Lesson 3

Pooled Financing Issues

Overview

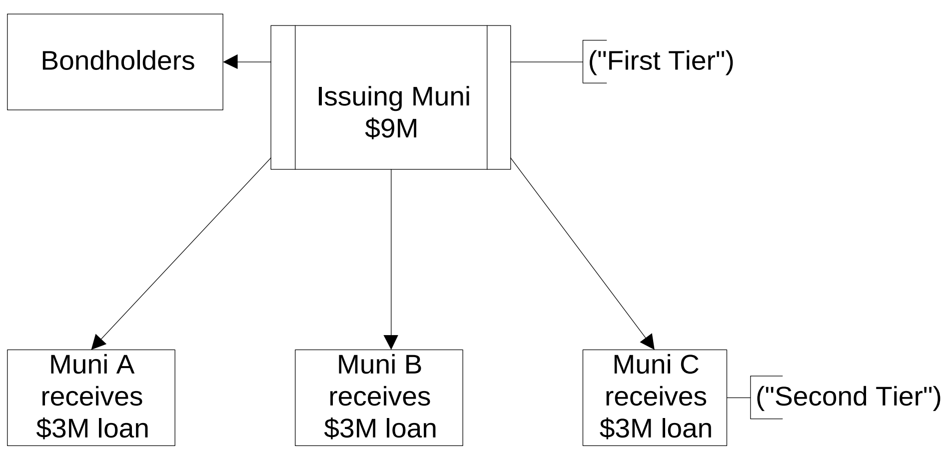
Introduction

Thus far, the text has discussed bond issues in which there was only one conduit borrower. However, an issuer can loan bond proceeds to two or more unrelated entities. When this occurs, it is called a pooled financing issue.

Regulations § 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.

Although pooled financing issues include mortgage and student loan pools, mortgage and student loan pools have their own tax rules. Mortgage and student loan pools are not discussed in this lesson. Further information is available about these types of bonds in the Phase II text.

Diagram of a Pooled Financing



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Advantages of Pooled Financing Issues

Pooled financing issues may present the following advantages:

- an overall lower cost of issuance for each borrower,
- provide tax-exempt financing to unsophisticated borrowers, and
- potential lower cost of borrowing for each borrower

Disadvantages of Pooled Financing Issues

Pooled financings may have the following disadvantages:

- each borrower is affected by the credit of the other borrowers
- inability of the issuer to make loans because of market saturation or change in interest rates, and
- complexity of tax rules applicable to pooled financings

Arbitrage rules

Pooled financing issues present their own special problems with respect to arbitrage, and therefore have many special rules that apply only to them.

In pooled financings, there are both purpose and nonpurpose investments; and both are of equal importance. However, the investments must be separately identified because the arbitrage rules apply differently to them.

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Allocation Rules – Conduit Expenditure

One of the most significant rules is contained in Regulations § 1.148-6(d)(2). Although this rule is applicable to all conduit issues, it is especially significant in a pooled financing. This rule provides, generally, that gross proceeds invested in a purpose investment are allocated to an expenditure when the conduit borrower allocates the gross proceeds to an expenditure.

In other words, the mere loaning of funds by the issuer, except for qualified mortgage loans and qualified student loans, does not result in the proceeds being spent. Proceeds have to be spent by the conduit borrower for the governmental purpose of the issue to be considered spent by the issuer (See Regulations § 1.148-6(d)(2))

Conduit Loans

Further, Regulations § 1.148-6(d)(2)(iii) provides that even though the proceeds are allocated to an expenditure, they continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment. This means that as long as the loan is outstanding, proceeds are allocated to the loan as a purpose investment. When the loan is repaid in full, the proceeds are deallocated.

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Enterprise Zone Bonds

Special rules apply for pooled financing enterprise zone bonds. Although they are not discussed in this text, they can be found in Regulations § 1.1394-1(f),(g),(j) and (n).

Objectives

At the end of this lesson you will be able to:

- Identify the different types of pooled financing issues.
- Differentiate between purpose and nonpurpose investments of both the issuer and the conduit borrower.
- Apply the yield restriction rules to pooled financing issues at both the issuer and the conduit borrower levels.
- Compute the yield of purpose investments.
- Apply the small issuer and the spending exceptions to rebate to nonpurpose investments in pooled financing issues.
- Identify other rules, other than arbitrage rules, that apply to pooled financings.

Contents

This lesson contains the following topics:

Section 1

Types of Pooled Financing Issues

Overview

Introduction

Generally, a pooled financed issue is either a:

- governmental pool, or
- qualified 501(c)(3) pool

This section gives a general description of each of these types of pools. It is possible to have a pooled financing issued to finance two or more exempt facilities or a qualified small issue pool, but such financings are rare and will not be discussed in this lesson.

A governmental pool might be issued as Build America Bonds. Special rules concerning Build America Bonds are included in the Phase I text

In this Section

This section contains the following topics:

Governmental Pools

Introduction

A **governmental pool** is one where a governmental entity issues bonds and then loans the proceeds to other governmental entities.

Generally, pooled bonds will be issued by a constituted authority such as a public facilities authority or an on behalf of entity such as a facilities finance corporation.

Example 1. Authority A issues bonds in the principal amount of $90M. The proceeds are loaned to the following cities in the following amounts:

- City A - $30M
- City B - 30M
- City C - 30M

Example 2. Authority A issues bonds in the principal amount of $75M. The proceeds are loaned to the following unrelated governmental entities:

- Hospital Authority - $25M
- Solid Waste Authority - 25M
- Electrical Power Authority - 25M

As long as all of the borrowing entities use the funds for proper governmental purposes, Authority A is considered to have issued one pooled financing issue of governmental bonds in each of the above examples. In Example 2, the authorities will be using the funds for their own purposes and will not be reloaning the proceeds to a taxable entity.

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Introduction (continued)

Authority A could also mix the borrowers shown above and still be considered to have issued one pooled financing issue of governmental bonds, as the following example illustrates.

Example 3. Authority A issues bonds in the principal amount of $100M. The proceeds could be loaned to the following entities:

- City A
- Hospital Authority
- Solid Waste Authority.

As long as the borrowing entities are government entities and the funds are used for proper governmental purposes, Authority A is considered to have issued one issue of governmental bonds.

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Tax Treatment at the Pool Level ("First-Tier")

As stated above, an issuer of a governmental pooled financing issue is treated as issuing one governmental bond issue. Accordingly, the "first-tier" issuer will file a Form 8038-G. This "first-tier" issue is also referred to as the "conduit financing issue." According to Regulations § 1.150-1(b), a **conduit financing** issue is an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

This bond issue is subject to all of the tax rules that apply to any other governmental issue. Specifically, the issue is subject to § 103 and the applicable provisions of §§ 141 through 150. This means that the proceeds of the issue loaned to the governmental borrowers must meet all of the applicable requirements under §§141-150. (See Diagram on Page __-1)

Note that the issue would not have to meet the rules of § 147 because it is not considered to be a private activity bond. Additionally, all rules and exceptions that apply only to governmental bonds would also apply to the pooled financing issue.

Tax Treatment at the Borrower Level ("Second-Tier")

Each borrower in a governmental pool is a conduit borrower, but can also be an issuer of its own tax-exempt obligation (if and only if the borrower is a valid issuer in its own right). According to Regulations § 1.150-1(b), a loan to each borrower is called a **conduit loan.** The borrower level is referred to as the "second tier."

The conduit issuer and the borrower(s) may want to treat the "second-tier" issue as a tax-exempt obligation. You will recall from Phase I of this text that a tax-exempt obligation under § 103 must be issued by a valid issuer and possess the requisite characteristics of tax-exempt debt (i.e. valid under state law, exercise of borrowing power, intent of repayment, etc.). Tax-exempt obligations include loans and leases in addition to bonds.

If a "second-tier" obligation is to be a tax-exempt obligation, the loan to a governmental entity is also required to comply with the applicable provisions of §§ 141 through 150, including the filing by the borrower of Form 8038-G. If not, the issue is technically a taxable issue.

501(c)(3) Pools

Introduction

A **qualified 501(c)(3) pool** is one in which a governmental entity issues one issue of bonds and then loans the proceeds to two or more unrelated 501(c)(3) organizations.

<u>Example</u>. Authority X issues bonds in the principal amount of $90M. The proceeds are loaned to the following entities in the following amounts:

- 501(c)(3) Hospital System - $40M
- 501(c)(3) Animal Shelter - 25M
- 501(c)(3) University - 25M

Authority X is considered to have issued one issue of qualified 501(c)(3) bonds that must comply with all of the rules in §§ 103 and 141 through 150 that normally apply to qualified 501(c)(3) bonds. Any special rules and exceptions that apply to qualified 501(c)(3) bonds will also apply to the pool issue.

For example, §§ 147(a), (c), and (d) will not apply to the pool issue.

Using Regulations § 1.150-1(c) to Identify a Pool

Regulations § 1.150-1(c)

Regulations § 1.150-1(c) provides the definition of an issue. This definition applies for all purposes of §§ 103 and 141-150. To review, the term "issue" generally means two or more bonds that meet all of the following requirements:

- The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart.
- The bonds are sold pursuant to the same plan of 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.

Sometimes you will see an Official Statement that includes two or more series of bonds, with each series identifying a different conduit borrower. Initially, it will look like a pooled financing because more than one conduit borrower is involved. However, you must determine whether the two series of bonds are a single issue under Regulations § 1.150-1(c). If they are, then, the issue may be a pooled financing.

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Example

Authority M issues bonds in the amount of $150M on January 1, 2003. The Official Statement shows three series of bonds, Series A for $50M to City N, Series B for $50M to City O, and Series C for $50M to City P, all issued on January 1, 2003. All three series of bonds are included in the same remarketing agreement, the same underwriting agreement, the same indenture, and the same insurance agreement. Each series has its own supplemental indenture. The same bond counsel issued an unqualified opinion for each series. City N, City O, and City P each filed its own Form 8038-G in the amount of $50M. Authority M does not file a Form 8038-G for $150M. City N, City O, and City P each signs a loan agreement for the borrowed proceeds. The payments on the loans by each City secure the debt service on the series of bonds the proceeds of which were loaned to such city. Payments made by one City cannot be used to make debt service payments on a series of bonds that are not related to such City's loan. For example, if City N defaults on its loan, Authority M cannot use loan payments made by City O or City P to pay debt service on City N's series of bonds. The Official Statement specifically identifies the bonds by amount and maturity date that correspond with each loan. Specifically, City N's $50M bonds all mature on June 1, 2025. City O's $50M bonds all mature on June 1, 2011, and City P's $50M all mature on June 1, 2020.

This is not a single issue because the three Series of bonds are not reasonably expected to be paid from substantially the same source of funds. Thus, it is not a pooled financing.

In a traditional pooled financing, each borrower signs a loan agreement, but the loan repayments from the borrowers secure all of the debt service on the bonds.

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Using Regulations § 1.150-1(c) to Identify a Pool, Continued

Example

Assume the same facts as in **the preceding example**, except that City N files a Form 8038 (rather than a Form 8038-G) and loans the proceeds to Hospital X and Hospital Y. Hospital X and Hospital Y are unrelated 501(c)(3) organizations. There is only one indenture. Each hospital signs a loan agreement, but no specific bonds are allocated to the loans. The series of bonds related to City N, the proceeds of which are loaned to Hospital X and Hospital Y, is a qualified 501(c)(3) pooled financing issue.

Remember that Authority M's issue is not a pooled financing issue, so City N's issue is not a second-tier issue. In this situation it is the same as City N issuing bonds by itself, and the bonds are not connected to those of Cities O and P.

Section 2

Rules Under §§ 147 and 149

Overview

Introduction

This section discusses rules applicable to pooled financings under §§ 147 and 149.

In This Section

This section contains the following topics:

Treatment of Certain Pooled Financing Bonds Under §149(f)

Introduction

Section 149(f) provides that interest on a pooled financing bond will not be tax exempt, unless two requirements are met:

- Reasonable expectations requirement, and
- Cost of issuance payment requirement

These provisions are effective for all bonds issued after October 21, 1988. There are special rules for bonds issued after October 21, 1988, that refund bonds issued before the effective date.

Legislative History

Section 149(f) was added to the Code to curb the following abuses by governmental issuers:

- issuing bonds without immediate need for the funds
- issuing bonds without an expectation that potential borrowers would use the funds for governmental purposes
- issuing bonds for the sole purpose of "locking in" current low interest rates
- allowing bonds to remain outstanding longer than necessary

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Treatment of Certain Pooled Financing Bonds Under §149(f),
Continued

Definition of a Pooled Financing Bond for Purposes of § 149(f)

Solely for purposes of §§ 149(f)(4)(A) and (B), a "pooled financing bond" is defined as follows:

1. The bond is one of the following types:
   - governmental,
   - qualified 501(c)(3),
   - exempt facility bonds of the following types:
     - airports,
     - docks,
     - wharves,
     - environmental enhancements of hydroelectric generating facilities,
     - qualified public education facilities,
     - qualified green building and sustainable design projects,
     - qualified highway or surface freight transfer facilities,
     - high speed intercity rail facilities, if owned by a governmental unit (if not owned by the governmental unit, then only 75 percent of the bond is included),
     - solid waste disposal if owned by a governmental unit, and
2. More than $5,000,000 of the proceeds are reasonably expected at the time of the issuance of the bonds to be used directly or indirectly to make or finance loans to two or more ultimate borrowers.

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The Reasonable Expectation Requirement- Pre May 17, 2006

If the interest on a pooled financing bond is to be tax exempt, the bond must meet two requirements (reasonable expectations and cost of issuance). The first requirement is referred to as the **reasonable expectation requirement.**

Prior to May 17, 2006, § 149(f)(2)(A) described the reasonable expectation requirement as follows:

- The issuer reasonably expects that at least 95 percent of the net proceeds will be used directly or indirectly to make loan to ultimate borrowers within three years from the date of issuance.

An increase in interest rates or anticipated changes in federal income tax laws, regulations, or rulings, may not be used as a basis for reasonable expectations.

“Net proceeds" is defined in § 149(f)(2)(C) and means proceeds reduced by:

- proceeds placed in a reasonably required reserve or replacement fund,
- proceeds used to pay issuance costs, and
- proceeds used to pay interest during the three-year period

If the bond is a refunding bond, then the three-year period begins on the date of issuance of the original bond.

Note: The definition of “net proceeds” for purposes of § 149(f) is different from the definition of “net proceeds” in § 150(a)(3).

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Treatment of Certain Pooled Financing Bonds Under §149(f), Continued

The Reasonable Expectation Requirement-Post May 17, 2006

After May 17, 2006, if the interest on a pooled financing bond is to be tax exempt, the bond must still meet two requirements (reasonable expectations and cost of issuance). However, a strengthened reasonable expectations requirement is in effect for bonds issued after May 17, 2006.

Section 149(f)(2)(A) reasonable expectation requirement for pool loan bonds issued after May 17, 2006 are met if the issuer reasonably expects that

- as of the close of the 1-year period beginning on the date of issuance of the bonds, at least 30 percent of the net proceeds of the bonds (as of the close of such period) will have been used directly or indirectly to make or finance loans to ultimate borrowers, and
- as of the close of the 3-year period beginning on such date of issuance, at least 95 percent of the net proceeds of the bonds (as of the close of such period) will have been used for such purposes.

An increase in interest rates or anticipated changes in federal income tax laws, regulations, or rulings, may not be used as a basis for reasonable expectations.

“Net proceeds" is defined in § 149(f)(2)(C) and means proceeds reduced by:

- proceeds placed in a reasonably required reserve or replacement fund,
- proceeds used to pay issuance costs, and
- proceeds used to pay interest during the three-year period

The Reasonable Expectation Requirement-Post May 17, 2006

If the bond is a refunding bond, then the three-year period begins on the date of issuance of the original bond.

Note that the definition of "net proceeds" for purposes of § 149(f) is different from the definition of "net proceeds" in § 150(a)(3).

In addition to strengthening the reasonable expectations test, pool financing bonds issued after May 17, 2006 must also meet two additional requirements:

- **Written Loan Commitment Requirement**
  This requirement is met if prior to the issuance of its pooled financing bonds, the issuer receives written loan commitments identifying the ultimate potential borrowers of at least 30 percent of the net proceeds of the bonds. This requirement will not apply to an issuer which is a
  - State (or an integral part of a State) issuing pooled financing bonds to make or finance loans to subordinate governmental units of such State, or
  - State-created entity providing financing for water-infrastructure projects through the federally-sponsored State revolving fund program

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Treatment of Certain Pooled Financing Bonds Under §149(f),
Continued

The Reasonable Expectation Requirement-Post May 17, 2006

- **Redemption Requirement**
  This requirement is met if to the extent that less than the percentage of the proceeds of an issue are used as required to be used under § 149(f)(2) (A)(i) [30% of the proceeds used within 1 year of issuance] or 149(f)(2) (A)(ii) [95% of the proceeds used within 3 years of issuance], by the close of the period identified in such clause, the issuer uses an amount of proceeds equal to the excess of
  - the amount required to be used under such clause, over
  - the amount actually used by the close of such period, to redeem outstanding bonds within 90 days after the end of such period

Definition of Reasonable Expectations

Regulations § 1.148-1(b) provides that an issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Factors relevant to a determination of reasonableness include:

- issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations,
- the level of inquiry by the issuer into factual matters,
- the existence of covenants, enforceable by bondholders, that require implementation of specific expectations, and
- reasonable expectations of the conduit borrower, if it is reasonable and prudent for the issuer to rely on those expectations

Because of the significance of the reasonable expectations requirement, it will be discussed in detail later in this section.

Treatment of Certain Pooled Financing Bonds Under §149(f),
Continued

The Cost of Issuance Requirement

The second requirement to be met for the interest on a pooled financing bond to be tax exempt is the cost of issuance requirement. Section 149(f)(3) describes the cost of issuance requirement as follows:

- at least 95 percent of the reasonably expected legal and underwriting costs must be paid by the 180th day after the date of issuance, and
- the payment of legal and underwriting costs are not contingent on the disbursement of the proceeds

The example below illustrates how the determination of whether or not the issue meets this requirement can sometimes be obscured by the structure of the deal

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Treatment of Certain Pooled Financing Bonds Under §149(f),
Continued

Example

On January 1, 2002, Hospital Authority X issues $15M in variable rate bonds. All of the sale proceeds are invested in a guaranteed investment contract (GIC.) On the issuance date, in order to generate funds to pay issuance costs of $200,000 (excluding underwriter's discount), the underwriter sells the right to receive a portion of the remarketing fees to Unrelated Third Party (UTP). The UTP pays $200,000 for the rights, and this amount is deposited into the Cost of Issuance Account to pay the issuance costs. The underwriter receives no other payment for his services at this time. The remarketing agreement states that remarketing fees will be charged to each borrower, and that a portion of these remarketing fees represents underwriting costs. Each year that loans are outstanding, the borrowers are charged a percentage of the outstanding loan amount that is paid to the remarketing agent.

In this example, the underwriting fees are contingent on the disbursement of the proceeds because the "remarketing fees" paid by the borrowers include underwriting costs. These underwriting fees are paid to the underwriter (as the remarketing agent) throughout the life of the loan. The UTP has done nothing more than loan the program administrator an amount to pay issuance costs; the "loan" will be repaid through remarketing fees paid by the borrowers over the life of the loan.

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Treatment of Certain Pooled Financing Bonds Under §149(f),
Continued

What Is a Loan?

Section 149(f)(7) provides that loans of proceeds of the issue must be used for governmental purposes rather than investment. Additionally, the proceeds cannot be used by an agency of the issuer unless the agency is a political subdivision or instrumentality of the issuer.

Mixed Use Issues

IRC Section 149(f)(7)(B) provides that if only a portion of a bond issue is reasonably expected to be used to finance loans to 2 or more ultimate borrowers, then that portion and the other portion will be treated as separate issues for purposes of testing whether the pool bond rules have been met.

Example. County X issues $70M aggregate principal amount of bonds. County X loans $20M to School District A, $30M to School District B and $20M to Agency C. Agency C uses the proceeds to fund the retirement fund of its employees. The loans to School District A and School District B are purpose investments but the loan to Agency C is a nonpurpose investment. Thus, for purposes of 149(f), the loans to the School Districts are treated as a separate issue from the loan to Agency C.

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Treatment of Certain Pooled Financing Bonds Under §149(f), Continued

Example

Cities A and B each need $10 million to repair and maintain municipal buildings. To save issuance costs, City A and City B request State Authority (an integral part of the State) to issue tax-exempt bonds on their behalf. State Authority was already planning a $10 million bond issue for its own purposes. State Authority issues $33.6 million principal amount of bonds on June 1, 2006 having a coupon rate of 3%. Interest is payable on September 1 and March 1 of each year. On this date, State Authority reasonably expects that Cities A and B will each borrow $11.2 million at 3% interest. ($1.2 million has been added to each principal amount in order to pay issuance and reserve costs.) On the issue date, $3 million is placed into a reserve fund, and all issuance costs are paid.

Issuance costs include the following:

•	Underwriter's discount	$300,000
•	Bond insurance premium	200,000
•	Bond counsel fee	100,000
		$600,000

As of May 31, 2009 the Cities and State Authority have completed their projects and all of the proceeds have been spent. Determining if the bonds meet the requirements of a pooled financing issue under § 149(f) includes the following:

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Treatment of Certain Pooled Financing Bonds Under §149(f), Continued

Example (continued)

1. Does the issue meet the definition of a pooled financing issue?

According to § 149(f)(7)(B) this issue will actually be two separate issues for § 149 purposes. Issue 1 will be earmarked for Cities A and B in the amount of $22,400,000.

Issue 2 is for State Authority in the amount of $11,200,000 (issuance costs and the reserve proceeds have been divided equally among the three). Under IRC section 149(f)(7), the portion used by State Authority for its own purposes is treated as a separate issue. Thus, for purposes of the pooled financing definition, we need to only consider Issue 1. Issue 1 meets the definition because more than $5 million will be loaned to 2 or more unrelated borrowers.

2. Was the reasonable expectations requirement met? To answer this, we need to compute net proceeds as follows:

Gross proceeds	$22,400,000
Less:	
Reserve fund	<2,000,000>
Issuance costs	< 200,000>
Bond interest (9/1/06 – 3/1/09)	<1,680,000>*
Net proceeds	$18,520,000
Required loan percentage	× .95
Required loan amount	$17,594,000
Actual loan amount	22,400,000

* 22,400,000× .03 x 2.5=1,680,000

Because the actual loan amount exceeds 95 percent of the net proceeds, the issue meets the reasonable expectations requirement.

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Treatment of Certain Pooled Financing Bonds Under §149(f),
Continued

Example
(continued)

3. Does the issue meet the cost of issuance payment requirement?

   This test is met because the underwriting and legal costs were paid within 180 days of the issuance date, and were not contingent on the making of the loans.

4. Does the issue meet the written loan commitment test?

   This test is met even if there is not a written loan commitment because the State Authority is an integral part of the State. .

5. Does the issue meet the redemption requirement test?

   This test is met because no bonds are required to be redeemed pursuant to § 149(f) (5).

Issue 1 meets all of the requirements of IRC section 149(f).

The Reasonable Expectations Requirement

Significance of the Reasonable Expectations Requirement

The reasonable expectations requirement is of utmost importance to pooled financing issues, not only for purposes of § 149(f), but also for Regulations §§ 1.148-2(e)(2)(i) and 1.148-10(a).

Failure to meet the reasonable expectations requirement under § 149(f) will result in the pooled issue being a taxable issue, even if unloaned proceeds are used to redeem bonds at the end of the three-year period after issuance.

An issue that does not meet the reasonable expectations requirement under Regulations § 1.148-2(e)(2)(i) is denied the advantages of a temporary period. The issuer may not be able to make yield reduction payments to meet the yield restriction requirements. (See Regulations § 1.148-5(c)(3)(i)).

Further, an issue that does not meet the reasonable expectations requirement can be considered to be an abusive arbitrage device under Regulations § 1.148-10(a).

Because of the potentially serious ramifications, in every pooled financing issue, a careful analysis and determination as to whether the expectations of the issuer were reasonable as of the issue date is imperative.

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Analyzing the Issuer's Reasonable Expectations for IRC section 149(f)

Section 149(f) requires an issuer to reasonably expect to make loans to borrowers within three years of the issuance date. In order to determine if the issuer's expectations are reasonable, an in-depth analysis of various factors contributing to the reasonableness of those expectations must be made.
In addition to the guidance provided by Regulations § 1.148-1(b), other factors that should be considered in the determination of the reasonable expectations requirement are:

- What steps has the issuer taken to encourage entities to borrow from the pool? How serious is the issuer about loaning the proceeds?
- If the loan proceeds are invested in a GIC, does the draw-down schedule accommodate the needs of the borrowers?
- Are the criteria for making the loans reasonable, i.e. can a majority of potential borrowers expect to be able to meet the criteria, or are the criteria so stringent that it would be difficult for any borrower to meet them?
- Who makes the decision about whether or not a potential borrower will actually be granted a loan? Does that entity have something to gain by loaning or not loaning proceeds?
- What steps have the borrowers taken to preliminarily start the projects?
- What is the history of the issuer with respect to pooled financings?
- What fees are the borrowers expected to pay

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Analyzing the Issuer's Reasonable Expectations for IRC section 149(f) (continued)

- Does the promotional material include this information?
- Why did respondents not borrow from the pool?
- Were there any applicants who were rejected? Why?
- How valid is the demand survey?
    - Has the project been approved by the board of the borrower?
    - How specific is the project plan?
    - Is the borrower's credit rating high enough to borrow?
    - How current is the data in the demand survey?
    - How soon is the project expected to be started/completed?
    - Who conducted the demand survey? What, if any, is their relationship to any other participant in the bond issuance?
    - Were allowances made to consider loans that most likely would not be made?
    - What is the borrower's access to the market? What other borrowing options do they have?

[Add questions about loan commitments]

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Ramifications of not meeting the Reasonable Expectations Requirement

If the issue does not meet the reasonable expectations requirement, then under § 149(f), the interest on the bonds is not tax-exempt under § 103.

A determination of the reasonableness of the issuer's expectations should be made as of the date of issuance. Facts and circumstances surrounding subsequent events that affect the amount of proceeds loaned should be carefully analyzed to determine whether they are mitigating factors or whether they are additional evidence that the issuer's expectations, contrary to what was stated in the documents, were unreasonable.

Example

State V issues a pooled financing issue in the amount of $100M on July 1, 2006. State V sized the bonds based on a demand survey of cities and counties conducted by an independent third-party that was completed on January 1, 2006. Although the demand survey showed that 15 borrowers were seriously interested in borrowing $10M each from the pool, State V discounted some of the statements made by the borrowers, but felt comfortable that it would easily be able to loan $100M immediately. In all other ways, the State's expectations would be considered reasonable on the issuance date. As of September 11, 2006, $50M of the proceeds were loaned. During the period immediately following that date and ending June 30, 2009, various borrowers were reluctant to borrow from the pool because the planned projects were suspended indefinitely due to economic downturns in their immediate areas. As a result, State V used the $50M in unloaned proceeds to redeem an equal principal amount of bonds on September 1, 2009.

In this situation, the State V could not have foreseen the economic problems suffered suddenly by the borrowers. Therefore, the economic slump may be considered a mitigating factor and the tax-exempt status of the bonds might not be affected.

Note: If on the issue date, an issuer did not reasonably expect to loan the proceeds, the redemption of all or a portion of the bonds is not a mitigating factor that remedies a failure to meet the reasonable expectations tests.

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Reasonable Expectations under Regulations § 1.148-2(e)(2)(i)

This section of the regulations applies to pooled financings just as it applies to all bond issues. However, even though this section requires that the issuer reasonably expect to spend only **85% of the net sale proceeds** within three years (as opposed to the **95% of net proceeds** required by § 149(f)), Regulations § 1.148-2(e)(2)(i) has two other requirements that must be met. Unlike § 149(f), Regulations § 1.148-2(e)(2)(i) applies to all bond issues regardless of size or type.

The three-year temporary period is available to an issue only if the issuer reasonably expects to satisfy three tests.

The three tests are the:

- Expenditure test,
- Time test, and
- Due diligence test.

For pooled financings, the tests apply separately to each conduit loan; but within each loan, these tests are applied on an aggregate basis (not project by project.)

Expenditure Test

The **expenditure test** is met if at least 85% of the **net sale proceeds** are allocated to expenditures on the capital projects by the end of the three-year temporary period. **Capital projects** are defined in Regulations § 1.148-1(b).

Example. Hospital X, one of three borrowers in a pooled financing issue, borrows $15M on January 1, 2002, the issuance date of the bonds. The loaned proceeds are invested in a GIC that restricts the withdrawals to $5M each year for three years. The project is started on March 1, 2002 and completed on December 15, 2004 using funds from the Hospital's capital funds account. The loan proceeds in the GIC are withdrawn as permitted and used to replenish the capital funds account.

Hospital X has met the expenditure test because at least 85% of the net sale proceeds were expected to be and were actually allocated to expenditures by the end of the three-year temporary period. Remember that governmental and 501(c)(3) bonds can use the allocation rule of Regulations § 1.148-6(d)(1) allowing the issuer to allocate proceeds not later than 18 months after the project is placed in service.

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Net Sale Proceeds vs. Net Proceeds	Regulations § 1.148-2(e)(2) refers to **net sale proceeds,** while § 149(f) refers to **net proceeds**. The definition of **net sale proceeds** is in Regulations § 1.148-1(b). Section 149(f)(2)(C) provides that net proceeds has the meaning given by § 150 but shall not include proceeds used to finance issuance costs and shall not include proceeds to pay interest on the bonds. Both definitions exclude deposits to a 4R fund (i.e. reasonably required reserve or replacement fund).
Time Test	The time test is met if the issuer incurs within six months of the issue date a substantial binding obligation to a third party to expend at least five percent of the net sale proceeds of the issue on the capital projects. The obligation is not binding if it is subject to contingencies within the issuer's or a related party's control. **<u>Example</u>**. Borrower C, one of three conduit borrowers in a pooled financing issue, borrows $6M on the issuance date of the bonds, October 1, 2002. On April 1, 2003, Borrower C arranges with its own building department to start a roads project on June 1, 2003. The time test has not been met because Borrower C did not enter into an agreement with a third party to spend five percent of the net sale proceeds within six months of the issuance date and 5% of the proceeds were not spent within six months of the issuance date.
Due Diligence Test	The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceeds with due diligence.

Maturity Limitation Under § 147(b)(4)

General Rule for Qualified 501(c)(3) Bonds

Section 147(b)(4) provides that a pooled financing issuer of qualified 501(c)(3) bonds may elect to comply with the 120 percent rule by comparing the average maturity of each loan to the expected economic life of the facilities being financed with the loan.

Requirements

In order to make this election, the bonds must meet the following requirements:

- 95 percent or more of the net proceeds of the pool issue must be used to finance loans to two or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations,
- the average maturity of each loan in the pool must not exceed 120 percent of the average reasonably expected economic life of the facilities financed by that loan,
- before the bonds are issued, there must be a demand survey which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of the pool issue,
- 95 percent or more of the net proceeds of the pool issue are to be loaned to 501(c)(3) organizations or governmental units within one year of issuance,
- any unspent proceeds after the one-year period must be used to redeem the bonds as soon as possible, but not later than 18 months after issuance, and
- the maturity date of any bond in the pool must not exceed 30 years

Making the Election

Regulations § 301.9100-7T(g) provides that an election under § 147(b)(4)(A) must be made in the bond indenture or a related document on or before the date of issue.

Refunding a Conduit Loan

Conduit Loan is Refunded

Regulations § 1.150-1(d)(2)(iii)(A) provides that when a conduit borrower obtains subsequent financing to refund the initial loan from a pool issuer, the use of the conduit refunding proceeds by the issuer determines whether or not the refunding issue is a refunding of the pool issue.

Regulations § 1.150-1(d)(2)(iii)(B) provides that when the issuer reasonably expects to use the proceeds of the conduit refunding issue for a new loan within the applicable temporary period, then the new loan(s) will be treated as proceeds of the original pool issue.

If, however, the issuer does not reasonably expect to re-loan the proceeds of the conduit refunding issue, then the conduit refunding issue is treated as a refunding of the pool issue (in addition to a refunding of the obligation that is a purpose investment.)

Example. In 1992, Authority J issues an issue that qualifies as a pooled financing. The proceeds are loaned to Hospitals K and L (governmental hospital). The proceeds are spent promptly on their respective projects. In 2002, Hospital K arranges with Authority M to borrow proceeds of its bonds. Hospital K plans to use the loan proceeds from Authority M to prepay its loan to Authority J.

When Authority J receives the pre-payment from Hospital K, it reasonably expects to loan the funds to City X for building maintenance. As long as the loan is made to City X within six months of its receipt of cash from Hospital K, the 2002 issue proceeds are treated as proceeds of the original pool issue.

If Authority J did not intend to re-loan the proceeds of the 2002 issue, but rather expected to use the proceeds to prepay the 1992 bonds for its own purposes, then the 2002 issue would be treated as a partial refunding of the 1992 pool issue.

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Advance Refunding of Pool Issue

In Rev. Rul. 2003-78, 2003-29 IRB 76, the Service ruled that a bond issue is an advance refunding issue if the issuer loans proceeds of the issue to a governmental unit, and within 90 days of the date the loan is made, but more than 90 days after the issue date of the bonds, the governmental unit uses the proceeds to redeem outstanding tax-exempt obligations of the governmental unit.

Example. On June 1, 2000, Issuer X, a governmental unit, issues pooled bonds to make loans to other governmental units to finance or refinance governmental projects of those units. On September 1, 2000, Issuer loans a portion of the proceeds of the Bonds to Borrower A, a governmental unit. On October 15, 2000, Borrower A uses the proceeds to redeem certain prior tax-exempt bonds issued by the Borrower. Because the redemption of the prior bonds occurs within 90 days of the date the loan to the Borrower is made, but more than 90 days after the issue date of the 2000 issue, the 2000 issue is an advance refunding issue.

Public Approval Under § 147

Introduction

We previously stated that 501(c)(3) pools are subject to all of the provisions of the Code and regulations that govern qualified 501(c)(3) bonds. This includes all of the requirements of § 147(f) regarding public approval. This requirement is commonly known as the "TEFRA Requirement," because it was originally added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982. (TEFRA)

The requirements of the regulations regarding approval can usually be met easily. However, the notice requirements contained in Regulations § 5f.103-2(f) and (g) present special problems for pools referred to as "blind pools." **Blind pools** are pooled financing issues issued without knowledge on the issuance date as to who will be the borrowers or the anticipated projects to be financed by the issue. Regardless of the difficulties that may be encountered, the rules must be met for the bonds to be considered qualified private activity bonds.

It would also appear that these approval requirements should be met for recycled loans as well as for initial loans in a pool.
On September 9, 2008, the IRS issued new proposed regulations (Proposed Treasury Regulations § 1.147(f)-1(b)(5)) relating to the public approval requirement under § 147(f) of the Code. The Proposed Treasury Regulations helped to resolve the issues related to the public approval requirements of blind pool financings mentioned above.

For 501(c)(3) pooled financings, the Proposed Regulations provide for a two-step public approval process.

- First, prior to the issuance of the bonds, public approval must be obtained based on the stated maximum principal amount of the bonds to be issued and a general description of the types of facilities to be financed with loans to be made from the bond proceeds. No information is required with respect to the locations or initial users of the facilities if the information is not known at that time.

- Second, before a loan is made from proceeds of the issue and potentially after the date of issue of the bonds, a supplemental public approval must be obtained based on particular information about the borrower and the financed facility, including the location of the financed facility.

Reasonable Public Notice

Regulations § 5f.103-2(g)(3) provides that "reasonable public notice" means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the governmental unit where a facility is to be located, of the proposed issue. The notice must state the time and place for the hearing and be published no fewer than 14 days before the hearing.

Notice is presumed to be reasonably designed to inform affected residents in the locality of the facility only if published in one or more newspapers of general circulation available to residents of that locality, or if announced by radio or television broadcast to those residents.

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Information Required

Regulations § 5f.103-2(f)(2) provides that a facility is within the scope of an approval if the notice of hearing and the approval contain:

> i) 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" or a "400-room airport hotel building", etc,
> ii) the maximum aggregate face amount of obligations to be issued with respect to the facility,
> iii) the initial owner, operator, or manager of the facility,
> iv) 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.

An approval is valid for purposes of this section with respect to any issue used to provide publicly approved facilities, notwithstanding insubstantial deviations with respect to the maximum aggregate face amount of the bonds issued under the approval for the facility, the name of its initial owner, manager, or operator, or the type or location of the facility from that described in the approval.

An approval or notice of public hearing will not be considered to be adequate if any of the items in subdivisions (i) through (iv) above with respect to the facility to be financed, are unknown on the date of the approval or the date of the public notice.

A "facility", according to Regulations § 5f.103-2f(4) includes a tract or adjoining tracts of land, the improvements thereon and any personal property used in connection with such real property. Separate tracts of land (including improvements and connected personal property) may be treated as one facility only if they are used in an integrated operation.

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Example

On January 1, 2001, Housing Authority X issues $100M of bonds stating its expectations to loan the proceeds of the bonds to two or more unrelated organizations described in § 501(c)(3). The borrowing organizations are expected to use the proceeds to acquire and operate existing multi-family housing complexes within State. Notice of public hearing was published in a timely manner in various local newspapers around the state along with a national newspaper. The notice listed approximately 500 multi-family housing complexes within various parts of the State that may be acquired with the bond proceeds. None of the facilities were contacted regarding the fact that they had been listed in the public notice as potential facilities that may be acquired with the proceeds. The hearing was held in City Hall Y. On the issuance date, the issuance costs were paid out of bond proceeds, and the remaining proceeds were invested in a GIC. As of January 1, 2002, none of the proceeds had been loaned.

<u>Analysis</u>
Let's compare the facts in this example with each of the requirements of the regulations.

Regulations § 5f.103-2(c)(3) requires that governmental units with geographic jurisdiction over each site of a facility to be financed by the issue must approve the issue. In order to meet this requirement, a governmental unit overseeing each potential facility must approve the issue. Accordingly, the State or each separate governmental unit needs to approve the issue.

Regulations § 5f.103-2(f)(2) (previously discussed) specifies the information that needs to be included in the notice and approval. Obviously, the information included in the notice is too vague to meet the information requirement. With respect to the maximum aggregate face amount of the obligations to be issued with respect to the facility, listing no amount whatsoever cannot be considered to be an insubstantial deviation. According to Regulations § 5f.103-2(f)(4), a "facility" includes a tract or adjoining tracts of land, the improvements thereon and any personal property used in connection with such real property. Separate tracts of land may be treated as one facility only if they are used in an integrated operation. Clearly, these facilities are separate and cannot be considered to be used in an integrated operation

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Public Approval Under § 147, Continued

Example (continued)

In addition, the facts show that the requirements Regulations § 5f.103-2(d) are not met because the hearings are not held at a location convenient for residents of the approving governmental unit.

Ramifications
The bonds do not meet the requirements of § 147, and therefore, cannot be considered to be qualified private activity bonds.

Additionally, the failure to meet the TEFRA requirement provides evidence that there was no expectation to loan the proceeds of the bonds as required by the reasonable expectations requirements of § 149(f) and Regulations § 1.148-2(e)(2).

Information Reporting Requirements of § 149(e)(2)

Introduction

Section 149(e) provides that specific information about the use of bond proceeds be included on Form 8038, Form 8038-G, or Form 8038-B.

The information required on Form 8038 includes (among other items):

- With respect to qualified nonhospital bonds, the name, employer identification number, amount of the qualified nonhospital bonds benefiting each 501(c)(3) organization, and if less than 95% of the proceeds of the pool issue are used for capital expenditures, the amount of all other nonhospital bonds outstanding as of the date of the issue that benefit the organization.
- With respect to qualified hospital bonds, the name and employer identification number for each 501(c)(3) organization benefiting from qualified hospital bonds.
- The amount of proceeds used for land, building and structures, equipment with recovery period of more than 5 years, equipment with recovery period of 5 years or less, and other type of property.

All of the information specified must be included for qualified private activity bonds. If the information is not included on Form 8038, then the bonds have not met the requirements of § 149(e). Furthermore, if this information cannot be supplied, it casts doubt on the issuer's reasonable expectations to loan the proceeds in a timely manner.

The only special pool related information required on Form 8038-G is the amount of the issue used to fund a loan to another governmental unit, the interest of which is tax-exempt. There is no requirement to list the governmental entities benefiting from the pool issue.

Treatment of Hedge Bonds under IRC § 149(g)

Introduction

Section 149(g)(3)(A) provides that a bond is a hedge bond unless:

- the issuer reasonably expects that 85 percent of the spendable proceeds of the issue will be used to carry out the governmental purposes of the issue within the three-year period beginning on the date the bonds are issued, and
- not more than 50 percent of the proceeds of the issue are invested in nonpurpose investments having a substantially guaranteed yield for four years or more.

Section 149(g)(3)(B) provides an exception for the second condition that allows the proceeds of the issue to be invested in non-AMT tax-exempt bonds.

Example. Authority Q issues pooled financing bonds in the principal amount of $50M on February 1, 2007. On the issuance date, the proceeds are invested in a GIC at a yield above the bond yield. Authority Q has written loan commitments from prospective borrowers who expect to borrow approximately $28M within the next year. Authority Q has other borrowers who have promised to borrow the rest of the proceeds, but the other borrowers do not plan to borrow until 2011 when their projects will be started.

Authority Q's bonds are hedge bonds. Note also that this is the same reasonable expectations test that is contained in Regulations § 1.148-2(e)(2)(A). Therefore, the issue does not qualify for a temporary period and the proceeds should be yield restricted from the issuance date. The reasonable expectation requirement of § 149(f)(2)(A)(ii) is also violated.

A bond is a hedge bond. So what?

If a bond meets the definition of a hedge bond in § 149(g)(3), it's a hedge bond, but that doesn't mean that the bond is a taxable bond.

In order for the hedge bond to be a taxable bond, the bond must fail to meet two other conditions. The first is contained in § 149(g)(2) – "the reasonable expectations requirement". The second is contained in § 149(f)(3) – "the cost of issuance requirement".

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Treatment of Hedge Bonds under IRC § 149(g), Continued

Reasonable Expectations Requirement

The reasonable expectations test of § 149(g)(2) requires that the issuer reasonably expect that spendable proceeds of the issue will be spent on the governmental purposes of the issue according to the following schedule:

- 10 percent within one year of the issuance date,
- 30 percent within two years of the issuance date,
- 60 percent within three years of the issuance date, and
- 85% within five years of the issuance date

Cost of Issuance Requirement

The cost of issuance requirement is the same as that for pooled financing bonds and is in § 149(f)(3). The requirements are:

- payment of legal and underwriting costs associated with the issuance are not contingent, and
- at least 95 percent of the reasonably expected legal and underwriting costs associated with the issue are paid not later than the 180th day after the issuance date

Example

On June 1, 2002 Authority K issued a pooled financing issue in the principal amount of $50M. The yield on the bonds is 7 percent. Potential borrowers were expected to borrow the proceeds in 2003 and spend the proceeds on or before June 1, 2007. On June 30, 2002 Authority K purchased $50M of State M's governmental bonds maturing in June 1, 2003 at a yield of 7.5 percent.

Clearly, Authority K's issue does not meet the three-year reasonable expectations test, but it meets the exception to the investment provision by investing in tax-exempt non-AMT bonds (which, as discussed below, is not considered investment property.) Therefore, the bonds do not meet the definition of a hedge bond. Because the bonds do not meet the definition of a hedge bond, there is no need to pursue this any further by looking at the five-year reasonable expectations or the cost of issuance requirement.

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Treatment of Hedge Bonds under IRC § 149(g), Continued

Example

State M issues $50M of short-term bonds on June 1, 2001 at a yield of 4 percent. State M theorizes that interest rates have hit their lowest point and will be on the rise again soon. State M invests all of the proceeds in a GIC yielding 4 percent. State M has no immediate plans to spend the money. Rather, it intends to use the proceeds later, if interest rates rise, to purchase, at below-market rates, its own long-term bonds to finance a project.

State M’s bonds are hedge bonds and illustrate precisely the scenario that Congress intended to prevent when it enacted § 149(g).

Section 3

Yield Restriction Rules

Overview

Introduction

Pooled financing issues consist of both purpose and nonpurpose investments. The loans to the conduit borrowers are **purpose investments**. Any other investments made by the issuer or the conduit borrower prior to allocating the proceeds to a governmental purpose are **nonpurpose investments**. Application of the yield restriction rules differs depending on the type and nature of the investment.

This section discusses the application of the yield restriction rules to the earnings of both purpose and nonpurpose investments of pooled financing issues. Your understanding of these concepts will be easier if you remember that the rules apply differently to purpose and nonpurpose investments of both the issuer and conduit borrower.

After determining whether the investment is a purpose or nonpurpose investment, the next step is to determine if the investment is "investment property" under § 148(b)(3). If an investment is NOT investment property as defined, then the earnings are not subject to the arbitrage rules. This definition applies to both purpose and nonpurpose investments. Because the loans to conduit borrowers in pooled financings often qualify as tax-exempt bonds, we need to find out when these tax-exempt bonds constitute "investment property." Also, because an issuer or conduit borrower may invest in tax-exempt bonds as a nonpurpose investment, we need to know if this investment constitutes investment property.

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AMT Bonds

Section 57 identifies certain tax-exempt bonds that are considered tax preference items for purposes of the alternative minimum tax ("AMT") of § 55. Those bonds that are subject to the alternative minimum tax are referred to as "AMT bonds."

Generally, AMT bonds are tax-exempt private activity bonds that are issued after August 7, 1986. There are exceptions for qualified 501(c)(3) bonds, certain refundings, and certain transitioned bonds. These excepted bonds are referred to as "non-AMT bonds."

Note that tax-exempt governmental bonds never even enter into the discussion because they are not private activity bonds. Though not "non-AMT" bonds by definition, they are still "non-AMT" bonds for discussion purposes.

Investment Property

The definition of investment property in § 148(b)(3)(A) contains a general exclusion for tax-exempt bonds. However, as summarized below, § 148(b)(3)(B) provides that certain tax-exempt bonds are investment property:

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 (§ 148(b)(3)(A))
Non-AMT bonds	AMT bonds (can only be nonpurpose)	Investment property (§ 148(b)(3)(B))
AMT bonds	AMT bonds (can be purpose or nonpurpose)	Not investment property (§ 148(b)(3)(A))
AMT bonds	Non-AMT bonds (can only be nonpurpose)	Not investment property (§ 148(b)(3)(A))

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Investment Property (continued)

Regardless of whether or not the investment is a purpose or nonpurpose investment, if it is not investment property, then the earnings derived from it are not subject to the arbitrage rules.

Remember that earnings on purpose investments may or may not be subject to the yield restriction rules, but are never subject to the rebate requirement. On the other hand, earnings on nonpurpose investments may or may not be subject to the yield restriction rules and/or rebate rules.

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Governmental Pools

When the borrowers in the pool are governmental entities, the loans are treated by the issuer as purpose investments. If the loans themselves qualify as governmental bonds, then these investments are not subject to the arbitrage rules. This is because:

- the loans are tax-exempt bonds, and
- the loans are not investment property under § 148(b)(3) – they are non-AMT bonds.

(See Regulations § 1.148-2(d)(2)(v)).

Similarly, if the pool issuer invested in tax-exempt non-AMT bonds with proceeds prior to loaning the funds to a conduit borrower, the investments would be nonpurpose investments, but the earnings on the investments would not be subject to the arbitrage rules for the same reasons stated above. However, nonpurpose investments in AMT bonds would be investment property, and the earnings would be subject to the arbitrage rules.

Example. State X issues bonds and loans the proceeds to Cities A, B, and C. Each of the Cities files Form 8038-G for their notes to the State. The loans to the Cities are purpose investments. The loans are investments that are tax-exempt bonds and not investment property, therefore the earnings on the investments are not subject to yield restriction, i.e. unlimited earnings with no temporary period. The yield that State X can earn on the loans is unlimited. Further, earnings on the loans (as purpose investments) are not subject to rebate.

However, the yield restriction (and rebate) rules may still apply to any other nonpurpose investments made by the Cities and State X during and after expiration of the temporary period, based on the yield of the pool issue.

Generally, loans to governmental entities are not subject to the yield restriction rules if the governmental borrower files Form 8038-G to make its note to the issuer a tax-exempt obligation that is not an investment under § 148(b)(3). However, if Form 8038-G is not filed, then further facts and circumstances need to be analyzed to determine if the investments are considered to be tax-exempt obligations. If the note does not qualify as a tax-exempt obligation, or if the note is an AMT bond (as defined by § 148(b)(3)(B)), then the earnings on the investment are subject to the yield restriction rules.

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501(c)(3) Pools

When the loans are made to 501(c)(3) organizations, the issuer's investments in the loans are treated by the issuer as purpose investments; however, these investments are subject to the yield restriction rules. This is because the loans are investment property under § 148(b)(2). The definition of materially higher for these investments is .125 percent (under Regulations § 1.148-2(d)(2)). (If these investments are program investments, then the definition of materially higher is 1.5 percent.)

However, if the pool issuer invests the proceeds of the bonds in 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 tax-exempt bonds are not investment property (as non-AMT bonds). Thus no yield limitation applies (under Regulations § 1.148-2(d)(2)(v)).

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Other Pools

When the loans are made to entities other than the above, such as owners of manufacturing facilities, the pool issuer's investments in the loans are purpose investments of the qualified small issue bond issue subject to the yield restriction rules. This is because:

- they are investment property under § 148(b)(3), and
- there is no specific exception for these purpose investments under Regulations § 1.148-2(d)(2)

Therefore, materially higher means .125 percent above the bond yield.

However, if the issuer invests proceeds in tax-exempt non-AMT bonds prior to loaning the proceeds to a conduit borrower, the investment is a nonpurpose investment; but because it is not investment property, it is not subject to the arbitrage rules.

Similarly, if the issuer invests proceeds in tax-exempt AMT bonds prior to loaning the proceeds to a conduit borrower, then the investment is a nonpurpose investment; but because it is not investment property, it is not subject to the yield restriction rules.

In this Section

This section contains the following topics:

Temporary Period Limitations

General Rule

Proceeds of pooled financing issues may be invested for temporary periods without regard to the yield restriction rules. Different rules apply at the issuer level and at the conduit borrower levels. According to Regulations § 1.148-2(e)(2)(i), the rules apply separately to each conduit loan. Also remember that the temporary period limitations apply only to nonpurpose investments. Purpose investments have no temporary period.

Pooled financing issues are permitted a three-year temporary period (or the five-year period if the conditions are met), but the issuer and the borrower must share it. The temporary period begins on the issuance date, without exception.

Application of the Multipurpose Issue Rules

The multipurpose issue rules are contained in Regulations § 1.148-9(h) and will be discussed later in this lesson. The general rule contained in Regulations § 1.148-9(h)(1) states that the portion of the bonds of a multipurpose issue reasonably allocated to any separate purpose is treated as a separate issue for all purposes of § 148 except for:

- arbitrage yield,
- rebate amount,
- minor portion, and
- 4R fund.

Therefore, the temporary periods (because they are not listed in the exceptions) apply separately to each purpose investment. This is because each loan (purpose investment) is treated as a separate issue. This rule is consistent with the treatment afforded under Regulations § 1.148-2(e)(2)(i).

Temporary periods apply separately to each conduit loan regardless of whether or not the loans are tax-exempt bonds.

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Proceeds at the Issuer Level

In order for the bond proceeds to qualify for any temporary period, the issuer must reasonably expect to meet the expenditure, time, and due diligence tests set forth in Regulations § 1.148-2(e)(2) with respect to each conduit loan financed by the issue. If the issuer reasonably expects that the conduit borrowers will meet these tests, then the issuer can invest the bond proceeds in nonpurpose investments for a period of six months without regard to the yield restriction rules. (See § 148(c)(2)(A) and Regulations § 1.148-2(e)(4)(i))

Proceeds at the Conduit Borrower Level

If the issuer reasonably expects that the expenditure, time, and due diligence tests would be met, then the bond proceeds may also be invested in nonpurpose investments (without regard to the yield restriction rules) by each conduit borrower for the period of time left in the three-year period that has not already been used by the issuer. (See Regulations § 1.148-2(e)(4)(i))

Example

City W issues pooled financing bonds on behalf of six conduit borrowers. Prior to issuance, City W obtains certifications from each borrower that:

- within three years, it will spend at least 85 percent of borrowed proceeds on qualified capital projects,
- within six months, it will enter into a binding contract with a third party to spend at least 5% of the net sale proceeds on the capital projects, and
- it will proceed with due diligence to complete the capital projects by expending the bond proceeds on the project.

Because the issuer has the requisite expectations, it may invest the bond proceeds for up to six months without regard to the yield restriction rules. In addition, the conduit borrowers may invest the bond proceeds for an additional two and one-half years (or more if the loan is made earlier) without regard to the yield restriction rules.

If the issuer held the proceeds for one year instead of six months, the conduit borrower's temporary period would only be two years. (See Regulations § 1.148-2(e)(4)(i))

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Construction Financing

Section 148(c)(2)(C)(i) provides for a two-year temporary period at the issuer level for proceeds of a pooled financing issue that the issuer elects to treat as a construction issue. (See § 148(f)(4)(C) for the definition of construction issue.)

Remember that under Regulations § 1.148-2(e)(4), the two-year temporary period applies only at the issuer level. The two-year temporary period is still integrated with the three-year temporary period. The conduit borrower has the rest of the three-year period i.e., the three-year period starts when the bonds are issued, not when the loan is made.

Section 4 of this lesson contains more information regarding construction issue elections and spending exceptions to rebate.

Other Temporary Periods

Regulations § 1.148-2(e)(2)(ii) provides that a five-year temporary period may apply in lieu of the three-year period, if:

- a longer period is necessary to complete the capital project, and
- there is proper certification to this effect.

Regulations § 1.148-2(e)(3) also sets forth a rule that allows a temporary period of 13 months for proceeds that are reasonably expected to be allocated to working capital expenditures within 13 months after issuance. Under Regulations § 1.148-2(e)(4)(i) the temporary period of the conduit borrower is reduced by the amount of time the proceeds are held by the issuer. Thus, if the issuer holds the proceeds for six months, the conduit borrower would only be allowed a temporary period of seven months.

Loan Repayments Received by the Issuer

Proceeds received by the issuer as repayment of loans from the conduit borrowers may be used to make new loans. Section 148(c)(2)(B) and Regulations § 1.148-2(e)(4)(ii)(A) provide that proceeds from the sale or repayments may be invested by the issuer without regard to yield limitation for three months from the date of the repayments.

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Temporary Period Limitations, Continued

Amounts Re-loaned to Conduit Borrowers

Regulations § 1.148-2(e)(4)(ii)(B) provides that any temporary period for proceeds held by a conduit borrower under a new loan made from the sale or repayment of a loan is reduced by the amount of time the proceeds are held by the issuer following the last repayment. As previously discussed, temporary periods can be three years or longer for capital projects, or 13 months for working capital financings.

The date the new loan is made is treated as the issue date.

Permitted Yield Spreads of Purpose Investments

Program Investments

Regulations § 1.148-2(d)(2)(iii) provides that for purpose investments that are program investments, other than student loans, "materially higher" means 1.5 percent.

An issuer may waive the right to treat an investment as a program investment. The investment would then be subject to the 0.125 percent permitted yield spread of other purpose investments. (See Regulations § 1.148-1(b) for the definition of program and purpose investments)

Tax-Exempt Bonds That are not Investment Property

Regulations § 1.148-2(d)(2)(v) provides that for investments that are tax-exempt bonds and are not investment property under § 148(b)(3) (AMT bonds), no yield limitation applies.

<u>Example.</u> Authority A issues a pooled financing issue and loans the proceeds to Cities B, C, and D. Cities B, C, and D each treat their own loans as tax-exempt obligations under § 103. Authority A and each of the Cities file their own Form 8038-G. Authority A is the bondholder for the obligations of Cities B, C, and D. As bondholder, Authority A has made investments in tax-exempt non-AMT bonds. Section 148(b)(3)(A) provides that tax-exempt non-AMT bonds are not investment property. Therefore, there is no limit on the yield that Authority A can earn on these bonds. The investment is not subject to yield restriction or rebate.

All Other Purpose Investments

Regulations § 1.148-2(d)(2)(i) provides that for purposes of all other purpose and nonpurpose investments, "materially higher" means 0.125 percent.

<u>Example.</u> Authority A issues $8M principal amount of five-year bonds at 3 percent. The proceeds are loaned to Corporations X, Y, and Z at a rate of 3.125 percent.

Authority A's loans to the corporations are purpose investments that may not have a yield in excess of 0.125 percent above the bond yield. The loans are not described in the definition of program investments in Regulations § 1.148-1(b).

Yield Reduction Payments

Introduction

Issuers of pooled financing bonds and conduit borrowers can reduce the yield on their **nonpurpose investments** by making yield reduction payments in accordance with Regulations § 1.148-5(c).

Why Yield Reduction Payments are Made in Pooled Financings

Yield reduction payments would be made if the pooled financing issuer still had proceeds on hand after the end of the six-month or the two-year temporary period that were invested above the spread allowed by the yield restriction rules.

Yield reduction payments would also be made if the pooled financing issuer had repayments that were expected to be used to finance new loans later than 3 months after the receipt of the repayment.

The yield reduction payment would allow the issuer to comply with the yield restriction requirements after the end of the temporary period.

Conduit borrowers can also make these payments if the borrowed proceeds are not spent within the appropriate temporary period, i.e. the three-year temporary period. The yield reduction payments will bring the yield of the nonpurpose investment down to the permitted level.

Manner of Payment

Generally, yield reduction payments are made at the same time and manner as rebate payments. Yield reduction payments must be made on or before any rebate payment.

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Nonpurpose Investments

Regulations § 1.148-5(c) applies to nonpurpose investments of bond proceeds that qualified for the:

- three-year or five-year temporary period available for capital projects under Regulations § 1.148-2(e)(2),
- 13-month temporary period for working capital financings under Regulations § 1.148-2(e)(3),
- six-month, two-year, or three-month loan repayment temporary periods only applicable to pooled financing issues under Regulations § 1.148-2(e)(4), and
- one-year temporary period for investment proceeds under Regulations § 1.148-2(e)(6)

Violating the yield restriction rules causes pooled bonds to be taxable arbitrage bonds.

Remember that if an issue does not meet the reasonable expectations test of Regulations § 1.148-2(e)(2), it does not qualify for a temporary period, and therefore cannot make a yield reduction payment.

Example. County R issues $40M principal amount of bonds on January 1, 1998, loaning $4M to each of 10 other counties. No construction projects are contemplated, but rather the borrowers intend to use the proceeds to buy equipment. The proceeds are invested in a GIC at a yield greater than .125 percent above the bond yield. The requirements for GIC withdrawals are stringent and do not accommodate the borrowers' needs. Some, but not all of the proceeds are loaned to borrowers within six months of the issuance date. The issuer does not meet the reasonable expectations test of Regulations § 1.148-2(e)(2).

The issuer has invested the proceeds after the end of the issuer's temporary period at a yield that is materially higher than the yield on the bonds. However, the issuer's expectations to spend the proceeds within three years were not reasonable and thus the issuer has not met the requirements of Regulations § 1.148-2(e)(2); therefore, no temporary period is permitted. Because the bonds do not qualify for a temporary period, no yield reduction payment is permitted. Consequently, the bonds are arbitrage bonds and the interest on the bonds is taxable from the issuance date.

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Yield Reduction Payments Are Inapplicable to Most Purpose Investments

Issuers of pooled bonds have to be aware of yield restrictions imposed on purpose investments, i.e. the loans to the conduit borrowers. Regulations § 1.148-2(a) imposes a general restriction that investments (both purpose and nonpurpose) cannot have a yield greater than .125 percent above the bond yield. Yield reduction payments **cannot** be made to reduce the yield on **purpose** investments, unless the purpose investments are allocable to qualified student loans, or if the purpose investments are part of an issue more than 5% of the value of which is a variable yield. (See Regulations § 1.148-5(c)(3))

Example. Assume that an issuer of a pooled financing loans the proceeds to three different owners of manufacturing facilities. The bond yield is 2 percent and the yield on the borrowers' loans is 2.5 percent. The issuer has earned a yield above the .125 percent permitted on purpose investments and cannot remedy the situation with a yield reduction payment. Consequently, the bonds are arbitrage bonds.

Section 4

Elements of Yield Computation

Overview

Introduction

The pool issuer is required to compute the yield on the pool issue and all purpose and nonpurpose investments that are made with the bond proceeds.

To determine whether the pool financing issue meets the requirements of § 148, the yield on the purpose and nonpurpose investments must be computed and compared to the yield on the issue.

This section discusses the computation of yield on the pool issue and the purpose investments. The computation of yield of nonpurpose investments is the same as for other types of bond issues.

The multipurpose issue allocation rules may affect the yield computation of the pooled financing issue and certain purpose investments.

In this Section

This section contains the following topics:

Multipurpose Issue Allocation Rules

Introduction

The 1993 final regulations (T.D. 8476) permit the application of the multipurpose issue rules to divide certain pooled issues for yield calculation purposes.

A **multipurpose issue** means an issue, the proceeds of which are used for two or more separate purposes determined in accordance with Regulations § 1.148-9(h). Generally, for purposes of § 148, the multipurpose rules provide that a portion of bonds reasonably allocated to a separate purpose is treated as a separate issue. (This is called "the general rule.") There are exceptions to the general rule that specifically address the following provisions of § 148:

- arbitrage yield,
- rebate amount,
- minor portion, and
- the 4R fund.

Remember that "the general rule" treats all purpose investments separately, and does not distinguish between those that are tax-exempt bonds and those that are not. The exceptions do distinguish between loans that are tax-exempt bonds and those that are not.

Regulations § 1.148-9(h)(3) provides that separate purposes may include:

- refunding a separate prior issue,
- financing a separate purpose investment,
- financing a construction issue, and
- any clearly discrete governmental purpose reasonably expected to be financed by that issue.

Although each purpose investment (loan to borrowers of the pool issue) may be considered to be for a separate governmental purpose, generally, in determining arbitrage yield, rebate amount, minor portion and 4R fund, they continue to be considered a single issue. An exception to this general rule is that if the loan is made to a governmental entity and such loan is a tax-exempt obligation, the arbitrage yield (§ 1.148-9(h)(1)(i)) and rebate amount (§ 1.148-9(h)(ii)) are computed as if that particular loan is a separate issue.

Accordingly, computation of yield on the pool issue may depend upon whether or not the conduit loans are tax-exempt obligations.

Computation of Bond Yield on the Pool Issue

Computing the Yield on an Issue When the Conduit Loans are not Tax-Exempt Bonds

Regulations § 1.148-9(h)(1)(i) provides that in computing the yield on a multipurpose issue for purposes of determining compliance with the yield restriction rules and arbitrage rebate requirements**,** the issue is treated as a single issue, unless the purpose investments are tax-exempt bonds**.**

Therefore, if none of the loans to borrowers qualify as tax-exempt bonds, for purposes of computing the yield on the issue, the issue is treated as a single issue.

Example. Authority A issues $50M principal amount of bonds and loans the proceeds to Hospitals X, Y, and Z. The loans to the Hospitals are not tax-exempt bonds. Therefore, when Authority A determines the yield on the pool issue, it will treat the issue as a single issue, computing one single yield for the pool issue.

If we assume that this yield of the pool issue is 4 percent, then the issuer must not earn more than 4.125 percent (unless the loans are program investments) on the loans to the Hospitals.

Any nonpurpose investments (other than those in non-AMT tax exempt bonds) that are made by the **issuer** prior to loaning the proceeds to the conduit borrowers (and after the expiration of the temporary period) must also be yield restricted to no more than 4.125 percent.

Any nonpurpose investments made by the **conduit borrower** after expiration of the temporary period must also be yield restricted to 4.125 percent.

The most important concept to remember is that the **pool yield** governs all investments. Do not be confused into thinking that nonpurpose investments made by the borrower prior to spending are yield restricted to the yield on the conduit loan.

Continued on next page

Computing the Yield When the Conduit Loans are Tax-Exempt Bonds

If the conduit loans are tax-exempt bonds, then, according to Regulations §§ 1.148-9(h)(1)(i) and 1.148-4(a), the yield on the pool issue is determined by treating the bonds allocated to separate purposes as separate issues.

Example 1. Authority A issues $60M principal amount of bonds and loans $20M each to Cities B, C, and D. Each City files Form 8038-G treating its note to County A as a tax-exempt bond. When Authority A computes the yield on the pool issue, it will allocate the bonds of the pool issue to each separate note. Therefore, the pool issue will have three separate yields – one for each note. **(**See Regulations § 1.148-9(h)(4)(iii) for the safe harbor for allocations of bonds used to finance separate purpose investments.)

According to Regulations § 1.148-4(a), the yield on an issue that would be a purpose investment (absent § 148(b)(3)(A)) is equal to the yield on the conduit financing issue that financed that purpose investment. Because this section treats each purpose investment as a separate issue of the pooled financing issue, it is consistent with Regulations § 1.148-9(h)(1)(i).

Regulations § 1.150-1(b) provides that a **conduit financing issue** means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Therefore, all nonpurpose investments made by Authority A and the Cities are subject to yield restriction based on the yield of the applicable portion of the pool issue. For example, if the yield on the portion of the pool issue allocated to City B is 6 percent but the yield on the note from City B is 7.5 percent, **nonpurpose investments** by Authority A and City B are yield restricted to a yield not more than 6.125 percent.

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Computing the Bond Yield When the Conduit Loans are Tax-Exempt Bonds

<u>Example 2</u>. Assume the same facts as in Example 1 except the yield on the bonds allocated to City B's loan is 4 percent. The loan to City B is for purposes of construction and thus Authority A has a two-year temporary period. The yield to Authority A on City B's loan is 7.5 percent. Prior to loaning the proceeds of the bonds to City B, Authority A can invest the proceeds without restricting the yield for a period of two years. Assume that the proceeds are invested by Authority A for only six months at a yield of 4.5 percent. After six months, the issuer loans $20M to City B. City B then invests the $20M in a GIC yielding 4.5 percent. At the time the loan is made to City B, thirty months remain in the three-year temporary period. Construction moves slowly and although some progress is made, all of the proceeds are not spent by the end of the temporary period. Therefore, after the temporary period ends, City B must either withdraw the remaining funds from the GIC and invest them at no more than 4.125 percent, or plan to make a yield reduction payment in order to meet the yield restriction rules.

Assume that the yield on the bonds allocated to City C is 4.25 percent and the yield to Authority A on City C's loan is 5 percent. Prior to loaning the proceeds, Authority A invests the proceeds for six-months at a yield of 5 percent. City C invests the proceeds until they are spent at a yield of 5 percent. After the temporary period, the yield on the investments acquired with the unspent proceeds must be restricted to a yield of 4.375 percent (4.25 percent plus .125 percent). If not, a yield reduction payment is required. See Regulations § 1.148-4(a).

It is important that you not be misled by the yield on the loan just because it is a tax-exempt bond in its own right. Nonpurpose investments of loan proceeds are limited by the pool yield as determined herein even though the loan is a tax-exempt bond.

Also, remember that the loans to the Cities will not be investment property under § 148(b)(3)(A), and that there are no yield restriction limits on tax-exempt bonds. So, computing the yield of the purpose investments when they are tax-exempt bonds is really of no consequence.

Application of Multipurpose Safe Harbor

<u>If the pro rata safe harbor in Regulations § 1.148-9(h)(4)(ii) is used to allocate the bonds of the pool issue, the yield on the bonds allocated to any tax-exempt conduit loans will be the same as the yield of the pool issue computed as a single issue unless fractional bonds are rounded up and down.</u>

Computation of Yield on Purpose Investments

Introduction

In a pooled financing, the issuer loans the bond proceeds to two or more conduit borrowers. Except for loans to other governmental entities that are not investment property under § 148(b)(3), these "purpose investments" must comply with the yield restriction rules set forth in Regulations § 1.148-2(d).

Specifically, to comply with the yield restriction rules, the interest earned by the issuer on the loans, (if they are investment property) must be within the permitted yield spread. Also remember that purpose investments are not permitted a temporary period and that under § 148(f)(4)(A), purpose investments are not subject to rebate.

Therefore, the issuer must treat each loan as a purpose (or program) investment and compute the yield on each loan. In computing the yield, the issuer must follow the specific rules outlined for purpose (or program) investments that are set forth in Regulations § 1.148-5.

These rules have been presented in the text for Phase I; however, because of their specific application to pooled financings, some of these rules will be repeated in this module. This section presents a basic computation of loan yield.

Note about Nonpurpose Investments

Although this section concentrates on the purpose investments of the pool issuer, we can't forget the application of the arbitrage rules to nonpurpose investments.

Pool issuers can and do invest bond proceeds in nonpurpose investments prior to loaning the proceeds to a borrower. Additionally, once the borrower receives the proceeds, they may be invested in nonpurpose investments until used for the project.

As long as these investments constitute investment property under § 148(b)(3), these nonpurpose investments are subject to the yield restriction rules of § 148. There is no difference in the way these rules apply to pooled financings.

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Basic Computation of Loan Yield

Regulations § 1.148-5(b)(1) provides that, in general, the yield on an investment is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. (Remember that yield reduction payments generally cannot be used to reduce the yield on purpose investments.)

Regulations § 1.148-5(b)(1) further provides that:

- Payments are amounts to be actually or constructively paid to acquire the investment.
- Receipts are amounts to be actually or constructively received from the investment, such as earnings and return of principal.

Payments made by the conduit borrower are not treated as paid until the conduit borrower ceases to receive the benefit of earnings on those amounts.

Qualified Administrative Costs

Regulations 1.148-5(e)(3)(i) provides that when computing the yield on a purpose investment, qualified administrative costs paid by the conduit borrower are taken into account. Thus, these costs increase the payments for, or decrease the receipts from, the purpose investments. This rule is applied even if the payments from the conduit borrower merely reimburse the issuer.

In other words, the issuer can recover qualified administrative costs from the conduit borrower, in addition to earning interest (to the extent of the permitted spread) on the loan itself. This is a common practice because it allows the issuer to charge the borrower for issuance costs, rather than having to pay them out-of-pocket.

Regulations § 1.148-5(e)(3)(ii)(A) provides that qualified administrative costs of purpose investments include:

- Costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment, and
- Costs of issuing, carrying, or repaying the issue, and any underwriters' discount

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Qualified Administrative Costs for Program Investments

Regulations § 1.148-5(e)(3)(ii)(B) provides that for program investments, qualified administrative costs include only costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

Administrative costs of the investment itself are not included.

Therefore, if these nonqualified costs are paid by the conduit borrower, then the issuer must consider these amounts as part of the earnings allowed by the permitted spread.

As stated in Section 2 in the discussion about permitted yield spreads, an issuer may waive the treatment of an investment as a program investment. Although the investment would be subject to the 0.125 percent permitted yield spread, administrative costs of the investment itself, if paid by the conduit borrower, would be taken into account when computing the yield on the investment.

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Example of Accounting for Qualified Administrative Costs in the Yield Computation of Conduit Loans that are not Tax-Exempt Bonds

Authority X issues a pool financing issue at a principal amount of $10,500,000 at a yield of 5%. The arrangement requires Authority X to pay $500,000 of issuance costs, but the authority will be reimbursed by Corporations Y and Z. After these costs are paid, the proceeds of the bonds are split equally and loaned to Corporations Y and Z, both of which are 501(c)(3) organizations. Both loans meet the definition of a program investment under Regulations § 1.148-1(b).

The yield on the pooled financing bonds is 4.99999 percent. (**See Figure 5-1)**

When computing the yield of the purpose investments, because they are both program investments, Regulations § 1.148-5(b)(2)(ii) permits the investments to be treated as a single investment. A portion of principal will be repaid each year along with five percent of the interest on the outstanding principal. Corporations Y and Z will each pay $725,819 as a loan repayment each year for ten years. This payment is broken down as follows:

Purpose	Amount
Principal and interest on loan of $5M	$ 1,387,078
Reimbursement of Issuance Costs	64,560
Total payment	$ 1,451,638

Figure 5-2 shows that the yield on each of the investments is equal to 7.42144 percent.

According to Regulations § 1.148-2(d)(2)(iii) the yield on program investments cannot exceed the bond yield by more than 1.5 percentage points. The yield on these investments exceeds the bond yield by 2.42145 percent (7.42144 minus 4.99999.)

However, Regulations § 1.148-5(e)(3)(i) and (ii)(B) provide that the reimbursement of issuance costs is taken into account when computing the yield on the investment, by increasing the payments or decreasing the receipts. Therefore, if each receipt is reduced by $64,560 (amount for issuance costs), then the yield becomes 6.43899, which is within the permitted spread (4.99999 + 1.5 = 6.49999.) **(See Figure 5-3.)**

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Caution! Note that this example is not illustrating the waiver of the 1.5 percent permitted spread to allow the issuer to deduct loan costs. The issuer is permitted to take issuance costs into account when computing the investment yield without waiving the 1.5 percent spread.

Figure 5-1: **Bond Yield Computation**

Issue Date: 1/1/98 Issue Price: $10,500,000 1 compounding interval
Yield: 4.999999

Payment Date	Debt Service Payments	Present Value
1-1-99	$1,359,798.03	$1,295,045.76
1-1-00	1,359,798.03	1,233,376.92
1-1-01	1,359,798.03	1,174,644.70
1-1-02	1,359,798.03	1,118,709.25
1-1-03	1,359,798.03	1,065,437.39
1-1-04	1,359,798.03	1,014,702.28
1-1-05	1,359,798.03	966,383.14
1-1-06	1,359,798.03	920,364.90
1-1-07	1,359,798.03	876,538.01
1-1-08	1,359,798.03	834,798.11
	$13,597,980.00	$10,500,000.45

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Figure 5-2: **Loan Yield Computation**

Loan Date: 1/1/98   Loan Amount: $10,000,000   1 compounding interval

Yield: 7.42144

Payment Date	Gross Loan Receipts	Present Value
1-1-99	$ 1,451,638	$ 1,351,348.42
1-1-00	1,451,638	1,257,987.56
1-1-01	1,451,638	1,171,076.75
1-1-02	1,451,638	1,090,170.35
1-1-03	1,451,638	1,014,853.56
1-1-04	1,451,638	944,740.18
1-1-05	1,451,638	879,470.75
1-1-06	1,451,638	818,710.59
1-1-07	1,451,638	762,148.18
1-1-08	1,451,638	709,493.51
	$ 14,516,380.00	$ 9,999,999.86

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Figure 5-3: **Loan Yield Computation**

Loan Date: 1-1-98 Loan Amount: $10,000,000 1 compounding interval
Yield: 6.43899

Payment Date	Net Loan Receipts	Present Value
1-1-99	$ 1,387,078.02	$ 1,303,167.23
1-1-00	1,387,078.02	1,224,332.59
1-1-01	1,387,078.02	1,150,267.02
1-1-02	1,387,078.02	1,080,682.02
1-1-03	1,387,078.02	1,015,306.55
1-1-04	1,387,078.02	953,885.93
1-1-05	1,387,078.02	896,180.94
1-1-06	1,387,078.02	841,966.79
1-1-07	1,387,078.02	791,032.31
1-1-08	1,387,078.02	743,179.09
	$ 13,870,780.02	$10,000,000.47

Section 5

Rebate Rules

Overview

Introduction

This section discusses both aspects of rebate:

- Liability for rebate (including the exceptions to rebate), and
- Computing the rebate liability.

Pooled financings are subject to the same rebate liability rules as non-pooled financings. However, some rules apply differently to pooled financings, and there are special rules that apply only to pooled financings.

Special Note

When discussing the yield restriction rules, we constantly differentiated between the treatment of pools that were made up of tax-exempt bonds and those that were not.

The same treatment is applicable when discussing the computation of rebate, **but not the spending exception to rebate.**

When discussing the spending exceptions, the entire pooled financing is always treated as a whole regardless of the type of loans that are present. The multipurpose issue allocation rules do not apply. In order to treat the loans separately, the issuer must make an election to do so.

Continued on next page

Computing Rebate

As with the yield restriction rules, calculating the amount of rebate due for nonpurpose investments of proceeds of pooled bonds made by the issuer and conduit borrowers differs depending on whether or not the loans are tax-exempt bonds.

Regulations § 1.148-9(h) provides that pooled bond issues are treated as a single issue for purposes of determining the rebate amount, even though the proceeds are being used for separate purposes and the issuer treats the pooled issue as a multipurpose issue.

The only exception to this is if all of the loans are tax-exempt bonds, then the pooled bond issue can be divided into separate issues with each issue being that portion of the bonds reasonably allocated to the conduit loan. In these cases, for rebate purposes, the yield on the loan is equal to the yield on that portion of the financing issue allocated to the loan. (See Regulations § 1.148-4(a))**.** Regulations § 1.148-9(h)(4)(iii) states that the allocation of bonds of a multipurpose issue is generally reasonable if the principal and interest payments of the allocated portion of the bonds and the interest and principal payments of the loans reasonably coincide as to time and amount. Regulations § 1.148-9(h)(4)(ii) provides that a pro rata allocation is a reasonable method for allocating bonds of a multipurpose issue.

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Exceptions to Rebate

A pooled financing issuer is permitted to use the same exceptions to rebate as any other issue. To review, these are:

- Six-month spending exception,
- Two-year spending exception,
- Eighteen-month spending exception, and
- Small issuer exception.

The general rule contained in Regulations § 1.148-7(b)(6) provides that the spending exceptions apply to a pooled financing issue as a whole, rather than to each loan separately, unless the issuer elects to apply them separately to each loan. We use this rule rather than the multipurpose rules because Regulations § 1.148-7(b)(6) applies specifically to pooled financings. Each of the spending exceptions is independent, so that a construction issue with a two-year spending period may also qualify for the six-month or eighteen-month exception.

The bond proceeds may be loaned to small issuers as defined by § 148(f)(4)(D).

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Electing Separate Treatment

If all the loans are tax-exempt bonds and the issuer elects to apply the spending exceptions separately, the spending exceptions are applied separately to each conduit loan, and the applicable spending requirements for a loan begin on the earlier of:

- the date the loan is made, or
- the first day following the one-year period beginning on the issue date of the pooled bond issue. (See Regulations § 1.148-7(b)(6)(ii)(A)).

Although the spending exceptions (and small issuer exception) apply on a loan by loan basis, the entire pooled financing issue will be arbitrage bonds if:

- any one of the loans fail to meet the spending exception (or small issue exception), **and**
- rebate is not paid accordingly. (A loan can fail a spending exception, but if rebate is paid the bonds will not be arbitrage bonds.)

Also, if the election is made, then the earnings on proceeds are subject to rebate while held by the issuer prior to the date on which the spending requirements for those proceeds begin. There are no exceptions to this rule. (See Regulations § 1.148-7(b)(6)(ii)(A))

Lastly, if the election is made, then the issuer may make all elections under the two-year spending exception separately for each loan. These include the election to pay penalty in lieu of rebate and the election to treat a portion of an issue as a construction issue. (See Regulations § 1.148-7(b)(6)(ii)(C))

Overview

Election to Postpone the Start of the Spending Requirements

Normally, the starting date of the spending requirements begins on the issuance date of the bonds, however § 148(f)(4)(C)(xi) provides a special election for pooled financings. This section provides that the issuer of a pooled financing can elect to postpone the starting date to the:

- date the loan is made, in the case of loans made within the one-year period after the issuance date, and
- date following such one-year period, in the case of loans made after such one-year period

As with the election to apply the spending exceptions separately to each loan, if this election is made, there is no spending exception to rebate available for earnings on proceeds held by the issuer prior to the loan date.

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Making the Election

According to Regulations § 1.148-1(d), the elections must be made in writing. They should be kept with the bond documents, but do not have to be attached to Form 8038.

Once made, the elections may not be revoked without the permission of the Commissioner. (See Regulations § 1.148-1(d))

Coordination

Typically, the pooled bond issuer will require that all of the conduit borrowers use the same trustee for purposes of receipts and expenditures. This eliminates the problems with different bookkeeping methods.

In this Section

This section contains the following topics:

Six-Month Spending Exception to Rebate

Treatment of Conduit Loan Proceeds When Election is Made to Treat Each Loan Separately

If the issuer makes the election under Regulations § 1.148-7(b)(6)(ii) to treat each loan separately for purposes of the spending exceptions, and none of the other rebate exceptions apply to a loan, then the borrower must expend all of the gross proceeds (as defined in Regulations § 1.148-7(c)(3)) within six months of the earlier of:

- the loan date, or
- the first day following the one-year period beginning on the issue date of the pooled bonds

See Regulations § 1.148-7(b)(6)(ii)

Treatment of Bond Proceeds Prior to Loan When Election is Made to Treat Each Loan Separately

If the election is made to treat each loan separately, Regulations § 1.148-7(b)(6)(ii)(A) provides that none of the spending exceptions are available for gross proceeds of the pooled financing issue prior to the date on which the spending requirements begin for the conduit loans.

Therefore, the bond proceeds are subject to rebate in the hands of the issuer prior to the loan date(s).

Treatment of Bond Proceeds When Election is not Made

If the issuer does not make the election to treat each loan separately, then the spending exceptions apply to the pooled financing issue as a whole. (See Regulations § 1.148-7(b)(6)(i))

This means that the applicable period for the spending requirements begins on the issuance date of the bonds, regardless of the loan date(s).

Two-Year Spending Exception to Rebate

Introduction

The two-year spending exception is obviously the most liberal of the spending exceptions to rebate. Therefore, if any of the proceeds of an issue are to be used for construction expenditures, the issuer will want to take advantage of this exception. Unless the entire issue qualifies as a construction issue, the election under § 148(f)(4)(C)(v) (and Regulations § 1.148-7(j)) must be made. This election allows the issuer to treat a portion of an issue as a construction issue. It is commonly referred to as **bifurcation election**. A disadvantage to making this election is that under Regulations § 1.148-7(d)(4), the issuer is prohibited from using the eighteen-month spending exception for the non-construction issue.

Recall from Phase I that, generally, in order to be a construction issue, an issuer must reasonably expect that at least 75 percent of the available construction proceeds ("ACP") will be used for construction expenditures.

The two-year spending exception can be met by the pooled financing in various ways:

- If **more than 75 percent** of the available construction proceeds of the **entire pooled issue**, treated as a whole, will be used for construction expenditures. (The § 148(f)(4)(C)(v) election need not be made because the entire issue qualifies as a construction issue),
- If **any** of the proceeds of the **entire issue** will be used for construction, the issuer can elect on or before the issue date to bifurcate the issue into two (and only two) separate issues, with one issue being a construction issue and the other a non-construction issue. In order to do this, the issuer must make the election under § 148(f)(4)(C)(v),
- If **any** of the proceeds of a **loan** will be used for construction, the issuer can elect on or before the issue date to **bifurcate the loan** into two separate issues, with one being a construction issue and the other a non-construction issue. In order to do this, the issuer must make the elections under Treasury Regulation § 1.148-7(b)(6)(ii) and § 148(f)(4)(C)(v).
- If **more than 75 percent** of the available construction proceeds of any loan will be used for construction expenditures, then the issuer must make the election under Regulation § 1.148-7(b)(6)(ii) to treat the loan as a construction issue.

Remember that these conditions apply to all pooled financing issues, whether or not the second-tier loans are tax-exempt bonds.

Continued on next page

Treating the Entire Issue as a Construction Issue

Assume that a conduit financing issuer issues bonds reasonably intending to loan half of the proceeds to Borrower X and half to Borrower Y. Borrower X expects to use 100 percent of its loan for construction expenditures, and Borrower Y expects to use 50 percent of its loan for construction expenditures. Since at least 75 percent of the proceeds (100% x 50% plus 50% x 50%) are expected to be used for construction expenditures, the entire issue is a construction issue that can use the two-year spending exception. Neither the election under Regulations § 1.148-7(b)(6)(ii) nor the election under § 148(f)(4)(C)(v) needs to be made.

The two-year spending periods for rebate exception begin on the issuance date of the bonds, as does the temporary period for yield restriction purposes.

Continued on next page

Bifurcation of the Entire Issue into Construction/ Non-construction Issues

Section 148(f)(4)(C)(v) and Regulations § 1.148-7(j) provide that an issuer may elect to treat a portion of an issue that is not a refunding issue as two separate issues if:

- one of the separate issues is a construction issue as defined in Regulations § 1.148-7(f),
- the issuer reasonably expects, as of the issue date, that this construction issue will finance all of the construction expenditures to be financed by the issue, and
- the issuer makes an election to apportion the issue by identifying the amount of the issue price of the issue allocable to the construction issue

There are two reasons why an issuer may make this election:

- to allow the issuer the use of the two-year spending exception to rebate for the part of the issue used for construction financing, or
- to allow the issuer to elect to pay the one and one-half percent penalty in lieu of rebate for the construction issue

Example. Issuer X issues bonds and loans half of the proceeds to Borrower Y and the other half to Borrower Z. Borrower Y expects to use 100 percent of its loan for construction, while Borrower Z only expects to use 30 percent for construction. Because only 65 percent of the entire issue will be used for construction expenditures, Issuer X cannot use the two-year spending exception for the entire issue. However, Issuer X has two options:

Bifurcation of the Entire Issue into Construction/ Non-construction Issues

<u>Option 1</u>
Issuer X can make the election under § 148(f)(4)(C)(v) to treat a portion of the entire issue as a construction issue. If this is made, all of Borrower Y's loan and 30 to 50 percent of Borrower Z's loan will comprise the construction issue. The only problem with this is that according to Regulations § 1.148-7(d)(4), the eighteen-month spending exception will not be available to the remaining part of the Borrower Z loan. Only the six-month spending exception is available.

<u>Option 2</u>
Issuer X can elect to apply the spending exceptions separately to each loan. Because 100 percent of Borrower Y's loan qualifies as a construction issue, Borrower Y can benefit from the two-year spending exception. Then Issuer X could make the election to bifurcate Borrower Z's loan into a construction and a non-construction issue. The construction issue can use the two-year spending exception, but the non-construction issue cannot use the eighteen-month exception.

Continued on next page

Bifurcation of the Entire Issue into Construction/ Non-construction Issues (continued)

Issuer X must weigh these options carefully before making a decision. If the election is made to treat each loan separately, the spending periods would begin on the loan date, and there would be no rebate exception available to Issuer X prior to the loan date. But the eighteen-month spending exception would be available to Borrower Z.

On the other hand, if the issue is bifurcated, then the spending requirements begin on the issue date, and if met, Issuer X can earn arbitrage and keep it. However, the eighteen-month spending exception is unavailable to Borrower Z.

Bifurcation of a Loan into Construction and Non-construction Issues

If an issuer wants the construction exception to apply separately to one loan or each loan, the issuer must first make the election under Regulations § 1.148-7(b)(6)(ii) to apply the spending exceptions separately to each loan. Then, the issuer must make the election under § 148(f)(4)(c)(v) to bifurcate any or each loan into a construction issue and a non-construction issue. In order to bifurcate a loan, the issuer must expect that at least 75 percent of the portion designated as a construction issue will be used for construction expenditures.

The two-year period begins on the earlier of the date the loan is made, or the day after the end of the one-year period after the bonds were issued.

The issuer is subject to rebate for the period it holds the bond proceeds.

The non-construction portion cannot use the eighteen-month exception to rebate. Only the six-month exception is available.

See Option 2 on the previous page for an example of bifurcating a loan.

Continued on next page

Arbitrage Considerations

If the entire issue is a construction issue, and the spending requirements are met by the conduit borrowers, the issuer is able to invest above the bond yield, and because the two-year spending exception is met, can keep the arbitrage earned, rather than rebating it to the government.

If the issuer elects to treat each separate loan as a construction issue, the two-year temporary period applies at the issuer level, but the spending exceptions to rebate only apply at the conduit borrower's level. (See Regulations § 1.148-7(b)(6)(ii)).

The conduit borrower will have an economic advantage if the issuer elects to treat the individual loans as construction issues subject to the two-year spending exception. The borrower will not be subject to yield restriction for the period it holds the bond proceeds (the remaining portion of the three-year period) and will not be subject to rebate if the spending schedule is met. Note that the two-year spending exception starts when the loan is made, but not later than one year after the date of the issue (See Regulations § 1.148-7(b)(6)(ii)), so that the conduit borrower will not end up with a two-year expenditure schedule that goes beyond the three-year temporary period.

Continued on next page

Arbitrage Considerations, continued

Example. Authority H issues a pooled bond issue on January 1, 1998, and reasonably expects to make loans to Cities A, B, and C. It does not expect that more than 75 percent of the proceeds of the entire issue will be used for construction expenditures. Thus, the entire issue cannot be a construction issue. However, City A expects that 50 percent of the expenditures of its loan from Authority H will be for construction. City B expects that more than 75 percent of its loan will be used for construction expenditures. City C does not expect that any of its loan will be used for construction activity. Authority H elects (under Regulations § 1.148-7(b)(6)(ii)) to apply the spending exceptions separately to each loan. The loans to Cities A, B, and C are made on February 1, 1998, March 1, 1998, and March 1, 1999 respectively. Thus, on the day the loan is made to City A, Authority H elects (under Regulations § 1.148-7(j)) to treat 50 percent of the loan to City A as a separate construction issue. The other 50 percent of City A's loan cannot use the two-year spending exception or the eighteen- month spending exception. City B's loan qualifies as a construction issue because more than 75 percent of it will be used for construction expenditures. City A will have 35 months, City B will have 34 months, and City C will have 22 months of the three-year temporary period. City C will not be able to use the two-year spending exception because it is not a construction issue. However, the six-month and eighteen-month exceptions are available. Nevertheless, Authority H must rebate any earnings on non-purpose investments of bond proceeds prior to the date the loans are made to City A, B, and C along with earnings on non-purpose investments of any proceeds loaned to City A, B, or C that do not meet one of the spending exceptions.

Eighteen-Month Spending Exception to Rebate

Treatment of Loan Proceeds When Election is Made to Treat Each Loan Separately	Making the election under Regulations § 1.148-7(b)(6)(ii) allows conduit borrowers to use any of the spending exceptions that apply to them. However, Regulations § 1.148-7(d)(4) prohibits the use of the eighteen-month exception when the two-year exception is used for another portion of the same issue.
Treatment of Bond Proceeds Prior to Loan When Election is Made to Treat Each Loan Separately	Regulations § 1.148-7(b)(6)(ii) specifically provides that none of the spending exceptions are available for gross proceeds of the pooled financing issue prior to the date on which the spending requirements begin for conduit loans. Therefore, the bond proceeds are subject to rebate in the hands of the issuer prior to the loan date.
Treatment of Bond Proceeds When the Election is NOT Made	When the election is not made, the spending exceptions apply to the pooled financing issue as a whole. The applicable periods for the spending requirements begin on the issuance date of the bonds.

Small Issuer Exception to Rebate

Applicability to the Pool Issuer

The small issuer exception from rebate under § 148(f)(4)(D) and Regulations § 1.148-8 is not available to the issuer at the pool level. (See § 1.148-8(d))

Treatment of Issue

Regulations § 1.148-8(d)(1) provides that the pooled financing issue is not counted toward the $5M size limitation of the issuer for purposes of applying the small issuer exception to its other issues if the:

- issuer is not an ultimate borrower in the financing, and
- conduit borrowers are governmental units with general taxing powers and not subordinate to the issuer.

The issuer of the pooled financing issue must rebate any excess earnings on nonpurpose investments while the proceeds are in the hands of the issuer prior to the date the loans are made.

Proposed Regulations published on September 26, 2007 would eliminate the favorable treatment in § 1.148-8(d)(1) for pool issuers.

Treatment of Conduit Borrower

Regulations § 1.148-8(d)(2) provides that a loan to a conduit borrower in a pooled financing issue qualifies for the small issuer exception, regardless of the size of the either the pooled financing or of any loan to other conduit borrowers, if:

- the bonds of the pooled financing are not private activity bonds,
- none of the loans to conduit borrowers are private activity bonds, and
- the loan to the conduit borrower meets all the requirements of the small issuer exception

This last condition refers to the provisions of § 148(f)(4)(D). When verifying if the loan meets the requirement, consider each loan as an "issue" and the borrower as the "issuer." Because this section applies to "small issuers," the borrowers are governmental entities.

The election under Regulations § 1.148-7(b)(6)(ii) is not required because it relates to application of spending exceptions only.

Continued on next page

Example

On June 1, 1998 Authority G issues bonds in the principal amount of $15M. On August 1, 1998 all of the proceeds of the bonds are loaned to Cities A, B, and C in amounts of $5M each. None of the loans to Cities A, B, and C are private activity bonds on the issuance date. Cities A and B have not and do not reasonably expect to issue any other governmental bonds during 1998. Cities A and B can qualify for the small issuer exception as long as each loan meets all of the requirements of the small issuer exception. The size of the pool issue ($15M) does not disqualify the individual Cities from meeting the exception.

City C has not and does not reasonably expect to issue any other governmental bonds during 1998. However, Authority X, which is subordinate to City C, expects to issue $5M principal amount of bonds in September 1998. Because Authority X is subordinate to City C, any bonds that it expects to issue are attributed to City C. Therefore, City C does not qualify for the small issuer exception to rebate. However, City C's failure to qualify for the exception does not affect the ability of Cities A and B to qualify for it. Each loan is treated separately under Regulations § 1.148-8(d)(2).

The small issuer exception to rebate begins for Cities A and B on the loan date of August 1, 1998. The small issuer exception does not apply to Authority G as the issuer. Therefore, any earnings above the bond yield from June 1 to August 1, 1998 must be rebated to the United States. However, if Authority G makes an election under Regulations § 1.148-7(b)(6)(ii) and City C meets a spending exception to rebate, Authority G's earnings above the bond yield from July 1 to August 1, 1998 must be rebated.

Example

Authority M issues bonds in the principal amount of $20M on January 1, 2000. City A borrows $10M. City B borrows $6M, and City C borrows $4M. City C, if it meets the requirements, can use the small issuer exception to rebate. Cities A and B do not qualify for the small issuer exception because the loan amounts are over $5M. However, they may qualify for another spending exception to rebate.

Continued on next page

Avoidance of Size Limitation

Regulations § 1.148-8(c)(2)(iii) provides an anti-abuse rule that prohibits the use of an entity formed or availed of to avoid the purposes of the $5M size limitation. It provides that all entities that would benefit from the avoidance will be treated as one issuer.

Situations in which an entity is formed or availed of to avoid the purposes of the $5M size limitation include those in which the issuer:

- issues bonds which, but for the $5M size limitation, would have been issued by another entity, and
- does not receive a substantial benefit from the project financed by the bonds.

Example. Authority X is a valid issuer and has a long history of issuing bonds within its state. Authority X wants to help 50 small municipalities purchase vehicles through loans at the lowest possible rate. A total of $40M will be needed to accomplish this. Authority X theorizes that if issuance costs can be paid with earnings on the bond proceeds, then the borrowers will not have to pay a surcharge on the loans. Authority X does not want to issue a $40M bond and loan the proceeds to the 50 municipalities because it does not want to be subject to the pooled financing rules and wants to take advantage of the small issuer exception. So, Authority X recruits ten municipalities to issue bonds in the amount of $4M each. Authority X manages the loan program. Each municipality will then loan the proceeds to five other municipalities throughout the state. The municipalities do not treat the bonds as pooled financings because they assert that they do not meet the definition of a pool in § 149(f) (claiming that each issue is less than $5M). The bond proceeds are invested in a GIC at a rate above materially higher than the bond yield. The expected earnings will cover issuance costs and because each issue is below $5M, each issuer expects to meet the small issuer exception to rebate.

Continued on next page

Avoidance of the Size Limitation (continued)

Analysis

Although it's true that each issue of $4M does not meet the definition of a pool under § 149(f), the controlling definition of a pooled financing issue for purposes of § 148 is contained in Regulations § 1.150-1(b). Therefore, each of the ten issues meets the definition of a pooled financing issue.

More importantly, though, the entire transaction is a situation in which the ten issuers were availed of to avoid the purposes of the $5M size limitation. According to Regulations § 1.148-8(e)(iii), all of the issues should be collapsed into one pooled issue the principal amount of which is $40M and the proceeds of which are loaned to various borrowers. The issue does not qualify for the small issuer exception to rebate for two reasons:

- the issue exceeds $5M, and
- the requirements of § 148(f)(4)(D)(i)(III) are not met because at least 95 percent of the net proceeds are not used for the local government activities of the borrower.

Therefore, all earnings on nonpurpose investments are subject to the arbitrage rules, both at the issuer and the borrower levels.

Rebate Computation

Introduction

The issuer is responsible for computing and paying the amount of rebate due.

All of the nonpurpose investments are included in the rebate computation. This includes investments acquired by the issuer prior to loaning the proceeds as well as investments acquired by the conduit borrowers after receipt and before expenditure of the loan proceeds.

Appropriate Yield When Loans are Tax-Exempt

According to Regulations § 1.148-9(h)(1)(ii), if the loans are tax-exempt obligations, then the portion of the bonds allocated to each loan **may** be treated as a separate issue for yield and rebate purposes. This means that a separate rebate computation may be prepared for each borrower. The final results can be netted with one Form 8038-T filed.

Regulations § 1.148-9(h)(4)(ii) provides a safe harbor for a pro rata allocation of bonds to loans. Regulations § 1.148-9(h)(4)(iii) provides a safe harbor when the interest and principal payments of the loan coincide in time and amount to the principal and interest payments of the deemed issue. Regulations § 1.148-4(a) provides that the yield on tax-exempt loans is the yield on the portion of the bond issue allocated to the loan.

Appropriate Yield When Loans Are not Tax-Exempt

If all of the loans are not tax-exempt loans, then one rebate computation is prepared for all of the nonpurpose investments for all of the proceeds. Nonpurpose investments are not separated on a loan by loan basis. The yield on the pool issue is used with no allocation of the bonds. One Form 8038-T is filed for all borrowers.

Section 6

Comprehensive Example

Facts:

On January 1, 1998, Authority K issues $10M principal amount of 10-year bonds. The bonds are sold at par. Principal and interest payments are made on January 1 and July 1 of each year. After payment of $600,000 in issuance costs, $9.4M is available for loans to conduit borrowers. The yield on the bonds is 6.88642 percent as shown in Table H-K-1.

On January 1, 1998, Authority K elects to apply the spending exceptions separately to each loan under Regulations § 1.148-7(b)(6)(ii) by including a statement to this effect in its arbitrage certificate.

On February 1, 1998, Authority K loans $4.7M to Hospital X. Hospital X plans to use the loan proceeds to build a new cardiac rehabilitation center. Hospital X agrees to reimburse Authority K for $300,000 of issuance costs (in 20 equal payments), plus annual loan servicing expenses of $500. Adding these costs to the semi-annual principal and interest payment of $328,900, Hospital X's total semi-annual loan payment will equal $344,150.

On April 1, 1998, Authority K loans $4.7M to Hospital Y. Hospital Y plans to use the loan proceeds to purchase new equipment for the hospital. Hospital Y agrees to reimburse Authority K for $300,000 of issuance costs (in 20 equal payments.) Hospital Y's total semi-annual loan payment will be $340,119 ($325,119 plus $15,000 for issuance costs.)

See attached schedules for investment activity, yield computations, and rebate computation.

Required:

1. Determine if Authority K, Hospital X, and Hospital Y have complied with the appropriate yield restriction rules.
2. Determine if there is any rebate due for Authority K or any of the borrowers.

Continued on next page

Comprehensive Example, Continued

Resolution: The following steps should be taken to determine compliance with the arbitrage rules.

Step	Action
1	Verify that the issue is a pooled financing issue under Regulations § 1.150-1(c).
2	Determine if the issue is a pooled financing issue under § 149(f)(4). If so, does it meet the pooled financing bond requirements?
3	Verify that the yield on the issue shown in Table H-K-1 is correct. How will this yield be used?
4	Identify the proceeds that are subject to yield restriction. Include proceeds while in the hands of the issuer, as well as loan proceeds under the control of the conduit borrowers.
5	Determine the appropriate temporary periods for the proceeds subject to yield restriction.
6	Analyze the cash activity to determine if any proceeds remained unspent after the expiration of the temporary period. (Remember that proceeds are not considered spent until spent by the borrower.)
7	If there are unspent proceeds subject to yield restriction, verify that the yield on the non-purpose investments is correct.
8	If the yield on investments is above the permitted spread, determine if a yield reduction payment can be made. Is it necessary to compute the yield on the purpose investments? If so, has the yield been computed correctly?
9	Obtain documentation for any elections regarding rebate that were made by the issuer.
10	Based on the elections (or lack of), determine if the issue(s) met an exception to rebate.
11	Verify that the rebate computation has been correctly prepared. Was the correct yield used? Were all earnings on investments properly included?

Continued on next page

TABLE H-K-1: YIELD OF POOL ISSUE

ISSUE PRICE	10,000,000.00
ISSUE DATE	1/1/98
COMP INTERVALS	2
YIELD	6.88642 %

DATE	DEBT SERVICE	PRESENT VALUE	DAYS
7/1/98	700,000.00	$676,699.81	180
1/1/99	700,000.00	$654,175.19	360
7/1/99	700,000.00	$632,400.33	540
1/1/00	700,000.00	$611,350.26	720
7/1/00	700,000.00	$591,000.86	900
1/1/01	700,000.00	$571,328.82	1080
7/1/01	700,000.00	$552,311.58	1260
1/1/02	700,000.00	$533,927.34	1440
7/1/02	700,000.00	$516,155.05	1620
1/1/03	700,000.00	$498,974.32	1800
7/1/03	700,000.00	$482,365.47	1980
1/1/04	700,000.00	$466,309.46	2160
7/1/04	700,000.00	$450,787.89	2340
1/1/05	700,000.00	$435,782.97	2520
7/1/05	700,000.00	$421,277.50	2700
1/1/06	700,000.00	$407,254.87	2880
7/1/06	700,000.00	$393,698.99	3060
1/1/07	700,000.00	$380,594.33	3240
7/1/07	700,000.00	$367,925.87	3420
1/1/08	700,000.00	$355,679.10	3600
TOTALS	$14,000,000.00	$10,000,000.00	

Continued on next page

TABLE H-X-1: YIELD OF LOAN TO X (PURPOSE INVESTMENT)

LOAN AMOUNT	4,700,000.00
ISSUE DATE	2/1/98
COMP INTERVALS	2
YIELD	7.00640 %

DATE	LOAN PAYMENTS	PRESENT VALUE	DAYS
7/1/98	328,900.00	$319,596.77	150
1/1/99	328,900.00	$308,779.60	330
7/1/99	328,900.00	$298,328.54	510
1/1/00	328,900.00	$288,231.22	690
7/1/00	328,900.00	$278,475.66	870
1/1/01	328,900.00	$269,050.28	1050
7/1/01	328,900.00	$259,943.92	1230
1/1/02	328,900.00	$251,145.77	1410
7/1/02	328,900.00	$242,645.41	1590
1/1/03	328,900.00	$234,432.76	1770
7/1/03	328,900.00	$226,498.07	1950
1/1/04	328,900.00	$218,831.95	2130
7/1/04	328,900.00	$211,425.29	2310
1/1/05	328,900.00	$204,269.32	2490
7/1/05	328,900.00	$197,355.56	2670
1/1/06	328,900.00	$190,675.80	2850
7/1/06	328,900.00	$184,222.13	3030
1/1/07	328,900.00	$177,986.88	3210
7/1/07	328,900.00	$171,962.68	3390
1/1/08	328,900.00	$166,142.38	3570
TOTALS	$6,578,000.00	$4,700,000.00	

Continued on next page

Comprehensive Example, Continued

TABLE H-Y-1: YIELD ON LOAN TO Y (PURPOSE INVESTMENT)

LOAN AMOUNT	4,700,000.00
ISSUE DATE	4/1/98
COMP INTERVALS	2
YIELD	7.00442%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
7/1/98	325,119.00	$319,571.13	90
1/1/99	325,119.00	$308,757.79	270
7/1/99	325,119.00	$298,310.33	450
1/1/00	325,119.00	$288,216.39	630
7/1/00	325,119.00	$278,464.00	810
1/1/01	325,119.00	$269,041.60	990
7/1/01	325,119.00	$259,938.02	1170
1/1/02	325,119.00	$251,142.49	1350
7/1/02	325,119.00	$242,644.57	1530
1/1/03	325,119.00	$234,434.19	1710
7/1/03	325,119.00	$226,501.63	1890
1/1/04	325,119.00	$218,837.48	2070
7/1/04	325,119.00	$211,432.66	2250
1/1/05	325,119.00	$204,278.41	2430
7/1/05	325,119.00	$197,366.23	2610
1/1/06	325,119.00	$190,687.94	2790
7/1/06	325,119.00	$184,235.62	2970
1/1/07	325,119.00	$178,001.63	3150
7/1/07	325,119.00	$171,978.58	3330
1/1/08	325,119.00	$166,159.33	3510
TOTALS	$6,502,380.00	$4,700,000.00	

Continued on next page

TABLE H-K-2: SCHEDULE OF CASH ACTIVITY OF Authority K					
DATE	PURCHASES	EARNINGS	REDEMPTIONS	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
1/1/98	10,000,000.00				10,000,000.00
2/1/98		37,000.00	4,700,000.00	4,700,000.00	5,337,000.00
3/1/98		18,000.00	600,000.00	600,000.00	4,755,000.00
4/1/98		14,500.00	4,700,000.00	4,700,000.00	69,500.00
7/1/98		2,300.00			71,800.00
12/31/98		3,500.00			75,300.00
7/1/99		3,567.00			78,867.00
12/31/99		3,500.00			82,367.00
7/1/00		3,700.00			86,067.00
12/31/00		3,769.00			89,836.00
7/1/01		3,800.00			93,636.00
12/31/01		3,801.00			97,437.00
7/1/02		3,850.00	5,000.00	5,000.00	96,287.00
12/31/02		3,700.00			99,987.00
7/1/03		2,803.00			102,790.00
12/31/03		3,016.00	99,774.00	105,806.00	-

Continued on next page

Comprehensive Example, Continued

TABLE H-K-3: YIELD ON Authority K's INVESTMENTS

ISSUE DATE	4/1/98
COMP INTERVALS	2
YIELD	10.82336%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
7/1/98	(69,500.00)	($69,500.00)	0
7/1/98	2,300.00	$2,240.18	90
12/31/98	3,500.00	$3,233.96	270
7/1/99	3,567.00	$3,126.66	450
12/31/99	3,500.00	$2,910.43	630
7/1/00	3,700.00	$2,918.79	810
12/31/00	3,769.00	$2,820.58	990
7/1/01	3,800.00	$2,697.78	1170
12/31/01	3,801.00	$2,559.95	1350
7/1/02	3,850.00	$2,459.84	1530
7/1/02	5,000.00	$3,194.59	1530
12/31/02	3,700.00	$2,242.64	1710
12/31/02	64,500.00	$39094.59	1710
	$35,487.00	$0.00	

Continued on next page

Comprehensive Example, Continued

TABLE H-X-2: SCHEDULE OF INVESTMENT ACTIVITY OF HOSPITAL X - PROJECT FUND					
DATE	PURCHASES	EARNINGS	REDEMPTIONS	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
2/1/98	4,230,000.00	-	-	-	4,230,000.00
3/1/98		15,600.00	1,000,000.00	1,000,000.00	3,245,600.00
4/1/98		16,523.00	500,000.00	500,000.00	2,762,123.00
6/1/98		14,508.00	500,000.00	500,000.00	2,276,631.00
12/31/98		11,986.00	500,000.00	500,000.00	1,788,617.00
6/1/99		10,034.00	750,000.00	750,000.00	1,048,651.00
12/31/99		7,074.00	1,048,651.00	1,055,725.00	-
6/1/00		-			-
12/31/00		-	-		-
6/1/01		-			-
12/31/01		-	-		-
6/1/02		-			-
12/31/02		-			-
6/1/03		-			-

TABLE H-X-3: SCHEDULE OF INVESTMENT ACTIVITY IN RESERVE FUND OF HOSPITAL X					
2/1/98	470,000.00				470,000.00
6/1/98		7,833.00		7,833.00	470,000.00
12/31/98	400,000.00	1,000.00	400,000.00	1,000.00	470,000.00
6/1/99	400,000.00	1,300.00	400,000.00	1,300.00	470,000.00
12/31/99		1,300.00		1,300.00	470,000.00
6/1/00		1,200.00		1,200.00	470,000.00
12/31/00		1,400.00		1,400.00	470,000.00
6/1/01	450,000.00		450,000.00		470,000.00
12/31/01		1,200.00		1,200.00	470,000.00
6/1/02		1,375.00		1,375.00	470,000.00
12/31/02		1,254.00		1,254.00	470,000.00
6/1/03		1,198.00		1,198.00	470,000.00

Continued on next page

TABLE H-Y-2: SCHEDULE OF INVESTMENT ACTIVITY OF Y'S PROJECT FUND

DATE	REDEMPTIONS	EARNINGS	PURCHASES	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
4/1/98	-	-	4,230,000.00	-	4,230,000.00
5/1/98	2,000,000.00	28,199.00	1,928,199.00	100,000.00	4,158,199.00
6/1/98	1,000,000.00	27,899.00	997,899.00	30,000.00	4,156,098.00
7/1/98	2,000,000.00	27,706.00	2,003,198.00	24,508.00	4,159,296.00
12/31/98	1,700,000.00	138,633.00	1,733,633.00	105,000.00	4,192,929.00
6/1/99	3,000,000.00	155,000.00	3,155,000.00	-	4,347,929.00
12/31/99	4,000,000.00	167,000.00	4,157,000.00	10,000.00	4,504,929.00
6/1/00	3,500,000.00	165,000.00	3,515,000.00	150,000.00	4,519,929.00
12/31/00	2,000,000.00	172,000.00	2,152,000.00	20,000.00	4,671,929.00
6/1/01	4,000,000.00	182,000.00	4,072,000.00	110,000.00	4,743,929.00
12/31/01	4,500,000.00	180,990.00	4,580,990.00	100,000.00	4,824,919.00
6/1/02	2,500,000.00	180,280.00	2,570,280.00	110,000.00	4,895,199.00
12/31/02	4,700,000.00	180,495.00	2,880,495.00	2,000,000.00	3,075,694.00
6/1/03	2,800,000.00	100,000.00	1,900,000.00	1,000,000.00	2,175,694.00
12/31/03	2,175,694.00	70,000.00		2,245,694.00	-

TABLE H-Y-3: SCHEDULE OF INVESTMENT ACTIVITY IN RESERVE FUND OF HOSPITAL Y

4/1/98	470,000.00				470,000.00
6/1/98		6,100.00		6,100.00	470,000.00
12/31/98	400,000.00	19,000.00	400,000.00	19,000.00	470,000.00
6/1/99	400,000.00	19,480.00	400,000.00	19,480.00	470,000.00
12/31/99		18,975.00		18,975.00	470,000.00
6/1/00		18,000.00		18,000.00	470,000.00
12/31/00		17,000.00		17,000.00	470,000.00
6/1/01	450,000.00	17,500.00	450,000.00	17,500.00	470,000.00
12/31/01	550,000.00	16,000.00	550,000.00	16,000.00	470,000.00
6/1/02		16,000.00		16,000.00	470,000.00
12/31/02		16,000.00		16,000.00	470,000.00
6/1/03		16,000.00		16,000.00	470,000.00

Continued on next page

TABLE H-Y-4: YIELD ON HOSPITAL Y'S INVESTMENT IN PROJECT FUND

ISSUE DATE	1/1/01
COMP INTERVALS	2
YIELD	7.58558%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
1/1/01	(4,671,929.00)	($4,671,929.00)	0
6/1/01	4,000,000.00	$3,877,817.19	150
6/1/01	182,000.00	$176,440.68	150
6/1/01	(4,072,000.00)	($3,947,617.90)	150
12/31/01	4,500,000.00	$4,177,131.34	360
12/31/01	180,990.00	$168,004.22	360
12/31/01	(4,580,990.00)	($4,252,310.42)	360
6/1/02	2,500,000.00	$2,249,743.30	510
6/1/02	180,280.00	$162,233.49	510
6/1/02	(2,570,280.00)	($2,312,988.08)	510
12/31/02	180,495.00	$155,523.64	720
12/31/02	4,700,000.00	$4,049,758.19	720
12/31/02	(2,880,495.00)	($2,481,980.47)	720
12/31/02	3,075,694.00	$2,650,173.82	1080
	723,765.00	($0.00)	

Continued on next page

TABLE H-Y-5: COMPUTATION OF YIELD REDUCTION PAYMENT

COMPUTATION DATE 1/1/03
COMP INTERVALS 2
YIELD 7.01142%

DATE	CASH FLOWS	FUTURE VALUE	DAYS
1/1/01	(4,671,929.00)	(5,362,329.16)	720
6/1/01	4,000,000.00	4,461,151.47	570
6/1/01	182,000.00	202,982.39	570
6/1/01	(4,072,000.00)	(4,541,452.20)	570
12/31/01	4,500,000.00	4,821,967.36	361
12/31/01	180,990.00	193,939.53	361
12/31/01	(4,580,990.00)	(4,908,752.06)	361
6/1/02	2,500,000.00	2,602,545.73	210
6/1/02	180,280.00	187,674.78	210
6/1/02	(2,570,280.00)	(2,675,708.49)	210
12/31/02	180,495.00	180,529.55	1
12/31/02	4,700,000.00	4,700,899.79	1
12/31/02	(2,880,495.00)	(2,881,046.45)	1
12/31/02	3,075,694.00	3,076,282.82	1
YRP DUE		**$58,685.06**	

Continued on next page

TABLE H-Y-6: PROOF OF YIELD AFTER YIELD REDUCTION PAYMENT

ISSUE DATE 1/1/01
COMP INTERVALS 2
YIELD 7.00150%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
1/1/01	(4,671,929.00)	($4,671,929.00)	0
6/1/01	4,000,000.00	$3,886,933.16	150
6/1/01	182,000.00	$176,855.46	150
6/1/01	(4,072,000.00)	($3,956,897.96)	150
12/31/01	4,500,000.00	$4,200,737.16	360
12/31/01	180,990.00	$168,953.65	360
12/31/01	(4,580,990.00)	($4,276,341.10)	360
6/1/02	2,500,000.00	$2,267,775.63	510
6/1/02	180,280.00	$163,533.84	510
6/1/02	(2,570,280.00)	($2,331,527.34)	510
12/31/02	180,495.00	$157,286.40	720
12/31/02	4,700,000.00	$4,095,659.54	720
12/31/02	(2,880,495.00)	($2,510,112.09)	720
12/31/02	3,075,694.00	$2,680,211.80	720
12/31/02	(58,685.06)	($51,139.15)	720
	665,079.94	(0.00)	

Continued on next page

Comprehensive Example, Continued

TABLE H-K-4: REBATE COMPUTATION

COMPUTATION DATE 1/1/03
COMP INTERVALS 2
YIELD 6.88642%

DATE	CASH FLOWS	FUTURE VALUE	DAYS
1/1/98	(10,000,000.00)	(14,028,779.49)	1800
2/1/98	4,700,000.00	6,556,429.80	1770
2/1/98	37,000.00	51,614.45	1770
3/1/98	600,000.00	832,281.95	1740
3/1/98	18,000.00	24,968.46	1740
4/1/98	4,700,000.00	6,482,861.64	1710
4/1/98	14,500.00	20,000.32	1710
7/1/98	2,300.00	3,119.22	1620
12/31/98	3,500.00	4,589.50	1441
7/1/99	3,567.00	4,520.82	1260
12/31/99	3,500.00	4,289.06	1081
7/1/00	3,700.00	4,382.40	900
12/31/00	3,769.00	4,316.34	721
7/1/01	3,800.00	4,206.20	540
12/31/01	3,801.00	4,068.02	361
7/1/02	5,000.00	5,172.16	180
7/1/02	3,850.00	3,982.56	180
12/31/02	3,700.00	3,700.70	1
12/31/02	64,500.00	64,512.13	1
2/1/98	(470,000.00)	(655,642.98)	1770
6/1/98	7,833.00	10,683.08	1650
12/31/98	1,000.00	1,311.29	1441
6/1/99	1,300.00	1,656.94	1290
12/31/99	1,300.00	1,593.08	1081
6/1/00	1,200.00	1,429.36	930
12/31/00	1,400.00	1,603.31	721
12/31/01	1,200.00	1,284.30	361
6/1/02	1,375.00	1,430.39	210
12/31/02	1,254.00	1,254.24	1
12/31/02	470,000.00	470,088.40	1

Continued on next page

5/1/98	(1,928,199.00)	(2,644,663.47)	1680
5/1/98	2,028,199.00	2,781,820.65	1680
6/1/98	1,027,899.00	1,401,905.29	1650
6/1/98	(997,899.00)	(1,360,989.64)	1650
7/1/98	2,027,706.00	2,749,937.90	1620
7/1/98	(2,003,198.00)	(2,716,700.60)	1620
12/31/98	1,838,633.00	2,410,974.62	1441
12/31/98	(1,733,633.00)	(2,273,289.54)	1441
6/1/99	3,155,000.00	4,021,273.55	1290
6/1/99	(3,155,000.00)	(4,021,273.55)	1290
12/31/99	4,167,000.00	5,106,426.81	1081
12/31/99	(4,157,000.00)	(5,094,172.37)	1081
6/1/00	3,665,000.00	4,365,502.64	930
6/1/00	(3,515,000.00)	(4,186,832.68)	930
12/31/00	2,172,000.00	2,487,421.90	721
12/31/00	(2,152,000.00)	(2,464,517.47)	721
6/1/01	4,182,000.00	4,655,221.25	570
6/1/01	(4,072,000.00)	(4,532,774.02)	570
12/31/01	4,680,990.00	5,009,834.38	361
12/31/01	(4,580,990.00)	(4,902,809.28)	361
6/1/02	2,680,280.00	2,788,254.98	210
6/1/02	(2,570,280.00)	(2,673,823.63)	210
12/31/02	4,880,495.00	4,881,412.96	1
12/31/02	(2,880,495.00)	(2,881,036.79)	1
12/31/02	3,075,694.00	3,076,272.50	1
4/1/98	(470,000.00)	(648,286.16)	1710
6/1/98	6,100.00	8,319.52	1650
12/31/98	19,000.00	24,914.44	1441
6/1/99	19,480.00	24,828.66	1290
12/31/99	18,975.00	23,252.81	1081
6/1/00	18,000.00	21,440.39	930
12/31/00	17,000.00	19,468.77	721
6/1/01	17,500.00	19,480.24	570
12/31/01	16,000.00	17,124.02	361
6/1/02	16,000.00	16,644.56	210
12/31/02	16,000.00	16,003.01	1
12/31/02	470,000.00	470,088.40	1

Continued on next page

Comprehensive Example, Continued

1/1/99	(1,000.00)	(1,311.04)	1440
1/1/00	(1,000.00)	(1,225.21)	1080
1/1/01	(1,000.00)	(1,145.01)	720
1/1/02	(1,000.00)	(1,070.05)	360
1/1/03	(1,000.00)	(1,000.00)	0
1/1/03	(58,685.06)	(58,685.06)	0
REBATE DUE		**$(15,429.14)**	

Summary

Review of Lesson 5

In a pooled financing issue, the issuer loans the proceeds to two or more borrowers. The two different types of pooled financing issues are:

- governmental, and
- qualified 501(c)(3)

Generally, proceeds of a pooled financing issue may be invested at unrestricted yield during a three or five-year temporary period. Any temporary period is split between the issuer and the conduit borrower, with the issuer limited to six months (or two years for construction issues.)

The yield restriction rules are applied based on the yield of the pooled financing issue. This yield is determined differently depending on whether or not the conduit loans are tax-exempt obligations.

A pooled financing issue may qualify for any of the spending exceptions or the small issuer exception to rebate. The issuer can treat all of the loans as one issue, or elect to apply the spending exceptions separately to each loan. In addition, if any of the proceeds will be used for construction expenditures, the issuer may elect to bifurcate the issue into two issues – one construction issue and one non-construction issue. If the two-year spending exception is met, then the construction portion will not be subject to rebate. However, the eighteen-month spending exception cannot be used for the non-construction issue.

Other rules under §§ 149(f) and 147(b)(4) also may apply to certain pooled financing issues.

The provisions of § 149(g) also apply to pooled financing issues.