

Taxation of Municipal Bonds

Raison d'être § 103 says that a state or local bond is exempt from federal income tax in the hands of the holder. Until 1969 it was thought it was unconstitutional to tax state bonds, now it is constitutional.

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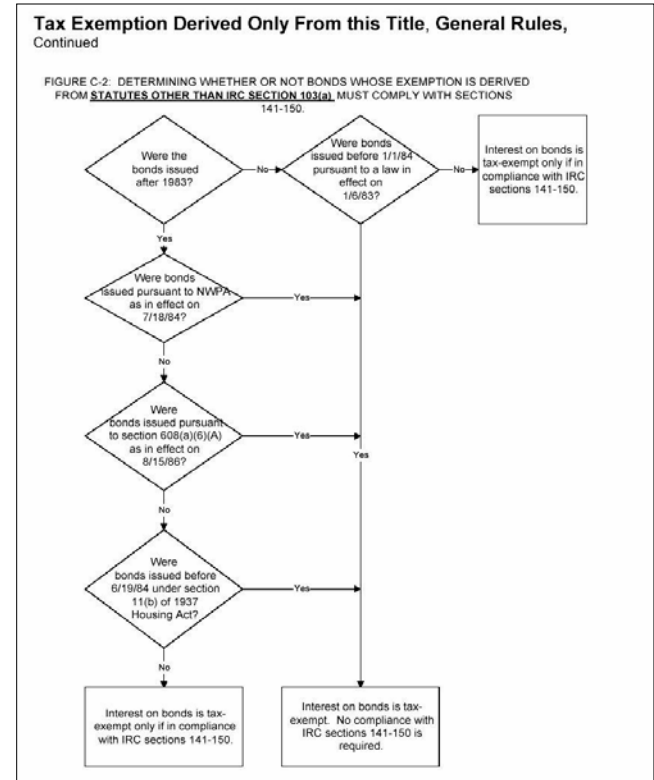
Framework of analysis

- Who is the bond benefiting?
 - Is it really a government bond?
 - An **Exempt** facility bond (which need or need not be owned by the government, a Qualified mortgage bond (not covered in class); Qualified veterans bond; Qualified small issue bond; Qualified student loan bond; Qualified redevelopment bond; Qualified **501(c)(3)** bond
 - Have the volume caps been exceeded?
 - Has there been a change in use?
- What is the bond for?
- Who is the holder?
- Is there arbitrage? And if so, what can be done about it?

General Rules and rules relating to bond-banks and hedge bonds

Raison d'être § 103 says that a state or local bond is exempt from federal income tax in the hands of the holder. Until 1969 it was thought it was unconstitutional to tax state bonds, now it is constitutional.

- 1) General Rules Applicable to all tax-exempt municipal bonds
 - a) construction of statutes and regulations
 - i) Tax exemptions from bonds can only come from the tax exempt bond title (that is, if it isn't around near 104-149, it doesn't exist)
 - ii) Rules of construction
 - (1) Statutes
 - (a) Any inclusions should be construed narrowly
 - (b) Any limits should be construed broadly
 - (2) Regulations: purpose of these regulations is to limit the benefits of tax-exempt status to only government persons¹
 - b) General prohibitions on the types of bonds (federally guaranteed bonds, hedge bonds, arbitrage bonds (see later))
 - i) Federal Guarantee Prohibited
 - (1) To be tax exempt, a bond more than 5% **cannot be federally guaranteed**, but there are exceptions (the US is considered to be 1) anything that can borrow on the credit of the US. DC is considered to be the US if it is an exempt facility bond, qualified small issue bond, or student loan bond)
 - (2) Any payment of more than 5% or principal or interest will remove bond from tax exempt status
 - (3) If the proceeds are invested **in federally insured accounts**, it will be treated as federally guaranteed²
 - (a) If a federal government agency is a user of a facility it is not a guarantor (so, don't worry)



¹ 1.141-2 The purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. The regulations under section 141 may not be applied in a manner that is inconsistent with these purposes.

² 149(b)(2)(B)(ii) invested (directly or indirectly) in federally insured deposits or accounts, or

- (b) A FDIC standby letter of credit issued by a bank who was insured by the FDIC is not a FDIC insurance. FDIC v. Philadelphia Gear Corp., 476 US 426, (1986),

(4) Exceptions

(a) By time

- (i) Initial temporary period (so a project fund can be invested in an FDIC-insured account only during the temporary period)

(b) By fund

- (i) Bona fide debt service fund can be invested in federally guaranteed securities 149(b)(3)(B)

(ii) 4r fund

(c) By agency (agencies that can federally guarantee bonds and they will not lose their tax exempt status)

- (i) Whoops bonds can be federally guaranteed. (Bonneville Power Authority)³

(ii) Federal Housing Administration 149(b)(3)(A)(i)

(iii) Veterans' Administration 149(b)(3)(A)(i)

(iv) Federal National Mortgage Association 149(b)(3)(A)(i)

(v) Federal Home Loan Mortgage Corporation 149(b)(3)(A)(i)

(vi) Government National Mortgage Association 149(b)(3)(A)(i)

(vii) State Water Pollution Control Revolving Fund Program

Notice 88-54

- ii) **Hedge bonds prohibited:** A bond is a hedge bond if 1) the issuer reasonably expects less than **85% of the spendable (or net sale proceeds) proceeds (a.k.a. to be used to carry out government purposes of the issue within a three year period)**.⁴ Less than 50% of the proceeds are put in non-purpose investments having a substantially guaranteed yield for four 4 years or more. (when rates were cheap would take issue bonds and keep them for no apparent reason. They would rebate or yield restrict any arbitrage to the government. Therefore, Sec. 149(g) removes the tax exemption for hedge bonds)

- (1) Exception available for non-PABs: if proceeds are invested in other tax exempt bonds, the bond will not be a hedge bond because the net amount of tax-exempt bonds available will not change.

- (2) Exception for investment in non-AMT bonds: Since exception is not available for non-PABs, there is no need to analyze the difference on the effect on the bond market between AMT-exempt and non-AMT exempt bonds⁵

- (a) Amounts held in a bona fide debt service fund are considered invested in something that is not-subject to AMT

³ 149(b)(3)(A)(iii) any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. 839(d) as in effect on the date of the enactment of the Tax Reform Act of 1984.

⁴ Net sale proceeds are sale proceeds (including underwriter's discount and accrued interest) less proceeds placed into a reasonable required reserve and replacement fund.

⁵ 149(g)(3)(B)(i) IN GENERAL.--Such term shall not include any bond issued as part of an issue 95 percent of the net proceeds of which are invested in bonds--

149(g)(3)(B)(i)(I) the interest on which is not includible in gross income under section 103 , and 149(g)(3)(B)(i)(II) which are not specified private activity bonds (as defined in section 57(a)(5)(C)).

- (3) Exceptions, whereby a hedge bond can still be tax exempt if...it is reasonably expected that it meets the hedge bond spending exceptions
 - (a) **10 percent** will be spent within 1 year of issuance
 - (b) **30 percent** will be spent within 2 years of issuance
 - (c) **60 percent** will be spent within 3 years of issuance
 - (d) **85 percent** will be spent within 5 years of issuance
 - (e) exception for under 30 days⁶
- c) cost of issuance limitations
 - i) Restrictions on costs of issuance in 147(g) -- applies to 501(c)(3)s, even though they can be used for working capital
 - (1) In general: limited to 2% of the proceeds (not face amount) of the bond
 - (2) For small mortgage revenue bond issues that are under 20m: 3.5%
 - (3) Definition of cost of issuance (from legislative history)
 - (a) Costs incurred in connection with borrowing
 - (b) Underwriters compensation
 - (c) Counsel fees (bonds, issuers, company counsel)
 - (d) Financial advisor fees
 - (e) Rating agency fees
 - (f) Trustee fees
 - (g) Accounting fees (including feasibility study)
 - (h) Printing costs
 - (i) Costs incurred in connection with public approval
 - (j) Engineering studies
 - (k) guarantee fees, other than for qualified guarantees.
- d) formalities required for all bonds (and exceptions)
 - i) Registration requirement: bonds must be in **registered** form (can be certificates or book entry – to 1) find the holders and 2) prevent drug traffic in bearer bonds)⁷
 - (1) Must report certain things in a form 8348
 - (2) Exceptions to registration
 - (3) bonds not of a type offered to the public,
 - (4) less with a maturity less than one year,
 - (5) Bonds sold outside the US⁸

⁶ 149(g)(3)(B)(iii) AMOUNTS HELD PENDING REINVESTMENT OR REDEMPTION.--Amounts held for not more than 30 days pending reinvestment or bond redemption shall be treated as invested in bonds described in clause (i).

⁷ 149(e): INFORMATION REPORTING REQUIREMENTS.--A bond satisfies the requirements of this paragraph if the issuer submits to the Secretary, not later than the 15th day of the 2d calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary may prescribe with respect to any portion of the statement), a statement concerning the issue of which the bond is a part which contains--

⁸ 163(f)(2)(B): 163(f)(2)(B) CERTAIN OBLIGATIONS NOT INCLUDED.--An obligation is described in this subparagraph if--

163(f)(2)(B)(i) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

163(f)(2)(B)(ii) in the case of an obligation not in registered form--

163(f)(2)(B)(ii)(I) interest on such obligation is payable only outside the United States and its possessions, and

- ii) TEFRA public approval requirements for Private Activity Bonds
 - (4) Note: prisons and sewers are not private activity bonds so these provisions don't apply
 - (5) General requirements (must be in this order)
 - (a) Reasonable public notice
 - (i) Safe harbor
 - 1. Must inform all jurisdictions government units involved (might be two units)
 - a. host approval: Additionally, Treas. Reg. section 5f.103-2(c)(3) provides that each governmental unit the geographic jurisdiction of which contains the facility to be financed by the issue must approve the issue. However, if the entire site of the bond-financed facility is within the geographic jurisdiction of more than one governmental unit with a State, then any one of such units may provide host approval for the issue with respect to that facility.
 - 2. Must state time and place
 - 3. Must be published no less than 14 days before hearing
 - 4. Must contain (insubstantial deviations acceptable) 26 CFR § 5f.103-2
 - a. A general, functional description of the type and use of the facility to be financed (e.g., "a 10,000 square foot machine shop and hardware manufacturing plant", "400-room airport hotel building", "dock facility for supertankers", "convention center auditorium and sports arena with 25,000 seating capacity", "air and water pollution control facilities for oil refinery"),
 - b. The maximum aggregate face amount of obligations to be issued with respect to the facility,
 - c. The initial owner, operator, or manager of the facility,
 - d. The prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.
 - (b) Public hearing
 - (c) Proper **elected** official must approve (must be after the hearing) – can be approved by referendum
 - (i) In MA it is the governor
 - (ii) Official need not be at the hearing
 - (6) Validity
 - (a) Public approval can be up to a 3 year finance plan
 - (7) Note: legislative history says that this is not intended to be a substitute for state APA compliance
- 2) Restrictions on loans to two or more conduit borrowers ("Bond Banks" or "pooled bonds" treas. Reg. § 150-1(b))

163(f)(2)(B)(ii)(II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

- a) Pooled financing bond is either 1) government 2) 501(c)(3), 4) airport; 5) dock; 5) wharf; 6) government fish ladder 7) 75% of private fish ladder 8) solid waste disposal unit **and** \$5m will go to two or more ultimate borrower 149(f)(4)(A), (B)
- i) Treas. Reg. section 1.150-1(b) defines a pooled financing issue as an issue the proceeds of which are to be used to finance **purpose investments** representing conduit loans to **two or more conduit borrowers**, unless those conduit loans are to be used to finance a single capital project.
 - (1) Note: as a rule any temporary period carries over from the issuer to the conduit borrower
 - (2) Requirements
 - (a) 95% of the net proceeds must be *expected to be allocated within three years* from date of issuance 149(f)(2). During that 3 years, the proceeds can be invested in non-purpose investments 1.148-2(e)(2) (this three years carries over to the conduit borrower, and does not begin anew)
 - (b) 1.148-6(d)(2): mere loaning of funds does not spend the money, the proceeds have to be spent by the conduit borrower for the government purpose.
 - (c) 1.148-6(d)(2)(iii): only when the loan is repaid in full, is it “deallocated”
 - (d) 95% of legal and underwriting costs must be paid with 180 days of issuance 149(f)(3)
 - (e) payment of legal and underwriting costs are not contingent on disbursement of proceeds
 - (i) when dealing with construction bonds (2 year), 2-year period applies only to the issuer, so it becomes part of the 3 year period.
 - (f) loans must be for government purposes, not investment 149(f)(5)
 - (g) **special election** for determining maturities
 - (i) § 301.9100-7T: in the bond indenture or on or before the date of issue, the issuer can elect to have the average maturity of EACH loan comply with the 120% rule (e.g. compare the average maturity of each loan to the expected economic life of the facilities. 147(b)(4))
 - (ii) no bond can be more than 30 years
 - (iii) unspent proceeds after one year must be used to redeem the bonds, ASAP, but not later than 18 months after issuance
 - (iv) 95% of net proceeds are to be loaned to the governments or 501(c)(3) within one year of issuance
 - (v) demand survey required: demand for financing greater than 120% of the pool
 - (3) treatment: treat the bonds as separate issues **if a portion is expected to be used to finance 2 or more ultimate borrowers** 149(f)(5)(B)

change in use rules

- 1) Parties reasonable expectations about the state of the world **reasonable expectations about the state of the world over the life of the bond count.** ⁹
 - a) If the parties reasonably expect it to be a private activity bond it will be, or they take a deliberate action to make it that¹⁰
 - b) **Contingency Provisions** in the bond that can exempt a bond from the the reasonable expectations test where there is a mandatory redemption procedure
 - i) The private business test and the private loan financing test may be disregarded if these four prongs are met: 1.141-2(2)(ii)
 - (1) The property will be used for a substantial amount of time before the action rendering it a private activity bond takes place 1.141-2(2)(ii)(A)
 - (2) There is a mandatory redemption period requiring that bond be redeemed within six months of the activity 1.141-2(2)(ii)(B)
 - (3) The issuer doesn't collude with a non-government entity after the issue to bring about the redemption 1.141-2(2)(ii)(C)
 - (4) The redemption can be considered a remedial action 1.141-2(2)(ii)(D)
- 2) Defining **Deliberate action**: is any action taken by the issuer that is **within its control (catastrophes don't count)**. An **intent** to violate the requirements of section 141 **is not necessary** for an action to be deliberate. 1.141-2(d)(3). Things are NOT deliberate if they are compulsory, or mandated by a change in the federal laws. 1.141-2(d)(2)(ii)
 - a) Dispositions of personal property by the government don't count as deliberate if 1.141-2(d)(4)
 - i) "**weighted average maturity**" of the bonds is less than 120% of the reasonable expected annual use of the personal property 1.141-2(d)(4). See note ¹¹

⁹ **reasonable expectations or reasonableness** if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met. 1.141-2(d)

¹⁰ 1.141-2(d)	Reasonable expectations and deliberate actions--(1) In general. An issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met.
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- ii) The issuer reasonably expects on the issue date that the fair market value of that **property on the date of disposition will be not greater than 25** percent of its cost¹²; and
- iii) the **property is no longer suitable for government use on the date of** deposition 1.141-2(d)(4)
- b) dispositions of personal property will not trigger the make the bond a private activity bond, if the issuer is required to put the money in a fund **commingled with other tax revenues** and they will spend the money on **government purposes in six months**
- c) date of occurrence of deliberate actions are when the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies. 1.141-2(e)

Determining what kind of entity the issue really is (state, or qualified 501(c)(3) person)

- 1) Purely state or local bonds that are (defining “state”)
 - a) State
 - b) Municipality
 - i) The term "State or local bond" means an obligation of a State or political subdivision thereof.¹³
 - c) Indian tribe

There are three steps involved in the computation:

1. Multiply each issue price by the number of years remaining until maturity
2. Add all of these products together.
3. Divide this sum by the principal amount of the bonds.

The computation below shows that the weighted average maturity of these bonds is 3.2 years.

Issue Price	Number of Years Until Maturity	Product
\$1M	1	1M
\$1M	2	2M
\$1M	3	3M
\$2M	5	10M
SUM OF PRODUCTS		16M
DIVIDED BY PRINCIPAL AMOUNT		16M/5M = 3.2

11 Calculating Weighted average maturity
12

1.141-2(d)(2)(ii)(B)	The issuer reasonably expects on the issue date that the fair market value of that property on the date of disposition will be not greater than 25 percent of its cost; and
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¹³ 103(C)(1)

- d) OBO or "on behalf of" issuers, which told you whether you qualify as an issuer on behalf of someone else there WAS a regulation that was discredited. (there are government agencies that have the power to issue bonds that are CONSTITUTED authorities, which are creatures of state legislation, that are beholden to the state).
- e) One kind of private corporation can issue the bonds -- 63-20 corps. There was a regulation which said that if there was a corporation met 6 characteristics that tied to a government (ie some things were created for a certain task).
- 2) A "Private activity bonds" that is a qualified bond¹⁴: Qualified bonds (which are more favored than PAB's but less than truly government bonds)
 - a) Exempt facility bond
 - b) Qualified mortgage bond
 - c) Qualified veterans bond
 - d) Qualified small issue bond
 - e) Qualified student loan bond
 - f) Qualified redevelopment bond
 - g) Qualified 501(c)(3) bond

Refundings: pyramid bonds, refundings of conduit loans

- 1) Reimbursements or "Pyramid bonds" used to pay for things that were already built
 - a) Note: refunding rules trump reimbursement rules. In fact, an obligation that has already been financed cannot be reimbursed.¹⁵
 - b) In general, it is better to refund than to refinance, because refunding breaks the chain of finance
 - c) General rule: (two requirements)
 - i) Requirement the first "official intent starts the clock on a longer period"; an issue will be treated as an expenditure, if within 60 days after the money is spent, the issuer adopts an official intent to do the project¹⁶ Official intent must be specific to be reasonable.¹⁷

¹⁴**103(B)(1)** [Subsection A doesn't apply to] Private activity bond which is not a qualified bond.--Any private activity bond which is not a qualified bond (within the meaning of section 141).

¹⁵ 1.149-2(g) Special rules on refundings--(1) In general--once financed, not reimbursed. Except as provided in paragraph (g)(2) of this section, paragraph (d) of this section does not apply to an allocation to pay principal or interest on an obligation or to reimburse an original expenditure paid by another obligation. Instead, such an allocation is analyzed under rules on refunding issues. See §1.148-9.

¹⁶ 1.150-2(d)(1): Official intent. Not later than 60 days after payment of the original expenditure, the issuer adopts an official intent for the original expenditure that satisfies paragraph (e) of this section.

¹⁷ 1.150-2(e)(3): Reasonableness of official intent. On the date of the declaration, the issuer must have a reasonable expectation (as defined in §1.148-1(b)) that it will reimburse the original expenditure with proceeds of an obligation. Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project (e.g., blanket declarations) are not reasonable. Similarly, a pattern of failure to reimburse actual original expenditures covered by official intents (other than in extraordinary circumstances) is evidence of unreasonableness. An official intent declared pursuant to a specific legislative authorization is rebuttably presumed to satisfy this paragraph (e)(3).

- (1) Possible to transfer official intent between issuers
 - ii) Requirement the second: reimbursement allocation must be within 18 months (after) the date of the expenditure or the date the project is placed in service (whichever is longer). But never more than three years.
 - (1) For small issuers, it is three years no matter what¹⁸
 - (2) For big construction projects (with architect's certification) there is a 5-year exception¹⁹
- d) Exceptions to general rule: these things can be spent at any time regardless of the timeline
 - i) Preliminary expenditures: 20% of the issue price can be spent at any time for "preliminary expenditures"²⁰
 - (1) What preliminary expenditures are: architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.
 - (2) What preliminary expenditures are not
 - ii) Anything less than the lesser of 5% or \$100,000 of the cost of the issue can be spent at any time.²¹
- 2) refunding conduit loans (**see also, section on arbitrage, p. on page 32.**)
 - a) if it is not investment property,²² (**see n. 22 above for a description of investment property**) it is not subject to yield restriction

¹⁸ 1.150-2(d)(2) (ii) Special rule for small issuers. In applying paragraph (d)(2)(i) of this section to an issue that satisfies section 148(f)(4)(D)(i)(I) through (IV), the "18 month" limitation is changed to "3 years" and the "3-year" maximum reimbursement period is disregarded.

¹⁹ 1.150-2(d)(2) (iii) Special rule for long-term construction projects. In applying paragraph (d)(2)(i) to a construction project for which both the issuer and a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project, the maximum reimbursement period is changed from "3 years" to "5 years."

²⁰ 1.149-2(f)(2) Preliminary expenditures exception. Paragraphs (d)(1) and (d)(2) of this section do not apply to any preliminary expenditures, up to an amount not in excess of 20 percent of the aggregate issue price of the issue or issues that finance or are reasonably expected by the issuer to finance the project for which the preliminary expenditures were incurred. Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

²¹ 1.150-2(d)(2): (f) Exceptions to general operating rules--(1) De minimis exception. Paragraphs (d)(1) and (d)(2) of this section do not apply to costs of issuance of any bond or to an amount not in excess of the lesser of \$100,000 or 5 percent of the proceeds of the issue.

- i) loans to government entities are usually considered purpose investments because they are 1) tax-exempt 2) not investment property
- ii) loans to 501(c)(3)s are subject to yield restrictions because they are not tax exempt. (Subject to .125% “materially higher” definition or 1.5% for a program investment) 1.148-2(d)(2). YRPS can’t be made 1.148-5(c)(3)
- iii) If the pool issuer invested proceeds in nonpurpose qualified 501(c)(3) bonds prior to loaning the proceeds to a conduit borrower, then the investment would not be subject to the yield restriction rules. This is because the bonds are not investment property (as non-AMT bonds) and because they are tax-exempt bonds, so no yield limitation applies (under Treas. Reg. section 1.148-2(d)(2)(v)). Because this would be a nonpurpose investment, it would be subject to rebate.
- iv) Loans to qualified small issuers are purpose investments because they are investments property, and there is no specific exemption
- v) Issuers of who invest in nonpurpose investments can make YRPS under 1.148-5(c) (these include rebates) – if he still has proceeds on hand after the 6 month temporary period
- b) Any temporary periods are reduced by the amount of time the proceeds were held following the last repayment. 1.148-2(e)(4)(ii)(A)
- c) if a user arranges to refund bonds, those proceeds can be relent by the first pool issuer within the 6 month temporary period, the new loans will be treated as proceeds of the original issue (and not a refunding) 1.150-1(d)(2)(iii)(B)
- d) but, if there was no intent to reloan the proceeds, then the refunding rules will apply

Private Activity Bonds

Methodology

- Conduct tests on the bonds
- See if they qualify as exempt facility bonds or 501(c)(3)s

If the pool issue consists of:	And the proceeds are invested in:	Then the investment is:
Non-AMT bonds	Non-AMT bonds (can be purpose or nonpurpose)	Not investment property (IRC section 148(b)(3)(A))
Non-AMT bonds	AMT bonds (can only be nonpurpose)	Investment property (IRC section 148(b)(3)(B))
AMT bonds	AMT bonds (can be purpose or nonpurpose)	Not investment property (IRC section 148(b)(3)(A))
AMT bonds	Non-AMT bonds (can only be nonpurpose)	Not investment property (IRC section 148(b)(3)(A))

Private business use test	Private security or payment test	Private loan financing test	Result
Not met	Not met	met	PAB
Met	met	Not met	PAB
Not met	Met	Not met	Not a Pab
Met	Not met	Not met	Not a Pab

- 1) A bond will either be a government bond, a qualified private activity bond (which includes exempt facility bonds, § 501(c)(3) bonds, and qualified small issue bonds.)
 - a) A purely **private activity bond**²³ (PAB) which is not a qualified bond is not eligible for a tax exemption. – in the case of joint agencies apply these tests to each agency individually²⁴ -- assumption is that unless it is specifically exempted it is a PAB (§ 103)
 - i) Defining private activity bonds: If it meets the “**private business use**” test and the “**private security or payment test**” –or– the **private loan financing test** or is used to acquire nongovernment output property
 - (1) Property to be converted doesn’t count: Nongovernment output property doesn’t include any property which is to be converted to a use not in connection with an output facility – unless it is a nuclear power facility²⁵
 - (a) **Output facility** means electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities. 1.141-1(b)
 - (2) Acquisition of nongovernmental output property exempts the bond if the amount exceeds the lesser of 5% of such proceeds or 5,000,000
 - (a) Non-governmental output property means any property which is an output facility (which doesn’t furnish water)
 - (b) In calculating whether the property is non-government , do not include any use before 10/14/87²⁶
 - (c) Non-governmental output property does not include private property acquired to provide output to areas owned or annex by the government (qualified service areas)²⁷
 - (i) Qualified service areas are areas within 10 years provided the same services to the property being acquired
 - (ii) Qualified annexed areas are areas that are less than 10% or less of the area, adjacent to, and the output from those areas is made available to the general public but the output capacity of the area

²³ 103	(a) Exclusion.--Except as provided in subsection (b), gross income does not include interest on any State or local bond. (b) Exceptions.--Subsection (a) shall not apply to— <ol style="list-style-type: none"> a. Private activity bond which is not a qualified bond.--Any private activity bond which is not a qualified bond (within the meaning of section 141).
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²⁴ 141(d)(6)

²⁵ 141(d)(4)

²⁶ 141(d)(2)

²⁷ 141(d)

plus the output capacity of the other acquired property does not exceed 10% of the output capacity of the property²⁸ (sized determined a tend of calendar year.)

1. annexed areas are treated as part of the qualified serve area for determining whether or not another area is annexed

(3) Private business test and private security or payment test

- (a) Private business test: if more than **10%** of the (aggregated²⁹) proceeds of the issue are used for any private business use § 141 (b)(1)

(i) Alternative ways of meeting the test

1. Or 5% of the payments, property, or borrowed money of the (proceeds used for private business, disproportionate related business use of the proceeds) the use is “**not related** or disproportionate to government use finance” to any government use of such proceeds (this is the “use not related version”)³⁰
 - a. E.g. a facility that is in a different building (a newsstand in a court would be related, but a newsstand in a separate building would not be)
2. or 5% or more of any “output facility” (other than for furnishing water) if nonqualified amount is more than 15m – all prior tax exempt issues that 5% or more of them will be used for this facility³¹
 - a. nonqualified amount is the lesser of the proceeds used for a business use or the proceeds of such issue to which there are payments. (501(c)(3) amounts are not taken into account if the issuer “elects” to treat it as a qualified bond.)
 - i. (elections must be made before the issue date, and filed with the bond)³²
3. Disproportionate use: the proceeds which are to be use for the government use (which the private use relates) - the proceeds of the issue which are to be used for private business use³³

(ii) Private use is defined: Direct Or Indirect Use By A natural Person Not In A Government Unit

1. private use is defined as not a government use
2. use by federal government (e.g. post offices is considered to be a not government unit)
3. use by individuals is always a not a government unit

²⁸ (141)(d)(3)(c)

²⁹ Fairfax County Economic Development Authority, 77 T.C. 546

³⁰ 141(B)(3)(A)

³¹ 141(B)(4)(A, B)

³² 1.141(c)	Elections. Elections must be made in writing on or before the issue date and retained as part of the bond documents, and, once made, may not be revoked without the permission of the Commissioner.
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³³ 141(b)(3)(B)

- (iii) if a property can be used by non-government entity (company) on the **same basis** as the general public, it is NOT a private activity.³⁴
- (b) **private security or payment test:** if payment of more than **10%** of the principle or interest is secured by property used for a private business, or property in respect of such property § 141 (b)(2). The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue)
 - (i) Alternative ways of meeting the test
 - 1. Or 5% of the payments, property, or borrowed money of the (proceeds used for private business, disproportionate related business use of the proceeds) the use is “not related or disproportionate to government use finance” to any government use of such proceeds (this is the “use not related version”)³⁵
 - 2. or 5% or more of any “output facility” (other than for furnishing water) if nonqualified amount is more than 15m – all prior tax exempt issues that 5% or more of them will be used for this facility³⁶
 - (ii) defining the portion that is secured by a private interest (use aggregate amount of private portions) – if something is secured by a private and a public obligation it meets the test
 - 1. look to **underlying agreement**
 - 2. look to present value of all payments³⁷

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1.103-7(b)(3)(i)	Trade or business test. (i) The trade or business test relates to the use of the proceeds of a bond issue. The test is met if all or a major portion of the proceeds of a bond issue is used in a trade or business carried on by a nonexempt person. For example, if all or a major portion of the proceeds of a bond issue is to be loaned to one or more private business users, or is to be used to acquire, construct, or reconstruct facilities to be leased or sold to such private business users, and such proceeds or facilities are to be used in trades or businesses carried on by them, such proceeds are to be used in a trade or business carried on by persons who are not exempt persons, and the debt obligations comprising the bond issue satisfy the trade or business test. If, however, less than a major portion of the proceeds of an issue is to be loaned to nonexempt persons or is to be used to acquire or construct facilities which will be used in a trade or business carried on by a nonexempt person, the debt obligations will not be industrial development bonds. Also, when publicly-owned facilities which are intended for general public use, such as toll roads or bridges, are constructed with the proceeds of a bond issue and used by nonexempt persons in their trades or businesses on the same basis as other members of the public, such use does not constitute a use in the trade or business of a nonexempt person for purposes of the trade or business test.
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³⁵ 141(B)(3)(A)

³⁶ 141(B)(4)(A, B)

³⁷

1.141-4(b)(2)	<p>(i) Use of present value. In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.</p> <p>(ii) Debt service--(A) Debt service paid from proceeds. Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. For example, debt service does not include payments of capitalized interest funded with proceeds.</p>
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- a. fixed yield doesn't take into account future events
 - b. variable yield uses the current interest rate, but a deliberate action requires a new calculation
- 3. debt secured by property is based on the fmV of the property
- 4. do not include in the debt service any amount paid though (ii) Debt service--(A) Debt service paid from proceeds. Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. For example, debt service does not include payments of capitalized interest funded with proceeds.
- 5. indirect payments count as government payments for the time that the property is used for a business use³⁸
 - a. private payment of operating expenses doesn't count³⁹
- 6. refinanced debt service doesn't change the percentage
 - a. Payments of debt service on an issue to be made from proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue⁴⁰ (if not deliberate)
 - b. Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.
 - i. In general, except as provided in paragraphs (c)(3)(iv) and (v) of this section, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property.
 - c. Payments are part of a bond issue⁴¹
 - i. A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue
 - ii. The issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and

³⁸ 1.141-4(c)(2)

³⁹ 1.141-4(c)(2)(C)

⁴⁰ 1.141-4(c)(2)(ii)

⁴¹ 1.141-4(c)(2)(iv)

- iii. The amount of payments reflects all or a portion of debt service on the issue.
- 7. Can allocate some to equity
 - a. If by 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to § 1.150-2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and
 - b. The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.
- 8. amounts pledge are not taken into account until actually pledged
- 9. fees paid can be considered to be a private security: payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.
 - a. Taxes paid from non-governmental sources are not considered a form of private security – so long as they are generally uniform 1.141-4(e)
 - i. Must have been reasonably expected to have paid those agreements – so any special agreement makes it a private security
 - ii. The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to be personally liable on a tax that does not generally impose personal liability, to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls; an agreement regarding the minimum market value of property subject to property tax; and an agreement not to challenge or seek deferral of the tax.
 - iii. Permissible agreements. The following are examples of agreements that do not cause a tax to fail to have a generally applicable manner of determination and collection: **an agreement to use a grant for specified purposes** (whether or not that agreement is secured); a representation regarding the expected value of the property following the improvement; an agreement to insure the property and, if damaged, to restore the property; a right of a grantor to rescind the grant if property taxes are not paid; and an agreement to reduce

or limit the amount of taxes collected to further a bona fide governmental purpose. For example, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

- b. Payment in lieu of taxes
 - i. Can't be uncommensurate to count as taxes
- c. Hazardous waste remediation bonds
 - i. Persons that are not private users. Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site are not taken into account as private security.
 - ii. If payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds, the payments are not taken into account as private payments.
 - iii. The payments are not required for the payment of debt service on the bonds;
 - iv. The amount and timing of the payments are not structured or designed to reflect the payment of debt service on the bonds;
 - v. The receipt or the amount of the payment is uncertain (for example, as of the issue date, no final judgment has been entered into against the nongovernmental person);
 - vi. The payments from those nongovernmental persons, when and if received, are used either to redeem bonds of the issuer or to pay for costs of any hazardous waste remediation project; and
 - vii. In the case when a judgment (but not a final judgment) has been entered by the issue date against a nongovernmental person, there are, as of the issue date, costs of hazardous waste remediation other than those financed with the bonds that may be financed with the payments.

(iii) Tax of general application will never meet the private security test

(iv) If there are private payments, may be able to disregard parts of the
pst

(c) defining ownership

- (i) IRS defines "used" as only the "actual or beneficial" "ownership" "direct use of the proceeds" 1-141-3(a)(1) and financed property is

considered to be a "direct" use of the proceeds⁴² -- if the property is leased look to 1) degree of control and 2) whether a non-government entity bears the risk of loss⁴³

- (ii) Management contracts generally result in a private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility. Distinguishing management contracts from leases
 - 1. criteria from service in Rev. Proc. 97-13
 - a. *the longer the term of the K, the less likely the compensation can be*
 - b. a long term K, has to be fixed they are looking at whether you are joint venturing, or whether or not you are hiring someone to run something for you
 - c. prohibit the sharing of dollar of net revenue
 - 2. a management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility 1.141-3(b)(4)(iii)(B)
 - 3. incidental contracts such as janitorial services don't count as management contracts 1.141-3(b)(4)(ii)

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1.141-3(a)(2)	... For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business. Similarly, the issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.
1.141-(a)3(b)	a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease , or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

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1.141-(b)3	<p>Leases. Except as provided in paragraph (d) of this section, the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all of the facts and circumstances, including the following factors--</p> <ul style="list-style-type: none"> (i) The degree of control over the property that is exercised by a nongovernmental person; and (ii) Whether a nongovernmental person bears risk of loss of the financed property
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4. granting admission privileges doesn't count 1.141-3(b)(4)(iii)(B)
5. research agreements are generally treated like any other business use (people end up building other buildings to handle private research)
 - a. bluebook says that there exclusive research project are bad (e.g. funded by drug companies) so research funded by drug companies can't be in buildings financed with tax exempt bonds
6. payment for services don't count
7. reimbursement of expenses is not a management contract
 - a. A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.
 - b. A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties. 1.141-3(b)(4)(iii)(C)
8. the major controversies are 1) how to measure the extend of use 2) management contracts
- (iii) management of public utilities appears to be exempted from the provisions which exclude management contracts 1.141-3(b)(4)(iii)(D)
- (iv) facilities that are not used by the general public that are somehow limited it use to a private person are considered to be private based on 1) whether they are physically proximate to a non-government use 2) whether a small number of non-government users received government benefit 3) whether the cost of the financed property is treated as depreciable by any non-government person 1.141-3(b)(7)(ii)(D)
 1. but facilities that are open to all, that private business use are treated as being public 1.141-3(c) – even if a certain user has 1) a preferred rate, or 2) is prohibited from paying the normal rate
 2. any **renewal arrangement** longer than 200 days takes something out of public use 1.141-3(c)(2)(ii)(C). rights of first refusal are treated as a renewal arrangement if the new compensation rate is calculated at the fmv at the time of the renewal
 3. The use of the financed property under the same or similar arrangements is predominantly by natural persons who are not **engaged in a trade or business.** 1.141-3(c)(2)(ii)
- (v) Use incident to transfer is not considered to be ownership 1.141-3(c)(5)

- (vi) Improvements on the building are not considered to be private ownership if 1.141-3(d)
 - 1. The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun; 1.141-3(d)
 - 2. The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use; 1.141-3(d)
 - 3. No portion of the improved building or any payments in respect of the improved building are taken into account under section the private security test 1.141-3(d)
 - 4. No more than 15 percent of the improved building is used for a private business use. 1.141-3(d)
- (4) dispositions of personal property will not trigger the make the bond a private activity bond, if the issuer is required to put the money in a fund **commingled with other tax revenues** and they will spend the money on **government purposes in six months**
- (5) must allocate large amounts to volume cap: if the nonqualified amount exceeds 15m, it will still be a private activity bond unless the issuer allocates a the whatever is over 15m to the § 146 volume cap⁴⁴
- (6) Private loan financing test
 - (a) If the proceeds exceeds that will go to non-government units is either 5% or 5m – unless the loan finances any government tax or assessment of **general application** or is a “nonpurpose investment”⁴⁵
- b) An arbitrage bond (§ 148)
- c) Purely Industrial development bonds⁴⁶

Volume Cap Issues for Qualified Private Activity Bonds

- 2) volume cap issues § 146 – anything that exceeds the volume cap is taxable
 - a) Technically speaking, the statute provides the way in which the volume cap will be allocated between state agencies. However, as a practical matter state legislatures can reallocate the funds. Opt-out provisions are in 146(e)
 - b) exceptions from volume cap
 - i) complete exclusions
 - (1) does not apply to rail facilities if owned by a government unit
 - (2) does not apply to 501(c)(3) bonds
 - (3) does not include refunding issues 146(i)
 - (a) requirements to exclude pre-1986 bonds from volume cap
 - (i) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, AND

⁴⁴ 141(B)(5)

⁴⁵ 141(c)

⁴⁶ 1.103-1

- (ii) either
 - 1. the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of such issue, OR
 - 2. the refunding bond has a maturity date not later than the date which is 17 years after the date on which the qualified bond was issued.
- (4) Airports
- (5) Docks and wharfs
- (6) Fish ladders
- (7) Solid waste disposal facilities that are owned by a government unit
- 146(h)(1)
- (8) 501(c) bonds: but these are subject to a 150m/year limit per “test period beneficiary”⁴⁷
- (9) veterans mortgage bonds: but these are subject to 143(d) limits
- (10) bonds issued by Indian tribes as per 7871(c)(3)(iii) if at least 95% are used for manufacturing facilities
- (11) government bonds whose non-qualified amount (private use) is **less than \$15m** 141(b)(5) and the issuer doesn’t allocate a portion of the volume cap to the amount over 15m
 - (a) nonqualified amount is defined as proceeds to be used for any private business use or proceeds with respect to which there are payment described in IRS 141(b)(2)
 - (b) nonqualified amounts must always be less than 5% needed to satisfy disproportionate use tests
 - (c) 10% needed to satisfy the PBT
 - (d) portions of government bonds used by 501(c)(3) organizations in excess of 15m are not subject to the volume cap
- ii) 75% exclusions
 - (1) high speed rail facilities not owned by government unit
- c) inclusion
 - i) applies to government bonds to the extent that private use exceeds 15m (and advance refundings of the bonds, where a volume allocation was made)
 - ii) general no portion of the volume cap can be allocated to building things outside the jurisdiction – but there are specific exceptions in 146(k), where, for example, a solid waste disposal plant can be showed to be recycling stuff from inside the state⁴⁸

⁴⁷ 145(b): In general.--A bond (other than a qualified hospital bond) shall not be treated as a qualified 501(c)(3) bond if the aggregate authorized face amount of the issue (of which such bond is a part) allocated to any 501(c)(3) organization which is a test-period beneficiary (when increased by the outstanding tax-exempt nonhospital bonds of such organization) exceeds \$150,000,000.

⁴⁸ 146(k)(2): (2) Exception for certain facilities where state will get proportionate share of benefits.-- Paragraph (1) shall not apply to any exempt facility bond described in paragraph (4), (5), (6), or (10) of section 142(a) if the issuer establishes that the State's share of the use of the facility (or its output) will equal or exceed the State's share of the private activity bonds issued to finance the facility.

- d) size of volume cap: 225m or \$75 * population of the state (whichever is greater) § 146
- e) elective carry forward of unused portions of volume cap
 - i) cannot carry forward volume cap for § 144 (qualified small issued bonds)
 - ii) things that can be assigned to the elective volume cap under 146(f)(5)
 - (1) qualified student loan bonds
 - (2) qualified mortgage bonds (or mortgage credit certificates),
 - (3) qualified redevelopment bonds,
 - (4) exempt facility bonds under section 142(a)
 - (5) enterprise zone facility bonds (Treas. Reg. section 1.1394-1(m)(3)).
 - iii) must elect to carry forward volume cap
 - (1) need not specifically, identify project, must provide a general description of the project
 - (2) election is irrevocable
 - (3) carry-forward election must be done at the end of the year

Qualified Private Activity Bonds

Private Activity Bonds that finance things that must be owned by a government

Private Activity Bonds that can be owned by non-government entities

§ 501(c)(3) bonds (remember volume cap issues relating to 501(c)(3) bonds)

- 1) What a *qualified* § 501(c)(3) bond is
 - a) It's a PAB bond that is issued under § 145 to finance property owned by a § 501(c)(3) or a government unit. (note, these used to be considered government bonds, not a variety of qualified PAB)
 - i) How it fits in hierarchy:
 - (1) Government: the best
 - (2) § 501(c)(3): private but handsome because they are PABs, since the money is being lent to something that meets the private loan financing test
 - (a) note: there is a requirement that there be approval by voter referendum or elected representative following reasonable notice 147(f)(2)(B)(ii)
 - (b) note: some state universities might qualify as government bonds, and avoid the limitations in § 501(c)(3) bonds
 - (3) exempt facility – § 501(c)(3)s can elect to treat their bonds as this
 - (4) other: PABS, private and ugly
 - ii) § 501(c)(3) bonds cannot meet both the private business use test and the private security test (uses a 5% of net proceeds test, instead of a 10% of proceeds test)
 - (1) to avoid meeting the private security test, a § 501(c)(3) no more than 5% of the interest in the bond can be secured by an interest in property use for private business use, or secured pay payments in respect of such property, derived from payments in respect of such property
 - (2) *note: principal payments made by the § 501(c)(3) do not count as it is treated as a government unit

- iii) election out: 145(e) allows § 501(c)(3) to elect out of treatment as a § 501(c)(3) if the bonds are exempt facility bonds, or qualified redevelopment bonds and § 146 applies to the bonds
- b) accounting
 - i) all of the net proceeds must be used to finance the property owned by a § 501(c)(3) or a government organization
 - (1) net proceeds is defined as proceeds minus 4r (reserve fund)
 - (2) no more than 5% of the proceeds can be used for any private business use, and **insurance costs are considered to be private business use** 1.145-2(c)(2)
- c) qualified § 501(c)(3) bonds can finance non-capital expenditures subject to arbitrage rules in **1.148-1(c)(4), 1.148-2(e)(3), 1.148-6(d)(3)**
 - i) general rule rule is that it is possible to finance non-capital expenditures if the organization can establish that it is actually broke
 - ii) exceptions
 - (1) if the working capital is inextricably tied to the actual product, it is acceptable (e. g. pre-opening expenses of a nursing home) (see arbitrage rules)
 - (2) tax exempt working capital financing can only be for the shortest amount of time possible
 - (a) rules say one has to declare how long it will take to repay the bond
 - (b) 9 month safe harbor for non-capital expenditures
- iii) Note: it appears that the old 150m limitation on non-hospital bonds applies to non-capital expenditures)
- d) all property is owned by a government organization or a qualified § 501(c)(3) group – 501(c)(4)s, for example, are not eligible
 - i) It otherwise wouldn't be a PAB, and in all cases the 5% “bad money test” is used⁴⁹ (this really means that 3% unrelated trade or business use is possible)
 - ii) Qualification for 501(c)(3) organization that must be certified in the bond documentation
 - (1) Organization must be a 501(c)(3) in good standing
 - (2) Legitimately organized
 - (3) Operating legitimately
 - (a) Open question as to the correct amount of diligence bond counsel must conduct
 - (4) Proposed venture that will be in **furtherance of their purpose**
 - (a) Note: the service views this narrowly, and does not count leasing to someone else as part of a 501(c)(3)'s purpose
 - (b) Definition of “unrelated trade or business” is found in caselaw surrounding § **513**
 - (i) Unrelated business use is counted against the 5% private use test⁵⁰

⁴⁹ **145(a)(2)(A):** 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

⁵⁰

- iii) Joint undertaking by § 501(c)(3) organizations under § 147(b)(4)
 - (1) Special rules election for pool bonds in 147(b): (pool bonds used to purchase equipment)
 - (a) 95% of the proceeds will to be used for the two organizations
 - (b) Maturity limitation of each loan term (not average bond life) of 30 years or 120% of the the life of the property § 147(b)(4) (flush text)
 - (c) And... Must conduct a demand survey before such bond is issued, a demand survey was conducted which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of such issue 147(b)(4)(B)(iii)
 - (d) Loans must be made with in one year of date of issue of the bonds
 - (e) Any unspent monies after one year must be redeemed
 - (2) Property must be owned by one 501(c)(3), not two of them, because service figures that because partnerships can't be 501(c)(3)s – doesn't matter if the a joint venture is substantially related to both 501(c)(3)s
 - (a) Will qualify, based on a test which treats 2 bonds as one bond for the purposes of § 501(c)(3)
 - (i) IRS treats each § 501(c)(3) as having an undivided interest in the venture
 - 1. note, that the former limitations still apply to each of the member corporations
 - (ii)
 - (b) Monies not spent in one year must be redeemed 147(b)(4)(B)(iii) in one year
 - (3) Under § 301.7701-3(b)(ii), a business entity with a single owner can elect to be classified as either an association or as an entity
 - (a) so But a single member LLC can be a 501(c)(3) for tax purposes
 - (b) IRS is still investigating whether single-member pass through entities can qualify for tax purposes
 - (4) Leases to entities, as a form of joint undertakings fail, because the act of leasing is not substantially related to the non-profit purpose
 - (a) One way around this is to form a new § 501(c)(3), with a different control group, which acquires the leases of the other one
- iv) Mixed use property
 - (1) Mixed area
 - (a) No regulations promulgated yet
 - (b) Probably possible to allocate by non-tax exempt bonds to a correct portion of the property

UTB	Non-UTB (RTB)
<ul style="list-style-type: none"> • Manufacture of tires by a college • Sale of drugs by a tax-exempt hospital to private patients of doctors 	<ul style="list-style-type: none"> • Wheat farm operated by tax-exempt college • College bookstore which sells books and things that are within the convenience doctrine • Gift shop in a hospital, where the gifts are for staff or patients

- (c) IRS course "the allocations of the bond proceeds and other sources of funds, and the use of the facility by various parties must be reasonable and consistently applied"
- (2) Mixed in time
 - (a) Under 141 regs, measure the use over the entire time period of the use of the property (not as a percentage per year) 1.141-3(g)
 - (i) Note: don't have to worry about leases one year and under because of grace period
- (3) Simultaneous use: allocate by revenue
- (4) Areas for use by general public will not be not be treated as private business use provided that it is available to everyone on the same basis. 1.141-3(c)
- v) Research agreements: Research agreement will be treated as a non § 501(c)(3): Rev. Proc 97-14
 - (1) Corporate sponsored research: corporation can only be given a right of first refusal on a license to use the fruits of the research (e. g. on the same basis as everyone else) (must be competitive price determined at the time of licensing, not at the inception of the contract)
 - (2) Cooperative research arrangements: involving basis research, not product testing are acceptable (original investigation, not going to a commercial sponsor)
 - (a) Must have multiple unrelated sponsors
 - (b) The type of research is determined by the qualified user
 - (c) Title to the patents rest with the qualified user
 - (d) sponsors can only get non-exclusive royalty-free license
- vi) Service contracts may result in ownership of a property by a non-qualified property unless it falls within a safe harbor (from Rev. Proc. 97-13) (**legal title is irrelevant, ownership for federal tax purposes is what matters**)
 - (1) Prohibited service contracts under Rev. Proc. 97-13: in general, a share of net profits is not acceptable
 - (a) If there is a substantial penalty for the § 501(c)(3) organization canceling the contracts with the manager, it is unacceptable
 - (2) Acceptable forms of service contracts
 - (a) Compensation based on a percentage of gross revenues **or** a percentage of gross revenues is not considered to be based on a share of net profits
 - (b) Productivity awards based on increase or decrease in gross revenues **or** reductions in total expenses is not considered to be a share of net profits
 - (c) Mere granting of admitting privileges to a doctor does not result in a rendering a hospital a private business use 1.141-3(b)(4)(iii)(B)
 - (d) Solely incidental contracts are not considered to be private business use (janitor, maintenance)⁵¹

⁵¹ Rev. Proc. 97-13(1.01)(7)(a) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing or similar services);

- (e) Reimbursement for expenses to a public utility company (see § 168(i)(1) Rev. Proc 97-13
- (f) Reimbursement of expenses of a service provider Rev. Proc 97-13
- (g) Safe harbors
 - (i) **95%** fixed fee arrangements and the term is less than **80%** of the useful life of the property or **15** years (whichever is less)⁵²
 - 1. or 20 years for public utility property
 - (ii) **80%** fixed fee arrangements and the term is less than **80%** of the useful life of the property or **10** years (whichever is less)⁵³
 - 1. or 20 years for public utility property
 - (iii) capitation fee
 - 1. if 50% of the compensation is based on a fixed fee or a capitation fee, and the term of the contracts is less than 5 years, and the contracts is terminable without penalty
 - (iv) 3 year per-unit contracts: a per unit fee contracts, which is less than three years comes within the safe harbor (e. g. all of the compensation must be based on a per unit fee and a fixed fee)⁵⁴
 - (v) 2 year contracts with a percentage of the revenue: during the start-up period, contracts for services to 3rd parties, facilities where people are unable to estimate gross revenues all compensation can be based the revenue, provided that the term of the contract is less than two years, including renewal options⁵⁵

⁵² Rev. Proc. 97-13: 95 percent periodic fixed fee arrangements. At least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section 5.03(1), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

⁵³ Rev. Proc. 97-13: 95 percent periodic fixed fee arrangements. At least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section 5.03(1), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

⁵⁴ Rev. Proc. 97-13: (5) Per-unit fee arrangements in certain 3-year contracts. All of the compensation [*14] for services is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

⁵⁵ Rev. Proc. 97-13: (6) Percentage of revenue or expense fee arrangements in certain 2-year contracts. All the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During the start-up period, however, compensation may be based on a percentage of either gross revenues, adjusted gross revenues, or expenses of a facility. The term of the contract, including renewal options, must not exceed 2 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term. This section 5.03(6) applies only to--

(a) Contracts under which the service provider primarily provides services to third parties (for example, radiology services to patients); and

- (3) General requirements for service contracts with § 501(c)(3) organization
 - (a) Must be no substantial penalties for terminating the contract with the manager
 - (b) Management company must not have substantial role within the § 501(c)(3) organization
 - (i) Services definition of management contracts⁵⁶
 - (ii) Cannot have overlapping board members cannot include, the CEO of the manager, or its governing body, and the § 501(c)(3) organization, and or related parties (as defined by 1.150-1(b)) or control group as defined by 1.150-1(e). (Direct control is a facts and circumstances test)⁵⁷ – and there is not a 20% of overlapping in voting power⁵⁸
 - 1. related parties is defined as
 - 2. "controlled group" is defined as any group of entities directly or indirectly controlled by the same entity or group of entities.
 - a. The point of this is to prevent the management entity from telling the § 501(c)(3) that they can't terminate the agreement
 - b. Indicia of being controlled
 - i. Right to remove a person without cause of the controlled entity
 - ii. Right to require the use of a fund or asset of the controlled entity
 - c. If a controlling entity controls a controlled entity, then it controls anything that is, in turn, controlled by that entity.
 - (c) Compensation must be for fair market value of services rendered
- e) Limitations on what a 501(c)(3) bond may be used for
 - i) Differentiation between hospital and non-hospital bonds mostly extinct
 - (1) Hospital bonds (accredited by JCAHO, everyone under care of physician, provides 24-hour care, primary to diagnose and care for sick people – rest or nursing homes are not hospitals)
 - (a) It otherwise wouldn't be a PAB, and in all cases the 5% "bad money test" is used (this is not the 90/10 test)
 - (i) This amount comes after the "4r" fund is deducted
 - (ii) 95% must be used for the hospital

(b) Management contracts involving a facility during [*15] an initial start-up period for which there have been insufficient operations to establish a reasonable estimate of the amount of the annual gross revenues and expenses (for example, a contract for general management services for the first year of operations).

56 .Rev. Prov 97-13: 03 Management contract means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. See § § 1.141-3(b)(4)(ii) and 1.145-2.

⁵⁷ 97-13: Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and

⁵⁸ 97-13: Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

- (iii) 2% for cost of issuance (note special rule⁵⁹)
 - (iv) 3% for bad costs
- (b) 95% will be used for a hospital
- (2) Non-hospital bonds – had an additional \$150m volume cap before August 5, 1997!
 - (a) This rule only applies to bonds which:
 - (i) Were made before 8/5/97
 - (ii) Refund qualified § 501(c)(3) bonds made before 1997
 - (iii) Bonds after 1997 which don't meet the following criteria
- (3) Note: it appears that the old 150m limitation on non-hospital bonds still applies to non-capital expenditures)
- ii) Absolutely prohibited completely naughty things
 - (1) Skyboxes, Airplanes, Gambling Establishments, Etc.-
 - (2) A private activity bond shall not be a qualified bond if issued as part of an issue and any portion of the proceeds of such issue is to be used to provide any airplane, skybox or other private luxury box, health club facility, facility primarily used for gambling, or store the principal business of which is the sale of alcoholic beverages for consumption off premises.
- iii) Maturity limitations:
 - (1) Can't be more than 30 years issuances between two § 501(c)(3)
 - (2) The average maturity can't be more than 120% of the life of the place § 147(b)(1)(B)
- iv) Residential rental facilities
 - (1) Property outside the jurisdiction of the issuer is considered to be investment property (for arbitrage purposes) unless as part of a federal or state ordered housing desegregation plan
 - (2) Generally can't be financed by § 501(c)(3) bonds (but exception is bigger than rule)
 - (a) Can use if the "first use" of the facilitate residential property family units
 - (i) § 145(d)(3)(A) allows people to consider a facility to be financed as the "first use" of the facility if the actual first use was pursuant to tax exempt financing
 - 1. Bonds for residential family unit property if their "first use" is for family units – if the property was a Cinderella bond Sec. 145(d)(3)(A)
 - a. They were first financed by taxable financing
 - b. There was a reasonable expectation of replacing the taxable financing exempt financing
 - c. Quickly replaced
 - 2. If there is no other financing, it is a first use

⁵⁹ 147(g)(2) SPECIAL RULE FOR SMALL MORTGAGE REVENUE BOND ISSUES.--In the case of an issue of qualified mortgage bonds or qualified veterans' mortgage bonds, paragraph (1) shall be applied by substituting "3.5 percent" for "2 percent" if the proceeds of the issue do not exceed \$20,000,000

- (ii) or, at the time of the financing there was a reasonable expectation that taxable financing would be replaced with tax-exempt bonds (Cinderella financing)
- (iii) or, taxable financing is replaced with tax-exempt financing
- (iv) or, under § 145(d)(3)(B), if there is no operating state or local program that finances residential rental facility the first time the property was financed, it can always be treated as a "first use" of the facility."
 - 1. Or, e. g. there was an ordinance in the area prohibiting the use of tax exempt bonds (this gives a corporation a later chance to finance under this section)
- (b) Can use if its purpose is to rehabilitate property for +/- 1 year after buying the property
 - (i) Must be greater than 5,000 or the adjusted basis of the property
- (c) Bonds may be used to buy "qualified low income property" as in the 20-50 or 40-60 low-income tests
- (3) There may be a problem when an organization which provides housing to the poor, might stray from its purpose in an attempt to comply with these provisions – this is resolved by safe harbors
 - (a) IRS notice 93-1 (controversial because it departs from statute)
 - (i) Will be considered "charitable" if they relieve the poor and the distressed
 - (ii) 75% of the units will be made available for families earning 60% or less of the areas median income
 - 1. can substitute housing for aged, handicapped, etc.
 - (iii) organization must adopt a general policy stating that the remaining 25% of the units will be made available to person on the "lower end of the economic spectrum, yet who may not necessarily be members of the charitable class"
 - (b) Rev. Proc. 96-32
 - (i) 20% of units must be occupied by people who make less than 50% of the median
 - (ii) or 40% must be occupied by people who make within 120% of 50% of the median
 - (iii) or 25% of the people can be provided to people whose incomes exceed the market rate
 - (iv) relief of the poor and distressed can also be determined on a safe-harbor basis (examples)
 - 1. deviations from safe harbor provisions
 - 2. rent limits and people with substantially more low income residents as determined by rent limit controls
 - 3. combating community deterioration
 - 4. elimination of discrimination and prejudice
 - 5. lessening neighborhood tension
 - 6. relief of the distress of the elderly and the handicapped

- (c) facilities that provide nursing care will not be treated as charities for the low income housing purposes. Rev. Rul 98-147
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 - (4) or, under § 145(d)(3)(B), if there is no operating state or local program that finances residential rental facility the first time the property was financed, it can always be treated as a "first use" of the facility."
 - (a) Or, e. g. there was an ordinance in the area prohibiting the use of tax exempt bonds (this gives a corporation a later chance to finance under this section)
- iv) Can use if it is a qualified residential rental facility as defined by 142(d)
 - (1) (check this)
- v) Can use if its purpose is to rehabilitate property for +/- 1 year after buying the property
 - (1) Must be greater than 5,000 or the adjusted basis of the property
- vi) Bonds may be used to buy “qualified low income property” as in the 20-50 or 40-60 low-income tests
- vii) There may be a problem when an organization which provides housing to the poor, might stray from its purpose in an attempt to comply with these provisions – this is resolved by safe harbors
 - (1) IRS notice 93-1 (controversial because it departs from statute)
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arbitrage bonds

- choose date to calculate arbitrage from
 - calculate yield. If under 2.5m, no arbitrage certificate is needed.
 - Determine which funds, and what beneficiaries fall under the arbitrage rules
 - See if abusive.
 - See if safe harbors exist
- 1) Interest on arbitrage bonds not excludible from gross income.⁶¹, nor is interest to carry tax-exempt bonds⁶²
 - 2) Mechanics: An “indenture” is a contract between the issuer and a bank that is acting as a trustee for a bondholder. This indenture creates the various funds. (Proceeds flow like a waterfall into 1) operative expenses; 2) repletion reserve; 3) debt service fund; 4) surplus; 5) a previously depleted 4r fund)
 - a) Project fund
 - i) Usually qualifies for unrestricted investment for three years, if being used for capital construction
 - ii) subject to both yield and rebate restrictions;
 - b) Reserve (4r) fund
 - i) if the size of the 4r fund is above 10%, it has to come from revenues, not sale proceeds (hence, under § 148, an issuer can’t put more than 10% into it)
 - ii) Limits Rev. Proc 84-26
 - (1) 10% of the principle of the issue if the bonds are issued at prices that differ from their principal amount by more than \sum 2% of principal, compensation to underwriters (de minimis)
 - (2) maximum annual debt service (seems to be 150% of annual debt service for PABs from 148(d)(3).. but this would be subject to rebate)
 - (3) 125% of the average annual debt service
 - iii) if a portion over the 10% is invested at something above the yield on the bonds, YRPs can be used
 - iv) If it is reasonably required, it can be invested without restriction

⁶¹ IRC § 148(i); City of Columbus, Ohio v. Comm., 106 TC 325 (1996), vacated 112 F3d 1201 (CA DC 1997).

⁶² IRC § 265

- v) are exempt from yield restrictions (if the fund is limited to a reasonably required amount); and are (almost) always subject to rebate
- c) (bona fide) Debt Service Fund: used primarily to achieve a proper matching of revenues with principle each year Treas. Reg. 1.148-1(b)⁶³
 - i) note: issuers with good credit don't need this
 - ii) exempt from yield restrictions and rebate -- is there a dsf reserve fund
- d) revenue fund: holds transfers until paid
- e) Construction fund
- f) Acquisition fund
- g) Proceeds fund
- h) Sinking fund: fund expected to be used to pay debt service 1.141-1(c)(2)
- i) Pledged fund: fund pledged to pay debt service 1.141-1(c)(3)
- 3) Methodology
 - a) Can the proceeds be invested with unrestricted yield?
 - i) If it is under 2.5m, it does not require an arbitrage certificate
 - ii) Calculation of yield
 - (1) Fixed rate
 - (a) Definition: a fixed yield bonds is any bonds who yield is fixed at the date of issuance. 1.148-1(b). If any portion is not fixed, it is not fixed. Look simply at unconditionally payable principle.
 - (2) Variable yield
 - (a) Definition: what is not a fixed issue
 - (i) Issuer must choose a date to have his variable yield rate calculated from. It may be the last day of any bond year ending before the first required rebate payment date and the end of each bond year or the end of each fifth bond year 1.148-3(e)(1)
 - (ii) Final computation date is the day that the issue is discharged 1.148-3(e)(1)
 - (b) Calculating yield of bonds subject to early redemption
 - b) If it is invested in an unrestricted yield investment, is rebate necessary?
 - c) Is it an abusive arbitrage device?
 - i) Unreasonably long debt service creates arbitrage (safe harbor is 120% of the economic life of the facility)
- 4) Defining arbitrage bonds, which are bonds who interest is not excludible from federal income tax because the sponsor has somehow used them to acquire an investment that

⁶³ Bona fide debt service fund means a fund, which may include proceeds of an issue, that--

- (1) Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and
- (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) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

yielded (or replace funds which are used to acquire higher yielding investments⁶⁴) more than the holder of the bond was being paid § 103(b)(2).⁶⁵

- a) A bond is an arbitrage bond if... (issuer knows it will happen, or he doesn't know it, but doesn't rebate)
 - i) Issuer **expects** to invest the **proceeds** at a **yield** that is **materially higher** than the **bond yield** in **taxable** securities (except that refunding issues may not be invested in tax-exempt securities). This is called "yield restricted investments"
 - (1) "expects" – whether or not the yield rules apply is based on the issuer's expectations
 - (a) could be based on a later problem, such as a labor dispute
 - (2) Defining proceeds
 - (a) *Sale proceeds*: gross cash amount paid (actually or constructively received) for bonds by bond purchasers at time of initial sale
 - (i) Includes underwriters discount § 1.148-1
 - (ii) Includes accrued interest § 1.148-1 – but does not include pre-investment accrued interest 1.148-1(b) (by omission)
 - (iii) Includes any sale of a right associated with the bond § 1.148-1; 1.148-4(b)(4) (recomputed yield when bond transferred)
 - (b) *Net Sale Proceeds*: sale proceeds minus whatever is put in the reserve fund or invested as a de minimis minor portion
 - (c) *Disposition proceeds*: when an issuer or conduit sells all or a portion of a bond-financed facility and gets cash in return 1.141-12(c), and 1.141-12(a)(4) (the funds must be treated as gross proceeds)
 - (d) *Investment proceeds*: amounts received from investing the proceeds of the issue
 - (i) Includes interest and dividends resulting from the investment of proceeds 1.103-13(b)(2)(ii)(A)
 - (ii) Does not include receipts from investment of amounts treated as proceeds because they are in a sinking fund § 1.103-13(b)(2)(ii)(B)
 - (e) *Net sale proceeds*: sale proceeds less any amount in 4r fund
 - (f) *Transferred proceeds*: where proceeds are used to pay a prior issue (refunding issue), transferred proceeds remaining proceeds of prior issue § 1.148-9(b)(1)
 - (g) *Proceeds*: \sum sale proceeds, investment proceeds, transferred proceeds
 - (i) Since transferred proceeds only exist in refunds, this term usually is just \sum sale proceeds, investment proceeds
 - (h) *Revenues*: Amounts other than an issuer's sale proceeds or investment proceeds
 - (i) *Replacement proceeds*: amounts that will be used to pay debt service on an issue, but not necessary a part of the issue
 - (i) Rule of thumb: if the issuer has the cash, why did he need to borrow any more – therefore they become replacement proceeds and subject to the arbitrage rules

⁶⁴ 148(a)

⁶⁵ 148(a): historically, there has been no requirement to continually monitor

- (ii) This includes things that only have a direct nexus to the issue 1) these amounts have sufficiently direct nexus to the issue or the government purpose of the issue **and** 2) the amounts invested would have been used for the government purpose if the bond proceeds were not used for that purpose. 1.148-1
1. parties should not do anything that would cause the IRS to think that they are linking one fund to this funding
 2. substantial beneficiary is defined as
 - a. issuer
 - b. party related to the issuer **1.148-1(c)(1)**
 - c. party controlled by the issuer (usually includes the ability to appoint and fire the board)
 - d. Rev. Rul 78-348: Bonds pledged to the state to secure an issue
 - e. Alabama Ruling (Rev. Rul. 82-101): Issuer sold land, and put the money in long-term treasury obligations which were put into a perpetual trust fund. Then the issuer issued \$100m of general obligation bonds, which were paid from the general fund but closely matched the income from the perpetual trust fund (though there was anticipation that the general fund would be funded from the other fund). The perpetual trust fund was pledged to secure the interest on the bonds. The service found there was a sufficient nexus
 - f. Texas Ruling (8308029): 100 year endowment fund was pledged to actually pay bonds was not a replacement fund because there wasn't a nexus
 - g. Preliminary earmarking does not make such a nexus
 3. safe harbors (not a substantial user) – replacement funds that are exempt from arbitrage rules
 - a. does not include (safe harbor for working capital financing)
 - i. working capital to be spent or retired in 3 years
 - ii. to refinance or refunding issue if under 120% of the working capital 1.148-1(c)(4)(B)(1)⁶⁶
 - b. guarantor under a **qualified guarantee** (e. g. a bank) a explained in 1.148-4(f)(4)
 - i. issuer must reasonably expect the present value of the fees for the guarantee to be less than the present value of the expected interest savings on the issue as a result of the guarantee
 - ii. arrangements must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments. (Reasonably procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional)

⁶⁶ For the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years

iii. fees for a guarantee must not exceed a reasonable, arm's length charge for the transfer of credit risk. In complying with this requirement, the issuer may not rely on the representations of the guarantor.

c. If a bank itself pledges a portfolio of securities it does not become a substantial beneficiary

(iii) Exceptions from rebate

1. if replacements are hand in a bona fide debt service fund, they are exempt from rebate. This fund is used to achieve a matching of revenues with principal and interest over each bond year year

a. limits on size of (bona fide) debt service fund

i. lesser of 10% of principal amount

ii. maximum annual debt service

iii. 125% of annual debt service

b. bond year is defined as one year period that is the basis for debt service 1.148-1(b)

2. replacement proceeds that are held by a small issuer are also exempt from rebate

(iv) usually found in a 1) pledged fund 2) sinking fund or 3) a negative pledge

1. sinking funds (funds that may be later used to pay off debt service)

a. includes debt service funds 1.148-2(c)(2)

b. includes replacement fund 1.148-2(C)(2)

2. pledged funds: amounts to (directly or indirectly) pay the principal or interest on the bond. 1.148-1(c)(3)(i). Therefore, replacement proceeds are created by pledging a note with a higher interest rate than the bond. Rev. Rul 78-348.

a. Does not need to be made by the borrower

b. Includes pledges or collateral

c. Includes letters of credit set aside by a bank with a higher yield

d. Rev. Rul 78-348: a redundant note pledged by a hospital as collateral is a pledged fund

e. Rev. Rul 78-348: pledge of collateral by a state to secure a bond of a county gives it a sufficient nexus

f. Rev. Rul 78-349: so long as there is no "reasonable assurance" that the funds will be available, the arbitrage rules are not available.

g. A pledge to a guarantor of an issuer creates a pledged fund

i. Safe harbors

ii. A pledge of more than 50% of the outstanding stock of a corporation that is a conduit borrower isn't a pledged fund unless that corporation was formed to avoid the creation of replacement proceeds

- iii. The amount does not exceed the reasonable needs for which it is maintained, the required level is tested no more than every 6 months, and the amount may be spent without substantial restrictions (other than to replenish)
- 3. negative pledges 1.148-1(c)(3)(ii) and PLR 8841027
 - a. negative pledges is defined as holding certain amounts pursuant to an agreement that such amounts will be maintained at a certain level or a promise not to do something
 - b. size of pleasure is measured by broad issue and not individual projects
 - c. safe harbors to not be negative pledges
 - i. the issuer or a substantial beneficiary may grant rights in the funds to a party that is superior to the rights of the guarantor 1.148-1(c)(3)(ii) and PLR 8841027 – or
 - ii. 6-month rule: amount does not exceed reasonable needs for which it was maintained **and** the required level is tested no more frequently than every six months, and the amount may be spent without substantial restrictions
- (j) *available amount replacement proceeds* is defined as if an issue has an unreasonably long maturity, its proceeds will be treated as replacement proceeds to the extent that 1) the term is longer than necessary for the government purpose and 2) the issuer will have amounts that it could use to retire the issue. 1.148-1(c)(4) (this test is also used in the abusive arbitrage device tests)
 - (i) safe harbor to avoid being classified as replacement proceeds 1) if the weighted average of the issue doesn't exceed more than 120% of the average reasonably expected economic life of the financed projects 1.148(c)(4)(i)(B)
 - (ii) Safe harbor for refunding issues
 - 1. If the prior issue qualified
 - 2. The refunding issue doesn't have a longer life than the prior issue
 - 3. Average maturity doesn't exceed more than 120% of the expected life of the project financed by the issue
- (k) *Gross proceeds*: \sum proceeds, replacement proceeds
 - (i) *Aka* \sum replacement proceeds, sale proceeds, investment proceeds, transferred proceeds
- (l) *Available construction proceeds* (really only applicable for two years): all amounts from the sale of bonds other than funds used to pay cost of issuance of deposited in a 4r fund (includes their earnings)
 - (i) Earnings included for first three semi-annual periods are based on reasonable expectations
 - (ii) 4th semiannual earnings amount based on actual earnings

- (iii) reserve fund earnings can be treated as part of ACP, unless there is an election not to 1.148-7(e)(3) – meaning that the earnings must be spent in conformity with other schedules
 - 1. earnings after substantial period are treated as arbitrage
 - 2. multi-purpose
 - a. if it is a multi-purpose issue, then the issuer must identify which part is under the election
 - b. if 75% of the issue is to be used for construction, no such election is necessary 1.148-7(d)(4)
 - (iv) issuance costs are not part of ACP
- (3) Calculating yield
- (a) Compounding intervals
 - (i) must be consistent
 - (ii) can use short first and last compounding intervals
 - (iii) can use any day count convention, so long as consistent
 - 1. supposed to use a semi-annual convention for qualified mortgage bonds and qualified student loan bonds
 - (b) fixed yield bond is a bond whose yield is fixed and determinable on the date of issue. 1.148-1(b).
 - (i) Fixed yield issue is an issue which is made completely of fixed yield bonds
 - (ii) Bonds are part of the same issue if they are
 - 1. sold at the same time (or within less than 15 days) § 1.150-1(c)(b)(i)
 - 2. sold in the same plan 1.150-1(c)(b)(ii); 3) payable from the same source of funds 1.150-1(1)
 - a. defining “same plan”
 - i. if they are considered to be part of the same facility, it is the same plan
 - ii. but, short term bonds used to finance working capital and long term bonds for the project are not the same plan 1.150-(c)(1)(ii)(B)
 - (iii) yield is the discount rate that results in the aggregate present value
 - 1. calculations of fixed rate bonds not effected by subsequent events
 - 2. bonds subject to early mandatory redemption must be calculated as if they end on that date 1.148-4(b)(2)
 - 3. unconditional payments include principal payments, interest payments, amounts paid to guarantor, amounts paid to hedge 1.148-4(b)
 - (iv) identical bonds subject to a mandatory sinking fund redemption where the bonds are issued with OID greater than .25% times the number of years to the weighted average maturity of the bond are redeemed at their present value rather than their principal amount
- (c) variable interest rate yield

- (i) computed each time a rebate amount is computed, can be selected by the issuer
 - (ii) the yield is computed separately for each computation period
 - (iii) any amount actually paid for the principal of the bond
 - (iv) floater/inverse floater transactions: a fixed and a floating bond which produce a spread can be valued together
- (d) yield on investments (same manner as bonds) 1.148-5(b)(2)
 - (i) calculate the yield on investments separately, as per each class of investment
 - 1. purpose investments: investment used to carry out the government purpose of the bond issue including
 - 2. non-purpose investments: something that isn't considered a purpose investment
 - 3. program investments: 1.148-1(b): student loan bonds, qualified mortgage revenue bonds and qualified veterans mortgage revenue bonds
 - 4. don't count qualified hedging guarantees (whether or not premiums paid on investment contracts can be taken into account for determining bond yield) (swaps, floors, swaps, and collars are okay)
 - a. must be primarily entered into to reduce risk
 - b. contracts cannot contain significant investment elements
 - c. all substantially identical bonds of a issue must be covered by the hedge
 - d. the hedge must be interest based (can't be a commodity swap)
 - e. payments to the issuer under the contracts must correspond closely in time and amount
 - f. payments can't accrue earlier than the issue date of the hedge bonds or longer than the hedged interest payments
 - g. any payments to be made to the hedge provider must be reasonably expected to be derived from the source of funds that absent the hedge would have to be used to pay the bonds
 - h. the hedge must be identified no more than 3 days after the date in which the parties enter into the contracts
- (4) Defining materially higher
 - (a) Proceeds after the **end of a three year period** can be invested at no higher than **.125%** (1/8) above bond yield
 - (i) Can purchase SLGs (state and local government series) securities to make up for the difference
 - (ii) nonpurpose investments: .125% -- but it is entirely subject to rebate
 - (b) Refunding issues: where an issue will be used within 90 days to pay off another issue
 - (i) Limited to no more than .001% above yield on refunding issue

- (ii) Yield reduction payments generally not allowed
- (c) refunding escrow: .001% 1.148-2(d)(2)
 - (i) of course, if a refunding escrow has a life of 6 months or less, it qualifies for a rebate
- (d) replacement proceeds: .001% 1.148-2(d)(2)
- (e) program investments, other than student loans: 1.5% 1.148-2(d)(2)
 - (i) program must involve the origination of acquisition of program investments 1.148-1(b)
 - (ii) 95% of the program loans represent one more more loans to a substntail number of person representing the general public, states, or political subdivisions, § 501(c)(3) organization, persons who provide housing 1.148-1(b)
 - (iii) 95% of the receipts must go to pay debt service, admin costs, losses, additional loans, 1.148-1(b)
 - (iv) the program documents must prohibit any program obligor (or a related person) from purchasing program bonds in an amount related to the amount tof the program loan (such a purchase would provide a private obligor a tax deduction without offsetting interest income). 1.148-1(b)
 - (v) issue has not waived the right to treat the investment as a program investment 1.148-1(b)
- (f) student loan investments: 2% 1.148-2(d)(2)
 - (i) tax-exempt obligations that are not considered to be investment property: no limit 1.148-2(d)(2)
- (5) Since funds can't be invested in taxable securities, it is necessary to define them
 - (a) In general, municipalities that invest in tax exempt proceeds will not be subject to arbitrage rules
 - (b) Advance refundings can't be invested in tax exempt securities
 - (c) AMT-exempt bonds: revenues above yield from bonds that are reinvested in things that are not subject to the alternative minimum are considered to be arbitrage
- (6) Exceptions (things that an issuer can invest at what he expects will be a materially higher yield – but he is still subject to rebate). The only advantage to such yield unrestricted investments is that they can be invested investments which have characteristics that people like (ie maturity, credit strength, without having to worry about yield restrictions)
 - (a) By time
 - (i) Temporary period (usually three years, but 5 years with architect's certificate) which it usually takes an issuer to build a capital project.
 - 1. summary of timing
 - a. **general rule:** 3 years⁶⁷ for capital projects. Must fulfill three requirements

⁶⁷ § 148(f)(4)(C)(iii)(II) EXCEPTION FOR REASONABLE RETAINAGE.--The spending requirement of clause (ii)(IV) shall be treated as met if--100 percent of the available construction proceeds of the

- i. due diligence test: if completion and allocation of proceeds is done with due diligence (based on reasonable expectations)
- ii. time test: 1.148-2(e)(2)(i)(B)⁶⁸: issuer must incur a substantial binding obligation to a third party to expend at least 5% of the net sale proceeds on the capital project within 6 months of the date of issuance of the bonds (binding obligations must be secured to be considered allocated). Examples of contracts: architects, architects, construction, acquisition, site development. construction materials acquisition contracts (based on reasonable expectations)
- iii. expenditure test: 1.148-2(e)(2)(i)(A): 85% of the net sale proceeds of the issue are allocated to expenditures on the capital project within three years of the date of issuance of the bonds (based on reasonable expectations)
- b. mortgage revenue bonds: 3 years
- c. pooled financing to unrelated borrowers: 2 years 1.148-2(e)(4)(iii), 148(c)(2)(D)
 - i. can elect to treat each conduit loan separately. 1.148-7(c)(6)
- d. “restricted working capital”: 1.148-2(e)(3)(i)
 - i. 13 months
 - ii. note: costs of issuance are excluded from this definition
- e. refunding: 13 months
 - i. must be primary used to achieve a proper matching of revenues and debt service within each bond year
 - ii. must be depleted at least once each bond year except for a reasonably carryover amount not to exceed the greater over the fund earnings for the immediately preceding bond year or 1/12 of the debt service for the immediately preceding bond year
- f. investment proceeds is defined as income from investment of proceeds: 1 year from date of receipt

construction issue are spent for the governmental purposes of the issue within the 3-year period beginning on the date the bonds are issued.

⁶⁸ General 3-year temporary period for capital projects and qualified mortgage loans--(i) In general. The net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of 3 years beginning on the issue date (the 3-year temporary period). The 3-year temporary period also applies to the proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting qualified mortgage loans in each place that capital projects appears in this paragraph (e)(2). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. These rules apply separately to each conduit loan financed by an issue (other than qualified mortgage loans), with the expenditure and time tests measured from the issue date of the issue.

- g. pooled financing (to make loans to 2 more other borrowers): 6 months
- h. replacement proceeds: 30 days from the day they are first treated as replacement proceeds
- i. advance refunding: 30 days
- j. exception: 5 years with an architect's certificate
- k. RANs: the maturity date of the issue **1.148-2(e)(3)(i)**
- l. TAN, it is the lesser of 2 years or 60 days after the payment of taxes
- m. extensions: as per Rev. Proc 89-5
- 2. uses
 - a. proceeds used to build a capital project
 - b. capitalized interest (note, this is part of the de minimis exception of) § 1.148-6(d)(3)(ii)(A)(3)⁶⁹
 - i. interest can be capitalized up to one year after the project is placed in service⁷⁰
 - c. 3 year period applies to costs of issuance
 - i. cost of issuance is usually paid first
 - ii. cost of issuance includes the underwriters discount
- 3. three requirements
 - a. within six months the issuer must incur a binding obligation to a third party to spent at least 5% of the *net sale proceeds* 1.148-2(e)(2)(A)
 - i. *Net Sale Proceeds*: sale proceeds minus whatever is put in the reserve fund or invested as a de minimis minor portion
 - b. completion of the project will proceed with "due diligence" 1.148-2(e)(2)(A)
 - c. within three years, the issue will spend at least 85% of the proceeds on capital projects. 1.148-2(e)(2)(A)
- 4. aggregation: an issuer financing a number of projects doesn't need to be sure that he complies completely, just that the aggregation of his project complies
- (ii) restricted working capital exception (generally 13 months, or lesser of 2 years or 60 days after payment of taxes in a TAN)⁷¹

⁶⁹ Interest on the issue for a period commencing on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service;

⁷⁰ Interest on the issue for a period commencing on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service;

⁷¹ (3) Temporary period for restricted working capital expenditures—

(i) General rule. The proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Paragraph (e)(2) of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

(ii) Longer temporary period for certain tax anticipation issues. If an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment

1. however, as a practical matter, these monies could be deposited in a 4r fund
- (iii) after which, anything materially higher must be sent to the government in the form of a *yield reduction payment* (YRP)
 1. YRP can offset a rebate, so there is no double payment 1.148-3(d)(1)(v)
- (b) By fund
 - (i) Can invest the “minor portion” at any rate: 148(d):
 1. minor portion is lesser of 100k, or 5% of proceeds
 - a. 4r fund is also included in the minor portion
 2. note: for advance refunding bonds, the proceeds of the refunded issues invested in higher yielding non-purpose investments cannot exceed the sum of the 4r: 149(d)
 - (ii) bona-fide debt service fund in the first 13 months
 1. will be considered to be replacement proceeds after 13 months 1.148-2(e)(5)(ii)
 2. requirements
 - a. must be completely drawn down to zero at least annually
 - b. regulations allow for reasonably carryover amount of the greater of
 - i. earnings on the fund for the prior bond year
 - ii. 1/12 of the prior year’s debt service (e.g. can deposit funds into the fund one month ahead of the due dates)
- (c) by issuer
 - (i) small issuer exception to rebate (*municipality that does not intend to issue more than 10m worth of bonds in a calendar year* 148(f)(4)(D))
 1. allocation: individual governments can allocate their pool, but that allocation is irrevocable, made in advance.
 2. requirements
 - a. issuer must have general taxing powers
 - b. bonds must be government, and not PAB bonds
 - c. at least 95% of the proceeds must be used for local government activities of the issuer or of government units located within the issuer’s boundaries
 - d. on the date of issue issuance, the issuer must not reasonably expect to issue more than 5m
 - e. requirements for pools (conduit borrower)
 - i. bonds can’t be PABs
 - ii. none of the loans to the other borrowers are PABs
 - iii. loans to all of the conduit borrowers meet the 5m limit
 - iv. (note: a conduit borrow with its on 5m limit need not be counted twice)
 3. things that must be counted to see if it reaches 5m

of those taxes without interest or penalty, the temporary period under paragraph (e)(3)(i) of this section is extended until the maturity date of the issue.

- a. issue itself
- b. previous issues in same calendar year
- c. reasonably expected issues in same calendar year
- d. issuers by “related entities” that are subject to aggregation
- e. short term issues of TANs
- f. everything else that qualifies for an exception
- g. it is issued by a related entity if it
- 4. determining which entities to count
 - a. entities that issue bonds on behalf of other entities are treated as a single user
 - i. attribution goes both ways: between the issuing entity and the one it is “on behalf of” (and vv)
 - b. bonds issued by subordinate users are counted against the superior entity
 - i. the bonds of the child are attributed to the parent, but not vv.
 - ii. Based on “controlled entity” test 1.103-1
 - c. entities deliberately formed to violate the rule are considered one entity
 - i. they would have been issued by another entity
 - ii. issuer didn’t receive a substantial benefit from the project 1.148-8(c)(2)(iii)
- 5. things that don’t count towards this limit
 - a. taxable issues
 - b. (note: a conduit borrow with its on 5m limit need not be counted twice)
- 6. result: exempts the issuer from rebate of the gross proceeds, reserve fund, or replacement proceeds
 - a. not an exception from arbitrage 1.148-8(c)(2)(i)
 - b. still needs to establish a temporary period and a reserve fund 1.148-8(c)(2)(ii)
- (ii) small issuers using the 5m exception
 - 1. current refunding bonds with no increase in face value can have a 5m exception
 - 2. must have originally been under a 5m exception the first time around
 - 3. either a weighted average maturity over under 3 years, or new bonds are less shorter the old bonds
 - 4. refunding bonds do not mature more than 30 years after the issuance of the old ones
- (d) Special funds
 - ii) Any actually earned arbitrage must be **rebated**
 - (1) Constitutionality: it was argued that this was a 100% tax, but Supremes in *South Carolina v. Baker* declared that this was constitutional

- (2) Practical reasons: bonds subject to rebate allow the purchaser to decide where he wants to invest the proceeds, so he can make the choice based on creditworthiness
- (3) Exceptions
 - (a) Spending exceptions which render an issuer exempt from rebate (if you spend the money fast, there isn't much to rebate anyway)
 - (i) If an issuer expects (and actually does) spend the funds (not the reserve funds) within x months, he is exempt within rebate
 1. no election needed
 2. can count capitalized interest
 3. Specific time-based spending exceptions (does not apply to reserve funds)
 - a. 6 month § 148(f)(4): general rule
 - i. additional 6 months (12 months) only for 501(c)(3) if the amount unspent after the first 6 months doesn't exceed proceeds
 - b. 18 months § 1.148-7(d): capital project, industrial development bond, qualified mortgage bond
 - i. 15% must be spent in 6 months § 1.148-7(d)
 - ii. 60% within 12 months § 1.148-7(d) (is it 45%?)
 - iii. 100% in 18 months § 1.148-7(d) (disregarded if there is due diligence and the amount is less than 3% of the issue price or 250,000)
 - c. 2 year § 148(f)(4): limited to **construction projects** financed with government or 501(c)(3) bonds, or PAB bonds for government facilities
 - i. must also qualify for three year temporary period for unstricted investment 1) arbitrage certificate must include expectations to qualify for the three year period 2) might want to certify estimated income; 3) need to certify that 75% will be spent on construction expenses
 - ii. construction is not acquisition
 - iii. defining construction projects: 1) 75% of the proceeds used (or allocated) to construction expenses (can use actual facts rather than exceptions, but these facts are not dispositive of whether it is a construction issue for purposes of an election to pay the penalty); 2) must be on property owned by a government or 501(c)(3) group; and 3) bonds must be government bonds, 501(c)(3) bonds, or PAB used to finance property owned by a government unit
 - iv. this period can be used for construction of **personal property** (including software) if 1) substantial portion of the property is completed more than six months (from above exception)_after construction was contracted (or begun, if earlier) 2) completion of the

property could not expect to occur within the six month period with the exercise of due diligence; and 3) if the issuer is doing the building, 75% of the costs must be attributed to purchases of supplies

- v. election (at date of issuance) to pay a 1.5% (times the amount of ACP above actual proceeds) penalty instead of rebate. However, can make a later post-issuance decision to terminate the penalty (**termination election**) within 90 days of substantial completion of the project or the end of the three year temporary period, but this post issuance penalty is 3%, and issuer must use available proceeds to redeem at earliest date.⁷² Penalties due 90 day after accrual.

vi. these definitions can probably be used to pay interest

(b) Small issuer (under \$5m)

- (i) Small issuers are still subject to yield restrictions
 - 1. small issuers can make YRPs, so they don't need to find precisely fitting investments

(c) quickly spent government funds

- (i) gross proceeds of such issue are expended for the governmental purposes for which the issue was issued no later than the day which is 6 months after the date of issuance of the issue, and

(d) Purpose (v. non-purpose) investments of proceeds

- (i) Defining purpose investments (code defines "nonpurpose investment" as everything else (securities, stocks, bonds, etc.)
 - 1. Either a loan by a government entity to another government entity for its use in a government program
- (ii) Instead of rebate, the issuer can use the tax from permitted arbitrage to pay operating expenses. Stuff not needed can go for further government purposes or programs.
 - 1. still has a permitted spread, beyond which things need to be properly used

(4) Timing

(a) Usually must rebate ever five years

- (i) every five years at least 90% of the accrued difference should be paid 148(f)
- (ii) if the bond is redeemed the rebate must be made within 60 days
- (iii) penalty is 50% of unpaid rebate – penalty waived if paid within 180days, unless due to willful neglect
 - 1. no overpayment of under 5,000 can be recovered before the final computation date

b) Exceptions from arbitrage (can invest and keep money)

- i) Minor portion: Lesser of 100,000 or 5% of sale proceeds 148(e)

⁷² 1.148-7(1)

5) Mechanics of refundings: where a municipality issues a “refunding issue” and uses the proceeds to pay principal, interest, or redemption price on a prior issue of its own bonds

a) The restrictions on refundings can be triggered by various things

i) Safe harbors: Things that are not refundings (generally use of bond proceeds to pay interest)

(1) Use of bond proceeds within one year after issuance to *pay interest* on another issue

(2) Where interest is a capital expenditure (capitalized interest)

(e. g. *interest paid* during construction of any other circumstance qualifying for capitalization for federal tax purposes) 1.266-1

(3) Use of proceeds to *pay interest*

on another issue in circumstance covered by de minimis exceptions to the rule of "proceeds spent last" for working capital expenditures. 1.148-6(d)(3)(ii)(A)

(4) Where a party assumes the debt service within 6 months of the purchase of the property. 1.150-1(d)(2)(ii)(B)

(a) Within six months of the acquisition one party arranges financing to redeem the earlier issue

(b) The step transaction doctrine can apply

(5) With a qualifying reorganization, the asset acquisition and debt assumption can be done simultaneously or within 6 months 1.150-1(d)(2)(ii)(B)

(6) Exception: General form for use of the special rule on a "conduit refunding issue"

(a) first a government entity issues a conduit financing issue and uses the proceeds to make a conduit loan to a conduit borrower

(b) then the conduit borrower, decides it wants to pay off the conduit loan, and arranges for a conduit refunding issue

(c) the new issue will be treated as refunding the old issue -- **unless** the conduit financing issue was **reasonably expected** to make a new loan within the applicable temporary period 1.150-1(d)(2)(iii) (must make new loan fast)

(i) 6 months after 1986

(ii) 3 years in a pre-1986 issue 1.103-14(b)(11)

(d) if it passes this test, then the new loan is treated as being made from the proceeds of the conduit financing issue, and not the newer, conduit refunding issue

(7) Exception: small-time "program investments" (e. g. qualified mortgage loans, qualified student loans) can have their debt retired without causing the prior issue to be treated as a refunding. 1.150-1(d)(2)(ii)(B)

(a) Criteria for exception

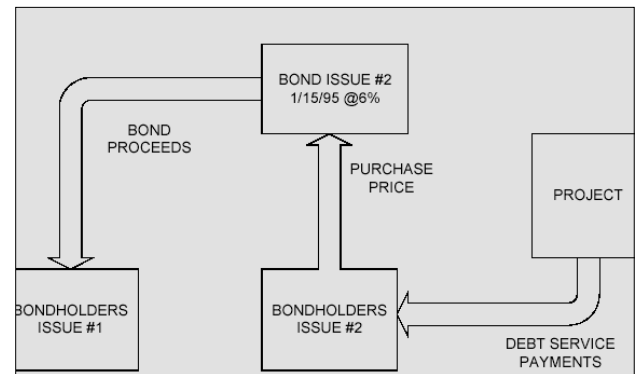


Figure 1: Mechanics of Refunding

- (i) presence of numerous borrowers
 - (ii) pooled, or credit-enhanced security, so that each borrower's credit strength is not dispositive of the credit strength as a whole
 - (b) with retirement of mortgages look to temporary financing rules in § 143(i) – this is more of a substantive rule than an arbitrage rule
- ii) Where a new issue is used to pay a debt service of a prior issue (obvious)
 - (1) Includes redemption premiums
 - (2) Includes any amount paid to retire the prior issue 1.150-1(d)(3)
- iii) Where there is a significant modification in the terms of the bond 1.1001-3
 - (1) Look to substance of transaction 1.150-1(d)(2)(iv)
 - (2) **Look to obligor, not conduit borrower:** this means that § 501(c)(3) cannot refund by using a different conduit borrower
 - (3) Refunding restrictions only apply if there refunding issue and the prior issue have the same obligor or related obligors. 1.150-1(d)(2)(ii)
 - (a) Separately incorporated entities are different obligors
 - (b) Only if one controls the governing board of the other
 - (4) Even in limited circumstances a refunding can occur if the revenues of the bonds are used to pay the debt service of a prior bond PLR 9507010; 57 FR 5102
- b) Four major requirements 1) number of refundings 2) type restrictions; 3) yield limitation; 4) unspent proceeds become “transferred proceeds”)
 - i) Number of refundings
 - (1) Bond that were issued after 1985 as § 501(c)(3) bonds or government bonds may not be advance refunded with tax exempt bonds more than once
 - ii) Type of refunding
 - (1) **Advance refundings:** if any of the proceeds are held for more than 90 days (only for government or § 501(c)(3) bonds)⁷³
 - (a) Usually used for bonds that are not callable, will not get immediate savings until you get rid of the old issue
 - (b) Restrictions on advance refundings of project bonds:
 - (i) No advance refundings at all for any project bond that is not a § 501(c)(3) or a government bond
 - (ii) Only one advance refunding government or § 501(c)(3) bond (if issued post 1996), 2 if before that. (“generation rule”)
 - (iii) Note: can still refund with taxable bonds

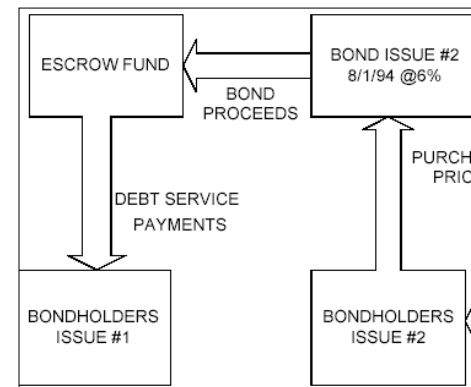
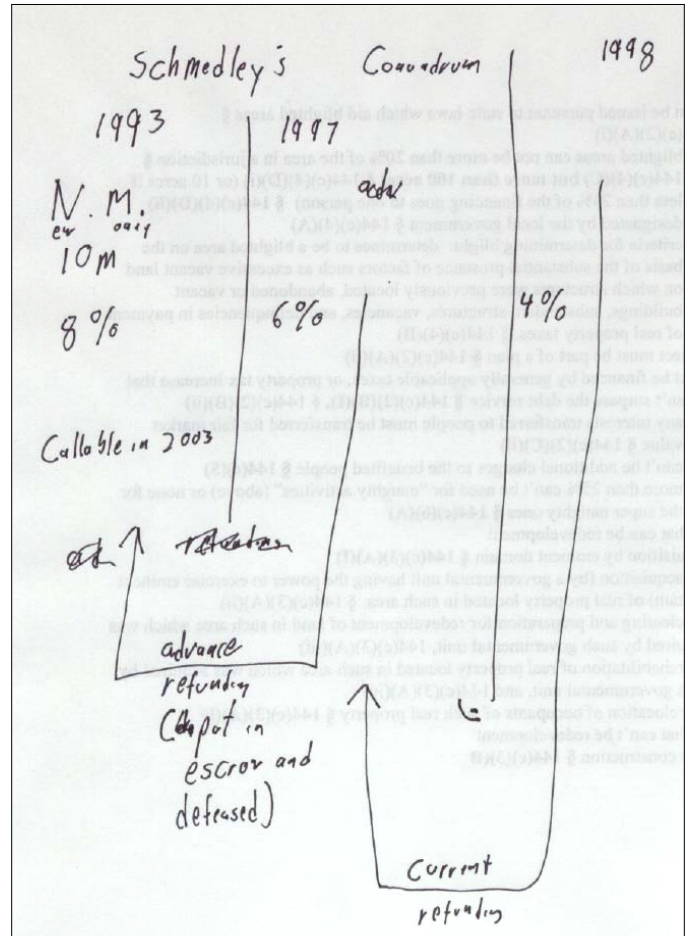


Figure 2: Advance Refundings

⁷³ 149(d)(2) CERTAIN PRIVATE ACTIVITY BONDS.--An issue is described in this paragraph if any bond (issued as part of such issue) is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond).

1. can only refund taxable bonds with tax exempt bonds after 90 days before the retirement of the taxable bonds 1.149-d(1)(e)(2)
- (c) first redemption date rule a.k.a. "first call requirement": if a tax-exempt advance refunding will produce a savings in debt service, the issuer must redeem the prior issue on the first optional redemption date § 149(d) (this is pretty much economically true, anyway)
- (d) if the yield is lower than the yield on a prior issue, the size of the refunding issue will have to be larger than the size of the prior issue because the issuer has to use some of the principal of its proceeds investments to pay part of the interest on the prior service
- (e) Yield restrictions on proceeds from advance refundings (congress does not like to have two bonds and different interest rates outstanding)
 - (i) Minor portion: 100,000 or 5% can be invested at unrestricted yield 149(d)(3)(A)(v)
 - (ii) Bona fide debt service funds
 1. these, in general, have 13 month temporary periods
 2. defeased issued probably cannot have such a fund
 - (iii) Temporary periods
 1. for the first 30 days, there is no yield restriction, afterwards there is 149(d)(3) -- **but still subject to rebate**
 - a. this applies to
 - i. refunding escrow (if it has a life of less than 90 days it falls within the general 6 month exception to rebate, unless it has a "practical purpose" to explain the difference between taxable and exempt rates, there is no temporary period 1.148-7(c)(4))
 - ii. proceeds reasonably expected to pay principal or interest on the prior issue
 - iii. replacement proceeds of the refunding issue, except for proceeds in the bona fide debt service fund
 - iv. transferred proceeds 1.148-9(d)(2)(i)
 - b. temporary periods end on the issuance date of the refunding issue
 - (iv) During the period between the new issue and the redemption, the proceeds can only be invested at .001% above the yield on the refunding issue. 1.148-2(2)(ii)
 1. Cannot make YRP to reduce greater yield. 1.148-5(c)(ii)
 2. Can use SLGs which are sold at .05% below market rates
 3. If the yield on the new issue is lower than the yield on the prior issue, the size of the refunding issue will have to be larger than the size of the prior issue because the issuer has to use some of the principle of its proceeds investments to pay part of the interest on the prior issue
 - (v) with a current refunding, there is little potential for arbitrage since it only extend to 90 days

- (f) advance refundings (not current refundings) automatically end a temporary period for unspent proceeds of the prior issue
- (2) **Current refunding** is defined as within 90 days of the date of issuance, the issuer uses the entire proceeds to pay principle of interest on the prior issue
 - (a) Exempt from state volume ceiling
 - (b) Temporary periods
 - (i) Proceeds continue to have their initial temporary periods. 1.148-9(d)(2)(iii)(A)
 - (ii) In general: 90 day temporary period (duh) 1.148-9(d)(2)(iii),⁷⁴ and exempt from rebate, but it is hard to find a better investment
 - (iii) Prior issue proceeds can use their own exceptions if spent within their own expenditure schedule. 1.148-7(b)(1) -- this is the only time that the 18 month and two year exceptions are available
 - (iv) If the refunding has a term of 270 days or less, the temporary period is 30 days
 - (v) The aggregate amount for all issues in a series can't exceed 90 days
- (c) Refunding escrow of a temporary refunding is not treated as proceeds for purpose of the 6-mnth exception, so transferred proceeds become proceeds of the refunding issue for purposes of computing arbitrage, but not for purpose of determining whether it has been spent 1.148-7(b)(1)(ii)



⁷⁴ (d) Temporary periods in refundings--(1) In general. Proceeds of a refunding issue may be invested in higher yielding investments under section 148(c) only during the temporary periods described in paragraph (d)(2) of this section.

- (i) General temporary period for refunding issues. Except as otherwise provided in this paragraph (d)(2), the temporary period for proceeds (other than transferred proceeds) of a refunding issue is the period ending 30 days after the issue date of the refunding issue.
- (ii) Temporary periods for current refunding issues--(A) In general. Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days.

- iii) transferred proceeds restrictions (a.k.a. transferred proceeds rule): when proceeds of an issue pay the principal of the prior issue, anything left unspent become transferred proceeds.
- (1) **Transferred Proceeds Penalty:** If an issuer lowers its borrowing cost in a refunding, its permitted investment yield on any proceeds must be reduced. **See Error! Reference source not found.**
 - (a) *Principal to principal method:* transferred proceeds arise upon the use of a refunding bond proceeds to pay prior principal
 - (b) The yield on the refunding issue, will, in effect be substituted for the yield on the prior issue
 - (i) If the transferred proceeds are in a refunding escrow
 - 1. current refundings: can use YRPs
 - 2. advance refundings: have to take transferred proceeds penalty in the form of lower interest rates
 - (ii) can't change valuations from present value to market value to get around this restriction
 - (c) Purpose is to encourage municipalities to reduce an issuer's interest costs or produce some benefit other than arbitrage
 - (d) *Refunding escrow* is defined as any fund that contains proceeds of a refunding issue for use in paying principal or interest on the prior issue ("when in doubt, pro-rate")
 - (i) If both revenues and unspent prior issues are put in, it is called a *mixed escrow*
 - (ii) Purpose of this rule is to prevent issuers from allocating their revenues to long-term investments
- (iii) Attributes
 - 1. Note: amounts from different source will not be treated as part of the same escrow, unless the substance of the transaction so indicates.
 - a. Safe harbors
 - i. Issue can deposit revenues into an escrow at least 6 months before or after the deposit of refunding issue proceeds, and it won't be treated as the same escrow
 - ii. Issue can deposit "completely separate funds" in an escrow
 - 2. proceeds of the refunding escrows are subject to yield restriction based on the refunding issue if proceeds are used to pay principal of prior issue, they transfer.
 - a. contributed funds must be "allocated to" (or spent) on the earliest maturing payments – funds originally used for a short term purpose must continue to be used for that purpose
 - b. prior issue proceeds from a project fund also must be allocated to the earliest maturing payments

- c. prior issue proceeds from a reserve fund must be spent ratably (4r funds are treated as having a long-term purpose)
 - d. revenues from other than a bona fide debt service fund must be spent at least as fast as the rest of the issue proceeds
- 3. proceeds of the prior issue are subject to yield restriction based on prior issue yield unless and until they transfer to the refunding issue – and which point they are subject to the refunding issue (new) yield
 - a. monies in escrow will be considered defeased, and their ratings will go to AAA, but the money is not considered to be spent
- 4. revenues will become replacement proceeds if the issuer contributes them to be used to pay off the prior issue
- (2) If portions of the prior issue are retired on different dates, the proceeds will transfer proportionately
- (3) applies to advance and current refunding
- (4) no movement of funds required: if an issue is retired in stages, designation of proceeds as transferred proceeds will occur under a pro-rata rule 1.148-4(b)(6)
- (5) where this comes up
 - (a) any remaining unspent proceeds of the old issue will be considered to be transferred proceeds
 - (b) proceeds of a prior issue held in a reserve fund stay as proceeds of the prior issue the new issue pays off the old issue on the *transfer date* or date of principal payment. Afterwards the reserve fund is part of the refunding issue. (So a reserve fund will be subject to the old rules until retired)
 - (i) transfer date is at date of payment of principal
 - (ii) in an advance refunding in which the bonds are defeased, the defeasance will occur on the issuance date of the refunding issue, that is, when the principal is paid not on the date of the defeasance
 - (c) has been applied to refunding escrows (but since the new rules only allow for one refunding, this problem does not come up as much)
- c) other mechanical rules
 - i) first redemption date rule: if a tax-exempt advance refunding will produce a savings in debt service, the issuer must redeem the prior issue on the first optional redemption date § 149(d)
 - ii) can only be one reserve fund 1.148-9(e) – and that reserve fund has to adhere to the size tests
 - (1) Limits on size of reserve fund from Rev. Proc 84-26
 - (a) 10% of the principal of the issue if the bonds are issued at prices that differ from their principal amount by more than \sum 2% of principal, compensation to underwriters (de minimis)

- (b) maximum annual debt service (seems to be 150% of annual debt service for PABs from 148(d)(3).. but this would be subject to rebate)
 - (c) 125% of the average annual debt service
- (2) these limits appear to be substantive limits, not just arbitrage limits
- (3) sale proceeds limit does not apply to the total size of the reserve fund, but legislative history says that a new refund should be counted against the 10% limit
- iii) high to low: refundings: size of the issue will have to be larger than the size of the prior issue because the issuer has to use some of the principal of its proceeds investments to pay part of the interest on the prior issue
- iv) low to high: low refundings: issuer has an incentive to defer retirement of prior issue as long as possible, by leaving it outstanding until maturity.
 - (1) Rules state that the issuer can't recover the cost of issuance
- v) Net refundings (could be low to high or high to low): interest is defeased: original proceeds plus income from investments pays the interest on the prior bonds and the principal amount at maturity or in redemption
 - (1) In defeased bonds, the holders continue to receive tax exempt interest
- vi) Crossover refundings: income from investment of the refunding proceeds pays interest on the refunding bonds until a crossover date on which the refunding proceeds pay the principal of the prior bond issue – would only be desirable if the arbitrage rules is not available under market conditions
- vii) Gross refundings: refunding pays the principal and interest on the prior bonds without using income from the refunding proceeds and the investment income pays debt service on a portion of the refunding bonds 1.148-10(c) (actually, this is impractical because the issuer would use a gross refunding only if it believed that the terms of the prior bonds did not permit a net refunding)
- d) Prohibition on abusive refundings⁷⁵
 - i) Abusive transaction is defined as “*obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates*”
 - (1) Might be acceptable to obtain a material financial advantage that is not based on arbitrage
 - (2) Or obtain a financial advantage that is not based on arbitrage (can get extension to file)⁷⁶
- 6) Ways monies **can** be invested

⁷⁵ 149(d)(4) ABUSIVE TRANSACTIONS PROHIBITED.--An issue is described in this paragraph if any bond (issued as part of such issue) is issued to advance refund another bond and a device is employed in connection with the issuance of such issue **to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates.**

⁷⁶ 149(e)(2) INFORMATION REPORTING REQUIREMENTS.--A bond satisfies the requirements of this paragraph if the issuer submits to the Secretary, not later than the 15th day of the 2d calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary may prescribe with respect to any portion of the statement), a statement concerning the issue of which the bond is a part which contains--

- a) non-purpose investments: non-purpose investments can't be invested, sold, or used to purchase things below fair market value 1.148-6(a)(1) (anti-yield burning)
 - i) in general, there is a rebuttable presumption that the price is excessive
 - (1) checking accounts can be used, but it has to be some form of ordinary financial management and not yield burning
 - ii) safe harbors
 - (1) securities traded on an established market
 - (2) guaranteed investment contracts (c) purchased using a "three-bid" safe harbor under the regulations
 - (a) three bids must be disinterested, but if there is a 4th it can be interested
 - (i) may be an exception in earlier versions of the regs for 1) GICs with maturities of under three months; 2) GICs on a traded securities market; 3) GICs yielding at least .25% less than the bond yield if it wasn't for the purpose of offsetting arbitrage (these aren't safe harbors)
 - (b) GICs can be secured or unsecured
 - (c) Determination of which bid is best is *net* of broker fees (e.g. issuer must subtract a broker fee from whatever the price is) to the extent that it exceeds the present value of .05% of the weighted average amount reasonably expected to be invested each year. Broker fees must ALSO be reasonable. 1.148-6(a)(3)
 - (i) Steps to apply the .05% limit on deductibility
 - 1. .05% doesn't apply to small issues (under 5m)
 - 2. computer the present value of annual payments reasonably expected to be invested each year of the term of the contract.
 - 3. present value is computed with a taxable interest rate
 - (ii) reasoning any brokers fee over .05% has a direct economic impact on the bond
 - (d) The yield on the winning GIC must not be less than what is offered to people who don't have bond proceeds to invest
 - (e) Terms of the GIC (including collateral security requirements) must be reasonable
 - (f) GIC provider must certify the administrative costs that it is paying to a GIC broker, and all third parties in connection with GIC
 - (3) **CDs** purchased under a regulatory safe harbor
 - (a) Applies only if it is not less than yield on comparable government securities
 - (b) It is the highest published yield
- b) Investment property (if it isn't investment property it is not subject to yield restriction)
 - i) Investment property is defined as ("may include any property that is held principally as a vehicle for the production of income")
 - (1) includes
 - (a) securities § 148(b)(2)
 - (b) obligations § 148(b)(2)
 - (c) investment property

- (i) under the legislative history if a contractor were willing to charge less in return for being paid earlier this could be considered investment type property 1.148-1(b).
- (d) annuity contracts § 148(b)(2): added to keep out pension arbitrage bonds
- (e) investment contracts § 148(b)(2) – even if 3rd parties use the proceeds incorrectly
 - (i) Harbor Bancorp: bonds issued for checks drawn on a nonexistent account turned out to be invested for investment contracts.. and then reissued for federal tax purposes 3 months later
- (f) Alternative Minimum tax bonds are considered investment property if they are 1) “specified private activity bonds”; 2) issued after August 7, 1986. § 57(a)(5)(C)
- (g) non-PAB bonds that are used to acquire residential property outside the jurisdiction (unless according to a desegregation order)
- (h) private activity bonds as they relate to the alternative minimum tax § 148(b)(3)(B) § 57(a)(5)(C), because there is such a spread between them
- (i) can include the benefit from making a prepayment if it is motivated by investment. PLR 9142012 (a prepayment schedule with increasing payments need not be an investment contract)
- (j) residential property located outside the jurisdiction. § 148(b)(2)(E); § 1.48-1(b); § 148-1T(b)
- (k) proposed regulations
 - (i) prepayments if the purpose is to obtain investment income
 - (ii) interest rate caps will be treated as investment property if they are purchased faster than inflation § 1.148-1(e)
- (2) does not include
 - (a) other tax exempt bonds
 - (i) but an exception to the exception is "specific private activity bonds § 148(b)(3)(B)
 - (ii) private activity bonds which are subject to the alternative minimum tax end up counting, § 57(a)(5)(C)⁷⁷

If the pool issue consists of:	And the proceeds are invested in:	Then the investment is:
Non-AMT bonds	Non-AMT bonds (can be purpose or nonpurpose)	Not investment property (IRC section 148(b)(3)(A))
Non-AMT bonds	AMT bonds(can only be nonpurpose)	Investment property (IRC section 148(b)(3)(B))
AMT bonds	AMT bonds (can be purpose or nonpurpose)	Not investment property (IRC section 148(b)(3)(A))
AMT bonds	Non-AMT bonds (can only be nonpurpose)	Not investment property (IRC section 148(b)(3)(A))

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- (b) prepayment of bulk acquisition (e. g. bulk electricity) is not investment property PLR 9142012
 - (c) if a prepayment is made for a business purpose – e. g. if a substantial number of people do so for the same reason, and not for an investment purpose § 1.148-1(e)
- 7) Administrative remedies
 - a) Can seek PLR
 - i) Adverse PLRs can be appealed to tax court. (With split results, since congress may be sympathetic.)
- 8) enforcement
 - a) abusive arbitrage devices: anything that goes against the spirit of the arbitrage rules
 - i) if there is a device where they are yielding more than 5%, than all bonds become taxable
 - (1) overburdening of the tax exempt bond market (doesn't make things taxable)
 - (a) penalty is that no blending is permitted when calculating yields for arbitrage purposes:
 - (b) 1.148-6(d)(3)(iii)(B): any other funds available will be considered to have replaced the actually spent bond proceeds and will be subject to yield restrictions and rebate
 - (2) exploitation
 - (a) mortgage sale
 - (b) window refunding
 - (c) conduit loan sale
 - (3) excess proceeds of advance refundings: make all the bonds taxable if more than 1%
 - ii) repo agreements are considered to be arbitrage bonds. IRC § 148(g).
 - b) bad faith non-arbitrage certificate: Rev. Rule 85-182: facts and circumstances will determine whether or not a certificate was issued in bad faith based on criteria
 - i) size of the project relative to population of issuer Rev. Rule 85-182
 - ii) issuance of bonds without the credit support necessary to permit use of the proceeds for the construction of the project Rev. Rule 85-182
 - iii) difficult that is likely to be incurred in obtaining the required credit Rev. Rule 85-182
 - iv) provision for redemption of the bonds at the end of 3 years if credit support is not secured Rev. Rule 85-182
 - v) earnings on obligations in which the escrowed bonds proceeds are invested sufficient to pay all costs of issuance Rev. Rule 85-182
 - vi) costs of construction far in excess of the average cost of such projects in the jurisdiction of the issuer Rev. Rule 85-182
 - vii) an issuer the size of which is grossly disproportional to both the size of the indebtedness the issuer issued in the several years immediately prior to the issue and the aggregate amount of IDBs issued in that period
 - viii) service can blacklist agencies for bad faith

Qualified Private Activity Bonds

- 1) Defining extent of deliberate action for purposes of remedial action: The percentage of outstanding bonds that are nonqualified bonds equals the highest percentage of private business use in any 1-year period commencing with the deliberate action,⁷⁸
 - a) Usually allocation is on a “pro-ratta” basis
 - b) However, when redeeming or defeasance bonds, an issuer has the option of treat bonds with longer maturities (determined on a bond-by-bond basis) as the nonqualified bonds. **check this – does this mean that an issuer can arbitrary decide which bonds to redeem****⁷⁹
- 2) Can do a financing that is mandatory redeemable
 - a) An automatic renewal provision is subject to a cancellation requirement
- 3) Remedial measures – only satisfy private activity test (and any proceeds that were advance refunded)⁸⁰, not private security or payment test⁸¹
 - a) if in the course of human an the property that an issue is used for becomes a private activity bond, an issuer can remedy it (making it no longer a PAB) by satisfying **five criteria and redeeming the bonds** – this makes it no longer a deliberate action
 - i) Issuer must have reasonably expected the bond not to be a PAB⁸² (will provide a certificate attest to this)
 - ii) Maturity can’t be more than 120% expected economic life of the property⁸³ (will provide a certificate attest to this)

⁷⁸ 1.141-12(j)(1)
⁷⁹

1.141-12(j)(2)	Allocation of nonqualified bonds. Allocations to nonqualified bonds must be made on a pro rata basis, except that, for purposes of paragraph (d) of this section (relating to redemption or defeasance), an issuer may treat bonds with longer maturities (determined on a bond-by-bond basis) as the nonqualified bonds.
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⁸⁰ 1.141-12(b)(2)	If proceeds of an issue were used to advance refund another bond, a remedial action taken with respect to the refunding bond proportionately reduces the amount of proceeds of the advance refunded bond that is taken into account under the private business use test or the private loan financing test.
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⁸¹ 1.141-12(b)
⁸² 1.141-12(a)(1)

⁸³ 1.141-12(a)(2)	Maturity not unreasonably long. The term of the issue must not be longer than is reasonably necessary for the governmental purposes of the issue (within the meaning of § 1.148-1(c)(4)). Thus, this requirement is met if the weighted average maturity of the bonds of the issue is not greater than 120 percent of the average reasonably expected economic life of the property financed with the proceeds of the issue as of the issue date.
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- iii) Whatever transaction happened that turned the issued into a PAB, must have resulted from a bona fide arms-length transaction at fair market value⁸⁴ (will prove a certificate from appraisals to attest to this)
- iv) The issuer must treat any disposition proceeds as gross bond proceeds for purposes of section 148.
- v) Proceeds (“disposition proceeds”) of the issue that are affected by the deliberate action must have been expended on a governmental purpose before the date of the deliberate action.⁸⁵ A.k.a. “all has been spent”
- b) Technicalities of redeeming the bond, three flavors 1) redemption; 2) alternative use of facility; 3) alternative use of proceeds -- **note special rules for non-profits⁸⁶ -- IRS says that the commission can make other means of redemption⁸⁷**
 - i) Redemption or defeasance: if all the nonqualified bonds are redeemed
 - (1) Can’t use tax-exempt bonds unless the tax-exempt bonds are qualified bonds, taking into account the purchaser's use of the facility
 - (2) If redeeming for cash, must redeem a pro rata portion of the nonqualified bonds (e.g. not passing the test) at earliest call date – anything not redeemed by their call date, must be put into escrow
 - (a) If the government does not have the cash on hand, it must produce the cash itself – often through taxable bonds
 - (3) If defeasing, must put in Escrow (“defeasance escrow”) must be set up if bonds are not redeemed within 90 days of the date of the deliberate action
 - (a) must inform commissioner within 90 days⁸⁸
 - (b) irrevocable escrow⁸⁹

⁸⁴ 1.141-12(a)(3)	Fair market value consideration. Except as provided in paragraph (f) of this section, the terms of any arrangement that results in satisfaction of either the private business tests or the private loan financing test are bona fide and arm's-length, and the new user pays fair market value for the use of the financed property. Thus, for example, fair market value may be determined in a manner that takes into account restrictions on the use of the financed property that serve a bona fide governmental purpose
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⁸⁵ 1.141-12(a)(5)

⁸⁶ 1.141-12(e)(2)	Special rule for use by 501(c)(3) organizations. If the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must in addition be treated as reissued for purposes of sections 141, 145, 147, 149, and 150 and, under this treatment, satisfy all of the applicable requirements for qualified 501(c)(3) bonds. Thus, beginning on the date of the deliberate action, nonqualified bonds that satisfy these requirements must be treated as qualified 501(c)(3) bonds for all purposes, including sections 145(b) and 150(b).
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⁸⁷ 1.141-12(h)

⁸⁸ 1.141-12(d)(3)

⁸⁹ 1.141-12(d)(5)

- (c) amount: to redeem bonds on their earliest call date in an amount that, together with investment earnings, is sufficient to pay all the principal of, and interest and call premium on, bonds from the date the escrow is established to the earliest call date.⁹⁰
- (d) Interest rate of escrow: The escrow may not be invested in higher yielding investments or in any investment under which the obligor is a user of the proceeds of the bonds.⁹¹
- (e) Can't be more than 10.5 years⁹²
- ii) alternative use of proceeds: must be exclusively cash – this provision is considered to be a creature of IRS largess
 - (1) consider that is considered to be cash
 - (2) disposition is reasonably expected to be used in two years
 - (3) cash isn't used in a manner that would cause the issue to meet either the private business tests or the private loan financing test, either now or based on subsequent actions⁹³
 - (4) anything that is used as an alternative use that is a private activity, is redeemed or defeased as above⁹⁴
 - (5) if proceeds used for a non-qualified bonds for the 501(c)(3)s are treated as "reissued"
 - (a) whether a bond is "reissued" is based on the definition in effect at the date of the "deliberate action"⁹⁵
 - (b) determining whether a bond is reissued, is not done with respect to § 147⁹⁶
- iii) alternative use of facility: entire facility is sold to a user who will put it to use in a qualified manner

⁹⁰ 1.141-12(d)(5)

⁹¹ 1.141-12(d)(5)

⁹² 1.141-12(d)(4)	The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (d) if the period between the issue date and the first call date of the bonds is more than 10 1/2 years.
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⁹³ 1.141-12(e)(1)(iii)	The disposition proceeds are treated as proceeds for purposes of section 141 and are used in a manner that does not cause the issue to meet either the private business tests or the private loan financing test, and the issuer does not take any action subsequent to the date of the deliberate action to cause either of these tests to be met; and...
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⁹⁴ 1.141-12(e)(1)(iv)	If the issuer does not use all of the disposition proceeds for an alternative use described in paragraph (e)(1)(iii) of this section, the issuer uses those remaining disposition proceeds for a remedial action that meets paragraph (d) of this section.
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⁹⁵ 1.141-12(g)

⁹⁶ 1.141-12(g)

- (1) must be used in an “alternative manner” (e.g. non-profit)⁹⁷
 - (a) usually a gift to charity
- (2) if facility used for a non-qualified bonds for qualifying purpose by a 501(c)(3)s are treated as “reissued”⁹⁸
 - (a) whether a bond is “reissued” is based on the definition in effect at the date of the “deliberate action”⁹⁹
 - (b) determining whether a bond is reissued, is not done with respect to § 147¹⁰⁰
- (3) action doesn’t involve a disposition to a purchaser who, in turn, finances his purchase with other tax-exempt bonds
- (4) escrow: unless disposition is for “services” the proceeds must be placed in an escrow account pending payment that doesn’t pay more than the yield on the bonds¹⁰¹
- (5) if there is absolutely no money, the IRS will enter into closing agreements if there is no cash.¹⁰²
 - (a) An issue of bonds that is under an examination by the Service is not eligible for the program. Rev Proc 97-15
 - (b) Must notify bondholders

⁹⁷ 1.141-12(f)(1)	(1) The facility with respect to which the deliberate action occurs is used in an alternative manner (for example, used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization rather than a governmental person);
⁹⁸ 1.141-12(f)(2)	(2) The nonqualified bonds are treated as reissued, as of the date of the deliberate action, for purposes of sections 55 through 59 and 141, 142, 144, 145, 146, 147, 149 and 150, and under this treatment, the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds;
⁹⁹ 1.141-12(g)	
¹⁰⁰ 1.141-12(g)	
¹⁰¹ 1.141-12(f)(4)	Any disposition proceeds other than those arising from an agreement to provide services (including disposition proceeds from an installment sale) resulting from the deliberate action are used to pay the debt service on the bonds on the next available payment date or, within 90 days of receipt, are deposited into an escrow that is restricted to the yield on the bonds to pay the debt service on the bonds on the next available payment date.
¹⁰² Rev. Proc 97-15	This revenue procedure provides a program under which an issuer of state or local bonds may request a closing agreement with respect to outstanding bonds (1) to prevent the interest on those bonds from being includible in gross income of bondholders or (2) to prevent the interest on those bonds from being treated as an item of tax preference for purposes of the alternative minimum tax for bondholders, in each case as a result of an action subsequent to the issue date that causes those bonds to fail to meet certain requirements of §§ 141 through 150 of the Internal Revenue Code of 1986 relating to use of proceeds.

- (c) Must pay a closing agreement amount: an estimate of the federal income tax liability that is not required to be paid with respect to interest accruing on the nonqualified bonds commencing on the date of the subsequent action, as provided in this section. Rev Proc 97-15
 - (i) Amount of interest accruing on the nonqualified bonds in each calendar year to next redemption date Rev Proc 97-15
 - (ii) Multiply by .29 Rev Proc 97-15
 - (iii) Reduce to present value Rev Proc 97-15
 - (iv) Sum Rev Proc 97-15
- (d) Qualified bonds are not exempt from AMT
- c) Effects of remedial measures:
 - i) proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds¹⁰³ rather than the transferred property.¹⁰⁴
 - (1) even if it an installment sale, the proceed will be treated as part of the transferred property¹⁰⁵
 - (2) allocation of proceeds¹⁰⁶ must be done proportionately (to the principal), to only the outstanding bonds: If property was financed by multiple sources, disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds.

¹⁰³ 1.141-12(c)(1)	Disposition proceeds are any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition (disposition) of property (other than investments) financed with the proceeds of an issue.
¹⁰⁴ 1.141-12(c)(2)	Allocating disposition proceeds to an issue. In general, if the requirements of paragraph (a) of this section are met, after the date of the disposition, the proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds rather than the transferred property...
¹⁰⁵ 1.141-12(c)(2)	... If a disposition is made pursuant to an installment sale, the proceeds of the issue continue to be allocated to the transferred property.

ii) After a remedial action is taken

(1) Resulting or loans are not analyzed under the private activity test.¹⁰⁷

(2) disposition treated as equal to the proceeds of the issue that had been allocable to the transferred property immediately prior to the disposition¹⁰⁸

- 4) Exempt facility bonds. These are things that are exempted by nature of the **use** of the facility. They will be exempt¹⁰⁹ if 95% of the proceeds (good costs) are used to finance¹¹⁰ (so-called “qualified PABs”) – qualified bonds are not exempt from AMT. Must be of character and size commensurate with exempt facilities, and buildings must be somehow subordinate to the main use of the facility. In general, they must all pass the public use test, but sewage facilities are deemed to have already passed.

142(a)	Facility	Must be gov owned?	Criteria
1	Airports	yes (see options)	• Not included in volume cap (§ 146(g)(3))

¹⁰⁶ 1.141-12(c)(3)	Allocating disposition proceeds to different sources of funding. If property has been financed by different sources of funding, for purposes of this section, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funding not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of the outstanding bonds that are allocable to that property. For purposes of this paragraph (c)(3), principal amount has the same meaning as in § 1.148-9(b)(2) and outstanding bonds do not include advance refunded bonds.
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¹⁰⁷ 1.141-12(i)(1)	If a remedial action is taken under paragraph (d), (e), or (f) of this section, the private business use or private loans resulting from the deliberate action are not taken into account for purposes of determining whether the bonds are private activity bonds
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¹⁰⁸ 1.141-12(i)(2)	After a remedial action is taken, the amount of disposition proceeds is treated as equal to the proceeds of the issue that had been allocable to the transferred property immediately prior to the disposition.
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¹⁰⁹ 142(a)1-12

¹¹⁰ 142(a)

142(a) ¶	Facility	Must be gov owned?	Criteria
			<ul style="list-style-type: none"> • No restrictions on the amount of land that can be purchased for noise abatement under 147(c) • must be owned by a governmental unit or leased if there is an irrevocable election not to take depreciation • can't be used for: 1) lodging, 2) retail beyond the size of what is needed to serve the passengers and staff • offices must be 1) on the premises¹¹⁴ and 2) no more than a de minimis amount can be unrelated to activity • storage or training facilities (that are related) can be included¹¹⁶ • property for any private business use¹¹⁷ cannot be included if it is 1) any lodging facility (different before terminal;¹²⁰ 3) office buildings not for the government unity or the operating authority¹²¹; or 4) and industry • can buy unimproved land near the airport • noise abatement doesn't qualify • must be open to general public, common carriers and charter companies • remote parking facilities are too far away • must serve or be available on a regular basis for general public use not constructed for the exclusive use of
2	docks and wharves	yes (see options)	<ul style="list-style-type: none"> • Not included in volume cap (§ 146(g)(3))

¹¹¹ 142(b)1(B)(i)
¹¹² 142(b)1(B)(ii)
¹¹³ 142(b)1(B)(iii)
¹¹⁴ 142(b)2(A)
¹¹⁵ 142(b)2(B)
¹¹⁶ 142(c)(1)
¹¹⁷ 141(b)(6) (check this)
¹¹⁸ 142(c)(2)(A)
¹¹⁹ 142(c)(2)(B)
¹²⁰ 142(c)(2)(C)
¹²¹ 142(c)(2)(D)
¹²² 142(c)(2)(E)
¹²³ 1.103-8(e)2

142(a) ¶	Facility	Must be gov owned?	Criteria
			<ul style="list-style-type: none"> • No restrictions on the amount of land that can be purchased for noise abatement under 147(c) • must be owned by a governmental unit or leased if there is an irrevocable election not to take depreciation • offices must be 1) on the premises¹²⁷ and 2) no more than a de minimis amount can be unrelated to activities • storage or training facilities (that are related) can be included¹²⁹ -- need only be functionally related¹³⁰ (30%) • property for any private business use¹³² cannot be included if it is 1) any lodging facility;¹³³ 2) a retail facility

¹²⁴ 142(b)1(B)(i)

¹²⁵ 142(b)1(B)(ii)

¹²⁶ 142(b)1(B)(iii)

¹²⁷ 142(b)2(A)

¹²⁸ 142(b)2(B)

¹²⁹ 142(c)(1)

¹³⁰ 1.103-8(e)(2)(d)(iii) (... includes property which, ... is functionally related and subordinate to a dock or wharf such as the structure alongside which a vessel docks, the equipment needed to receive and to discharge cargo and passengers from the vessel, such as cranes and conveyors, related storage, handling, office, and passenger areas, and similar facilities.)

¹³¹

Rev. Rul. 79-385	... facilities are directly related to and located adjacent to the docking terminal. Accordingly, both the offshore docking terminal and the onshore storage facilities financed with M's bond proceeds qualify as exempt activities and the exception provisions of section 103(b)(4)(D) of the Code apply to the industrial development bonds
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¹³² 141(b)(6) (check this)

¹³³ 142(c)(2)(A)

¹³⁴ 142(c)(2)(B)

¹³⁵ 142(c)(2)(C)

¹³⁶ 142(c)(2)(D)

¹³⁷ 142(c)(2)(E)

77- 186	A graving dock, an outfitting berth, and other facilities, to be built adjacent to a shipyard in a public port for lease to a nonexempt corporation for use primarily in the construction of ocean-going vessels and in the subsequent repair of the vessels constructed, do not qualify as docks or wharves within the meaning of section 103(b)(4)(D)
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¹³⁹ 1.103-8(e)2)

142(a) ¶	Facility	Must be gov owned?	Criteria
			<p>buildings not for the government unity or the operating authority¹³⁶ or 4) and industrial park or manufactu</p> <ul style="list-style-type: none"> • dry docks do not count as docks or wharfs¹³⁸ • must serve or be available on a regular basis for general public use not constructed for the exclusive use o are acceptable if it is open to the public). Revenue ruling says that if covered by ICC, it is acceptable. • Need not be directly on the dock (30 miles out is acceptable)
3	Mass commuting facilities	yes (see options)	<ul style="list-style-type: none"> • must be owned by a governmental unit or leased if there is an irrevocable election not to take depreciation • offices must be 1) on the premises¹⁴³ and 2) no more than a de minimis amount can be unrelated to activit • storage or training facilities (that are related) can be included¹⁴⁵ • property for any private business use¹⁴⁶ cannot be included if it is 1) any lodging facility;¹⁴⁷ 2) a retail faci buildings not for the government unity or the operating authority¹⁵⁰ or 4) and industrial park or manufactu • can be personalty, realty, or improvements. However, it does not include the vehicles • must have scheduled daily commutes • tourist use acceptable¹⁵² • must serve or be available on a regular basis for general public use not constructed for the exclusive use o

¹⁴⁰ 142(b)1(B)(i)

¹⁴¹ 142(b)1(B)(ii)

¹⁴² 142(b)1(B)(iii)

¹⁴³ 142(b)2(A)

¹⁴⁴ 142(b)2(B)

¹⁴⁵ 142(c)(1)

¹⁴⁶ 141(b)(6) (check this)

¹⁴⁷ 142(c)(2)(A)

¹⁴⁸ 142(c)(2)(B)

¹⁴⁹ 142(c)(2)(C)

¹⁵⁰ 142(c)(2)(D)

¹⁵¹ 142(c)(2)(E)

¹⁵² **Rev. Rul. 76-11**

¹⁵³ 1.103-8(e)2)

142(a) ¶	Facility	Must be gov owned?	Criteria
			<ul style="list-style-type: none"> No restrictions on the amount of land that can be purchased for noise abatement under 147(c)
4	facilities for the furnishing of water	yes (see options)	<ul style="list-style-type: none"> must be either owned by a government unit or the rates for the furnishing or rates are regulated by a federal agency offices must be 1) on the premises¹⁵⁵ and 2) no more than a de minimis amount can be unrelated to activities water must be made available to all people, including public, commercial, and utility users¹⁵⁷ must serve or be available on a regular basis for general public use not constructed for the exclusive use of a particular person or entity
5	Sewage facilities	No – and passes public use test!	<ul style="list-style-type: none"> automatically pass public use test no matter who they are used for¹⁵⁹ definition: “any property used for the collection, storage, treatment, utilization, processing, or final disposal of sewage” 95%¹⁶¹ must be “used for the collection, storage, treatment, utilization, processing, or final disposal of sewage” Need not be owned by a government unit For the secondary treatment of water (not pollution control) offices must be 1) on the premises¹⁶³ and 2) no more than a de minimis amount can be unrelated to activities these do not include water pollution control facilities definitions of sewage facility found in Regs. 26 CFR § 1.142(a)(5)-1¹⁶⁵

¹⁵⁴ 142(e)(2)

¹⁵⁵ 142(b)(2)(A)

¹⁵⁶ 142(b)(2)(B)

¹⁵⁷ 142(e)

¹⁵⁸ 1.103-8(e)(2)

¹⁵⁹ 1.103(a)(2)

¹⁶⁰ Treas. Reg. 1.103-8(f)(2)(i)

¹⁶¹ **1.142(a)(5)-1**

¹⁶² 1.103-8(f)(2)(i)

¹⁶³ 142(b)(2)(A)

¹⁶⁴ 142(b)(2)(B)

¹⁶⁵

(1) Sewage facility defined. A sewage facility is property--

(i) Except as provided in paragraphs (b)(2) and (d) of this section, used for the secondary treatment of wastewater; however, for property treating wastewater reasonably expected to have an average daily raw wasteload concentration of biochemical oxygen demand (BOD) that exceeds 350

142(a) ¶	Facility	Must be gov owned?	Criteria
6	solid waste disposal facilities	No!	<ul style="list-style-type: none"> • automatically pass public use test no matter who they are used for¹⁶⁶ • Need not be owned by a government unit • Volume cap does not apply, since these are deemed to be government owned • means any property or portion thereof used for the collection, storage, treatment, utilization, processing, or • offices must be 1) on the premises¹⁶⁸ and 2) no more than a de minimis amount can be unrelated to activities • includes landfills and “waste to energy” plants • solid waste must not have any market value.¹⁷⁰ (though it is still waste if someone will cart it away for free) • further statutory definition from Solid Waste Disposal Act (42 U.S.C. §3252(4)):. The term 'solid waste' means any solid, liquid, or gaseous waste, including solid, liquid, or gaseous waste, from agricultural operations, and from community activities, but does not include solids or dissolved material in water effluents, dissolved materials in irrigation return flows or other common water pollutants." (seems to include) • eligible properties: are used for the: collection, storage, treatment, utilization, processing, or final disposal of • a rule of thumb: something that goes into a waste dump, not a sewer • recycling facilities count

milligrams per liter as oxygen (measured at the time the influent enters the facility) (the BOD limit), this paragraph (b)(1)(i) applies only to the extent the treatment is for wastewater having an average daily raw wasteload concentration of BOD that does not exceed the BOD limit;

(ii) Used for the preliminary and/or primary treatment of wastewater but only to the extent used in connection with secondary treatment (without regard to the BOD limit);

(iii) Used for the advanced or tertiary treatment of wastewater but only to the extent used in connection with and after secondary treatment;

(iv) Used for the collection, storage, use, processing, or final disposal of--

(A) Wastewater, which property is necessary for such preliminary, primary, secondary, advanced, or tertiary treatment; or

(B) Sewage sludge removed during such preliminary, primary, secondary, advanced, or tertiary treatment (without regard to the BOD limit);

(v) Used for the treatment, collection, storage, use, processing, or final disposal of septage (without regard to the BOD limit); and

(vi) Functionally related and subordinate to property described in this paragraph (b)(1), such as sewage disinfection property.

(2) Special rules and exceptions--(i) Exception to BOD limit. A facility treating wastewater with an average daily raw wasteload concentration of BOD exceeding the BOD limit will not fail to qualify as a sewage facility described in paragraph (b)(1) of this section to the extent that the failure to satisfy the BOD limit results from the implementation of a federal, state, or local water conservation program (for example, a program designed to promote water use efficiency that results in BOD concentrations beyond the BOD limit).

¹⁶⁶ 1.103(a)(2)

142(a) ¶	Facility	Must be gov owned?	Criteria
7	Qualified residential rental projects	No!	<ul style="list-style-type: none"> • Need not be owned by a government unit • must serve or be available on a regular basis for general public use not constructed for the exclusive use of • Must be used for residential use (the units must be complete living facilities with a kitchen and bathroom) • properties for residential use • Not for transients. Not a dorm, frathouse, Hotels, motels, dormitories, fraternity and sorority houses, rooming • Series of qualifications found in 142(d)(3) • offices must be 1) on the premises¹⁷⁷ and 2) no more than a de minimis amount can be unrelated to activities • can split structure between qualified residential use and other uses • can make an irrevocable election to be either a 20-50 or 40-60 test property¹⁷⁹ (based on actual occupancy)

¹⁶⁷ 1.10308(f)(2)(ii): Only expenditures for that portion of property which is a solid waste disposal facility qualify as expenditures for solid waste disposal facilities. The fact that a facility which otherwise qualifies as a solid waste disposal facility operates at a profit will not, of itself, disqualify the facility as an exempt facility. However, whether a collection or storage facility qualifies as a solid waste disposal facility depends upon all of the facts and circumstances. Thus, land and facilities for the collection of materials to form a slag heap which is not preliminary to the recycling or other final disposal of such materials within a reasonable period of time will not qualify. The term does not include facilities for collection, storage, or disposal of liquid or gaseous waste except where such facilities are facilities which... are functionally related and subordinate to a solid waste disposal facility

¹⁶⁸ 142(b)2(A)

¹⁶⁹ 142(b)2(B)

¹⁷⁰ 1.103-8(f)(2)(ii)(a)

¹⁷¹ 1.103-8(f)(2)(ii)(b)

¹⁷² 1.103-8(f)(2)(ii)(b) ("Where any person is willing to remove such property at his own expense but is not willing to purchase such property at any price, such material is waste.")

¹⁷³ 1.103-8(f)(2)(ii)(a)

¹⁷⁴ 1.103-8(e)2

¹⁷⁵ Rev. Rul. 85-182: **These provisions, however, do not permit an issuer to make a certification of expectations in bad faith. Bad faith is present where the likelihood of completion of the project as contemplated is remote.**

¹⁷⁶ 1.103-8(b)(4)(i): Substantially all of each project must contain such units and functionally related and subordinate facilities. Hotels, motels, dormitories, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks and courts for use on a transient basis are not residential rental projects.

¹⁷⁷ 142(b)2(A)

¹⁷⁸ 142(b)2(B)

142(a) ¶	Facility	Must be gov owned?	Criteria
			<p>after the date of 50% occupancy 2) 1st day on which all bonds are retired 3) date on which § 8 assistance t</p> <ul style="list-style-type: none"> ○ 20-50: if 20 percent or more of the residential units in such project are occupied by individuals wh ○ 40-60: if 40 percent or more of the residential units in such project are occupied by individuals wh <ul style="list-style-type: none"> • No rules as to how much to charge • People can remain in apartments if their income increases above 140% of the media required amount, but
8	Facilities for the local furnishing of electric energy or	No!	<ul style="list-style-type: none"> • expires 1997¹⁸¹ -- procedure for election to terminate financing in statute • must serve or be available on a regular basis for general public use not constructed for the exclusive use o • Need not be owned by a government unit (can only have 20% of their voting power owned by governmen • Must be for a city and 1 contiguous county, or 2 contiguous counties¹⁸³ unless FERC says so¹⁸⁴ • Can only furnish an area consisting of a city and 1 contiguous county.¹⁸⁵

¹⁷⁹ 142(d)

¹⁸⁰ 142(d)(1)(A)

¹⁸¹ 142(f)(2)(A)	<p>(3) Termination of future financing.--For purposes of this section, no bond may be issued as part of an issue described in subsection (a)(8) with respect to a facility for the local furnishing of electric energy or gas on or after the date of the enactment of this paragraph unless--</p> <p>(A) the facility will--</p> <ul style="list-style-type: none"> (i) be used by a person who is engaged in the local furnishing of that energy source on January 1, 1997, and (ii) be used to provide service within the area served by such person on January 1, 1997 (or within a county or city any portion of which is within such area), or <p>(B) the facility will be used by a successor in interest to such person for the same use and within the same service area as described in subparagraph (A).</p>
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¹⁸² 1.103-8(e)2)

¹⁸³ 142(f)(1)(A)

¹⁸⁴ 142(f)(2)(A)	<p>In general.--A facility shall not be treated as failing to meet the local furnishing requirement of subsection (a)(8) by reason of electricity transmitted pursuant to an order of the Federal Energy Regulatory Commission under section 211 or 213 of the Federal Power Act (as in effect on the date of the enactment of this paragraph) if the portion of the cost of the facility financed with tax-exempt bonds is not greater than the portion of the cost of the facility which is allocable to the local furnishing of electric energy (determined without regard to this paragraph).</p>
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¹⁸⁵ 142(g)(2)(B)

142(a) ¶	Facility	Must be gov owned?	Criteria
	gas		<ul style="list-style-type: none"> offices must be 1) on the premises¹⁸⁶ and 2) no more than a de minimis amount can be unrelated to activities¹⁸⁷
9	local district heating or cooling facilities	No!	<ul style="list-style-type: none"> “property used as an integral part of a local district heating or cooling system... (or steam)”¹⁸⁸ must serve or be available on a regular basis for general public use not constructed for the exclusive use of a government unit Need not be owned by a government unit (can only have 20% of their voting power owned by government) Can be used for residential or commercial uses must serve or be available on a regular basis for general public use not constructed for the exclusive use of a government unit offices must be 1) on the premises¹⁹¹ and 2) no more than a de minimis amount can be unrelated to activities¹⁸⁹
10	Qualified hazardous waste facilities	No!	<ul style="list-style-type: none"> Need not be owned by a government unit (can only have 20% of their voting power owned by government) offices must be 1) on the premises¹⁹³ and 2) no more than a de minimis amount can be unrelated to activities¹⁹⁰ can be any facility for the disposal of hazardous waste by incineration or entombment “the portion of the facility provided by the issue” must be bigger than the portion of the facility which the government unit owns must serve or be available on a regular basis for general public use not constructed for the exclusive use of a government unit
11	high-speed	No!	<ul style="list-style-type: none"> Need not be owned by a government unit, but non-government units must elect not to take a deduction under section 167 or 168

¹⁸⁶ 142(b)2(A)

¹⁸⁷ 142(b)2(B)

¹⁸⁸ 142(g)(1)

¹⁸⁹ 1.103-8(e)2)

¹⁹⁰ 1.103-8(e)2)

¹⁹¹ 142(b)2(A)

¹⁹² 142(b)2(B)

¹⁹³ 142(b)2(A)

¹⁹⁴ 142(b)2(B)

¹⁹⁵ 142(h)

¹⁹⁶ 1.103-8(e)2)

¹⁹⁷ 142(i)(2) Election by nongovernmental owners.--A facility shall be treated as described in subsection (a)(11) only if any owner of such facility which is not a governmental unit irrevocably elects not to claim with respect to the property to be financed by the net proceeds of the issue.
 (A) any deduction under section 167 or 168, and
 (B) any credit under this subtitle,

142(a) ¶	Facility	Must be gov owned?	Criteria
	intercity rail facilities		<ul style="list-style-type: none"> • Only 25% included in volume cap (§ 146(g)(3)) • No restrictions on the amount of land that can be purchased for noise abatement under 147(c) • offices must be 1) on the premises¹⁹⁸ and 2) no more than a de minimis amount can be unrelated to activities²⁰⁰ • storage or training facilities (that are related) can be included²⁰⁰ • must be expected to go over 150 mph • must be available to the public as passengers²⁰¹ • doesn't include rolling stock • must serve or be available on a regular basis for general public use not constructed for the exclusive use of

¹⁹⁸ 142(b)2(A)

¹⁹⁹ 142(b)2(B)

²⁰⁰ 142(c)(1)

²⁰¹ 142(i)(1)	For purposes of subsection (a)(11), the term "high-speed intercity rail facilities" means any facility (not including rolling stock) for the fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas (within the meaning of section 143(k)(2)(B)) using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops, but only if such facility will be made available to members of the general public as passengers.
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²⁰² 1.103-8(e)2)

²⁰³ 141(b)(6) (check this)

²⁰⁴ 142(c)(2)(A)

²⁰⁵ 142(c)(2)(B)

²⁰⁶ 142(c)(2)(C)

²⁰⁷ 142(c)(2)(D)

²⁰⁸ 142(c)(2)(E)

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142(i)(3):	Use of proceeds.--A bond issued as part of an issue described in subsection (a)(11) shall not be considered an exempt facility bond unless any proceeds not used within a 3-year period of the date of the issuance of such bond are used (not later than 6 months after the close of such period) to redeem bonds which are part of such issue.
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142(a) ¶	Facility	Must be gov owned?	Criteria
			<ul style="list-style-type: none"> property for any private business use²⁰³ cannot be included if it is 1) any lodging facility,²⁰⁴ 2) a retail facility, 3) any building not for the government unit or the operating authority²⁰⁷; 4) and industrial park or manufacturing facility proceeds must be used in 3.5 years²⁰⁹
12	environmental enhancement projects of hydroelectric generating facilities (fish ladders)	No!	<ul style="list-style-type: none"> Not included in volume cap (§ 146(g)(3)) must be owned by a governmental unit or leased if there is an election not to take depreciation,²¹⁰ the lease must be for a term of not less than 10 years must be federally licensed²¹³ offices must be 1) on the premises²¹⁴ and 2) no more than a de minimis amount can be unrelated to activities of the facility at least 80% of the net proceeds must be used to “protects or promotes fisheries or other wildlife resources or other purposes related to the environment” the rest is a recreational facility or other improvement required by the terms and conditions of any Federal licensing permit for the operation of such generating facility must serve or be available on a regular basis for general public use not constructed for the exclusive use of any person or entity
13	qualified public educational facilities.		<ul style="list-style-type: none"> Sunset provision December 31, 2001 Not included in volume cap (§ 146(g)(3)) Need not be owned by a government unit must be greater than the greater of \$10 * state population or \$5m²¹⁸ per year,²¹⁹ but the state can carry it forward

²¹⁰ 142(b)1(B)(i)

²¹¹ 142(b)1(B)(ii)

²¹² 142(b)1(B)(iii)

²¹³ 142(j)(1)(A)

²¹⁴ 142(b)2(A)

²¹⁵ 142(b)2(B)

²¹⁶ 142(j)(1)(ii)	the use of which is related to a federally licensed hydroelectric generating facility owned and operated by a governmental unit, and... is a recreational facility or other improvement required by the terms and conditions of any Federal licensing permit for the operation of such generating facility
142(j)(2)	use of proceeds.--A bond issued as part of an issue described in subsection (a)(12) shall not be considered an exempt facility bond unless at least 80 percent of the net proceeds of the issue of which it is a part are used to finance property described in paragraph (1)(B)(i).

²¹⁷ 1.103-8(e)2)

142(a)	Facility	Must be gov owned?	Criteria
			<ul style="list-style-type: none"> offices must be 1) on the premises²²¹ and 2) no more than a de minimis amount can be unrelated to activit part of a public elementary school or a public secondary school and owned by a private, for-profit corpora

²¹⁸ 142(k)(5)
²¹⁹ 142(k)(5)(a)

²²⁰ 142(k)(5)(f)(ii) State may elect to carry forward an unused limitation for any calendar year for 3 calendar years following the calendar year in which the unused limitation arose under rules similar to the rules of section 146(f), except that the only purpose for which the carryforward may be elected is the issuance of exempt facility bonds described in subsection (a)(13).

²²¹ 142(b)2(A)
²²² 142(b)2(B)
²²³ 142(k)(1)

glossary and definitions

Types of bonds

- 1) Revenue bond: like a non-recourse borrowing, one is borrowing a facility to produce revenue, and the bond is secured based on the ability to produce revenue (stadium, hotel, etc.)
- 2) Double barrel bonds: revenue pledged first, GO backs it up.
- 3) BAN or Bond Anticipation note: for when there will be a long-term thing built
- 4) TAN: TAN: tax anticipation note (ie expecting tax from state gov)
- 5) RAN: revenue anticipation note: when something is expected to be received
- 6) TIF: Tax increment financing -- a bond that is based on increased value of property. Since it is targeted financing, want to get a set of people paying it back
- 7) General Obligation bond (multiple criteria)
 - a) If the General Obligation bond is to finance a large number of programs, whether or not it is a private activity bond is determined based on the reasonable expectations of the issuer if
 - i) It is for a **general government** purpose unit
 - ii) It finances at least **25 separate purposes** (as defined in § 1.150-1(c)(3))
 - iii) does not **predominantly** finance fewer than **4 separate** purposes.
 - iv) The issuer adopted a fund method of **accounting** for its general governmental purposes that makes tracing the bond proceeds to specific expenditures unreasonably **burdensome**.
 - v) Issuer expects **to allocate all of the net proceeds of the issue to capital expenditures within 6 months** of the issue date and adopts reasonable procedures to verify that net proceeds are in fact so expended. A program to randomly spot check that 10 percent of the net proceeds were **so expended generally** is a reasonable verification procedure for this purpose.
 - vi) Issuer expects on the issue date to expend all of the net proceeds of the issue **before expending** proceeds of a **subsequent issue** of similar general obligation bonds.
 - vii) Issuer expects that it will **not** make any **loans to nongovernmental persons** with the proceeds of the issue.
 - viii) issuer expects that expenditures that it could within six months from the issue would that are qualified (e. g. don't meet the private business tests) would be more than 125 percent of the capital expenditures to be financed with the net proceeds of the issue.²²⁴

- ix) The issuer reasonably expects on the issue date that the weighted average maturity of the issue is not greater than 120 percent of the weighted average reasonably expected economic life of the capital expenditures financed with the issue. To determine reasonably expected economic life for this purpose an issuer may use reasonable estimates based on the type of expenditures made from a fund.
 - x) The issuer expects the average maturity of the issue is less than 120 percent of the average **economic life** of the capital expenditures financed with the issue.²²⁵
- 8) Tax assessment bonds
- a) proceeds to the borrower paying the assessment is disregarded in determining whether the private business use test is met. However, the use of the loan proceeds is not disregarded in determining whether the private business use test is met. 1.141-3(d)
- 9) short term obligations
- a) all rules as to reasonably obligations run from the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates). 1.141-3(g)(2)(ii)
 - b) Payments of debt service on an issue to be made from proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue²²⁶ (if not deliberate)

Other terms from § 1.141-1

- 1) **Common areas** is defined as portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility. § 1.141-1(b)

1.141-2(d)(5)(iii)	The issuer reasonably expects on the issue date that the capital expenditures that it could make during the 6-month period beginning on the issue date with the net proceeds of the issue that would not meet the private business tests are not less than 125 percent of the capital expenditures to be financed with the net proceeds of the issue.
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1.141-2(d)(5)(vii)	The issuer reasonably expects on the issue date that the weighted average maturity of the issue is not greater than 120 percent of the weighted average reasonably expected economic life of the capital expenditures financed with the issue. To determine reasonably expected economic life for this purpose an issuer may use reasonable estimates based on the type of expenditures made from a fund.
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²²⁶ 1.141-4(c)(2)(ii)

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- 2) **Consistently applied** means applied uniformly to account for proceeds and other amount § 1.141-1(b)
- 3) **Discrete portion** means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls, partitions, or other physical barriers are examples of a discrete portion.
- 4) **Financed** means constructed, reconstructed, or acquired with proceeds of an issue.
- 5) **Governmental bond** means a bond issued as part of an issue no portion of which consists of private activity bonds. 1.141-1(b)
- 6) **Governmental person** means a state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. It does not include the United States or any agency or instrumentality thereof.
- 7) **Hazardous waste remediation bonds** is defined in § 1.141-4(f)(1).
- 8) **Measurement period** is defined in § 1.141-3(g)(2).
 - a) For an issue of **short-term obligations** that the issuer reasonably expects to refund with a long-term financing (such as bond anticipation notes), the measurement period is based on the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates).
 - b) Special rule for **reasonably expected mandatory** redemptions. If an issuer reasonably expects on the issue date that an action will occur during the term of the bonds to cause either the private business tests or the private loan financing test to be met and is required to redeem bonds to meet the reasonable expectations test of § 1.141-2(d)(2), the measurement period ends on the reasonably expected redemption date.
 - c) Special rule for ownership by a nongovernmental person. The amount of **private business use resulting from ownership by a nongovernmental** person is the greatest percentage of private business use in any 1-year period.
 - d) Can't increase the amount of time to decrease the percentage: If an issuer establishes the term of an issue for a period that is longer than is reasonably necessary for the governmental purposes of the issue for a principal purpose of increasing the permitted amount of private business use, the Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any 1-year period
 - e) Determining average percentage of private business use. The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. Appropriate adjustments must be made for beginning and ending periods of less than 1 year.
 - f) Determining the average amount of private business use for a 1-year period--(i) In general. The percentage of private business use of property for any 1-year period is the average private business use during that year. This average is determined by comparing the amount of private business use during the year to the total amount of private business use and use that is not private business use (government use) during that year.

- i) To determine how much the facility is in use in a one year period for government uses calculate it based on the average amount of time a non-government use is using the facility within the time it is in use²²⁷
- ii) Simultaneous use. In general, for a facility in which government use and private business use occur simultaneously, the entire facility is treated as having private business use.
 - (1) If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (for example, reasonably expected fair market value of use). For example, the average amount of private business use of a garage with unassigned spaces that is used for government use and private business use is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

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- (ii) Uses at different times. For a facility in which actual government use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. In determining the total amount of actual use, periods during which the facility is not in use are disregarded.
- (iii) Simultaneous use. In general, for a facility in which government use and private business use occur simultaneously, the entire facility is treated as having private business use. For example, a governmentally owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use. If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (for example, reasonably expected fair market value of use). For example, the average amount of private business use of a garage with unassigned spaces that is used for government use and private business use is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.
- (iv) Discrete portion. For purposes of this paragraph (g), measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility.
- (v) Relationship to fair market value. For purposes of paragraphs (g)(4)(ii) through (iv) of this section, if private business use is reasonably expected as of the issue date to have a significantly greater fair market value than government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use. This determination of relative fair market value may be made as of the date the property is acquired or placed in service if making this determination as of the issue date is not reasonably possible (for example, if the financed property is not identified on the issue date). In general, the relative reasonably expected fair market value for a period must be determined by taking into account the amount of reasonably expected payments for private business use for the period in a manner that properly reflects the proportionate benefit to be derived from the private business use.

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- (2) Discrete portion. For purposes of this paragraph (g), measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility.
- (3) Common areas. The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit.
- (4) Pre-arrangement: if an issuer enters into an arrangement for private business use a substantial period before the right to actual private business use commences and the arrangement transfers ownership or is an arrangement for other long-term use (such as a lease for a significant portion of the remaining economic life of financed property), private **business use commences on the date the arrangement is entered into**, even if the right to actual use commences after the measurement period. For this purpose, 10 percent of the measurement period is generally treated as a substantial period.
- 9) **Nongovernmental person** means a person other than a governmental person.
- 10) **Output facility** means electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.
- 11) **Proceeds** means the sale proceeds of an issue (other than those sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund). Proceeds also include any investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period). Disposition proceeds of an issue are treated as proceeds to the extent provided in § 1.141-12. The Commissioner may treat any replaced amounts as proceeds.
- 12) **Project period** means the period beginning on the issue date and ending on the date that the project is placed in service. In the case of a multipurpose issue, the issuer may elect to treat the project period for the entire issue as ending on either the expiration of the temporary period described in § 1.148- 2(e)(2) or the end of the fifth bond year after the issue date.
- 13) **Public utility property** means public utility property as defined in section 168(i)(10).
- 14) **Renewal option** means a provision under which either party has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for 1-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).
- 15) **Replaced amounts** means replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds.
- 16) **Weighted average reasonably expected economic life** is determined under section 147(b). The reasonably expected economic life of property may be determined by reference to the class life of the property under section 168.
- 17) **reasonable expectations** or reasonableness if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a

deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met. 1.141-2(d)

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