For the most part, the changes are responsive to practical comments of issuers, borrowers and practitioners informed by practical experience. The new regulations represent a refinement of existing rules, rather than a reconceived framework for new rules. They aspire to achieving practical results, even though some of the provisions may not represent a theoretically pure framework. To that extent, the new regulations are dramatically different in approach than Rev. Proc. 2016-44.

2016-17 Priority Guidance Plan of the Treasury Department and the IRS

The IRS and the Treasury Department have released their 2016-17 Priority Guidance Plan dated August 15, 2017. This Priority Guidance Plan lists five projects not already completed:

- Guidance on remedial actions for tax-advantaged bonds under sections 54A, 54AA and 141.
- Regulations on the definition of political subdivision under section 103 for purposes of the tax-exempt, tax credit and direct-pay bond provisions.
- Final regulations on public approval requirements for private activity bonds under section 147(f).
- Final regulations on the definition of issue price for tax-exempt bonds under section 148.
- Regulations on bond reissuance under section 150.

In light of the recent substantial achievements of the Treasury Department and the IRS in completing published guidance, we can be hopeful that at least some of these projects may be completed this upcoming year. My personal vote (and hope) is that the Treasury Department and the IRS focus on publishing the final regulations on the public approval requirement. Those regulations do not concern questions of high tax policy, but could provide substantial reduction in tax compliance burden and cost for tax-exempt bond issuers and borrowers. Those regulations are a much needed “nuts and bolts” type of project. Also, that project is relatively discrete, and it would be realistic to finalize those regulations in relatively short order.

There is less immediate practical need for completion of the other projects, and each can be expected to be much more difficult to complete. Also, each of the projects on the definition of political subdivision, the definition of issue price, and reissuance raise difficult and daunting questions. My view is that each would likely lead IRS and Treasury Department attorneys down a rabbit hole from which they would likely not return for many years.

September 2016