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Arbitrage and Rebate

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I. GENERAL CONCEPTS OF ARBITRAGE.

A. Tax-Exempt vs. Taxable Interest.

Holders of tax-exempt bonds are not required to treat interest as "gross income" for federal income tax purposes—*i.e.,* this interest is "excluded" from income subject to tax. Because this interest is tax-exempt, holders are willing to accept a lower rate of interest on their investment than is otherwise available for taxable investments (the interest rate on comparable term bank CDs and similar taxable obligations is generally higher because most purchasers must pay income tax on the interest income). Thus, if other factors are disregarded, with respect to both taxable and tax-exempt obligations of comparable term, even though the interest rates differ, the investor receives the same amount of money.

State income tax laws vary. Some states do not have state income taxes, and therefore a purchaser of a tax-exempt bond who is a resident of that state will not have state income tax liabilities for interest on tax-exempt bonds. Some states have laws that provide that if interest on a bond is excluded from gross income for federal income tax purposes and it is issued by that state or one of its political subdivisions, the interest will be excluded from taxable income for purposes of that state's income tax laws. Some state law provisions contain broad exemptions from income and other taxes (such as franchise or estate and gift taxes) for interest on bonds owned by residents of that state and issued by the state or one of its political subdivisions, regardless of the federal tax treatment of the interest. Notwithstanding varied state tax treatment of interest on state and local bonds, state laws governing authorization, validity, and enforceability of bonds do not set forth principles similar to the arbitrage rules under federal tax law.

B. Federal Subsidy.

This differential between tax-exempt and taxable interest rates is viewed by the federal tax rules as a federal subsidy afforded to state and local governments that is designed to lower the cost of financing qualified public projects/purposes. If an Issuer can borrow at 5%, rather than 7%, the cost of repaying the loan for a public project will be lowered. This form of subsidy, however, presents an opportunity for abuse—the opportunity to "borrow low and invest high," thereby earning a spread or profit called arbitrage.

C. Classic Arbitrage.

Example: Issuer wishes to build a courthouse costing $1M, but doesn't want to increase the local tax levy to raise the money. It issues $10M of bonds with a 5% annual interest rate and a 5-year maturity and spends the $1M on the courthouse and invests the remaining $9M of proceeds of the bonds. Issuer invests proceeds from the sale of the bonds in a 8% Treasury obligation that matures in 5 years. For each of the 5 years, Issuer will earn a 3% spread or profit (the difference between the 5% interest rate it is paying on the bonds and the 8% interest rate it is earning on its investments, ignoring reinvestment or compounding). This amounts to $220,000 per year of arbitrage profit. In 5 years, the total profit will be $1,100,000—enough to pay for building the courthouse. At that point, the Issuer can "cash in" the investment and use the proceeds to repay and retire the bonds; the $9M of invested proceeds plus the investment earnings are sufficient to cover all the principal and interest on the $10M of bonds . No local tax receipts will ever have been used to pay the debt.

D. Purpose of Arbitrage Rules.

The arbitrage rules are designed to limit the opportunity for an Issuer to earn this spread, so that Issuers will borrow only to finance projects rather than to create arbitrage. Bonds which receive a federal subsidy through other means (e.g. Build America Bonds) are also be subject to arbitrage restrictions (though for qualified tax credit bonds, the arbitrage rules are modified in certain respects).

E. Format of Arbitrage Rules: Three General Categories.

The arbitrage rules are divided into three general categories: (1) yield restriction rules ("Can you earn it?"), (2) rebate rules ("Can you keep it?") and (3) structural rules ("Can you do it?").

1. **The Yield Restriction Rules**. These rules date back to the late 1960s. In general, these rules govern the circumstances in which an Issuer is allowed—and not allowed—to invest the "gross proceeds" of a bond offering at a rate higher than the borrowing rate (the interest rate on the bonds).

2. **The Rebate Rules**. These rules date back to the early and mid-1980s. In general, these rules provide that, in most cases, any investment spread (i.e., positive arbitrage) earned must be surrendered, or "rebated," to the Treasury Department (the "Treasury").

3. **The Structural Rules.** These rules treat bonds as taxable arbitrage bonds based upon the structure of the issue, regardless of whether any gross proceeds are invested above any yield limit and regardless of whether any rebate is paid. For example, a bond issue is an issue of arbitrage bonds if sale proceeds in excess of 10% of the stated principal amount (or issue price in cases of issues with more than de minimis premium or discount) is used to fund a reserve.

All three categories of rules are intended to regulate the same event—arbitrage earnings—although with different approaches. One may argue that the yield restriction rules are no longer needed, but this argument has not yet been accepted in the Internal Revenue Code of

1986, as amended (the "Code") or by the Internal Revenue Service (the "IRS"). Instead, tax practitioners must apply these three independent sets of rules to every potential arbitrage situation.

F. Code and Regulations.

The arbitrage rules are found in Code § 148 and in § 1.148 of the Treasury Regulations ("Treas. Reg."). Practitioners must be aware of the history involved in "building" arbitrage law, which has been incremental: an earlier version of the Code or the Treasury Regulations may apply to a bond issue that is outstanding. To complicate matters, over the past several years the IRS and Treasury have issued proposed regulations, also found under § 1.148 of the Treas. Regs., which have not yet been finalized, but which in some cases permit the Issuer to elect to apply the proposed rules. This session, however, discusses only current law.

II. IDENTIFICATION OF "GROSS PROCEEDS."

A. Same Definition for All Rules.

To apply the yield restriction rules and the rebate rules, one must identify the "gross proceeds" of the bond issue. All three rules use the same definition of "gross proceeds."

B. Categories of "Gross Proceeds."

There are two general categories of "gross proceeds:" (1) "proceeds," which consist of (i) "sale proceeds" from the issuance of the bonds, (ii) "investment proceeds" from earnings on such sale proceeds, and (iii) in a refunding issue, unspent sale or investment proceeds of a prior issue that "transfer" to the refunding issue as "transferred proceeds" and (2) "replacement proceeds," which consist of other amounts that are treated as gross proceeds. In addition, under Treas. Regs. §1.141-12, amounts derived from the sale, exchange, or other disposition of property (other than investments) financed with bond proceeds ("disposition proceeds") are treated as gross proceeds for arbitrage purposes in some cases. See definition of "proceeds" in Treas. Reg. §1.148-1(b). Amounts that have been properly allocated to expenditures are no longer treated as proceeds of the bonds."

1. **"Proceeds."** This category includes the proceeds received from the sale of the bonds and investment proceeds earned on the sale proceeds. For a refunding issue, this category can also include "transferred proceeds," which are unexpended sale or investment proceeds of the refunded bonds that are "transferred" to the refunding bonds when principal of the refunded bonds is discharged with refunding bond proceeds. Examples of transferred proceeds can include sale proceeds and investment earnings thereon in a project fund established with refunded bond proceeds, unexpended sale proceeds and investment earnings in an escrow fund funded by the refunded bonds and unexpended sale proceeds and investment earnings thereon in a debt service reserve fund funded for the refunded bonds. **Sale proceeds can also arise in the case of the sale of a right associated with a bond (e.g., the sale of a call right), or the receipt of remarketing premium (under IRS Note 2008-41), in addition to certain other circumstances.**

2. **"Replacement Proceeds."** This category consists of other money of the bond Issuer or another party that is a substantial beneficiary of the issue that has a "nexus" to the bonds.

Example. Issuer borrows $1M to build a courthouse. The bonds have a 20-year maturity and a 5% rate. The actual proceeds, including investment earnings, are spent within a short time on the courthouse. Instead of structuring the bond issue with level debt service (essentially the same payment each year that will pay both principal and interest, similar to a conventional home mortgage), Issuer structures the deal with a "bullet maturity"—all principal on the bonds comes due in 20 years. Issuer takes the annual revenues that it would have used to pay principal, accumulates those and invests such accumulated revenues each year in 7% Treasury obligations that mature when the bonds mature. Issuer will now earn a 2% spread each year on the revenues it would normally have used to pay the bonds. This will substantially reduce the revenues required to pay debt service on the bonds. The accumulated revenues are "replacement proceeds."

See definition of "replacement proceeds" in Treas. Reg. §1.148-1(c).

This plan of financing, commonly referred to as an "invested sinking fund," was popular in the mid- to late-1970s and resulted in a 1978 extension of the arbitrage rules to amounts other than proceeds, including invested sinking funds.

In general, under current law the arbitrage rules are applicable to invested amounts, as well as actual bond proceeds, if there is a sufficient nexus between the invested amounts and the bond issue. This nexus between invested amounts and a bond issue can exist under three principles:

a. Prior Dedication Principle. Under the prior dedication principle, the invested amounts and the bonds are linked because the Issuer previously dedicated the invested amounts to the very purpose for which the Issuer subsequently borrowed the money. The Treasury Regulations emphasize that it is not enough that the invested fund was *merely available* for the same purpose, or that there was a *preliminary earmarking* of the invested fund for the same purpose. It must be clear that the invested fund *would have been used for the same specific purpose absent the borrowing if the proceeds of the issue were not used or to be used for that governmental purpose*. For example, if an Issuer solicits contributions for a new cancer center, but instead borrows for that purpose and invests the contributions at a higher yield, the nexus would be established and the campaign contributions would be "replacement proceeds."

b. Sinking Fund Principle. Under the sinking fund principle, the invested amounts have the required nexus if the fund is established with the *reasonable expectation that the fund will in fact be used to pay debt service on the bonds.* Look to the Issuer's expectations. If the Issuer actually expects to pay debt service from another source, then an invested fund that *could* have been used for debt service or other purposes, but that the Issuer reasonably expects not to use for debt service, will not constitute a sinking fund, and amounts in the fund will not be "replacement proceeds." If such a fund is *pledged as security*, however, it might have the required nexus under the pledged fund principle, which is discussed next.

c. Pledged Fund Principle. Under the pledged fund principle, the invested amounts have the required nexus if they are pledged (directly or indirectly) to the payment of the bonds. The pledge can exist by *formal declaration* or *where* *the bondholders have a reasonable assurance that the invested fund will be available if needed to pay the bonds* (even if the borrower encounters financial difficulties). Look to the bondholders' expectation and to the legal restrictions. A pledge is a clear indication that the invested fund could have been used for the purpose of the borrowing and, unless other permitted uses of the fund could deplete it, the only purpose for maintaining the fund is to support the borrowing. For example, a Repair and Replacement Fund funded from revenues may be pledged, but its primary purpose is to finance capital improvements and maintenance expenses. The fund could be depleted for those purposes, making it likely that there is no reasonable assurance that amounts in such fund would be available to pay debt service on the bonds, even if the Issuer encountered financial difficulties.

A pledge to a guarantor of the bonds (*e.g.*, a bank issuing a letter of credit to secure bonds) is treated the same as a direct pledge to the trustee or bondholders.

A negative pledge in the bond documents requiring the borrower to maintain a specified amount in available cash may also be treated as a pledged fund if the safe harbor is not satisfied. In general under the safe harbor, the amount must be reasonable for the purposes for which it was established, must be tested no more frequently than every six months, and there may be no restrictions on spending the amounts between the testing dates.

d. Other Replacement Proceeds. The Regulations provide that replacement proceeds arise when bonds are expected to remain outstanding longer than necessary for the governmental purpose for which they were issued.

C. Application of Yield Restriction and Rebate Rules.

Once the "gross proceeds" of an issue are identified, you must apply both the yield restriction rules and the rebate rules to determine whether compliance has been achieved in the investment of those gross proceeds.

The yield resitrction and rebate rules apply to investment property that is gross proceeds. Investment property includes debt instruments ("obligations" as defined in Treas. Reg. 1.150-1(b)), stock instruments ("securities" as defined in § 165(g)(2)(A) or (B)), annuity contract (as defined in § 72) and property held principally for the passive production of income (“investment-type property” as defined in Treas. Reg. §1.148-1(e)).

III. THE YIELD RESTRICTION RULE AND ITS EXCEPTIONS.

A. General Rule.

The general yield restriction rule is that gross proceeds may not be invested at a yield materially higher than the yield on the bonds. This rule requires calculations and interpretations necessary to determine yield on the bonds and yield on investments made with proceeds. The following are highlights:

1. **Yield on Bonds.** The "yield" on an issue of bonds is determined under Treas. Reg. §1.148-4 and is computed using a *present value* (or economic accrual) method. Key components of this determination include: (a) the definition of the target "issue price" of the bonds, (b) the deduction of bond insurance premiums, letter of credit fees, and other "qualified guarantee" payments from the purchase price in (a), and (c) adjustments to debt service payments that are required to be taken into account for items such as mandatory and optional redemption assumptions. Yield is determined by calculating the discount rate (*i.e.*, the yield) necessary to make the present (discounted) value of the debt service payments over the life of the bonds equal to the adjusted issue price, or target, calculated as of the issue date.

   a. *Issue price* is determined under Treas. Reg.§1.148-1(f), which allows an issuer to choose from several rules. Under the general rule, issue price is the first price at which a substantial amount (10%) of bonds with the same credit and payment terms (generally, each maturity of an issue) are sold to the public. Under the hold-the-offering-price rule, issue price is the price at which the bonds were initially offered to the public, so long as each underwriter agrees in writing that it will not offer or sell the bonds at a higher price during the period starting on the sale date and ending on the earlier (i) of close of business on the fifth business day after the sale date or (ii) the date of the sale of 10% of the bonds to the public at a price no higher than the initial offering price to the public, which may be demonstrated by a certification from the underwriter, accompanied by supporting documentation such as a copy of the pricing wire. For bonds sold in a competitive sale process meeting specified requirements of the regulations, including the receipt of at least three bids, the Issuer may rely upon the reasonably expected initial offering price of the bonds as the issue price, as certified by the winning bidder. For bonds that are issued in exchange for property, issue price is determined under Code §§ 1273 and 1274 and the Regulations thereunder.

   b. In the case of *variable rate bonds*, actual payments of debt service are considered to determine yield, which in effect requires a *retroactive determination*. In the case of *fixed yield bonds, anticipated payments* can be used, which permits a *prospective determination* of yield upon issuance of the bonds.

   c. The *underwriter's discount* and *expenses of issuance* cannot be taken into account to determine yield. If such items were taken into account, they would increase the bond yield and thus be recoverable through a higher permitted investment yield; however, the Treasury Regulations preclude such treatment.

d. A "*qualified hedge*," such as certain interest rate swap agreements, may, under certain circumstances, be taken into account in determining the yield on the bonds.

2. "Materially Higher Standard." The permissible maximum investment yield on the gross proceeds is called the "materially higher standard," which is defined in the Treasury Regulations in various ways:

a. 1/8% above the bond yield is the general rule.

b. 1/1000% above the bond yield is the rule for replacement proceeds.

c. Other special rules. *See* Treas. Reg. §1.148-2(d)(2)(iii) – (v).

3. Yield on Investments. Yield on investments of gross proceeds is also determined using a present value (or economic accrual) method. *See* Treas. Reg. §1.148-5.

a. Fair Market Value. Investments must be purchased for fair market value ("FMV"). This in effect prohibits deflection of arbitrage profits to a third party. The FMV of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction. Certain safe harbors apply in making a FMV determination of certain types of investments, as described below.

b. How FMV is determined.

i. Except as otherwise provided, an investment that is not of a type traded on an established securities market (within the meaning of Section 1273 of the Code) is rebuttably presumed to be acquired or disposed of for a price that is not equal to its FMV.

ii. The purchase price of a certificate of deposit ("CD") with a fixed interest rate, a fixed payment schedule, and a substantial penalty for early withdrawal is its FMV if the yield on the CD is not less than— (A) The yield on reasonably comparable direct obligations of the United States; and (B) The highest yield that is published or posted by the provider to be currently available from the provider on reasonably comparable certificates of deposit offered to the public.

iii. *Bidding* may be required for other investments that do not have independently established prices, such as guaranteed investment contracts ("GICs"). *See* Treas. Reg. §1.148-5(d)(6)(iii) for safe harbor bidding procedures for GICs and yield-restricted defeasance escrows.

iv. United States Treasury State and Local Governments Series obligations ("SLGS") purchased directly by state and local government Issuers from the Treasury are always treated as purchased at FMV. Note:

In certain instances, the Treasury will suspend the availability of SLGS subscriptions, making SLGS unavailable and requiring Issuers to invest proceeds in alternative investments.

c. **Reduction for Costs of Investing.** The costs associated with investing may only be used to reduce yield if they meet the requirements of Treas. Reg. §1.148-5(e). *E.g.*, certain "qualified administrative costs" or broker's fees for a GIC.

d. **Yield Reduction Payments Under Treas. Reg. §1.148-5(c).** For certain investments, Issuers can make yield reduction payments when the Issuer is not able to purchase yield-restricted investments or does not know the yield (as is the case for a variable yield bond). These payments are paid to the Treasury and have the effect of reducing the yield on yield-restricted investments and provide an important area of coordination between yield restriction and rebate rules and are similar in effect to rebate payments. *Note:* Yield reduction payments are NOT always a permitted way to bring investments' yield down to the bond yield.

e. **Allocations to Expenditures.** When calculating investment earnings, proceeds are generally treated as invested until they are allocated to expenditures, which may or may not be coterminous with the Issuer's cash outlay. For example, amounts are treated as spent when a check is sent if there is an expectation that funds will be withdrawn from the checking account within 5 days, and account earnings attributable to the actual number of days until the draw are ignored.

B. Exceptions to the Yield Restriction Rule.

1. **General**. The Code and Treasury Regulations contain numerous exceptions to the general rule requiring yield restriction. *See* Treas. Reg. §1.148-2. The more important ones are:

a. **3-Year Temporary Period for Construction Proceeds.** Unrestricted yield on investment of sale proceeds (including investment earnings) for 3 years after issuance if the Issuer reasonably expects that (i) 85% will be spent within that period, (ii) substantial binding commitments to spend 5% are made within 6 months after issuance, *and* (iii) work and expenditure of bond proceeds will proceed with due diligence. The three years may be extended to up to five years if both the Issuer and a licensed architect or engineer certify that a longer period is necessary to complete the capital project.

b. **Reserve Fund.** Unrestricted yield on investment of a reasonably required reserve or replacement ("4R") fund.

i. **Funding Limitation.** Generally, absent significant original issue discount ("OID") or original issue premium ("OIP") (i.e. more than a de minimis amount (*see* Treas. Reg. §1.148-1)), sale proceeds of no more than 10% of the stated principal amount of the bonds may be used to fund any reserve or replacement fund. If more than 10% is used to fund a reserve or replacement fund, the bonds will be arbitrage bonds, regardless of whether the reserve or replacement fund is invested in higher yielding investments.

ii. Size Limitation. The amount that is not subject to yield restriction and that qualifies as a 4R fund is limited to the lesser of: (x) maximum annual debt service ("MADS") of the issue, (y) 125% of average annual debt service ("AADS") of the issue, or (z) generally (absent significant OID or OIP), 10% of the stated principal amount of the bonds. For 4R funds that secure more than one issue, such as a parity reserve fund, the size limitation may be measured on an aggregate basis.

iii. Reasonably Required. *See* Rev. Proc. 84-26 for "unusual facts and circumstances test" for general obligation bonds. Note: The Arbitrage Certificate (described below) will usually include an attestation from the municipal advisor or underwriter (as appropriate) regarding this.

c. Bona Fide Debt Service Fund. This exception applies if the fund is designed to accumulate revenues on an annual basis for matching against annual debt service requirements (*e.g.*, revenue bond debt service or bond fund). The fund must be depleted at least once each year, except for a reasonable carryover amount that does not exceed the greater of 1/12 of annual debt service in the prior bond year or the earnings in the fund in the prior bond year.

d. Miscellaneous Other Rules. Special rules exist for pooled financings, refunding proceeds, minor portion, *etc.* Detailed rules also exist for yield limitations on "purpose investments," which are defined further below and are generally investments acquired with bond proceeds in the form of loans to qualifying borrowers (for example, owners of single-family housing purchased with single-family mortgage revenue bond proceeds, and hospitals or schools in qualified 501(c)(3) bond financings).

2. Rebate Analysis. Even if a fund meets one of these exceptions to yield restriction (i.e., Can I earn it?), the fund must still be analyzed under the rebate rules (i.e., Can I keep it?) to determine if there is arbitrage that must be rebated.

C. Arbitrage Certificate.

1. The Issuer must certify expectations as to use of proceeds (e.g., for 3-year expenditures to qualify for temporary period), yield calculation, proceeds, issue price, bona fide debt service funds and reasonably required reserve funds, among other matters. Although the regulations require as a structural rule that the issuer provide certification, the regulations do not specify the content of the certification. Arbitrage certifications are required by counsel, not so much to comply with the requirement for certification but to establish that the rules will be met.

2. Tax counsel often include certifications related to other tax matters (e.g., private activity bond rules), and the document may be called No Arbitrage Certificate, Tax Compliance Agreement, Tax Exemption Certificate and Agreement, Tax Regulatory Agreement, or other variations.

IV. THE GENERAL REBATE RULE AND MECHANICS.

A. General Rule.

Even if the Issuer is *permitted* to earn a higher yield under the yield restriction rules and related exceptions, arbitrage profit from investments *must* be *paid*, or "rebated," to the Treasury. In other words, if the amount actually earned is greater than the amount that would have been earned if the proceeds had been invested at the bond yield, that excess must be rebated, *absent a rebate exception*.

1. Rebate applies to "gross proceeds," which is the same as the extended definition of proceeds discussed above. Thus, "replacement proceeds" are included.

2. Once again, rebate requires calculation of bond yield and investment yield. Rules are essentially the same as for yield restriction.

3. Note that there is *no* such thing as "materially higher" for this purpose. *Everything* over the bond yield is subject to rebate unless there is an exception that is applicable. However, the computation does allow for an annual rebate credit that means a small amount of the rebate profit does not need to be rebated.

4. The rebate rules make a distinction between "nonpurpose" and "purpose" investments. Purpose investments are investments which are made to carry out the governmental purpose of the issue and are subject to a separate rebate requirement. Examples include mortgages acquired in a qualified single-family mortgage bond or loans acquired or otherwise financed in a student loan bond program or other obligations acquired in conduit-type financings permitted under the law (such as a loan to a hospital in a qualified 501(c)(3) bond financing). A "nonpurpose" investment would be an investment not acquired to carry out the governmental purpose of the issue (e.g., investing funds on deposit in the reserve fund in a money market account or portfolio of securities, or investing proceeds held in a construction fund pending disbursement to pay costs of constructing a school building or civic center). The key distinction is whether the investment carries out the “purpose” of the issue by making the bond proceeds available from the issuer to a qualifying borrower (such as making a loan to a developer to construct a low-income housing project), or whether the investment is merely acquired pending some purpose-related expenditure of proceeds of the issue or the payment of debt service on the issue.

B. Payment of Rebate.

Rebate amounts are required to be paid as follows:

1. At least 90% must be paid not later than 60 days after each interim computation date (any date selected that is not later than 5 years after the issue date, and every 5 years thereafter).

2. 100% must be paid not later than 60 days after the final computation date (the date the entire issue matures or is fully redeemed). Certain special final computation date rules apply to issues retired within 3 years of the issue date. See Treas. Reg. §1.148-3(e)(2).

3. Rebate amount paid with IRS Form 8038-T.

4. Failure to pay correct rebate amount when due causes bonds to be "arbitrage bonds" (*i.e.*, taxable) unless:

a. The IRS determines failure was not caused by willful neglect, *and*

b. The Issuer promptly pays the penalty owed to the Treasury Department (50% or 100% plus interest, depending on type of bond issue).

The Treasury Regulations contain rules for waiver of penalty in cases where late payment is paid promptly after discovery, and nonpayment is accidental. (*See* Treas. Reg. §1.148-3(h)).

5. The Treasury Regulations allow recovery of rebate overpayments if Issuer convinces IRS it has made an overpayment. There are some limitations on when Issuer may get money back, and a claim for a refund must be filed no later than two years after the final computation date for the issue to which the overpayment relates. *See* Treas. Reg. §1.148-3(i).

C. Basic Computation Principles.

Computation of rebate amount—in general:

1. Uses a *future value* (or economic accrual) method. *See* Treas. Reg. §1.148-3(j) for examples.

2. Identify dates and amounts of payments for and receipts from each investment of gross proceeds during the computation period ending on the computation date.

3. Future value those amounts, by assuming that interest is earned and compounded over the period, to the computation date, at a rate equal to the bond yield.

4. Rebate amount: if the future value of the receipts on the investments (*i.e.*, earnings, sales, capital gains, maturities) exceeds future value of the payments on the investment (*i.e.*, purchase prices), that excess is the rebate amount. By "future valuing" at the bond yield, if the Issuer's actual rate of return is *lower* than the bond yield, the future value of the receipts will NOT be greater than the future value of the payments, so no rebate will be owed. This situation is commonly referred to as "negative arbitrage" and has generally been the rule in the relatively recent period of very low interest rates, beginning in about 2008 through mid- 2022. However, this period may be ending as interest rates have risen over the last few years.

D. Accounting for Expenditures.

1. As with yield restriction, earnings on proceeds cease to be considered proceeds for rebate purposes when they are allocated to expenditures. Not all withdrawals of funds are treated as expenditures for arbitrage and rebate purposes. For example, transferring funds from a bond proceeds fund to a water and sewer account (even if controlled by the operating arm of the Issuer rather than the financial department) is not an "expenditure."

2. In general, payments for capital expenditures are treated as spent when paid to an unrelated third party or as a reimbursement for prior expenditures which meet the rules of Treas. Reg. §1.150-2.

3. Amounts used to pay working capital expenditures (salaries, insurance, etc.) are not treated as spent (and thus, still subject to arbitrage and rebate rules) unless they fit within an exception for *de minimis* expenditures under Treas. Reg. §1.148-6(d) or the Issuer establishes that there are no other available amounts to pay expenditures ("proceeds spent last" rule).

4. Issuers are generally given up to the later of 18 months after the financed project is placed in service or an expenditure is paid to make a "final allocation" of bond proceeds, but no later than date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier.

V. EXCEPTIONS TO REBATE RULE.

A. Summary.

There are five important exceptions to the rebate requirement: (1) the "small issuer" exception, (2) the 6-month spending exception, (3) the 18-month spending exception, (4) the 24-month spending exception, and (5) the "bona fide debt service fund" exception.

B. Small Issuer Exception.

The bond issue is "completely" exempt from the rebate requirement under this exception; however, the issue is still subject to the yield restriction rules. The other exceptions to rebate are "partial" only. See Code §148(f)(4)(D) and Treas. Reg. §1.148-8.

1. The exception applies if:

a. The Issuer is a governmental unit with general taxing powers;

b. No part of the issue is a private activity bond (*i.e.*, only available for governmental bonds);

c. 95% of proceeds are used for local governmental purposes (*i.e.*, no "pooled financing"); and

d. The Issuer reasonably expects, as of the issue date, that the aggregate face amount of *all* tax-exempt bonds (other than private activity bonds) issued by it and "subordinate entities" during the same calendar year will not exceed $5,000,000.

2. $5,000,000 Size Limitation.

a. Tax-exempt private activity (i.e., non-governmental) bonds are not counted.

b. *Current* refunding bonds are not counted (*see* below).

c. Must apply aggregation rules (*can be complicated)*.

i. Issuer and all entities (other than "political subdivisions") that issue bonds "on behalf of" that Issuer are treated as a single Issuer.

ii. Bonds issued by a "subordinate entity" are also aggregated. An entity is subordinate to another entity (the "superior entity") if it is controlled by the superior entity. The control test is satisfied if *either*

(x) the superior entity can approve and remove a majority of the subordinate entity's governing body without cause, or

(y) the superior entity can require the use of funds or assets of the subordinate entity for any purpose of the superior entity.

iii. A "political subdivision" with substantial taxing, eminent domain, and police powers is not considered a subordinate entity under Treas. Reg. § 1.150-1(e) and does not have to worry about bonds issued by a superior entity—it only worries about bonds that are issued by entities that are subordinate to it.

d. *Anti-abuse rule*: an entity "formed or availed of" to avoid the $5M limit, and all entities that would benefit from the avoidance, are treated as one Issuer.

e. $5,000,000 increased by up to an additional $10,000,000 for bonds issued after 1997 to finance *public school construction*.

3. Ability to use this exception can be "allocated" by superior entity to subordinate entity (*e.g.*, from a county to its sanitary district that otherwise qualifies but does not have general taxing power).

4. The Code contains complicated provisions on how to treat *refunding bonds* under the $5,000,000 exception. *In general*, once original bonds qualify for the small Issuer exception, refunding bonds issued in a subsequent year in a *current refunding* (i) remain entitled to the small Issuer exemption without "counting" again, and (ii) do not count against the $5,000,000 limit in that subsequent year. Note, however that there are additional qualification rules e.g. – face amount doesn't exceed $5 million, weighted average maturity of the issue not greater than the refunded issue (exception for 3 year rule), and final maturity date not more than 30 years and still have to be a small issuer. Oftentimes, it may not be material to issuers to meet a small issuer exception in a refunding context because, in a current refunding, the 6-month exception from rebate will likely be met. However, if there are transferred proceeds or a 4R fund, the qualification may be important.

5. The test is based on *either* the Issuer's reasonable expectation at the time of issuance of the bonds or actual facts during the calendar year in which the bonds are issued.

Therefore, if the Issuer issues $4,000,000 in bonds that are subject to the exception, but later in the year issues another $5,000,000 for an unexpected need (for example, to fund a litigation judgment), the first issue will not lose rebate exception treatment.

C. 6-Month Spending Exception.

The general rule is that if all proceeds are spent within 6 months after their issue date, no rebate is due. See Code §148(f)(4)(B) and Treas. Reg. §1.148-7(c).

1. Applies to all types of bonds—governmental purpose bonds, §501(c)(3) bonds and other private activity bonds ("PABs").

2. Available for refunding as well as new money issues. *This is the only spending exception for refunding issues.*

3. This does not apply to or affect proceeds on deposit in a debt service reserve fund. Those proceeds do not have to be spent, but they are subject to rebate. Thus, where a reserve fund is included in the issue, this is only a partial exemption.

4. Has a *carry over* spending exception: governmental and §501(c)(3) bonds (*i.e.*, not PABs) can expend 5% of proceeds over an additional 6 months.

5. *Cannot* meet the test by retiring principal with proceeds.

6. Special rules apply for tax and revenue anticipation notes or bonds ("TRANs")—cumulative cash flow deficit and other working capital financings.

D. 18-Month Spending Exception.

The general rule is that if all proceeds are spent within 18 months after issue date, no rebate is due. *See* Treas. Reg. §1.148-7. Note: This exception was added by the 1993 Treasury Regulations and is not part of the Code.

1. Applies to all types of bonds—governmental purpose bonds, §501(c)(3) bonds and PABs.

2. Applies only to bonds issued after June 30, 1993.

3. Does not apply to or affect proceeds deposited in a debt service reserve fund. Those proceeds do not have to be spent, but they are subject to rebate. Thus, where a reserve fund is included in the issue, this is only a partial exemption.

4. For bonds issued to finance capital projects, including acquisitions (*i.e.*, not limited to "construction," as is the 24-month exception).

5. Basic requirements:

a. Issue must qualify for either the 3-year or 5-year temporary period exception from yield restriction.

i. In practice, a project that qualifies for the 5-year temporary period is a construction project, thus entitling the Issuer to the 24-month, not 18-month, exception to Rebate.

b. Available proceeds (which includes interest earnings) must be spent for governmental purpose within 18 months after issue date according to following progress benchmarks:

i. At least 15% within 6 months;

ii. At least 60% within 12 months;

iii. 100% within 18 months (except allowed additional 12 months to spend "reasonable retainage"); and

iv. There is also a *de minimis* exception to total expenditure, equal to the lesser of 3% of available proceeds or $250,000.

"Reasonable retainage" means an amount not to exceed 5% of available construction proceeds as of the end of the spending period, that is retained for reasonable business purposes relating to the property financed with the proceeds of the issue.

6. The regulation provides that the amount of investment earnings included in "available proceeds" is "estimated earnings," based on reasonable expectations at closing, for the first two benchmarks. The estimated earnings are treated as earned upfront for purposes of calculating the 6-month spending benchmarks. Actual earnings must be used for the last benchmark.

7. *Cannot* meet the test by retiring principal with proceeds.

8. *Cannot* mix the 18-month exception with the 24-month exception (described below).

E. 24-Month or "2-Year" Spending Exception.

The general rule is that if all proceeds are spent within 24 months after the issue date, no rebate is due. *See* Code §148(f)(4)(C) and Treas. Reg. §1.148-7(f).

1. Applies only to governmental purpose bonds, §501(c)(3) bonds and certain PABs issued for governmentally owned projects (*e.g.*, solid waste facilities or airports but not to PABs in general).

2. Applies only to bonds issued after December 19, 1989.

3. Applies only to a "*construction issue*":

a. The Issuer must reasonably expect that 75% of available construction proceeds be spent on construction expenditures for issue to qualify as a construction issue.

b. Can "*bifurcate*" the issue by election to treat a portion as construction issue.

i. Election must be in the Non-Arbitrage or Tax Certificate.

ii. Remainder of issue can meet 6-month exception (but not 18-month exception).

iii. All "construction expenditures" must be in the 24-month portion. That is, cannot include only that part that is expected to meet the spend-down benchmarks in the 24-month portion of the issue.

c. "Construction expenditures" are

i. Capital expenditures (chargeable to capital account);

ii. For the cost of real property (other than acquisition of land or other existing real property) or constructed personal property, such as

(x) Buildings, improvements to land, other inherently permanent structures, including wiring, plumbing, HVAC, pipes, ducts, etc.

(y) Constructed tangible personal property such as subway cars, fire trucks, *etc.*, if:

(1) substantial portion is complete more than 6 months after construction began or contract entered into,

(2) Issuer could not have reasonably expected, with exercise of due diligence, completion to have occurred within that 6 months, *and*

(3) if Issuer does the work itself, not more than 75% of capitalizable cost is for acquisition of components, raw materials, or supplies.

4. Available construction proceeds ("ACP"), which includes interest earnings, must be spent for governmental purpose within 24 months after the issue date according to following progress benchmarks:

i. At least 10% within 6 months;

ii. At least 45% within 12 months;

iii. At least 75% within 18 months; *and*

iv. 100% within 24 months (except allowed for additional 12 months to spend "reasonable retainage").

5. Interest earnings included in ACP for the first three benchmarks are the "estimated earnings," based on reasonable expectations at closing, with the estimated earnings treated as earned upfront. Actual earnings must be used for the last benchmark. However, in the case of the 24-month exception, the Issuer may elect in the Non-Arbitrage or Tax Certificate to use actual earnings for all benchmarks.

a. Earnings on a reserve fund during the 24-month period will be included in ACP unless an election is made in the Non-Arbitrage or Tax Certificate to exclude them.

b. In any event, even if no election is made, after the 24-month period, the Issuer must pay rebate on the reserve fund earnings. Thus, this can only be a partial exemption if a reserve fund involved.

6. Election of 1-1/2% penalty in lieu of rebate.

a. The Issuer in a construction issue may elect on or before issue date to pay 1-1/2% penalty to United States in lieu of calculating rebate amount on ACP if required spending schedule is not met. NOTE: This election is rarely made, as it can result in an Issuer paying rebate when it otherwise would not have if the election was not made.

b. Computed separately for each spending period, including each 6-month period after end of 4^{th} spending period during which any unspent ACP remains.

c. Penalty equals 1-1/2% of "under expended" proceeds (*even if* rebate would have been $0).

d. Payable within 90 days after end of each spending period with IRS Form 8038-T.

e. Issuer may elect to terminate the 1-1/2% penalty by making an *additional* penalty termination payment and taking the following actions:

i. Elect to terminate penalty within 90 days after earlier of end of initial temporary period or substantial completion;

ii. Within 90 days after end of initial temporary period, pay penalty equal to 3% of unexpended ACP at end of initial temporary period times number of years (to 2 decimals) in initial temporary period;

iii. Not invest unexpended ACP in higher yielding investments; and

iv. Use unexpended ACP to redeem bonds at earliest possible redemption date.

F. Multipurpose Issue Rules.

Refunding and new money portions of an issue are generally treated as separate issues for purposes of the exceptions to rebate rules. The refunding portion may be entitled to a rebate spending exception under the 6-month spending exception only, provided the issue is properly bifurcated. *See* Treas. Reg. § 1.148-9(h). Once the new money portion is identified, it must be assessed individually.

G. *Bona Fide* Debt Service Fund Exception.

In general, these funds are exempt from rebate requirements, but there are special qualification requirements that are not applicable in the yield restriction rules:

1. Fixed rate governmental bonds with an average maturity of at least 5 years meet the test under Code §148(f)(4)(A).

2. Otherwise, to qualify, must meet one of these tests:

a. Earnings do not exceed $100K per year, *or*

b. Average annual debt service is not more than $2.5M.

H. Drawdown Loans

A lender may allow the Issuer to draw down funds as needed and only owe interest to the extent funds are drawn, with a requirement that all funds be drawn by a particular date (typically, the end of the three-year temporary period). To the extent funds are drawn down and allocated to expenditures when drawn (through a current outlay of cash or through an allocation to expenditures previously paid) in this manner, there are generally no proceeds to be invested.

VI. THE SINGLE ISSUE RULE.

A. Single Issue.

Treas. Reg. §1.150-1(c) provides that bonds are treated as part of a single issue if <u>all</u> the following requirements are met:

1. The bonds are sold at substantially the same time (less than 15 days apart).

2. The bonds are sold pursuant to the same plan of financing (e.g., to finance a single facility or related facilities). The complete definition of "plan of financing" is not provided in the regulations. It is clear that a single issue can be used to finance unrelated facilities.

3. The bonds are expected to be paid from the same source of funds, determined without reference to guarantees from parties unrelated to the obligor.

4. Tax-exempt bonds and taxable bonds (including build America bonds and qualified tax credit bonds) are not part of the same issue. Similarly, different types of taxadvantaged taxable bonds are not treated as part of a single issue (for example, build America bonds are not treated as part of a single issue with qualified school construction bonds).

Treatment of multiple series of bonds as a single issue will cause each series to be subject to the same arbitrage yield, for example.

B. Treatment as Separate Issues.

Bonds that would otherwise constitute a single issue may be treated as separate issues for certain purposes if each separate issue finances a separate purpose and would qualify as a tax-exempt issue in its own right. Issues qualifying for this treatment are referred to as "multipurpose issues." There are several separate multipurpose issue rules. The main multipurpose rule for application of the arbitrage rules is found in Treas. Reg. §1.148-9(h). A general multipurpose rule found in Treas. Reg. §1.150-1(c)(3) does not affect the application of the arbitrage rules and certain other provisions of the tax laws to the single issue.

C. Draw-down Loans.

1. Bonds issued pursuant to a draw-down loan (typical in direct bank loans for construction) are treated as part of a single issue, with an issue date being the first date on which the aggregate draws under the bond exceed the lesser of $50,000 or 5% of the issue price.

2. There are special rules relating to treating each draw as a separate issue with respect to bonds with sunset (termination) dates found in Notices 2010-81 and 2011-63. There are also special rules for treating draw-down loans as a single issue for IRS Form 8038 and 8038-G reporting purposes. *See* Treas. Reg. § 1.149(e)-1(e).

VII. HEDGE BONDS.

A. Definition.

The term "hedge bond" as defined in Code §149(g) refers to any bond for which:

1. The Issuer does not reasonably expect at the time of issuance of the bonds to spend at least 85% of the proceeds within three years of issuance to carry out the governmental purpose of the issue (and therefore, is not getting a temporary period exception to yield restriction); or

2. The Issuer invests more than 50% of the proceeds of the bond issue in nonpurpose investments having a substantially guaranteed yield for four years or more.

B. Purpose of the Hedge Bond Rule.

The hedge bond rule is intended to address situations where an Issuer might issue bonds without a present need for financing to hedge against a potential rise in interest rates at a future time when financing is needed. The rule is in the nature of an anti-abuse rule.

C. Spending Requirements.

A hedge bond will not be tax-exempt unless the Issuer reasonably expects at the time of issuance that the following spending requirements will be met with respect to the issue's net sale proceeds:

1 year	10%
2 years	30%
3 years	60%
5 years	85%

D. Exceptions to Hedge Bond Rules.

1. Investment of bond proceeds in Non-AMT bonds. Bonds whose proceeds are invested in tax-exempt bonds that are not subject to alternative minimum tax are generally exempt from the hedge bond rules.

2. In general, a refunding bond shall be treated as meeting the hedge bond requirements only if the original bond met such requirements. However, a refunding bond will be treated as a hedge bond unless there is a significant governmental purpose for the issuance such as saving debt service or to escape burdensome document provisions (but not to hedge against future increases in interest rates).

VIII. ABUSIVE ARBITRAGE DEVICE.

A. Definition.

Any action is an "abusive arbitrage device" if the action has the effect of –

1. Enabling the Issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and

2. Overburdening the tax-exempt bond market (as described below).

Treas. Reg. §1.148-10 provides generally that an abusive arbitrage device makes the bonds taxable retroactive to the issue date (even if rebate payments are made). This restriction is in addition to the specific arbitrage limitation and rebate requirement discussed above.

B. Exploitation.

Exploitation of tax-exempt versus taxable rates involves the structuring of a transaction for a principal purpose of obtaining a material financial advantage in violation of Code §148. In this analysis, substance over form will be considered.

C. Overburdening.

An action overburdens the tax-exempt bond market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is reasonably necessary to accomplish the governmental purpose of the bonds. Factors indicating overburdening include the failure to qualify for a temporary period under Treas. Reg. §1.148-2(e)(2) (three years for capital projects), (e)(3) (working capital temporary period), or (e)(4) (pooled financings), and failure to satisfy the 120% weighted average maturity limitation test of Treas. Reg. §1.148-1(c)(4)(i)(B).