Module C

Allocation and Accounting Rules

Overview

Introduction

If proceeds of an issue meet the usage and investment requirements set forth in IRC sections 141 through 148, interest on the bonds of the issue will generally not be includible in the bondholders' gross income. Whether these requirements have been met often depends on the answers given to the following three general allocation questions:

1. Were the bonds of the bond issue properly identified and allocated to the issue?

2. Were the proceeds of the allocable bonds properly identified and allocated to the bond issue?

3. Were the proceeds properly allocated to expenditures and investments?

The Code and accompanying regulations provide issuers with detailed guidance for the proper allocation and accounting of bond proceeds. The current allocation regulations are found under the arbitrage provisions in Treas. Reg. section 1.148-6. These rules apply not only for arbitrage and rebate purposes but also for purposes of allocating proceeds to expenditures for IRC section 141 purposes. **See Treas. Reg. section 1.141-6(a).**

- Note however, that the allocation and accounting rules of IRC section 141 have generally not been written yet. The section 141 regulations reserved the subsections of 1.141-6.

Both Treas. Reg. sections 1.141-6(a) and 1.148-6(a) generally provide that allocations to account for gross proceeds, investments, and expenditures of an issue may be made using any reasonable, consistently applied accounting method. Allocations under IRC section 141 and IRC section 148 must be consistent with each other.

Treas. Reg. section 1.148-6(a)(2) provides that an accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item.

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Overview, Continued

Objectives

At the end of this module, you will be able to:

- Identify the three general types of allocations that typically must be made in order to determine compliance with the usage and investment rules of IRC sections 141 through 148.
- Identify and allocate bonds to a bond issue.
- Identify and allocate bond proceeds to bonds of an issue.
- Apply the universal cap rule to a set of facts.
- Identify and allocate proceeds to expenditures and investments.

In this module

This module contains the following topics:

Section 1

Allocations of Bonds

Introduction

Compliance with the tax-exempt bond rules cannot be determined unless, at the outset, all of the bonds of an issue are properly identified and allocated to the issue. Treas. Reg. section 1.150-1(c) provides the general rules for determining how bonds are allocated to a bond issue.

Definition - Issue

The term "issue" is defined in the regulation as two or more bonds that meet all of the following requirements:

- The bonds are sold at substantially the same time (sold less than 15 days apart).
- The bonds are sold pursuant to the same plan of financing. Factors to take into account in making this determination include the purposes for the bonds and the structure of the financing.
- The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor. **See Treas. Reg. section 1.150-1(c)(1).**

This definition is applicable to bonds issued after June 30, 1993 and is applicable for all purposes under IRC section 103 and 141-150. (See Treas. Reg. section 1.103-13(b)(10) and Rev. Rul. 81-216, 1981-2 C.B. 21, for the prior definition of the term "issue".)

Example 1

Series A bonds are sold on April 1, 1999, to finance the acquisition of land as a site for City A's future municipal water facility. Series B bonds are sold on April 8, 1999, to finance the construction of the water facility. Both Series A bonds and Series B bonds mature in twenty years and will be paid from water fees levied on City residents. The Series A bonds and Series B bonds should be identified as bonds of the same issue and allocated to that issue.

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Example 2

City A issued Series A bonds on April 1, 1999, for the purpose of financing its operating expenses. The Series A bonds mature in six months. City A also issued Series B bonds on April 1, 1999, for the purpose of financing sewer improvements. The Series B bonds mature in 20 years. The Series A bonds and Series B bonds should not be identified as bonds of the same issue since the bonds are not part of the same plan of financing.

General Rule – Allocation of Taxable and Tax-Exempt Bonds

Treas. Reg. section 1.150-1(c)(2) provides that taxable bonds and tax-exempt bonds are not part of the same issue.

- An allocation of tax-exempt bonds to a separate issue in a transaction (or series of related transactions) that include taxable bonds may, however, also result in the creation of an abusive arbitrage device or other abusive structure (e.g., structures involving windows or unreasonable allocations of bonds).

Permissive Exception: Bonds Financing Separate Purposes

Treas. Reg. section 1.150-1(c)(3) provides that bonds financing separate purposes may be allocated to, and treated as, separate issues.

- Examples of separate purposes include refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose.
- Each of these separate issues independently must be comprised of tax-exempt bonds.
- This permissive exception does not apply for purposes of IRC sections 141(b)(5), 141(c)(1), 141(d)(1), 144(a), 148, 149(d), and 149(g).

See Treas. Reg. section 1.148-9(h) for multipurpose issue allocations for arbitrage and rebate purposes.

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Permissive Exception: Reasonable Allocation Method

Bonds must be allocated between each of the separate issues using a reasonable, consistently applied allocation method. **See Treas. Reg. section 1.150-1(c)(3).**

- An allocation is not reasonable if it achieves more favorable results under IRC sections 103 and 141 through 150 than could be achieved with actual separate issues.

- All allocations with respect to this permissive separate issues exception must be made in writing on or before the issue date.

If any separate issue consists of refunding bonds, the allocation rules in Treas. Reg. section 1.148-9(h) must be satisfied. See Section 3, Part II of Module E for a discussion of multipurpose issue allocations.

Section 2

Allocation of Proceeds to an Issue

Overview

Introduction

Once bonds have been properly identified and allocated to an issue, proceeds of the bonds must be properly identified and allocated to the bonds of the issue. In order to complete this step, a basic understanding of the term "proceeds" and its related terms is necessary.

The definition of "proceeds" provided in Treas. Reg. section 1.141-1 for qualification purposes is somewhat different from the definition provided in Treas. Reg. section 1.148-1(b) for arbitrage and rebate purposes.

In this section

This section contains the following topics:

Definition of Proceeds

Treas. Reg. Section 1.141-1 Definition of Proceeds

Proceeds is defined under Treas. Reg. section 1.141-1 to include the following:

1. sales proceeds of an issue (other than those sales proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund);

2. investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period);

3. disposition proceeds of an issue are treated as proceeds to the extent provided for under the remedial provisions of Treas. Reg. section 1.141-12; and

4. any replaced amounts treated by the Commissioner as proceeds.

Disposition proceeds are defined in Treas. Reg. section 1.141-12(c)(1) as any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition of property (other than investments) financed with the proceeds of an issue.

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Treas. Reg. Section 1.148-1(b) Definition of Proceeds

Proceeds is defined under Treas. Reg. section 1.148-1(b) to include the following:

1. sale proceeds;
2. investment proceeds; and
3. transferred proceeds.

Treas. Reg. section 1.148-1(b) also provides, however, that proceeds does not include amounts actually or constructively received with respect to a purpose investment that are properly allocable to:

1. the immaterially higher yield under Treas. Reg. section 1.148-2(d), or section 143(g), or
2. qualified administrative costs recoverable under Treas. Reg. section 1.148-5(e).

- Sale proceeds are defined in Treas. Reg. section 1.148-1(b) as any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right that is associated with a bond, and that is described in Treas. Reg. section 1.148-4(b)(4). Also under Treas. Reg. section 1.148-4(h)(5) amounts received upon the termination of certain hedges are sale proceeds.
- Treas. Reg. section 1.148-1(b) defines investment proceeds as any amounts actually or constructively received from investing proceeds of an issue.
- Transferred proceeds are defined in Treas. Reg. section 1.148-9. Under that section, when proceeds of a new issue of refunding bonds discharge the outstanding principal of a prior issue,

  1. the proceeds of the prior issue transfer to the refunding issue, and

become transferred proceeds of the refunding issue.

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Definition of Gross Proceeds

Treas. Reg. section 1.148-1(b) also specifically defines the term "gross proceeds" to mean any proceeds (as defined above for IRC section 148 purposes) and replacement proceeds of an issue.

Replacement proceeds, the second component of gross proceeds, are defined in Treas. Reg. section 1.148-1(c). They are amounts that have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose.

Some examples of replacement proceeds are:

1. Gifts for specified purposes. A donor might provide funds for a building but the issuer decides to issue tax-exempt bond proceeds to build the building.
2. Sinking funds denoted to pay principal and interest on debt issues.
3. Pledged funds which an amount that is directly or indirectly pledged to pay principal or interest of an issue.
4. Excess cash available when bonds are outstanding longer than necessary.

One Issue Rule

The Rule

Gross proceeds are generally allocable to only one issue at a time. Treas. Reg. section 1.148-6(b)(1) provides that if amounts are simultaneously proceeds of one issue and replacement proceeds of another issue, those amounts are only allocable to the issue of which they are proceeds.

Example 3

City A issues bonds to advance refund a prior issue and places the proceeds of the refunding bonds in escrow. These amounts constitute sales proceeds of the refunding bonds. However, under the replacement proceeds definition of Treas. Reg. section 1.148-1(c), these amounts also constitute proceeds of the prior issue. To prevent counting these proceeds twice, the one-issue rule provides that the amounts are allocable only to the refunding issue.

In effect, this rule provides that proceeds will not be allocated to two issues simultaneously for purposes of calculating arbitrage and rebate.

Universal Cap Rule

General Rule

Treas. Reg. section 1.148-6(b)(2)(ii) provides an overall limitation on the amount of gross proceeds allocable to an issue. The general "universal cap" rule is that amounts that would otherwise be gross proceeds allocable to an issue are allocated to the issue only to the extent the value of non-purpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue.

- The value of all outstanding bonds is referred to as the universal cap.
- For purposes of the universal cap rule, gross proceeds allocable to cash, tax-exempt bonds that would be non-purpose investments (except for the specific exception provided for in IRC section 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as non-purpose investments.
- Non-purpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the non-purpose investments for purposes of the universal cap rule.
- For purposes of the universal cap rule, the values of bonds and investments are determined under Treas. Reg. sections 1.148-4(e) and 1.148-5(d), respectively.

Example 4

If the value of outstanding bonds is $20,000,000, the amount of non-purpose investments that may be allocated to the issue is limited to $20,000,000 (the universal cap).

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Universal Cap Deallocating Procedures

If the amount of nonpurpose investments exceed the universal cap, Treas. Reg. Section 1.148-6(b)(2)(iv) provides the rule for deallocating excess amounts. Specifically, that section provides that nonpurpose investments allocable to gross proceeds necessary to eliminate the excess cease to be allocated to the issue, in the following order:

1. non-purpose investments allocable to replacement proceeds;

2. non-purpose investments allocable to transferred proceeds;

3. non-purpose investments allocable to sale proceeds and investment proceeds.

Example 5

City A issues bonds to advance refund a prior issue and places the proceeds in a refunding escrow. City A also uses revenues to establish a reserve fund. Generally, the reserve fund would constitute replacement proceeds of the refunding issue. However, the universal cap prevents allocation of the replacement proceeds (the reserve fund) to the issue until sufficient original proceeds and transferred proceeds have been expended that such proceeds fall below the universal cap.

- This rule proves very beneficial to the issuer where the proceeds of the reserve fund are invested at high yields, which is often the case.

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Universal Cap Reallocations

Amounts that cease to be allocated to an issue as a result of the application of the universal cap rule may be reallocated to another issue.

- Treas. Reg. section 1.148-9(b)(3) provides that to the extent non-purpose investments allocable to proceeds of a refunding issue exceed the universal cap for the issue on the date that amounts become transferred proceeds of the refunding issue, those transferred proceeds and corresponding investments are reallocated back to the issue from which they transferred on that same date to the extent of the unused universal cap of the prior issue.

- Except as provided in Treas. Reg. section 1.148-9(b)(3), amounts that cease to be allocated to an issue as a result of the application of the universal cap rule may only be allocated to another issue as replacement proceeds.

Example 6

On January 1, 1995, $100,000 of non-purpose investments allocable to proceeds of Issue A become transferred proceeds of Issue B, but the unused portion of Issue B's universal cap is $75,000 as of that date. On January 1, 1995, Issue A has unused universal cap in excess of $25,000. Thus, $25,000 of non-purpose investments representing the transferred proceeds is immediately reallocated back to Issue A on January 1, 1995, and are proceeds of Issue A. On the next transfer date the $25,000 receives no priority in determining transferred proceeds as of that date but is treated the same as all other proceeds of issue A subject to transfer.

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Nonmandatory Application of Universal Cap Rule

If an issuer reasonably expects, as of the issue date, that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not apply on any date on which an issue actually has all of the following characteristics:

1. No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve fund.

2. The net proceeds of the issue-

   - qualify for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings and were allocated to expenditures during an applicable temporary period; or
   - were deposited in a refunding escrow and expended as originally expected.

3. The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;

4. None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; and

5. No proceeds of the issue are invested in qualified student loans or qualified mortgage loans. **See Treas. Reg. section 1.148-6(b)(2).**

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Universal Cap Determination Dates

There are dates on which, unless the above "reasonable expectations" exception applies, an issuer must determine whether application of the universal cap rules results in a reduction or reallocation of gross proceeds of an issue. **See Treas. Reg. section 1.148-6(b)(2)(iii).**

- The general rule is that the amount of the universal cap and the value of the nonpurpose investments generally must be determined as of the first day of each bond year beginning with the first bond year that commences after the second anniversary of the issue date.
- For refunding and refunded issues, there is a special rule that provides that the universal cap and values must be determined as of each date that proceeds of the refunded issue would become transferred proceeds of the refunding issue but for the universal cap rule.

Otherwise, an issuer may generally apply the universal cap at any time.

Factors Indicating Possible Application of Universal Cap Rule

The following are factors that may indicate that the universal cap rule applies to an issue:

- Issuer fails to expend proceeds of an issue as expected.
- Bonds are rapidly retired from revenues.
- Toward the end of the term of an issue, non-purpose investments allocable to escrows and reserves of the issue are substantial.
- Endowment funds are pledged to pay debt service.

Section 3

Expenditure and Investment Allocations

Introduction

Once proceeds and bonds are identified and properly allocated to an issue, the allocable proceeds must be properly allocated to expenditures and investments. Once these allocations have been verified, determinations regarding whether or not the usage and investment restrictions of IRC 141 through 148 have been met can be made.

This section covers the rules governing such allocations.

In this Section

This section contains the following topics:

Allocation of Funds to Expenditures

General Rule

Generally, gross proceeds are allocated to an issue and are subject to yield restriction and rebate rules until an event occurs that allocates the proceeds away from the issue, or "deallocates" the proceeds.

- Under the regulations, amounts cease to be proceeds of an issue when they are allocated to an expenditure for a governmental purpose such as the construction of a courthouse, roadway, etc.

- Gross proceeds are not deallocated, however, when used to acquire a non-purpose investment. Such proceeds continue to be subject to yield restriction and rebate.

- If the issuer expends gross proceeds for a purpose investment, such as a loan to a conduit borrower (private entity such as a 501(c)(3) organization rather than a governmental issuer):

  1. the proceeds are not allocated to an expenditure until the conduit borrower actually spends the money unless,

  2. the purpose investment is with respect to a qualified mortgage bond or a qualified student loan bond issue.

- Even after such an expenditure by the conduit borrower, the proceeds remain allocated to the issue (for yield restriction purposes) until the sale, discharge, or other disposition of the purpose investment.

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Allocation Methods of Funds to Expenditures

Often, an issuer will have several sources of funds available to finance a particular project. The question then becomes how to allocate expenditures to the various sources. Treas. Reg. section 1.148-6(d)(1)(i) provides that any of the following methods may be used to allocate funds from different sources to expenditures made for the same governmental purpose, if applied consistently:

1. Specific tracing. Specific tracing is the matching of bond proceeds to expenditures dollar for dollar and the most direct method of accounting for proceeds. With multiple issues, this would generally require maintaining separate accounts for each issue.

2. Gross proceeds spent first. This methodology is useful where the issuer has available funds that are not bond proceeds. This permits the issuer to spend the bond proceeds first, thereby reducing arbitrage and rebate liabilities. Compare this to the working capital expenditure rule discussed below.

3. First-in, first-out. Where there is more than one bond issue, this method would permit the issuer to treat the proceeds of the first issue as first spent, the proceeds of the second issue next, and so on.

4. Ratable allocation method. Rather than maintaining separate accounts for multiple issues, the issuer places all proceeds in a single account. Proceeds are deallocated proportionately.

Proceeds of an issue must be allocated using the specific tracing method if an issuer fails to maintain books and records sufficient to establish the accounting method for an issue. **See Treas. Reg. section 1.148-6(a)(3).** This provision applies to bonds issued on or after May 16, 1997.

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Current Cash Outlays Requirement

Regardless of the accounting method, any allocation of gross proceeds to expenditure requires a current outlay of cash. The issuer must reasonably expect this outlay of cash to occur not later than 5 banking days after which the allocation of gross proceeds to expenditures is made. **See Treas. Reg. section 1.148-6(d)(1)(ii).**

Timeframe Requirement

Treas. Reg. section 1.148-6(d)(1)(iii) provides that an issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of:

1. the date the expenditure is paid; or
2. the date that the project, if any, that is financed by the issue is placed in service.

- The allocation must be made within 60 days after the fifth anniversary of the issue date or, if earlier, 60 days after the retirement of the issue.
- Treas. Reg. section 1.148-6(d)(3)(iii) applies only to bonds issued on or after May 16, 1997.

Working Capital Expenditure Rules

Working Capital Expenditures-General Rule

In keeping with the general policy of limiting the issuance of bonds until the proceeds are actually needed for a governmental purpose, the regulations create a restrictive allocation rule for working capital expenditures.

- Working capital expenditures are defined in Treas. Reg. section 1.150-1(b) as any cost that is not a capital expenditure. Current operating expenses of a municipality are an example of working capital expenditures.

- Treas. Reg. section 1.148-6(d)(3)(i) generally provides that proceeds of an issue may only be allocated to working capital under a "gross-proceeds-spent-last" method. Under this rule, the issuer may only allocate proceeds to working capital expenditures to the extent that the working capital expenditures exceed other amounts available to the issuer.

Available Amounts

Available amounts for working capital expenditure purposes include cash, investments, and other amounts held in accounts, or otherwise by the issuer or a related party, that may be used for working capital expenditures, of the type being financed by an issue,

- without a legislative or judicial action, and

- without legislative, judicial, or contractual requirement that those amounts be reimbursed.

The following items are treated as unavailable:

1. A reasonable working capital reserve. Such reasonable reserve, however, is not to exceed 5 percent of the actual working capital expenditures of the issuer in the preceding fiscal year.

    - In determining working capital expenditures of the issuer in the prior year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

2. A qualified endowment fund of a 501(c)(3) organization. **See Treas. Reg. section 1.148-6(d)(3)(iii)(C).**

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Exceptions to the General Rule

Treas. Reg. section 1.148-6(d)(3)(ii) provides exceptions to the general rule that proceeds of an issue may only be allocated to working capital expenditures under a "gross-proceeds-spent-last" method.

General de minimis exception. The general rule does not apply to expenditures to pay the following costs:

- Issuance costs.
- Qualified administrative costs.
- Fees for qualified guarantees or payments for a qualified hedge.
- Interest on the issue for a period beginning 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.
- Various amounts paid to the United States under arbitrage provisions of IRC section 148 such as rebate payments, yield reduction payments, and penalty-in-lieu of rebate payments.
- Costs, other than the aforementioned costs that do not exceed 5 percent of the sales proceeds of an issue and that are directly related to capital expenditures financed by the issue.
- Principal and interest on an issue paid from unexpected excess sale or investment proceeds.
- Principal and interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

Extraordinary items exception. The general rule typically does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues.

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Exceptions to the General Rule (continued)

Exception for payment of principal and interest on prior issues. The general rule typically does not apply to expenditures for:

1. payment of principal, interest, or redemption prices on a prior issue, and

2. for a crossover refunding issue, interest on that issue.

The exceptions above do not apply if the allocation merely substitutes gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds.

Impact of Working Capital Expenditure Rule

The effect of this general rule for allocations to working capital expenditures is clear. Since gross proceeds remain allocable to the issue until other funds are unavailable, the proceeds remain subject to the arbitrage and rebate rules for a longer period of time. This limits the issuer's incentive to finance normal operating expenses with tax-exempt bonds while investing the proceeds of the bonds or other amounts on hand in higher yielding instruments.

Grant Expenditure Rule

Treas. Reg. section 1.148-6(d)(4) provides that gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made. Transfers of money or property to a transferee that is a related party to, or agent of, the transferor are not considered grants.

- Any amount of a bond-financed grant that is repaid to the transferor is treated as unspent proceeds of the issue as of the repayment unless expended within 60 days of the repayment date.

Reimbursement Allocations

Definition

A reimbursement allocation is an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an expenditure that was originally paid from sources other than the bond proceeds (an original expenditure). A reimbursement bond is the portion of an issue allocated to reimburse such expenditure. **See Treas. Reg. section 1.150-2(c).**

Example 7

City A spends $5,000,000 from its general funds on May 1, 1998, in connection with the construction of a courthouse. City A may issue $5,000,000 of bonds on January 1, 1999 and allocate the gross proceeds to the prior expenditure. If the reimbursement is proper, City A may invest the gross proceeds of the bonds without arbitrage consequences.

Reimbursement Allocations-Treas. Reg. Section 1.150-2

In allocating gross proceeds of reimbursement bonds, Treas. Reg. section 1.148-6(d)(5) states that the rules of Treas. Reg. section 1.150-2 apply. If, however, the gross proceeds are used to reimburse a working capital expenditure, the rules of Treas. Reg. section 1.148-6(d)(3) apply.

General Operating Rules for Reimbursement

Treas. Reg. section 1.150-2(d) provides the general operating rules for reimbursement allocations. Essentially, proceeds of a reimbursement bond will be treated as expended for the governmental purpose of the original expenditure on the date of the reimbursement allocation if the following three requirements are met:

1. Official intent.

2. The reimbursement period.

The nature of the expenditure.

Each of these requirements are discussed in further detail in Module D.

Commingled Funds

Special Rules for Commingled Fund Allocations

Treas. Reg. section 1.148-6(e) imposes special accounting rules for commingled funds.

- Under Treas. Reg. section 1.148-1(b), a commingled fund means any fund or account (other than an open-end regulated investment company) that contains both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of the issue. As mentioned above, issuers frequently commingle gross proceeds of an issue with other funds. This is done to invest the funds more efficiently.

- Treas. Reg. section 1.148-6(e)(2) requires all payments and receipts with respect to investments in a commingled fund be allocated to each investor at the close of each fiscal period using a "consistently applied, reasonable ratable allocation method." The fiscal period must be a consistent fiscal period that does not exceed three months.

- To illustrate, if the issuer commingles funds, it cannot simply allocate any lower yielding investments to the gross proceeds portion of the funds without allocating a ratable portion to the other sources of funds.

- For purposes of these rules, the term investor means each different source of funds. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, it is treated as two investors.

Safe Harbor Allocation Methods for Commingled Funds

Treas. Reg. section 1.148-6(e)(2)(ii) sets forth safe harbor ratable allocation methods for allocating items in commingled funds in proportion to either-

1. The average daily balances of the amounts in the commingled fund from different investors during a fiscal period; or

2. The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.

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Special Mark-to-Market Requirement for Internal Commingled Funds

Treas. Reg. section 1.148-6(e)(5) provides a special mark-to-market requirement for allocating to investors in an internal commingled fund with a longer-term investment portfolio (remaining weighted average maturity of investments held by the fund exceeds 18 months) their allocable portion.

- An internal commingled fund is a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund.

- The fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.

- The mark-to-market requirement does not apply to a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer.

Commingled Reserve Allocations

Treas. Reg. section 1.148-6(e)(6) provides that investments held by a commingled reserve (a commingled fund that serves as a common reserve fund, replacement fund or sinking fund for two or more issues) must be allocated ratably among the issues served by the fund in accordance with one of the following methods:

1. The relative value of the bonds of the issue;

2. The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or

3. The relative original stated principal amounts of the outstanding issues.

4. An issuer must make such allocations as of a date at least every 3 years and as of each date that an issue first becomes secured by the commingled reserve. If relative original principal amounts are used to allocate, allocations must also be made on the retirement of any issue secured by the commingled reserve.

Conclusion

The current allocation and accounting regulations attempt to provide a workable approach to account for expenditures and investments and prevent abuses of the tax-exempt market. Many of the principles contained in the current regulations originated in prior regulations. Section 4 will trace the historical development of these principles.

Section 4

History of Treasury Regulations

Introduction

Treas. Reg. Section 1.148-6 contains allocation and accounting rules that originated in prior sets of regulations.

Contents

This section contains the following topics:

1979 Regulations

Allocation Methods

Section 1.103-13(f)(1) of the 1979 regulations, adopted with changes as final regulations by T.D. 7627, published on June 7, 1979, was an attempt to solve the specific problem of tracing the proceeds of government issued bonds into acquired obligations. The term "acquired obligations" was defined as securities and obligations allocated to proceeds of an issue of governmental obligations during the period of time such issue is outstanding. **See Treas. Reg. section 1.103-13(b)(4)(ii).**

- Specific tracing was viewed, however, as an administrative burden. The problem was most acute in cases where a municipality issued multiple bonds and there was no requirement under local law or the bond indentures that the issuer separately account for the proceeds of each separate issue.

- Treas. Reg. section 1.103-13(f)(1) attempted to address the limitations of specific tracing. It provides that the governmental unit which issues numerous obligations or which commingles the proceeds of bonds with other revenues may allocate acquired obligations to the available proceeds of issued obligations using any reasonable method chosen by the issuer.

Reasonable Method

Treas. Reg. section 1.103-13(f)(1) permitted issuers to make allocations "at any time and under any reasonable method," provided that such method of allocation satisfied the following requirements:

1. all allocations had to be consistent with one another;

2. obligations purchased with the original proceeds of a refunding issue had to be allocated to such proceeds;

3. obligations not purchased with original proceeds of a refunding issue may not be allocated to such proceeds;

4. obligations purchased with amounts treated as proceeds under the sinking fund rules of Treas. Reg. section 1.103-13(g) must be allocated to those proceeds; and

5. if an obligation is allocated to two or more sources of funds, each receipt of principal or interest on the obligation must be allocated ratably among the several sources of funds.

1989 Regulations

Provision

On May 15, 1989, the Service issued temporary regulations interpreting the rebate provisions of IRC section 148(f).

- In general, these regulations applied to governmental bonds issued after August 31, 1986, and to private activity bonds issued after December 31, 1985.

- Treas. Reg. section 1.148-4T(a) contained the general rule for the allocation and accounting of investments made with bond proceeds. Specifically, an investment was considered allocated to an issue for the period:

  1. that begins on the date such gross proceeds are allocated to the issue and to the investment; and

  2. that ends on the date such gross proceeds cease to be allocated to the issue or to the investment.

- The 1989 regulations also introduced the concept of the universal cap. The 1989 regulations only applied this rule to refunding issues.

- Many of the definitions and rules relating to allocation and accounting were reserved in the 1989 regulations. The Service amended the 1989 regulations on April 25, 1991.

1992 Regulations

Introduction

On May 18, 1992, the Service published final regulations to replace the 1989 regulations. The 1992 final regulations were a modified version of three sets of proposed regulations published on January 30, 1992 (Treas. Reg. section 1.148-4), and February 12, 1992 (Treas. Reg. sections 1.148-6 and 1.148-11). The Service amended the 1992 regulations on September 30 and October 5, 1992.

- The 1992 regulations address issues not fully covered by the 1989 regulations. The allocation and accounting rules found in section 1.148-4 of the 1992 regulations are one such example.

- As a result of the 1992 regulations, Treas. Reg. section 1.103-13(f) of the 1979 regulations was withdrawn.

Facts and Circumstances

Treas. Reg. section 1.148-4(a) provided that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds of an issue for purposes of IRC 148.

- The reasonableness of the accounting method was based on the facts and circumstances.

- The regulations essentially adopted the rule in the 1992 proposed regulations that required a current outlay of cash and a governmental purpose for any expenditure of gross proceeds. (See Treas. Reg. section 1.148-4(d)(1)(ii).)

- Treas. Reg. section 1.148-4(a)(2) contained an anti-abuse provision for unreasonable accounting methods. That provision provided that an accounting method is not reasonable if it is employed as an artifice or device to avoid the arbitrage provisions.

- Treas. Reg. section 1.148-4(a)(4) provided that an accounting method may be changed in order to improve the accuracy of the accounting of bond proceeds. The current regulations do not contain a similar provision.

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Universal Cap

Under Treas. Reg. section 1.148-4(b)(3), a universal cap was placed on the amount of nonpurpose investments that can be allocated to a particular issue.

- The limitation equaled the outstanding value of the issue.
- Treas. Reg. section 1.148-4(b)(3)(vii) also contained an anti-abuse rule that prohibited issuers from allocating investments in such a manner as to avoid application of the universal cap.

1993 Regulations

Original Provision and Amendments

The 1993 regulations were published on June 18, 1993. The 1993 regulations provide the detailed allocation and accounting rules found in section 1.148-6. The regulations were amended on August 23, 1993, May 10, 1994, May 11, 1994, January 16, 1997 and again on May 9, 1997. The 1993 regulations generally apply to bonds issued after June 30, 1993 with permissive retroactive application of the regulations, **in whole, but not in part**, to outstanding issues issued prior to July 1, 1993.

Summary

The three basic types of allocations that must be made with respect to a bond issue are as follows:

1. allocating bonds to the issue;

2. allocating proceeds to bonds of the issue; and

3. allocating proceeds of the issue to expenditures and investments.

Failure to comply with the Code and applicable regulations with respect to allocations may result in the payment of rebate by the issuer or a determination that interest on the bonds is not tax-exempt.