MEMORANDUM*

USE OF TAX-EXEMPT BOND PROCEEDS
TO REIMBURSE PRIOR CAPITAL EXPENDITURES

March 1, 2012

I. Introduction, Scope and Effective Date

Proceeds of a tax-exempt bond issue are subject to arbitrage yield restrictions, arbitrage rebate requirements and other limitations under the Internal Revenue Code of 1986, as amended (the "Code"). When bond proceeds are spent, they are no longer treated as proceeds, and therefore are no longer subject to these restrictions.

A bond issuer or conduit borrower of bond proceeds will often spend money on a project before the bonds are issued, intending to reimburse such expenditures from bond proceeds. The use of bond proceeds to reimburse prior expenditures is governed by Treasury Regulation § 1.150-2 (the "Regulation"), which applies to all tax-exempt borrowing, including traditional governmental bonds, bonds issued to benefit nonprofit, 501(c)(3) organizations, and bonds issued to benefit for-profit corporations, such as exempt facility multifamily housing and small-issue manufacturing bonds. This Memorandum summarizes the requirements of the Regulation.

The Regulation does not apply when bond proceeds are used to pay off an existing loan or other obligation, if the bond proceeds are paid out to an unrelated entity, such as a bank or other lender.

II. General Requirements

An allocation of bond proceeds to reimburse the issuer for an expenditure made before the bond issue date is treated as an expenditure of such proceeds if the issue meets the following three requirements—

1. nature of expenditure,

2. official intent, and

3. reimbursement period.

III. Nature of Expenditure

The expenditure to be reimbursed must be a capital expenditure, a cost of issuing bonds, a grant, a qualified mortgage loan, a qualified veterans' mortgage loan, or a qualified student loan. In addition, certain

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* This memorandum is for general information purposes only. For legal advice concerning how these rules may apply to your specific facts, please contact a Gilmore & Bell attorney or your issuer's regular legal counsel.

extraordinary, non-recurring working capital expenditures that are not customarily payable from current revenues may be reimbursed, such as casualty losses or extraordinary legal judgments in excess of insurance coverage.

IV. Official Intent

A. *General Rule*. The official intent requirement is satisfied if, not later than 60 days after payment of the original expenditure, the bond issuer declares its intent to reimburse the expenditure with proceeds of a borrowing.

B. *Who Must Declare the Official Intent?* For traditional, governmental-purpose bonds, the bond issuer must declare the intent. If the issuer loans the bond proceeds to another governmental unit (*e.g.*, if a state agency issues bonds and loans the proceeds to a city or school district), either the bond issuer or the borrower may declare the official intent. The same rule applies for the following private activity bonds:

- Qualified 501(c)(3) bonds (bond proceeds will be loaned to an organization described in Code § 501(c)(3), such as a nonprofit health care institution, university, or nursing home),
- Qualified student loan bonds.
- Qualified mortgage bonds (also known as single-family mortgage revenue bonds).
- Qualified veterans' mortgage bonds.

For these categories of private activity bonds, either the bond issuer or the borrower may declare the official intent and may make other certifications related to reimbursement, as appropriate. For all other private activity bonds, such as exempt facility, multifamily housing bonds and small-issue manufacturing bonds, the actual bond issuer must declare the official intent.

C. *Official Intent - Requirements*.

1. Source and Form. The declaration of official intent can be in any reasonable form, including:

(a) a resolution of the governing body of the issuer or borrower (*e.g.*, a resolution passed by the city council or by the board of directors of a 501(c)(3) borrower);

(b) action by an appropriate representative of the issuer or borrower (*e.g.*, a person authorized or designated to declare the official intent of the issuer); or

(c) specific legislative authority for issuing bonds for the project.

2. Project Description/Fund Accounting. The declaration of official intent must generally describe the project. A “project” includes a property, project or program (*e.g.*, “highway capital improvement program,” “hospital equipment acquisition,” “school building renovation”). Alternatively, a project description is sufficient if it identifies, by fund name and functional purpose, the fund or account from which the original expenditure will be paid (*e.g.*, “parks and recreation fund - recreational facility capital improvement program”).

The Regulation allows for a reasonable deviation between the project described in the official intent and the actual project, if the actual project is reasonably related in function to the project described in the official intent. For example, "hospital equipment" is a reasonable deviation from "hospital building improvements," but "city office building rehabilitation" is **not** a reasonable deviation from "highway improvements."

3. Maximum Principal Amount. The declaration of official intent must state the maximum principal amount of bonds expected to be issued for the project.

D. *Intent Must Be Reasonable*. On the date of the declaration of official intent, the issuer must reasonably expect to reimburse the original expenditures from proceeds of a borrowing. Official intents declared as a matter of course or in amounts substantially greater than the amounts expected to be necessary for a project (*e.g.*, blanket declarations) are not reasonable. Also, a pattern of failing to reimburse actual expenditures covered by prior official intents is evidence of unreasonableness, absent extraordinary circumstances.

E. *Suggested Forms of Official Intent*. Attached to this Memo are two suggested forms of official intent: (1) a resolution to be adopted by the city council or board of aldermen of a city; and (2) a resolution of the board of directors of a 501(c)(3) corporation (the conduit borrower of bond proceeds) declaring official intent.

V. Reimbursement Period

A. *General Rule*. Bond proceeds must be allocated to reimburse the original expenditure within 18 months after the later of—

1. the date the original expenditure was paid, or

2. the date the project was placed in service or abandoned,

but in no event more than three years after the original expenditure was paid.

B. *Longer Time Period for Certain Governmental Bonds*. If the bond issue is exempt from arbitrage rebate under the $5,000,000-$15,000,000 small-issuer-exception (Code § 148(f)(4)(D)), the 18-month limitation is extended to three years, and the maximum three-year limit is disregarded.

C. *Reimbursement Allocation.* The reimbursement allocation must be in writing and must evidence an issuer's use of bond proceeds to reimburse an original expenditure. If bond proceeds are allocated to a reimbursement within 30 days after the bonds are issued, the issuer may treat such proceeds as allocated (and therefore spent) on the issue date.

D. *Long-Term Construction Projects*. The three-year maximum reimbursement period may be extended to five years if both the issuer and a licensed architect or engineer certify that at least five years are necessary to complete construction.

VI. Exceptions to Official Intent and Time-Limit Requirements.

Neither the requirement for a declaration of official intent (**Part IV** above), nor the 18-month/3-year time limit on allocating bond proceeds to reimbursement (**Part V** above) is required to reimburse the following costs:

A. *Issuance Costs*. Costs of issuing bonds.

B. *De Minimis Expenditures*. Expenditures not exceeding the lesser of $100,000 or 5% of the proceeds of the bonds.

C. *Preliminary Expenditures*. "Preliminary expenditures," not exceeding 20% of the aggregate issue prices of the bonds, expected to be issued for the project. "Preliminary expenditures" include architectural, engineering, surveying, soil testing, and similar costs that are incurred prior to commencement of construction, rehabilitation, or acquisition of the project. Preliminary expenditures **do not include** land acquisition, site preparation, or similar costs incident to the commencement of construction.

VII. Not Applicable to Refundings

The original expenditure to be reimbursed cannot be an expenditure to pay principal or interest on an obligation. For example, if a city uses cash on hand to pay off a maturing bond or note, then seeks to reimburse itself from a later tax-exempt issue, such a reimbursement would not be valid, and the proceeds so allocated would not be spent for tax purposes. Also, an issuer cannot reimburse itself for an expenditure which was paid from another obligation.

VIII. Anti-abuse Rules

A. *General Rule*. A reimbursement allocation will not be treated as an expenditure of bond proceeds if the action (a) enables the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage, and (b) overburdens the tax-exempt market (known as an "abusive arbitrage device" under Treas. Reg. § 1.148-10).

B. *One-Year Step Transaction Rule*. Normally, Treas. Reg. § 1.148-6 permits an issuer to allocate bond proceeds and other amounts to various uses using any reasonable, consistently applied allocation method. For example, an issuer may allocate cash on hand to pay issuance costs and to fund a bond reserve fund, and allocate bond proceeds to the project. Under the Regulation, however, if bond proceeds are allocated to reimburse an expenditure, and within one year after that allocation, "funds corresponding to such proceeds" are used in a manner that creates "replacement proceeds," the allocation is invalid. Replacement proceeds include amounts expected to be used to pay principal or interest of any bond issue, and amounts pledged to any bonds.

The meaning of the phrase "funds corresponding to the proceeds" is unclear. Presumably, it means that bond proceeds were first used to reimburse a borrower or issuer, then used within one year to establish a sinking fund or pledged fund for a bond issue. However, different methods may be used to trace or allocate such amounts, and the IRS may disagree with an issuer's method in order to invoke the anti-abuse rule. Therefore, we would not approve the use of cash from any source (other than a refunding bond issue) to establish a sinking fund or pledged fund for a bond issue within one year after a reimbursement allocation is made. The anti-abuse rule does not apply to moneys deposited into a bona fide debt service fund.

[Form of Official Intent Adopted by City]

RESOLUTION OF THE CITY COUNCIL [BOARD OF ALDERMEN]
OF THE CITY OF ___________, _________

BE IT RESOLVED BY THE CITY COUNCIL [BOARD OF ALDERMEN] OF THE CITY OF ___________, _________ , AS FOLLOWS:

RESOLVED, that the City of ___________, _________ (the "City") expects to make capital expenditures after the date of this Resolution in connection with the purchase of a new ___________________________________ (the "Project"), and the City intends to reimburse itself for such expenditures with the proceeds of bonds, notes, or a lease purchase agreement.

RESOLVED FURTHER, that the maximum principal amount of the lease agreement or other obligations expected to be issued for the Project is $__________.

ADOPTED by the City Council [Board of Aldermen] this _____ day of _________, 20__.

(SEAL)

____
Mayor

ATTEST:

____
City Clerk

[Form of Official Intent—Conduit Borrower]

RESOLUTION OF THE BOARD OF DIRECTORS OF [NAME OF BORROWER] DETERMINING ITS INTENT TO REIMBURSE ITSELF FOR CERTAIN CAPITAL EXPENDITURES.

WHEREAS, [Name of Borrower] (the "Borrower") has made certain capital expenditures in connection with ____ (the "Project"), prior to the date of this Resolution, and the Borrower expects to make additional capital expenditures for the Project in the future.

RESOLVED, that the Borrower intends to reimburse itself for all or a portion of such expenditures, to the extent permitted by law, with the proceeds of bonds or other obligations to be issued by a political subdivision or other governmental entity for the benefit of the Borrower (the "Bonds").

FURTHER RESOLVED, that the maximum principal amount of Bonds expected to be issued for the Project is $________.

* * * * *

The undersigned hereby certifies that the foregoing Resolution was duly adopted by the Board of Directors of [Name of Borrower] on ______________, 20__.

____
Secretary