Summary of Federal Arbitrage Law[1]

March 1, 2012

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1 INTRODUCTION AND SCOPE

1.1 Source of Tax Exemption.

(A) *Code Section 103*. Section 103(a) of the Internal Revenue Code of 1986, as amended (the "Code") provides that interest on any "State or local bond" (an obligation of a state or political subdivision of a state) is excluded from federal gross income. This is the basis for federal tax exemption of municipal bonds. But the exemption does not apply:

(1) to a private activity bond, unless it is a "qualified bond" under Code section 141;

(2) to an "arbitrage bond," defined in Code section 148; or

(3) to any bond unless it meets certain requirements of Code section 149. These include: the bond must be registered; the issuer must file a form 8038 or 8038-G with the Internal Revenue Service after the bonds are issued; limits on advance refunding; and rules relating to hedge bonds.

(B) *Focus on Arbitrage*. This memorandum focuses on the definition of "arbitrage bond."

1.2 Nature of Obligation. A state or local bond can be structured in several forms: as a note, a simple loan agreement, a bond, or a lease-purchase-agreement that qualifies as an "obligation" for tax purposes. In this memo we generally use the term "bond" or "issue."

1.3 Scope of this Memo; Disclaimer. This memo is designed to summarize the basic rules and exceptions of federal arbitrage law applicable to municipal bonds. This area of the tax law is complex and specialized, and a number of the details have been either simplified or omitted from this memo in order to focus on the key elements that will be most beneficial to public-finance professionals. For example, a refunding transaction may involve such complexities as the mixed-escrow rule and transferred proceeds, which are both beyond the scope of this memo but must be properly addressed in an actual financing. Bonds subject to optional redemption and sold to the public at a premium, and term bonds sold at a deep discount, may require special adjustments in the calculation of bond yield. Arbitrage rebate is calculated using the economic accrual method, in which investment purchases and receipts are future-valued at the bond yield. The arbitrage rules are introduced and summarized here, but not discussed in depth. Therefore, this memo should not be used as a basis for analyzing a proposed municipal bond transaction or for drawing legal conclusions.

2 ARBITRAGE BONDS

2.1 Basic Rule of Arbitrage.

(A) *Code Section 148.*

(1) Under the Code, the term "arbitrage bond" means any bond issued as part of an issue, any portion of the proceeds of which are <u>reasonably expected</u> (at the time of issuance of the bond) to be used directly or indirectly (a) to acquire higher yielding investments, or (b) to replace funds which were used directly or indirectly to acquire higher yielding investments. In addition, a bond becomes an arbitrage bond if the issuer <u>intentionally</u> uses any portion of the bond proceeds to do either (a) or (b) above.

(2) A "higher yielding investment" is an investment that produces a yield "materially higher" than the yield on the Bonds.

(B) *Basic Rule of Arbitrage*. The issuer cannot invest "gross proceeds" of a bond issue at a yield "materially" higher than the yield on the bonds. The term "gross proceeds is discussed in **Section 2.2** below.

(C) *Bond Yield*.

(1) <u>General</u>. Bond yield is the discount rate that, when used in computing the present value, as of the issue date of the bonds, of all payments of principal, interest, and fees for "qualified guarantees" on the issue (such as bond insurance or a letter of credit), produces an amount equal to the issue price of bonds. Underwriting fees and other issuance costs are not taken into account (in other words, underwriting fees and issuance costs do not increase the bond yield). Yield on a fixed-yield issue is generally computed as of the issue date and is not affected by subsequent unexpected events. Yield on a variable yield issue is computed on a "look-back" basis over a number of "yield periods." In municipal finance, yield is generally computed with semiannual compounding, using a 360-day year comprising twelve 30-day months.[2]

(2) <u>Special Rules</u>. The normal method of computing bond yield is modified in two situations. First, if bonds subject to optional redemption meet certain tests, described below, then the yield on the bond issue is computed by treating those callable bonds as redeemed on the date that

[2] Treas. Reg. section 1.148-4. Bond yield is a specialized calculation of internal rate of return.

produces the lowest yield on the issue (not just that bond). This can make the yield computation very complex. A callable bond is subject to this rule if (a) the bond is sold to investors at a premium that exceeds a certain threshold (sometimes referred to as a "yield-to-call bond"), (b) the bond has a "stepped" coupon, or (c) the bond is callable within 5 years after the issue date and meets an additional test. Second, special rules apply when term bonds (subject to mandatory "sinking fund" redemptions) are sold to investors at a deep discount. In this case, yield on the bond issue is computed by treating those bonds as redeemed at their "present value" (essentially the accreted value at the redemption date), which will be below par).[3]

2.2 Bond Proceeds.

(A) *Gross Proceeds*. The arbitrage rules apply to all "gross proceeds" of a bond issue. Gross proceeds consist of "proceeds" and "replacement proceeds," as described below.

(B) *Proceeds*. The "proceeds" of an issue include sale proceeds, investment proceeds, and "transferred proceeds." If bonds are issued to refund a prior issue, unspent proceeds of the refunded bonds become "transferred proceeds" of the refunding issue as principal of the refunded bonds is paid off by the refunding issue.

(C) *Replacement Proceeds*.

(1) General Definition. Replacement proceeds are amounts that have "a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used" for such purpose. Replacement proceeds include sinking funds, pledged funds, and certain "other replacement proceeds" (not discussed in this memorandum). **It is important to understand that any money contributed by an issuer or borrower, even if it was not derived from a bond issue, will be treated as gross proceeds, subject to the arbitrage rules, if that money becomes "replacement proceeds" under the arbitrage regulations.**[4]

(2) Sinking Funds. A sinking fund includes a debt service fund, redemption fund, reserve fund, or any similar fund, to the extent that the issuer reasonably expects to use the fund to pay principal or interest on the bonds. For example, tax revenues deposited in a debt service fund, utility system revenues deposited in a principal and interest account, and loan payments deposited in debt service fund for a private activity bond issue, are all treated as "sinking fund" proceeds and gross proceeds.

(3) Pledged Funds. A pledged fund is any amount that is directly or indirectly pledged to pay principal or interest on the bonds. The form of the pledge

[3] Treas. Reg. section 1.148-4(b).
[4] Treas. Reg. section 1.148-1(c).

is not important, but it must provide a reasonable assurance that the amount will be available to pay principal or interest on an issue of bonds if the issuer or borrower encounters financial difficulties. For example, a debt service reserve fund in a utility revenue bond issue, or in a hospital revenue bond issue, is normally pledged exclusively to the payment of the bonds; therefore, any utility system revenues, loan payments, or money from any source deposited in such a reserve fund will be "pledged" to the bonds and constitute replacement proceeds, which are gross proceeds.

2.3 Investments.

(A) *General*. Under Code section 148(b), "investment property" includes any security, obligation, an annuity contract, "investment-type property" (see below), and certain residential-rental projects. But if the bond proceeds are invested in a tax-exempt bond issued by an unrelated issuer, that bond is not counted as an investment, unless proceeds of an issue of (1) governmental bonds, (2) qualified 501(c)(3) bonds, or (3) certain private activity bonds issued for housing purposes, are used to purchase tax-exempt, private activity bonds that are subject to the alternative minimum tax under Code section 57(a)(5)(C). Also, the special "demand deposit" securities issued by the Bureau of Public Debt as part of the State and Local Government Series,[5] are treated as tax-exempt bonds. Bond proceeds invested in tax-exempt bonds are generally treated as not invested, and the yield on those investments cannot be blended with other investments.

(B) *Purpose and Nonpurpose Investments*. The Code distinguishes between "purpose investments" and "nonpurpose investments." A purpose investment is an investment acquired to carry out the governmental purpose of an issue, such as the loan of bond proceeds made by a bond issuer to a borrower. In a typical conduit financing, the purpose investment is the loan agreement itself. All other investments are nonpurpose investments, such as investments purchased in a project fund, debt service reserve fund, or a bond fund. The basic rule of arbitrage (yield restriction) applies to all types of investments, but arbitrage rebate (discussed below) applies only to nonpurpose investments.

(C) *Higher Yielding Investments*. A "higher yielding investment" is an investment that produces a yield materially higher than the bond yield. Usually, "materially higher" means 1/8%. For investments in a refunding escrow or investments made with replacement proceeds, materially higher means 0.001%. For certain purpose investments that qualify as "program investments," materially higher means 1.5%.[6]

(D) *Certain Prepayments for Goods and Services*.[7]

(1) General. Ordinarily, it easy to determine whether bond proceeds are spent or invested. But if bond proceeds are used to pre-pay for the purchase of a service or product (typically in exchange for a discounted

[5] 31 C.F.R. part 344. Note that the most commonly used type of SLGS are the "time deposit" SLGS, which definitely constitute investment property.
[6] Treas. Reg. Section 1.148-2(d).
[7] Treas. Reg. Section 1.148-1(e).

price), the prepayment may be treated as an *investment* of Bond proceeds, instead of as an *expenditure*, and investments are subject to arbitrage yield restriction and rebate. The Regulations provide that a prepayment creates investment-type property if "a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made."[8] But a prepayment does not result in investment-type property if –

(a) Customary Prepayments. Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(b) 90-Day Prepayments. The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(c) Natural Gas or Electricity. The prepayment is made to acquire a supply of natural gas or electricity and meets certain requirements set out in the Regulations.

(2) Customary prepayments. The determination of whether a prepayment is "customary" is based on all the facts and circumstances, but there is a safe harbor: a prepayment is deemed to be "customary," and is not treated as an investment of bond proceeds, if—

(a) The prepayment is made for (1) maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or (2) updates or maintenance or support services with respect to computer software; and

(b) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(3) Natural Gas or Electricity. The rules relating to prepayments for the purchase of natural gas or electricity, services areas, commodity swaps, and hedges are complex and beyond the scope of this memo.[9]

2.4 Exception During a Temporary Period.

(A) *General*. During a "temporary period," gross proceeds of an issue may be invested in higher yielding investments without causing bonds to be arbitrage bonds.

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[8] Treas. Reg. Section 1.148-1(e)(2)(i)(A).
[9] See Treas. Reg. Section 1.148-1(e)(2)(iii).

(B) *Three-Year Temporary Period For Capital Projects*.

(1) To be eligible for this temporary period, the issuer must reasonably expect to satisfy three tests: the expenditure test, the time test, and the due diligence test, as follows:

(a) Expenditure Test. The expenditure test is met if at least 85% of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period.

(b) Time test. The time test is met if the issuer incurs within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5% of the net sale proceeds of the issue on the capital projects.

(c) Due diligence test. The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceeds with due diligence.

(2) Note that the bonds qualify for this temporary period if the issuer reasonably expects, on the issue date, to meet each of the three tests. If unspent bond proceeds remain after three years, no adverse tax consequences would arise, assuming the issuer's expectations were reasonable. The temporary period ends on the third anniversary of the issue date, meaning that such unspent proceeds may no longer be invested at a materially higher yield.[10]

(C) *Five-Year Temporary Period For Capital Projects*. If the bonds are issued for a capital project involving "a substantial amount of construction expenditures," a 5-year temporary period is available if "both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project." In practice, this longer period is rarely available, because most projects can be completed in three years or less. If there are multiple projects, the financing can usually be broken down into two or more issues, with each issue meeting the 3-year test.[11]

(D) *13-Month Temporary Period For Bona Fide Debt Service Fund*. This exception allows an issuer to invest amounts in a debt service fund or principal-and-interest-account without yield restriction for up to 13 months. A "bona fide debt service fund" as a fund that—

(1) Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and

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[10] At the end of the 3-year period, the Regulations allow the issuer to make payments to the IRS, known as "yield reduction payments," in order to reduce the investment yield down to the bond yield. These payments are computed like rebate payments, discussed below. Treas. Reg. Section 1.148-5(c).

[11] Treas. Reg. Section 1.148-2(e)(2)(ii).

(2) Is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of: (i) the earnings on the fund for the immediately preceding bond year; or (ii) 1/12 of the principal and interest payments on the issue for the immediately preceding bond year.[12]

(E) *Temporary Periods For Refundings*. Proceeds of a current refunding bond may be invested without yield restriction for 90 days, but proceeds of an advance refunding have only a 30-day temporary period. Most issuers, investment bankers, and bond counsel ignore the 30-day period and treat the refunding escrow as yield-restricted from the beginning.[13] See the discussion of current and advance refundings in **Section 2.7** below.

(F) *Other Temporary Periods*. The regulations include additional temporary periods for restricted working capital expenditures (13 months), pooled financing bonds (6 months or 2 years), replacement proceeds (30 days), investment proceeds (1 year), and other amounts (30 days).[14]

2.5 Exception for Reserve Fund.

(A) "*Reasonably Required*." Amounts in a "reasonably required reserve or replacement fund" may be invested without yield restriction over the term of the bonds. Whether a reserve fund is funded from bond proceeds or from issuer equity, money in the fund is "gross proceeds" of the issue. A reserve fund may be invested without yield restriction up to the least of (a) 10% of the principal amount of the bonds, (b) the maximum annual debt service on the bonds, and (c) 125% of average annual debt service on the bonds.[15]

(B) *Limit on Use of Sale Proceeds*. Not more than 10% of sale proceeds of the bonds can be used to fund a reserve fund.[16]

2.6 Exception for the Minor Portion. In addition to the exceptions for temporary periods and reserve funds, gross proceeds not exceeding the lesser of 5% of the sale proceeds of the issue or $100,000 (the "minor portion") may be invested at yields materially higher than the bond yield.[17]

2.7 Basic Rule of Arbitrage Applied to Refunding Issues.

(A) *Advance Refunding.*

(1) General. An advance refunding bond is a bond issued more than 90 days before the last expenditure of bond proceeds to pay principal or interest on a refunded bond. Note that, for an advance refunding, there is no

[12] Treas. Reg. Sections 1.148-1(b) and -2(e)(5).
[13] Treas. Reg. Section 1.148-9(d).
[14] Treas. Reg. Section 1.148-2(e).
[15] Treas. Reg. Section 1.148-2(f).
[16] Code Section 148(d)(2).
[17] Code Section 148(e).

exception to the basic rule of arbitrage: the proceeds used to pay the refunded bonds cannot be invested above the bond yield (except for the 30-day temporary period). Also, yield on these proceeds is materially higher than the bond yield if the investment yield exceeds the bond yield by 0.001% or more.[18]

(2) SLGS. Most refunding escrows are invested in special United States Treasury Time Deposit Securities, State and Local Government Series (affectionately known as "SLGS"). Municipal issuers purchase these securities directly from the U.S. Treasury Department, Bureau of Public Debt. The issuer specifies the principal amount, interest rate, and maturity date for each SLG in a "subscription." All subscriptions for SLGS must be made using the Bureau's on-line system known as "SLGSafe." The interest rate can be any rate from zero percent up to the maximum permitted rate for SLGS of that maturity, as specified by the Bureau each date. These maximum rates are designed to be 1 basis point (0.01%) below the "then current estimated Treasury borrowing rate for a Treasury security of a comparable maturity."[19] The daily rate tables for SLGS can be found on the internet at: www.publicdebt.treas.gov.

(3) Open-Market Escrows. All securities (other than SLGS or tax-exempt bonds) purchased for a yield-restricted defeasance escrow must be purchased through a formal bidding procedure that complies with the Treasury Regulations. These regulations, which also apply to guaranteed investment contracts, are discussed in **Section 4** below.

(B) *Current Refunding*. A current refunding bond is one issued not more than 90 days before the last expenditure of bond proceeds to pay principal or interest on the refunded bond. As discussed above, the temporary period for a current refunding matches the definition of a current refunding: 90 days. Therefore, the issuer may invest the refunding proceeds at an unrestricted yield during those 90 days. In addition, since all the proceeds will be spent within 6 months, the portion of the proceeds used to refund the prior issue will satisfy the 6-month spending exception to arbitrage rebate (discussed below).

(C) *Reserve Funds*. A refunding issue may have a reserve fund like any other issue, and it may be invested without yield restriction, assuming it is sized properly as discussed above.

3 ARBITRAGE REBATE

3.1 Basic Concept. Under Code section 148(f), if gross proceeds are invested at a yield higher that the bond yield, the excess earnings must be paid (rebated) to the United States in five-year installments. The concept of a "materially higher" yield does not apply to rebate; any investment earnings at a yield over the bond yield will generate rebate. For example, if the annual yield on an issue of bonds is 4%, and bond proceeds are invested at

[18] Treas. Reg. Section 1.148-2(d)(2).
[19] 31 C.F.R. Section 344.2(b).

5%, the 1% differential must be rebated. Rebate is an additional layer of restrictions and consequences on top of the basic rule of arbitrage. Even if the issuer is permitted to invest bond proceeds at yields above the bond yield, such as investments during a temporary period or investments in a reserve fund, all excess earnings must be paid to the United States, unless the issuer qualifies for an exception to rebate. Rebate installment payments are due every five years and within 60 days after the last bond of an issue is paid. Failure to comply with the arbitrage rebate requirements may cause the interest on the bonds to become taxable, retroactive to their date of issuance.[20]

3.2 Calculation of Rebate.

(A) The rebate amount as of any computation date equals the excess of—

(1) the future value, as of that date, of all receipts on nonpurpose investments (interest received on investments and proceeds from the sale or redemption of investments) over

(2) the future value, as of that date, of all payments on nonpurpose investments (amounts paid to purchase investments).

(B) The future value of a payment or receipt is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received, plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the bonds, using the same compounding interval and financial conventions used to compute that yield.[21]

3.3 Nonpurpose Investments. The rebate rules apply to gross proceeds invested in nonpurpose investments, such as investments in a construction fund, reserve fund and debt service fund. Rebate does not apply to purpose investments, such as a loan agreement in a conduit financing or the mortgage loans financed in a single-family mortgage revenue bond issue. The yield on purpose investments is limited by other provisions of arbitrage law, but rebate is not applicable.

3.4 Rebate Exceptions.

(A) *Overview*. There are two major types of exceptions to rebate, one based on the size of the issue and the other based on spending the proceeds within certain spending periods. These are described below.

(B) *Small-Issuer ($5/$10/$15 million) Exception*.

(1) General. An issue is exempt from arbitrage rebate if—

(a) the bonds are issued by a governmental unit with general taxing powers;

(b) no bond of the issue is a private activity bond;

[20] Code Section 148(f).
[21] Treas. Reg. Section 1.148-3.

(c) 95% or more of the net proceeds of the bonds are used for local governmental activities of the issuer; and

(d) the issuer reasonably expects to issue no more than $5,000,000 face amount of tax-exempt bonds (other than private activity bonds) during the calendar year in which the bonds are issued. Regardless of the issuer's expectations, if the aggregate amount of non-private-activity bonds issued in a calendar year does not exceed $5,000,000, the bonds will qualify for this exemption. Generally, all tax-exempt bonds (other than private activity bonds) issued by a governmental unit or other subordinate entities (including "on behalf of" issuers, such as a public building corporation or other "63-20" corporation) must be counted toward the $5,000,000 limit. However, bonds issued to currently refund a prior issue, up to the outstanding amount of such prior issues, are not counted against the $5,000,000 limit.[22]

(2) Special Rule for Refunding Issues. If any portion of a bond issue (the "refunding portion") is used to refund a prior bond issue, then that refunding portion will not be exempt from rebate under the $5,000,000 rule unless:

(a) the face amount of the refunding portion does not exceed $5,000,000;

(b) the refunded bonds qualified under the $5,000,000 exception;

(c) the weighted average maturity of the refunding portion is not later than the remaining weighted average maturity of the refunded bonds;[23] and

(d) no refunding bond matures later than 30 years after the issue date of the original bonds.[24]

(3) Expanded Limit for Public School Construction Issues.

(a) The $5,000,000 limit is increased by the lesser of (i) $10,000,000 or (ii) the aggregate face amount of the bonds attributable to financing the construction of public school facilities. This means that, for most bonds issued by public school districts and community college districts to construct school buildings, a $15 million limit will apply.[25]

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[22] Code Section 148(f)(4)(D); Treas. Reg. Section 1.148-8.
[23] The limit on average maturity does not apply if the average maturity of the refunded bonds was three years or less.
[24] Code Section 148(f)(4)(D)(v).
[25] Code Section 148(f)(4)(D)(vii).

(b) The term “construction” generally means capital expenditures incurred to construct, reconstruct, renovate, rehabilitate, or improve buildings or structures, but does not include expenditures to acquire land, any interest in land, or other real property, or to acquire or improve moveable personal property, such as furniture, computers, photocopiers, books, or vehicles.[26]

(C) *Six-Month Spending Exception*.

(1) The obligation to pay rebate will be satisfied if (a) the “adjusted gross proceeds” of an issue (defined below) are expended for the governmental purpose of the bonds within 6 months after the issue date; and (b) rebate is paid on all gross proceeds not required to be spent within the 6-month period (other than amounts in any bona fide debt service fund). For governmental-purpose and qualified 501(c)(3) bonds, an additional 6 months is allowed to spend up to 5% of the sale proceeds of the bonds.

(2) For the purpose of meeting the spending test, the term “adjusted gross proceeds” means gross proceeds, less amounts held in a bona fide debt service fund or a reasonably required reserve or replacement fund. Also, use of gross proceeds of a bond issue to pay principal of that issue is not treated as an expenditure for the purpose of this test.[27]

(D) *Eighteen-Month Exception*.

(1) General. This exception is not available for refunding issues. The 18-month exception is satisfied if:

(a) the adjusted gross proceeds are spent for the governmental purpose of the issue in accordance with the following schedule:

Time Period After Issue Date	**Cumulative Percentage of Adjusted Gross Proceeds Spent**
6 months	15%
12 months	60%
18 months	100%

; and

(b) rebate is paid on all gross proceeds not required to be spent within the 18-month period (other than amounts in any bona fide debt service fund).

[26] See Code Sections 148(f)(4)(D)(vii) and 148(f)(4)(C)(6) and Treas. Reg. Section 1.148-7(g).
[27] Code Section 148(f)(4)(B) and Treas. Reg. Section 1.148-7.

(2) Special Rules. An issuer may take up to 30 months to spend any "reasonable retainage," not to exceed 5% of the net sale proceeds 18 months after the bonds are issued. "Reasonable retainage" means amounts retained by the issuer for reasonable business purposes, such as to ensure or promote compliance with a construction contract. Also, the failure to satisfy the final spending requirement at the end of the 18-month period is disregarded if the issuer or borrower uses due diligence to complete the project, and the amount of unspent gross proceeds does not exceed the lesser of 3% of the aggregate issue price of the bonds or $250,000. Just as in the six-month exception, use of gross proceeds of a bond issue to pay principal of that issue is not treated as an expenditure for this purpose.[28]

(E) *Two-Year Exception for Construction Bonds*.

(1) General. This rebate exception applies only to bonds issued to finance construction of property owned by a governmental unit or a 501(c)(3) organization. No rebate is payable on "available construction proceeds" (defined below) if such proceeds are expended for the governmental purpose of the issue within two years after the issue date, in accordance with the following schedule:

Time Period After Issue Date	**Cumulative Percentage of Available Construction Proceeds Spent**
6 months	10%
12 months	45%
18 months	75%
24 months	100%

(2) Special Rules. At the end of the two-year period, an amount of available construction proceeds equal to a "reasonable retainage" may remain unspent, so long as 100% of the available construction proceeds are spent within three years after the issue date. "Reasonable retainage" has the same meaning as in the 18-month exception described above. The retainage cannot exceed 5% of the available construction proceeds as of the end of the two-year period. In addition, the failure to satisfy the final spending requirement at the end of the two-year period is disregarded if the issuer or borrower uses due diligence to complete the project, and the amount of unspent gross proceeds does not exceed the lesser of 3% of the aggregate issue price of the bonds or $250,000. Use of available construction proceeds to pay principal of bonds of that issue will not be treated as an expenditure for this purpose.

(3) Definition of Available Construction Proceeds. "Available Construction Proceeds" are the sale proceeds of the construction issue, increased by

[28] Treas. Reg. Section 1.148-7.

earnings on such sale proceeds, earnings on amounts in any reasonably required reserve or replacement fund not funded from the issue, and earnings on all of the foregoing earnings, and reduced by the amount of the issue price in any reasonably required reserve or replacement fund and the issuance costs financed by the issue. Earnings on a debt service reserve fund (regardless of the source of funding) are included in available construction proceeds only until the earlier of the close of the two-year period or the date construction is substantially completed. The issuer may elect to disregard such earnings for purposes of the two-year spending test if investment earnings on the reserve fund are rebated beginning on the issue date.

(4) Penalty-in-Lieu-of-Rebate. An issuer may elect (on or before the issue date) to pay a penalty on unspent available construction proceeds instead of paying rebate. The penalty is 1.5% of the available construction proceeds not spent in accordance with the schedule, determined at the end of the relevant semiannual period. Penalties are payable to paid to the United States 90 days after the end of each semi-annual period.

(5) Rebate on Other Amounts; Division of Issue. Whether or not the two-year spending test is satisfied, the issuer must pay rebate on gross proceeds that are not available construction proceeds, such as amounts in a debt service reserve fund after the earlier of the end of the two-year period or the date construction is complete. The two-year spending exception also permits an issuer to elect to divide an issue which is only partially used for construction purposes, allowing a portion of the issue to be eligible for the two-year exception.[29]

(F) *Rebate Exception for Bona Fide Debt Service Fund*. For each bond year, earnings on investments in a bona fide debt service fund (defined above) are not subject to rebate if the gross earnings in the fund are less than $100,000 during such bond year. For governmental-purpose bonds with a weighted average maturity of at least five years and fixed interest rates, the $100,000 earnings limit does not apply (i.e., all earnings from investments held in a bona fide debt service fund would be exempt from rebate). For any bond issue, if the average annual debt service does not exceed $2,500,000, the $100,000 limit may be considered satisfied. Also, for a bond issue that meets either the 6-month, 18-month, or 24-month spending test, earnings on amounts in a bona fide debt service fund are not taken into account in computing rebate.[30]

4 FAIR MARKET VALUE OF INVESTMENTS

4.1 General. All investments of bond proceeds must be purchased and sold at fair market value.[31] This requirement is designed to avoid "yield burning," in which the seller of the investment "marks up" the price to be paid by the bond issuer to reduce the yield down to the bond yield. In general, the fair market value of an investment is the price at which a

[29] Code Section 148(f)(4)(C) and Treas. Reg. Section 1.148-7.
[30] Code Section 148(f)(4)(A).
[31] Treas. Reg. section 1.148-6(c) (the allocation and accounting rules).

willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction, as determined on the trade date. Except for certain safe harbors discussed below, if an investment is not traded on an established securities market, it is presumed to be bought or sold for a price that is not equal to its fair market value.[32] The fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury (such as a SLG or U.S. Treasury Bill) is its purchase price.

4.2 Safe Harbor for Certificates of Deposit. This safe harbor applies only to a certificate of deposit (a "CD") that has a fixed interest rate, a fixed payment schedule, and a substantial penalty for early withdrawal. The purchase price of such a CD is treated as its fair market value on the purchase date if the yield on the CD is not less than: (1) the yield on reasonably comparable direct obligations of the United States; and (2) the highest yield that is published or posted by the "provider" (the bank) to be currently available from the provider on reasonably comparable CDs offered to the public.[33]

4.3 Safe Harbor for Investment Contracts and Defeasance Escrows.

(A) *General*.

(1) If the procedures in these regulations are followed,[34] the purchase price of a guaranteed investment contract (a "GIC") and the purchase price of investments purchased for a yield restricted defeasance escrow will be treated as the fair market value. There are five elements to these fair-market-value rules:

- Bona Fide Solicitation for Bids.
- Receipt of Bids.
- Winning Bid.
- Winning Bidder Certification.
- Record Retention.

(2) Each of the elements is discussed below. The party that enters into the GIC with the bond issuer or sells the escrowed securities to the issuer is referred to as the "provider."

(B) *Bona Fide Solicitation for Bids.*

(1) In Writing. The bid specifications must be in writing and timely forwarded to potential providers.

(2) All Material Terms. The bid specifications must include all "material" terms of the bid. A term is material if it may directly or indirectly affect the yield or the cost of the investment.

[32] Treas. Reg. Section 1.148-5(d)(6).
[33] Treas. Reg. Section 1.148-5(d)(6)(ii).
[34] Treas. Reg. Section 1.148-5(d)(6)(iii).

(3) Representations. The bid specifications must include a statement notifying potential providers that submission of a bid is a representation that—

(a) the provider did not consult with any other provider about its bid,

(b) the bid was determined without regard to any other formal or informal agreement that the provider has with the issuer or any other person (whether or not in connection with the bond issue), and

(c) the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the regulations

(4) Commercially Reasonable Terms. The terms of the bid specifications must be “commercially reasonable,” which means that there must be a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of the investment. For example, for solicitations of investments for a yield restricted defeasance escrow, the hold-firm period must be no longer than the issuer reasonably requires.

(5) Expected Deposit and Draw-downs. [For GICs Only]. The terms of the solicitation must take into account the issuer’s reasonably expected deposit and drawdown schedule for the amounts to be invested.

(6) No Last Look. All potential providers must have an equal opportunity to bid. For example, no potential provider can be given the opportunity to review other bids (*i.e.*, a “last look”) before providing a bid.

(7) Three Reasonably Competitive Providers. At least 3 “reasonably competitive providers” must be solicited for bids. A reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

(C) *Receipt of Bids*.

(1) At Least 3 Bids. The issuer must receive at least 3 bids from solicited providers that do not have a “material financial interest” in the issue. A lead underwriter in a negotiated underwriting transaction has a material financial interest in the issue until 15 days after the issue date, and any entity acting as a financial advisor with respect to the purchase of the investment at the time the bid specifications are disseminated has a material financial interest.

(2) One Bid from Reasonably Competitive Provider. At least one of the 3 bids must be from a “reasonably competitive provider.” Note: at least 3 reasonably competitive providers must be solicited, but only one such provider need actually submit a bid.

(3) No Bid by Broker. If the issuer uses an agent (a broker) to conduct the bidding process, the agent must not bid.

(D) *Winning Bid*.

(1) Guaranteed Investment Contracts. If the investment is a GIC, the winning bid must be the highest yielding bona fide bid (determined net of any broker's fees).

(2) Defeasance Escrow. For a yield-restricted defeasance escrow, the following requirements must be met:

(a) The winning bid is the lowest cost bona fide bid (including any broker's fees). Any payment received by the issuer from a provider at the time a GIC is purchased (*e.g.*, an escrow float contract) for a yield-restricted defeasance escrow is taken into account in determining the lowest cost bid.

(b) The lowest cost bona fide bid (including any broker's fees) is not greater than the cost of the most efficient portfolio comprised exclusively of SLGS, determined using the SLGS rates available at the time that bids are required to be submitted.

(E) *Certification of the Winning Bidder*. The winning bidder must certify the administrative costs (e.g., a broker fee) that it will pay to third parties.

(F) *Retention of Records*. The issuer must retain the following records with the bond documents until 3 years after the last outstanding bond is redeemed:

(1) For GICs, a copy of the contract, and for purchases of other investments, the purchase agreement or confirmations.

(2) The receipt or other record of the amount actually paid by the issuer for the investments, including a record of any administrative costs (broker fees) paid by the issuer, and the provider's certification as to these costs.

(3) For each bid that is submitted, the name of the bidder, the time and date of the bid, and the bid results.

(4) The bid solicitation form.

(5) For a defeasance escrow, proof of the cost of the most efficient portfolio of SLGS.

4.4 Broker Fees.

(A) *General*. When an issuer engages a broker to solicit bids for an investment contract, the broker's fee is usually paid by the winning provider. Federal arbitrage law does not expressly limit the amount of the broker's fee. But if the fee exceeds a "qualified administrative cost," then the excess amount will be treated as if the provider paid it first to the issuer, which then paid it to the broker. Under this treatment, the excess fee counts as additional interest received by the issuer on the GIC. Such additional interest will increase the yield on the investment and could increase the issuer's arbitrage rebate liability. If the investment yield is materially higher than the bond yield, the bonds may become arbitrage bonds.[35]

(B) *Qualified Administrative Costs*.

(1) For GICs acquired in 2012, a broker's commission or similar fee is a qualified administrative cost to the extent that it does not exceed the lesser of (1) \$37,000 or (2) 0.2% of "computational base;" and for any bond issue, the issuer does not treat as qualified administrative costs more than \$103,000 in brokers' commissions or similar fees with respect to all GICs and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue. These dollar limits are adjusted annually for inflation.

(2) The term "computational base" means, for a GIC, the amount the issuer reasonably expects as of the issue date to be deposited in the GIC over the term of the contract, and for a defeasance escrow, the amount of gross proceeds initially invested in those investments.[36]

5 HEDGE BOND RULES

5.1 Definition of Hedge Bonds. The hedge bond rules are technically not related to arbitrage, but they are similar to the rules governing the three-year and five-year temporary periods. Under Code section 149(g), the term "hedge bond" means any bond unless—

(A) the issuer reasonably expects that 85% of the spendable proceeds of the issue will be used to carry out the governmental purposes of the issue within 3 years, and

(B) not more than 50% of the proceeds of the issue are invested in nonpurpose investments having a substantially guaranteed yield for 4 years or more.[37]

5.2 Consequences. Interest on a hedge bond is not tax-exempt unless two conditions are met:

(A) The payment of legal and underwriting costs associated with the issuance of the issue is not contingent, and at least 95% of the reasonably expected legal and underwriting costs associated with the issuance of the bonds are paid not later than the 180th day after the issue date; and

[35] Treas. Reg. Section 1.148-5(e).
[36] Treas. Reg. Section 1.148-5(e)(2)(iii).
[37] Code section 149(g).

(B) The issuer reasonably expects that—

(1) 10% of the spendable proceeds of the issue will be spent for the governmental purposes of the issue within the 1 year,

(2) 30% of the spendable proceeds of the issue will be spent for such purposes within 2 years,

(3) 60% of the spendable proceeds of the issue will be spent for such purposes within 3 years, and

(4) 85% of the spendable proceeds of the issue will be spent for such purposes within 5 years.

5.3 Comment. Under the arbitrage rules, if an issuer cannot meet the 3-year, 85%-expenditure test for the 3-year temporary period, the bonds can still be issued as long as the bond proceeds in the project fund are restricted to the bond yield (yield reduction payments are not permitted in this case, except for variable rate issues). But the hedge-bond rules must be satisfied. Therefore, the longest period over which the issuer can expect to spend the bond proceeds is five years, and the issuer must reasonably expect that it will meet the 10%, 30%, 60%, and 85% spending targets shown above.