

Lesson 6

Proceeds and Allocations

Overview

Purpose

The applicable rules concerning tax-exempt bonds focus on the use and investment of the proceeds of the bonds. To determine whether the bond issue complies with § 103, it is important to determine what constitutes the "proceeds" (and net proceeds, gross proceeds and other variations of proceeds) of the bond issue. With the exception of "**net proceeds**," these concepts of "**proceeds**" are not defined in the Code. Definitions are found in various parts of the regulations. Sometimes the definitions are the same, but sometimes there are different definitions of the same term for different purposes. Some definitions apply for all purposes of §§ 141 through 150 while others apply on a more limited basis. The first three sections in this lesson will enable you to identify the various types of proceeds.

In determining compliance with the tax rules governing how the proceeds may be used or invested, it is necessary to measure and track the proceeds. Therefore, the Code and regulations contain various rules on the allocation of proceeds to investments and expenditures. There are also rules on the allocation of bonds to those proceeds and to the purposes to which the proceeds are allocated. The other sections of this lesson will enable you to determine if the allocation rules are being applied correctly by the issuer.

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Overview, Continued

Proceeds

Since the definition of proceeds is different for different purposes, the context in which the proceeds are being considered is critical. Consider:

Section 141 provides that a bond is a private activity bond if more than a specified amount of the "proceeds" of the bond are used:

- for a private business use and the private security or payment test is met, **or**
- to make or finance private loans **or**
- to acquire nongovernmental output property.

To be eligible for tax exemption as a qualified private activity bond, the “**net proceeds**” of the bond must be used in specified ways.

Section 148(a)(1) provides that a bond is an arbitrage bond if the "**proceeds**" of the bond are reasonably expected, at the time of issuance, to be invested in higher yielding investments. Section 148(f)(4)(B)(i) provides that a bond is to be treated as complying with the rebate requirement if the “**gross proceeds**” of the bond are spent within six months of the issue date.

Allocations

The allocation rules govern the manner in which an issuer may account for its use of proceeds of a bond issue. Allocations to investments are critical in determining compliance with yield restriction and rebate under § 148, as is the timing of allocations to expenditures. Allocations to types of expenditures are critical in determining compliance with many of the rules under §§ 141 to 150. When multiple sources of financing are used, appropriate allocations must be made from the sources. When a bond issue finances more than one activity, it may be important to allocate portions of the bond issue to the respective activities.

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Overview, Continued

Objectives

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

- Identify gross proceeds for arbitrage purposes, including sale proceeds, investment proceeds, transferred proceeds and replacement proceeds
- Describe proceeds and net proceeds in the context of the private activity bond tests and the exempt facility bond rules
- Identify and allocate bonds to a bond issue and to portions of a multi-purpose bond issue
- Apply the universal cap rule to a set of facts
- Allocate proceeds to capital expenditures and working capital expenditures
- Explain the general rules for proper reimbursement allocations

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Overview, Continued

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Section 1

Proceeds of the Bonds Defined – § 148

Proceeds

Definition

Various categories of “proceeds” are defined in the arbitrage regulations as shown below:

Under Regulations:	Type of “proceeds”:	Purpose:
§ 1.148-1(b)	gross proceeds sale proceeds investment proceeds transferred proceeds	Arbitrage and Rebate
§ 1.148-1(c)	replacement proceeds	Arbitrage and Rebate
§ 1.148-10(c)	excess gross proceeds	Arbitrage

Prior Definitions

Proceeds are defined in various sections of the withdrawn arbitrage regulations as shown below:

Under Regulations:	Proceeds include:	Purpose:
§ 1.103-13(b)(2)	original proceeds and investment proceeds	Arbitrage
§ 1.103-13(g)	amounts in a sinking fund (replacement proceeds)	Arbitrage
§ 1.103-14(e)	transferred proceeds	Arbitrage
§1.103-15	excess proceeds	Arbitrage

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Proceeds, continued

**Allowable
Return on
Purpose
Investments
Is Excluded**

For purposes of defining “**proceeds**” for the arbitrage rules, Regulations § 1.148-1(b) provides that proceeds do not include amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under Regulations § 1.148-2(d) or § 143(g) or to qualified administrative costs recoverable under Regulations § 1.148-5(e).

Note

Other definitions of proceeds found in certain withdrawn regulations may be applicable to certain bond issues.

Sale Proceeds

Definition

Under Regulations § 1.148-1(b), “**sale proceeds**” means any amounts actually or constructively received from the sale of an issue. This includes amounts paid as underwriter's discount or other compensation, and any accrued interest (other than pre-issuance accrued interest).

Sale proceeds also include any amounts received as a result of a sale of a right associated with the bond. The transfer of rights associated with the bond is discussed in Regulations § 1.148-4(b)(4) and is more fully discussed in the Phase II, Lesson 2, Advanced Topics in Arbitrage text. In addition, a transfer of rights could result in a reissuance of the bonds, as described in the Phase III, Lesson 4, Reissuance text.

Sale proceeds (as well as issue price) will be adjusted to reflect amounts received or paid by the issuer in connection with the termination of an anticipatory hedge entered into before the issuance of bonds if the hedge was expected to be terminated in connection with the issuance. This is discussed in Regulations § 1.148-4(h)(5) and is more fully discussed in the Phase II, Lesson 2, Advanced Topics in Arbitrage text.

Note

Due to the exclusion of pre-issuance accrued interest, the amount of sale proceeds will not always be equal to the issue price of the bonds.

Net Sale Proceeds

Definition Regulations § 1.148-1(b) defines “**net sale proceeds**” as sale proceeds less the portion of sale proceeds invested in a reasonably required reserve or replacement fund under § 148(d) and as a part of a minor portion under § 148(e).

Investment Proceeds

Definition

Regulations § 1.148-1(b) defines “**investment proceeds**” as any amounts actually or constructively received from investing proceeds of an issue.

Because “**proceeds**,” as defined under Regulations § 1.148-1(b), does not include replacement proceeds, investment earnings on replacement proceeds are not investment proceeds. For example, investment proceeds do **NOT** include investment earnings with respect to the investment of amounts treated as gross proceeds because they are in a debt service fund or other sinking fund. However, such earnings may constitute gross proceeds for independent reasons, as discussed below.

Prior Definitions

Regulations § 1.103-13(b)(2)(ii)(A) defines investment proceeds as amounts received by the issuer, such as interest and dividends, resulting from the investment of proceeds.

Regulations § 1.103-13(b)(2)(ii)(B) provides that investment proceeds do **NOT** include receipts from investment of amounts treated as proceeds because they are in a sinking fund.

Transferred Proceeds

Applicable Regulations

Due to the various arbitrage regulations issued by the Service under § 148, an agent must determine the regulation applicable to the issue under audit so as to determine the appropriate definition of “**transferred proceeds**”. Generally, these are unspent proceeds of a prior bond issue, which has been refunded. These unspent proceeds will transfer to the refunding bond and will no longer be proceeds of the prior issue. Utilizing the appropriate definition is critical in determining the amount and the date on which the transferred proceeds are "transferred" to the refunding issue.

1993 Regulations

Transferred proceeds are defined in Regulations § 1.148-9(b). When proceeds of a refunding issue are used to make principal payments on the refunded bonds, any unspent proceeds of the refunded issue become proceeds of the refunding issue. The unspent proceeds "transfer over" to the refunding issue in amounts based on a formula provided in Regulations § 1.148-9(b)(1).

1992 Regulations

Transferred proceeds are defined in § 1.148-11(c)(9) of the 1992 regulations. The definition in this section is similar to the definition in Regulations § 1.148-9(b). The formula for transfer amounts is also similar to the 1993 definition, and is found in § 1.148-11(d) of the 1992 regulations.

1989 Regulations

Regulations § 1.148-8T(d)(8) defines transferred proceeds. "Transferred proceeds" means, with respect to a refunding issue, proceeds that have ceased to be proceeds of a refunded issue and are transferred proceeds of the refunding issue by reason of Regulations § 1.148-4T(e)(2) (including amounts actually or constructively received from investing such proceeds). The formula for transfer amounts under Regulations § 1.148-4T(e)(2) was quite different from prior and subsequent regulations, and used a “dollar for dollar” approach.

1979 Regulations

Regulations § 1.103-14(e)(2)(ii) defines transferred proceeds. The definition in this section is similar to the definition in Regulations. § 1.148-9(b), as is the formula for the transfer amounts.

Gross Proceeds

Definitions

Although § 148(a) only refers to proceeds of the bond, Regulations § 1.148-2(a) provides that the direct or indirect investment of the "**gross proceeds**" of an issue in higher yielding investments causes the bond issue to be an arbitrage bond.

"Gross proceeds" are referred to in § 148(f)(4)(B), and the term is defined in § 148(f)(6)(B):

Except as otherwise provided by the Secretary, the gross proceeds of an issue include--(i) amounts received (including repayments of principal) as a result of investing the original proceeds of the issue, and (ii) amounts to be used to pay debt service on the issue.

Gross proceeds are defined in Regulations § 1.148-1(b) to include proceeds and replacement proceeds, which is broader than the definition in the statute, as it includes certain replacement proceeds that might not be intended to be used for debt service. This definition in Regulations § 1.148-1(b) is to be applied in determining compliance with the arbitrage and rebate rules.

Application

In determining whether the bonds are arbitrage bonds, the examining agent must determine whether, in addition to the "proceeds" (sale proceeds, investment proceeds and transferred proceeds), the bond issue has any replacement proceeds.

Replacement Proceeds

Definition

Regulations § 1.148-1(c) defines **replacement proceeds**:

Amounts are replacement proceeds of an issue if they have a sufficient direct nexus to:

- the bond issue **or**
- the governmental purpose of the issue

to conclude that the amounts would have been used for the governmental purpose if the bonds were not used for such purpose.

For this purpose, payment of debt service is considered a governmental purpose of the issue. If an issuer sets aside moneys to be used to pay debt service on the bonds on a particular date, such amounts are considered replacement proceeds of the bonds.

The mere earmarking of funds for a governmental purpose, however, does not establish a nexus to cause the amounts to be replacement proceeds.

Replacement proceeds include, but are not limited to, sinking funds and pledged funds and certain “other replacement proceeds,” in each case to the extent that such amounts are held by or derived from a substantial beneficiary of the issue. For this purpose a substantial beneficiary of an issue includes the issuer and any related party to the issuer, and if the issuer is not a state, the state in which the issuer is located. A person is **not** a substantial beneficiary solely because they are a guarantor of the issue under a qualified guarantee.

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Replacement Proceeds, Continued

Sinking Fund Regulations § 1.148-2(c)(2) provides that a sinking fund includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay debt service on the bonds.

Example 1 City X has certain bonds outstanding. City X sells some real property and the city council decides to set aside the proceeds of the sale of the real property to pay the debt service on the bonds. The proceeds from the sale of the real property are considered replacement proceeds and investments of such moneys, and rebate of earnings on such moneys, must comply with § 148.

See also Rev. Rul. 79-134, 1979-1 C.B. 76; Rev. Rul. 80-13, 1980-1 C.B. 27.

Pledged Funds A pledged fund is any amount that is directly or indirectly pledged to pay the principal of or interest on the bonds. A pledge by the issuer must provide reasonable assurance that such moneys will be available to pay the debt service on the bonds even if the issuer has financial difficulties. A party other than the issuer or conduit borrower may provide a pledge to secure the debt service on the bonds. A pledge to a guarantor of bonds is an indirect pledge.

See Regulations § 1.148-1(c)(3)(i).

Example 2 County X, a political subdivision of State Y will sell \$50 million principal amount of bonds to finance the construction of a facility. State Y has surplus funds in the amount of \$50 million which it will invest in U.S. Treasury notes and pledges not to dispose of the notes while the bonds are outstanding. However, State Y does not reasonably expect to use the notes to pay debt service on the bonds. Because the notes are pledged as security for the bonds, the notes form a pledged fund for the bonds.

See Rev. Rul. 78-348, 1978-2 CB 95.

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Replacement Proceeds, Continued

Example 3 State A issued \$1 million principal amount of bonds and lent the proceeds to Corporation B. Corporation B owns a federally insured mortgage note to be pledged as collateral for bonds. The note has a materially higher yield than the yield on the bonds. There is reasonable assurance that the collateral will be available to pay debt service on the bonds. Accordingly, pledge of the mortgage note creates replacement proceeds.

See Rev. Rul. 78-348, 1978-2 C.B. 95.

Example 4 City Z issues \$10 million principal amount of bonds and loans the proceeds to Corporation X to construct a facility. Corporation X enters into an agreement with Bank A, which will provide a letter of credit as security for the bonds. Corporation transferred \$3 million to Bank A which Bank A sets aside in a separate account, which can only be used to pay any draws on the letter of credit. The \$3 million in the special account is a pledged fund.

See also PLR 8844042.

Negative Pledge Under Regulations § 1.148-1(c)(3)(ii), a negative pledge is holding certain amounts pursuant to an agreement for the benefit of the bondholders or a guarantor that such amounts, although not pledged, will be maintained at a certain level. **Such amounts will be replacement proceeds unless:**

- The issuer or a substantial beneficiary may grant rights in the funds to a party that are superior to the rights of the bondholders or guarantor; **or**
- The amounts do not exceed the reasonable needs for which they are maintained, the required level is tested no more frequently than every 6 months, **and** the amounts may be spent without substantial restrictions, other than the requirement to replenish the amounts by the next testing date.

See also PLR 8841027.

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Replacement Proceeds, Continued

Other Replacement Proceeds

Other replacement proceeds (Regulations § 1.148-1(c)(4)) may arise if on the issue date, the issuer reasonably expects that:

- the bonds will be outstanding longer than necessary for the governmental purpose; **and**
- there will be “available amounts” during the time that the bonds are outstanding longer than necessary

Available amounts are defined in Regulations § 1.148-6(d)(3)(iii). Available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of the issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

A determination whether the issue will be outstanding longer than necessary is made under Regulations § 1.148-10, which discusses abusive arbitrage devices arising from, among other things, overburdening the tax-exempt market by issuing too many bonds, issuing bonds too early or allowing bonds to remain outstanding too long.

The replacement proceeds are created at the beginning of each fiscal year in an amount equal to the available amounts. Essentially, the available amounts are treated as if they are proceeds.

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Replacement Proceeds, Continued

Safe Harbor

Regulations § 1.148-1(c)(4)(B) provides safe harbors against creation of “other replacement proceeds” for the portions of an issue used for certain purposes, if certain criteria is met:

Purpose	Safe Harbor Criteria
Finance restricted working capital expenditures	Bonds outstanding no longer than two years
Financing or refinancing capital projects	Weighted average maturity of bonds not greater than 120% of average reasonable expected economic life of financed capital projects
Refunding of bonds	Weighted average maturity of bonds not greater than weighted average maturity of the prior bonds and the prior bond issue met one of the two preceding safe harbor criteria

Excess Gross Proceeds

Definition

Regulations § 1.148-10(c)(1) provides that advance refunding bonds utilize an abusive device and are arbitrage bonds if the issue has any excess gross proceeds.

“**Excess gross proceeds**” are defined in Regulations § 1.148-10(c)(2) as all gross proceeds of an advance refunding issue that exceed an amount equal to one percent of the sale proceeds of the issue, exclusive of gross proceeds allocable to:

- (i) Payment of principal, interest, or call premium on the prior issue;
 - (ii) Payment of pre-issuance accrued interest on the refunding issue, and interest on the refunding issue that accrues for a period up to the completion date of any capital project for which the prior issue was issued, plus one year;
 - (iii) A reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund;
 - (iv) Payment of costs of issuance of the refunding issue;
 - (v) Payment of administrative costs allocable to repaying the prior issue, carrying and repaying the refunding issue, or investments of the refunding issue;
 - (vi) Transferred proceeds that will be used or maintained for the governmental purpose of the prior issue;
 - (vii) Interest on purpose investments;
 - (viii) Replacement proceeds in a sinking fund for the refunding issue;
 - (ix) Qualified guarantee fees for the refunding issue or the prior issue; and
 - (x) Fees for a qualified hedge for the refunding issue.
-

Excess Gross Proceeds, Continued

Application

To limit potential abuses in connection with advance refundings, the regulations limit the amount of gross proceeds permitted in connection with an advance refunding. Except for a de minimis amount equal to one percent of the sale proceeds of the issue, all gross proceeds of the advance refunding issue must fit within one of the 10 categories of permitted gross proceeds. Certain of the categories are described in terms of how the gross proceeds are applied, e.g., payment of costs of issuance. Other categories are based upon the reason the amounts constitute gross proceeds, e.g., replacement proceeds in a sinking fund for the refunding issue.

Disposition Proceeds

General

The term “**disposition proceeds**” is not used under § 148 or the related regulations. However, with respect to a change in use, Regulations § 1.141-12(a)(4) of the private activity bond regulations provides that disposition proceeds must be treated as gross proceeds for purposes of § 148 as a condition of the remedial action being effective for purposes of § 141.

Application

An agent examining a transaction where disposition proceeds may have resulted should analyze the transaction under § 141 and the related regulations, **and** should also analyze the treatment of disposition proceeds under § 148 and the related regulations.

Section 2

Proceeds of the Bonds Defined – § 141

Proceeds

Definition Proceeds are defined in the regulations as shown below:

Under Regulations	Proceeds include	Purpose
§ 1.141-1(b)	<ul style="list-style-type: none">• sale proceeds, other than those used to retire bonds of the issue but were not in a reasonably required reserve or replacement fund• investment proceeds during the construction period, net of rebate amounts• disposition proceeds in connection with change-in-use remediation permitted under Regulations § 1.141-12(e)• Commissioner may treat any replaced amounts as proceeds	Private activity bond tests

Sale Proceeds

Definition

Regulations § 1.141-1(a) incorporates the definition of “**sale proceeds**” from § 1.148-1(b) for purposes of applying the private activity bond regulations in §§ 1.141-0 through 1.141-16.

Under Regulations § 1.148-1(b), sale proceeds means any amounts actually or constructively received from the sale of an issue. This includes amounts paid as underwriter's discount or other compensation, and any accrued interest (other than pre-issuance accrued interest).

Sale proceeds also include any amounts received as a result of a sale of a right associated with the bond. The transfer of rights associated with the bond is discussed in Regulations § 1.148-4(b)(4).

Remember

Due to the exclusion of pre-issuance accrued interest, the amount of sale proceeds will not always be equal to the issue price of the bonds.

Investment Proceeds

Definition Regulations § 1.141-1(a) incorporates the definition of “**investment proceeds**” from § 1.148-1(b) for purposes of applying the private activity bond rules in Regulations §§ 1.141-0 through 1.141-16. Regulations § 1.148-1(b) defines investment proceeds as any amounts actually or constructively received from investing proceeds of an issue.

Application Proceeds for purposes of § 141 include any investment proceeds that accrue during the project period (net of rebate amounts attributable to the project period). Project period is defined in Regulations § 1.141-1(b) as the period beginning on the issue date and ending on the date that the project is placed in service.

Replaced Amounts

Definition

Replaced amounts are defined in Regulations § 1.141-1(b) as replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds. Regulations § 1.141-1(a) incorporates the definition of “**replacement proceeds**” from Regulations § 1.148-1. Effectively, replaced amounts are other replacement proceeds as defined in Regulations § 1.148-1(c)(4).

Disposition Proceeds

General

If a change in use of property causes the bond issue that financed the property to meet the private activity bond tests under § 141, the issuer may be able to remedy the violation. The methods for such remedial action by the issuer focus on “**disposition proceeds**” that may arise from the change in use of the property.

Disposition proceeds occur when an issuer or conduit borrower sells, exchanges or otherwise disposes of all or a portion of a bond-financed facility and receives cash or other amounts (including property, such as an agreement to provide services) in return. The amounts received are the disposition proceeds.

See Regulations § 1.141-12(c).

Application

An agent examining a transaction where disposition proceeds may have resulted should analyze the transaction under § 141 and the related regulations **and** should also analyze the treatment of disposition proceeds under § 148 and the related regulations.

Section 3

Proceeds of the Bonds – Other Code Provisions

Proceeds

Use Tests

Proceeds and net proceeds are part of the use of proceeds tests of other Code provisions. Some of them are shown below:

Code Section	Test	Purpose
§ 142(a)	95% or more of the “ net proceeds ” of an issue	Exempt Facility Bonds
§ 143(a)(2)	all “ proceeds ” of such issue (exclusive of issuance costs and a reasonably required reserve) – referred to as lendable proceeds in Regulations § 6a.103A-2(b)(1)(i)	Mortgage Revenue Bonds
§ 144(a)	95% or more of the “ net proceeds ” of the issue	Qualified Small Issue Bonds
§ 144(b)	“ net proceeds ” of which are to be used	Qualified Student Loan Bonds
§ 144(c)	95% or more of the “ net proceeds ”	Qualified Redevelopment Bonds

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Proceeds, Continued

Use Tests, continued

Code Section	Test	Purpose
§ 145(a)	100% of the “ net proceeds ” used to finance property owned and 95% of the “ net proceeds ” used	Qualified 501(c)(3) Bond
§ 147(c)	25% or more of the “ net proceeds ”	Limit on Land Acquisition for Qualified Private Activity Bonds
§147(g)	2 % of the “ proceeds ”	Limit on Costs of Issuance for Qualified Private Activity Bonds
§149(f)(2)	30 % of the “ net proceeds ” 95 % of the “ net proceeds ”	Required Expectations As To Amount Used To Make Loans From Pooled Financing Issues Within One Year And Three Years

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Proceeds, Continued

Definition Sections 142, 143, 144, 145, and 147 do not contain separate definitions of proceeds or net proceeds. Because bonds described in §§ 142, 143, 144, and 145 are described in § 141(e)(1), and § 147 is directly referred to in § 141(e)(3) related to qualified bonds, use of the definitions under § 141 would be applicable unless otherwise noted.

Note Section 150 provides a definition of net proceeds but does not define proceeds.

Net Proceeds

Definitions

Sections 142, 143, 144, 145, and 147 are in Subpart A of Part IV of Subchapter B of Chapter 1 of Subtitle A of the Code. Subpart C of Part IV contains § 150, which is entitled “Definitions and special rules.”

Section 150 provides definitions for purposes of “this part”, which means Part IV, including §§ 141 through 150.

Section 150(a)(3) defines net proceeds as the proceeds of an issue reduced by amounts in a reasonably required reserve or replacement fund.

The regulations under § 150 do not contain a definition of proceeds.

Because bonds described in §§ 142, 143, 144, and 145 are described in § 141(e)(1), and § 147 is directly referred to in § 141(e)(3) related to qualified bonds, use of the definitions related to “proceeds” found in § 141 would be applicable to determine the "proceeds" unless otherwise noted. Once the correct proceeds are determined the adjustment required by § 150(a)(3) is used to determine what is net proceeds.

Section 149(f)(2) defines net proceeds by reference to the definition in § 150, modified to exclude proceeds applied to costs of issuance and interest during the loan period.

Section 4

Allocations Generally

Overview of Allocation Rules

**General Types
of Allocations**

Unless the use and investment of proceeds of an issue comply with §§ 141 through 150, the interest on the bonds of the issue will not be excludible from the bondholders' gross income. Such compliance often depends on the answers given to the following four general allocation questions:

1. Were the bonds of the bond issue properly identified and allocated to the issue?
2. Were the proceeds of the allocable bonds properly identified and allocated to the bond issue?
3. Were the proceeds properly allocated to expenditures and investments?
4. To what property, if any, were the proceeds allocated upon expenditure?

The Code and accompanying regulations provide issuers with detailed guidance for the proper allocation and accounting of bond proceeds. Currently, allocation rules are found primarily in Regulations § 1.148-6. These rules apply not only for arbitrage and rebate purposes but also for purposes of allocating proceeds to expenditures for § 141 purposes.

See Regulations § 1.141-6(a).

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Overview of Allocation Rules, Continued

General Types of Allocations, continued

Note that most of the private activity bond tests allocation and accounting rules in Regulations § 1.141-6 are currently reserved. Proposed regulations were issued on September 26, 2006, to address, among other things, the question of what is the bond-financed property, or project, so that private business use of that property and, thus, of the proceeds can be determined.

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

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

Summary

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

1. allocating bonds to the issue;
2. allocating proceeds to bonds of the issue; and
3. allocating proceeds of the issue to expenditures (and property, if applicable) and investments

Failure to comply with the Code and applicable regulations with respect to allocations may result in the incorrect calculation of the required payment of rebate by the issuer or a determination that interest on the bonds is not tax-exempt. The rules that govern these allocations will be covered in the following sections.

Section 5

Allocations of Bonds to an Issue

General Rule

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

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

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

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

Example 1 Series A bonds are sold on April 1, 2009, to finance the acquisition of land as a site for City A's future municipal water facility and are issued on April 25, 2009. Series B bonds are sold on April 8, 2009, to finance the construction of the water facility and are issued on May 15, 2009. Both Series A bonds and Series B bonds mature in twenty years and will be paid from water fees levied on City residents. The Series A bonds and Series B bonds should be identified as bonds of the same issue and allocated to that issue. The dates of the issuance of the bonds are not relevant.

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General Rule, Continued

Example 2

City A sold and issued Series A bonds on April 1, 2009, for the purpose of financing its operating expenses. The Series A bonds mature in six months. City A also sold its Series B bonds on April 1, 2009, which were issued on April 8, 2009, for the purpose of financing sewer improvements. The Series B bonds mature in 20 years. The Series A bonds and Series B bonds should not be identified as bonds of the same issue since the bonds are not part of the same plan of financing.

See Regulations § 1.150-1(c)(1)(ii).

Allocation of Taxable and Tax-Exempt Bonds

Regulations § 1.150-1(c)(2) provides that taxable bonds and tax-exempt bonds are not part of the same issue, regardless of their security or source of payment and the timing of their sales.

An allocation of tax-exempt bonds to a separate issue in a transaction (or series of related transactions) that includes taxable bonds may, however, result in the creation of an abusive arbitrage device or other abusive structure (e.g., structures involving windows or unreasonable allocations of bonds). *See, e.g., Regulations § 1.148-10(d), example 3.*

An allocation of tax-exempt bonds to a separate issue in a transaction (or series of related transactions) that includes taxable bonds may also result in the creation of an abusive structure transferring significant benefits of a tax-exempt financing in a manner that is inconsistent with the purposes of § 141. *See, e.g., Regulations § 1.141-14(b), examples 4, 5, 6.*

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Permissive Exception

Bonds Financing Separate Purposes

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

- Examples of separate purposes include refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose.
- Each of these separate issues, when tested independently, must be comprised of tax-exempt bonds.

This permissive exception does **not** apply for purposes of §§ 141, 144(a), 148, 149(d), and 149(g). However, Regulations § 1.141-13(d)(1) provides separate authority for multi-purpose issue allocations for purposes of § 141.

Reasonable Allocation Method Required

Under Regulations § 1.150-1(c)(3), bonds must be allocated between each of the separate issues using a reasonable, consistently applied allocation method.

- An allocation is not reasonable if it achieves more favorable results under §§ 103 and 141 through 150 than could be achieved with actual separate issues.
 - All allocations with respect to this permissive separate issues exception must be made in writing on or before the issue date.
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Permissive Exception, Continued

Practical Application

The permissive allocation rule of Regulations § 1.150-1(c)(3) does not permit separate testing of bonds of the same issue (under the general definition) for compliance with §§ 141, 144(a), 148, 149(d), and 149(g). Regulations § 1.141-13(d)(1) permits separate issue treatment for purposes of section 141. Thus, generally, bonds in one bond issue could consist of an issue of qualified private activity bonds and bonds that are tax-exempt governmental bonds. However, a single issue cannot comprise a qualified small issue bond under § 144(a) and a qualified exempt facility bond under § 142.. Finally, all the proceeds and bonds of an issue are generally analyzed together for purposes of complying with the arbitrage rules, including rebate, and the limits on advance refundings.

Certain specific rules under §§ 141, 148 and 149(d), or the applicable regulations, provide for separate issue treatment of bonds for specific purposes under such sections. For example, § 141(b)(9) provides that an issuer may elect to treat bonds as a separate qualified 501(c)(3) bond issue for purposes of the private business tests and the private loan test of § 141.

Regulations under §§ 148 and 149 provide for separate issue accounting for certain refunding purposes. Regulations § 1.141-13(d) requires similar and consistent accounting for separate testing of bonds under § 141. These rules will be considered in the following section.

Section 6

Multipurpose Issue Allocations

Introduction

Introduction

Multipurpose allocation rules may apply where the proceeds of the bonds in a single issue, as described in Section 5, are used to finance or refinance distinct and separate governmental purposes. Typically, these involve separate projects, separate refundings or a refunding and a new project.

Regulations § 1.148-9(h) applies to allocations of multipurpose issues, including allocations involving refunding purposes of the issue. Consistent allocations are required for allocations under Regulations §§ 1.141-13(d) and 1.150-1(c)(3).

Separate Purposes

What is a Separate Purpose?

Regulations § 1.148-9(h)(3)(i) provides that separate purposes of a multipurpose issue include:

- refunding a separate prior issue
 - financing a separate purpose investment
 - financing a construction issue (as defined in Regulations § 1.148-7(f))
 - any clearly discrete governmental purpose reasonably expected to be financed by that issue
-

Capital Projects

Generally, capital projects that are (i) integrated or functionally related **and** (ii) qualify for the same initial temporary period under Regulations § 1.148-2(e)(2), are treated as having a single governmental purpose.

Example 1

City issues bonds and loans the proceeds to a qualified 501(c)(3) organization. The organization uses part of the funds to build an addition to a medical office building. The rest of the funds are used to build a parking lot adjacent to a hospital on the other side of City. Even though both projects qualify for the general three-year temporary period, they are not integrated or functionally related. Therefore, they are **not** treated as having a single governmental purpose.

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Separate Purposes, Continued

Refunding Issues

Regulations § 1.148-9(h)(3)(i) provides that the separate purposes of a refunding issue include the separate purposes of the prior issue, if any.

Financing Common Costs

Common costs of a multipurpose issue are **not** separate purposes.

Common costs include:

- issuance costs,
- accrued interest,
- capitalized interest on the issue,
- reserve or replacement fund,
- qualified guarantee fees, **and**
- similar costs properly allocable to the separate purposes of the issue

See Regulations § 1.148-9(h)(3)(ii).

Rules on Allocations of Multipurpose Issues

General Rule

As discussed above, the regulations permit allocation of portions of a bond issue among the issue's separate purposes. How are such allocations to be made?

Regulations § 1.148-9(h)(2)(i) provides generally that proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method.

An allocation is not reasonable if it achieves more favorable results under §§ 148 or 149(d) than could be achieved with actual separate issues.

An allocation may be made at any time, but once made may **not** be changed.

Allocations of Common Costs

Regulations § 1.148-9(h)(2)(ii) provides that a ratable allocation of common costs among the separate purposes of the multipurpose issue is generally reasonable.

Another method may be used if it more accurately reflects the economic benefit or burden of the costs.

Allocations of Bonds of a Multipurpose Issue

Introduction If an issuer treats a bond issue as a multipurpose issue having separate purposes, the issuer must also allocate each bond in the bond issue to the separate purposes of the multipurpose issue.

Safe Harbor for Allocation of Bonds Regulations § 1.148-9(h)(4)(i) provides that the portion of the bonds of a multipurpose issue allocated to a separate purpose must have an issue price that bears the same ratio to the aggregate issue price of the multipurpose issue as the portion of the sale proceeds of the multipurpose issue used for that separate purpose bears to the aggregate sale proceeds of the multipurpose issue.

Regulations § 1.148-9(h)(4)(ii) provides that this pro rata method of allocation based on the relative amount of sales proceeds will be considered to be a reasonable method of allocating the bonds of a multipurpose issue.

Allocation of Refunding Bonds The rules with respect to allocations of bonds used to refund two or more prior issues are discussed in the Phase III, Lesson 3, Refundings text.

Safe Harbor for Allocation of Purpose Investments Regulations § 1.148-9(h)(4)(iii) provides that an allocation of a portion of the bonds of a multipurpose issue to a particular purpose investment is generally reasonable if that purpose investment has principal and interest payments that reasonably coincide in time and amount to principal and interest payments on the bonds allocated to that purpose investment.

Example 2 Housing Authority X issues a \$10,000,000 bond issue to finance qualified mortgage loans for owner-occupied residences under § 143. The Authority originates \$5,000,000 of loans at 5 percent and six months later originates \$5,000,000 of loans at 6.5 percent. A portion of the maturing bonds can be allocated to each purpose investment (loans) as long as the principal and interest payments of both coincide in time and amount.

Section 7

Allocation of Proceeds to Bond Issues

Overview

Introduction

Once bonds have been properly identified and allocated to an issue, proceeds of the bonds must be properly identified and allocated to the bonds of the issue. In order to complete this step, a basic understanding of the term "**proceeds**" and its related terms is necessary. This will provide an opportunity to review certain items from Sections 1, 2 and 3. Remember that the definition of "proceeds" provided in Regulations § 1.141-1 for qualification purposes is somewhat different from the definition provided in Regulations § 1.148-1(b) for arbitrage and rebate purposes.

One Issue Rule

The Rule

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

Example 1

City A issues bonds for water and sewer improvements and places 5% of the proceeds of the bonds in a reserve fund which is pledged to benefit the bonds and a prior bond issue. The amount deposited into the reserve fund constitutes sales proceeds of the new bonds. However, under the replacement proceeds definition of Regulations § 1.148-1(c), these pledged amounts also constitute gross proceeds of the prior bond issue. To prevent counting these proceeds twice, the one-issue rule provides that the amounts are allocable only to the new bond issue.

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

Universal Cap Rule

General Rule

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

The value of all outstanding bonds is referred to as the universal cap.

For purposes of the universal cap rule, gross proceeds allocable to cash, tax-exempt bonds that would be non-purpose investments (except for the specific exception provided for in § 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as non-purpose investments.

Non-purpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the non-purpose investments for purposes of the universal cap rule.

For purposes of the universal cap rule, the values of bonds and investments are determined under Regulations §§ 1.148-4(e) and 1.148-5(d) respectively. Valuation is discussed in the Phase II, Lesson 2, Advanced Topics in Arbitrage text.

Example 2

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

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Universal Cap Rule, Continued

Universal Cap Deallocating Procedures

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

1. non-purpose investments allocable to replacement proceeds;
 2. non-purpose investments allocable to transferred proceeds;
 3. non-purpose investments allocable to sale proceeds and investment proceeds.
-

Example 3

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

This rule is beneficial to the issuer when the proceeds of the reserve fund are invested at high yields.

Universal Cap Reallocations

Generally, amounts that cease to be allocated to an issue as a result of the application of the universal cap rule are only reallocated to another issue as replacement proceeds.

Regulations § 1.148-9(b)(3) provides a special rule for transferred proceeds. To the extent non-purpose investments allocable to transferred proceeds of a refunding issue exceed the universal cap for the refunding issue, the excess amount of transferred proceeds will be allocated back to the prior issue.

See Phase III, Lesson 3, Refundings text.

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Universal Cap Rule, Continued

Nonmandatory Application of Universal Cap Rule

Pursuant to Regulations § 1.148-6(b)(2), if an issuer reasonably expects, as of the issue date, that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not apply on any date on which an issue actually has **all** of the following characteristics:

- No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve fund;
- The net proceeds of the issue either:
 - qualify for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings and were allocated to expenditures during an applicable temporary period; **or**
 - were deposited in a refunding escrow and expended as originally expected;
- The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;
- None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; **and**
- No proceeds of the issue are invested in qualified student loans or qualified mortgage loans.

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Universal Cap Rule, Continued

Universal Cap Determination Dates

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

The general rule is that the amount of the universal cap and the value of the nonpurpose investments generally must be determined as of the first day of each bond year beginning with the first bond year that commences after the second anniversary of the issue date.

For refunding and refunded issues, there is a special rule that provides that the universal cap and values must be determined as of each date that proceeds of the refunded issue would become transferred proceeds of the refunding issue but for the universal cap rule and need not otherwise be determined in the bond year in which such a date occurs.

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

Factors Indicating Possible Application of Universal Cap Rule

The following situations may result in the universal cap rule affecting the allocations of gross proceeds to an issue:

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

Allocating Disposition Proceeds

Allocation to An Issue

Although a proper expenditure for a capital asset will result in the reduction of the amount of proceeds of an issue, a change in use of bond-financed property resulting from a disposition will often generate cash or other assets.

Regulations § 1.141-12(c)(2) provides for the following result if the conditions to applying the remedial provisions of Regulations § 1.141-12(a) are met:

After the date of the disposition, the proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds rather than the transferred property. If a disposition is made pursuant to an installment sale, the proceeds of the issue continue to be allocated to the transferred property. If an issue does not meet the requirements for remedial action... or the issuer does not take an appropriate remedial action, the proceeds of the issue are allocable to either the transferred property or the disposition proceeds, whichever allocation produces the greater amount of private business use and private security or payments.

Universal Cap Not Applicable

Note that only the allocation rules under Regulations § 1.148-6(d) are made applicable to allocations for private activity testing. Thus, the universal cap rule, found in Regulations § 1.148-6(b), does not apply to the allocation described in the preceding paragraph. However, for purposes of complying with the requirement that the disposition proceeds be treated as gross proceeds for yield restriction and rebate, the universal cap rule would apply.

See Regulations § 1.141-12(i) for the rule limiting the amount of disposition proceeds for purposes of future compliance after the issuer has taken a remedial action to cure a change in use.

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Allocating Disposition Proceeds, continued

Allocations among Sources

In situations where proceeds and other sources have financed property, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funding not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of those outstanding bonds. For this purpose, “principal amount” is the principal amount of plain par bonds and the present value of other bonds, and outstanding bonds do not include advance refunded bonds.

See Regulations § 1.141-12(c)(3).

Allocations to Non-qualified Bonds

Regulations § 1.141-12 provides for the allocation of a change in use to specified non-qualified bonds. The rules governing this allocation are covered in the next Phase I Lesson, Remedial Actions / Change in Use Rules.

Section 8

Allocations to Expenditures

Overview

Introduction

Once proceeds and bonds are identified and properly allocated to an issue, the allocable proceeds must be properly allocated to the governmental purpose of the issue or other permitted uses. Once these allocations have been verified, determinations can be made regarding whether or not the usage restrictions or qualification requirements of §§ 141 through 150 have been met.

This section covers the rules governing allocations to expenditures. The following section will cover allocations to investments.

General Rule

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

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

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

A payment of gross proceeds to a related party is not an expenditure. See Regulations § 1.150-1(b) for the definition of related party and Regulations § 1.150-1(e) for the definition of controlled group.

Allocations to Expenditures – General Rules

Allocations to Purpose Investments

If the issuer expends gross proceeds for a **purpose investment**, such as a loan to a conduit borrower (another government entity or a private entity, such as a 501(c)(3) organization or owner of an exempt facility other than a governmental unit), then:

- the proceeds are not allocated to an expenditure for the governmental purpose of the issue until the conduit borrower actually spends the money, **and**
- even after such the expenditure by the conduit borrower, the proceeds remain allocated to the issue in the form of the purpose investment (for yield restriction purposes) until the sale, discharge, or other disposition of the purpose investment.

Note: The rule requiring expenditure of the proceeds by the conduit borrower before deallocation of the proceeds does **not** apply to purpose investments made with proceeds of a qualified mortgage bond or a qualified student loan bond issue. Rather, the proceeds are considered expended for the governmental purpose upon the acquisition of the mortgage loan or student loan. As with any purpose investment, the proceeds will continue to be allocated to the purpose investment (the mortgages or student loans) for yield restriction and other compliance purposes.

Allocations to Property

For purposes of testing the use of proceeds under § 141 with respect to private use, Regulations § 1.141-6(a) provides that “[f]or purposes of §§ 1.141-1 through 1.141-15, the provisions of § 1.148-6(d) apply for purposes of allocating proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under section 141 and section 148 must be consistent with each other.”

Continued on next page

Allocations to Expenditures – General Rules, Continued

Allocation Methods

Often, an issuer will have several sources of funds available to finance a particular project. Sometimes it is critical for compliance purposes that a particular source be used for a particular expenditure, for instance to avoid violation of the private activity rules. The question then becomes how to properly allocate funds from the various sources to the expenditures.

Regulations § 1.148-6(d)(1)(i) provides that any of the following methods may be used to allocate funds from different sources to expenditures made for the same governmental purpose, if applied consistently:

1. Specific tracing. Specific tracing is the matching of bond proceeds to expenditures dollar for dollar and the most direct method of accounting for proceeds. With multiple sources, this would generally involve maintaining separate accounts for each source. The other methods may be used for commingled or separate accounts. Specific tracing is also the fall-back method of allocation. See below.
2. Gross proceeds spent first. This methodology is useful where the issuer has available funds that are not bond proceeds. This permits the issuer to spend the bond proceeds first, thereby reducing arbitrage and rebate liabilities. Compare this to the working capital expenditure rule discussed below.
3. First-in, first-out. Where there is more than one source, this method would permit the issuer to treat the proceeds of the first issue as first spent, the proceeds of the second issue next, and so on.
4. Ratable allocation method. For each expenditure the multiple sources of funds are accounted for as financing a portion of each expenditure in proportion to the relative amount of the total funds represented by each source.

Proceeds of an issue must be allocated using the specific tracing method if an issuer fails to maintain books and records sufficient to establish the accounting method for an issue.

See Regulations § 1.148-6(a)(3).

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Allocations to Expenditures – General Rules, Continued

Current Cash Outlays Requirement

Regardless of the accounting method, any allocation of gross proceeds to expenditure requires a current outlay of cash. The issuer must reasonably expect this outlay of cash to occur not later than five banking days after which the allocation of gross proceeds to expenditures is made.

See Regulations § 1.148-6(d)(1)(ii).

Timeframe Requirement

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

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

The allocation must be made within 60 days after the fifth anniversary of the issue date or, if earlier, 60 days after the retirement of the issue.

Working Capital Expenditure Rules

General Rule

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

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

Regulations § 1.148-6(d)(3)(i) generally provides that proceeds of an issue may only be allocated to working capital under a "proceeds-spent-last" method. Under this rule, the issuer may only allocate proceeds to working capital expenditures to the extent that the working capital expenditures exceed "available amounts". For this purpose, "proceeds" includes "other replacement proceeds", described in Regulations § 1.148-1(c)(4).

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Working Capital Expenditure Rules, Continued

Available Amounts

“**Available amounts**” means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Available amounts for working capital expenditure purposes exclude the proceeds of the bond issue, but include cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party, if those amounts may be used for working capital expenditures of the type being financed by the issue,

- (i) without a legislative or judicial action, **and**
- (ii) without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

The following items are treated as unavailable:

- A reasonable working capital reserve. Such reasonable reserve, however, is not to exceed 5 percent of the actual working capital expenditures of the issuer in the preceding fiscal year.
- In determining “working capital expenditures of an issuer for a prior fiscal year,” any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.
- Certain qualified endowment funds of a 501(c)(3) organization. *See Regulations § 1.148-6(d)(3)(iii)(C).*

Note: For purposes of determining whether an issue meets the statutory safe harbor for expenditure of TRANs proceeds (§ 148(f)(4)(B)(iii)(II)), the phrase “aggregate available amount” in the definition of the cumulative cash flow deficit is to be treated as having the same meaning as “available amount,” except that any reasonable working capital reserve is to be treated as available.

See Regulations § 1.148-6(d)(3)(iii)(D).

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Working Capital Expenditure Rules, Continued

Exceptions to the General Rule

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

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

- Issuance costs.
- Qualified administrative costs.
- Fees for qualified guarantees or payments for a qualified hedge.
- Interest on the issue for a period beginning on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service.
- Amounts paid to the United States under the arbitrage provisions of § 148: rebate payments, yield reduction payments, and penalty-in-lieu of rebate payments.
- Costs, other than those listed above, that do not exceed 5 percent of the sales proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses).
- Principal and interest on an issue paid from unexpected excess sale or investment proceeds.
- Principal and interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

Extraordinary items exception. The general rule typically does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues. If, however, an issuer or related party maintains a reserve for such items, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

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Working Capital Expenditure Rules, Continued

Exceptions to the General Rule (continued)

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

- payment of principal, interest, or redemption prices on a prior issue, and
 - for a crossover refunding issue, payment of interest on the refunding issue
-

No Exception if Replacement Proceeds Created

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

Impact of Working Capital Expenditure Rule

Because gross proceeds remain allocable to the issue until other funds are unavailable, the proceeds remain subject to the arbitrage and rebate rules for a longer period of time. This limits the issuer's incentive to finance normal operating expenses with tax-exempt bonds while investing the proceeds of the bonds or other amounts on hand in higher yielding instruments.

Grant Expenditure Rule

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

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

Reimbursement Allocations

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

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

Reimbursement Allocations- Regulations § 1.150-2 In allocating gross proceeds of reimbursement bonds, Regulations § 1.148-6(d)(5) states that the rules of Regulations § 1.150-2 apply. If the gross proceeds are used to reimburse a working capital expenditure, the rules of Regulations § 1.148-6(d)(3) also apply.

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

1. Official intent.
2. The reimbursement period.
3. The nature of the expenditure.

Each requirement is discussed in further detail in Section 9.

Private Business Tests Allocations (Proposed)

Introduction As noted above, currently Regulations § 1.141-6 provides that the rules of Regulations § 1.148-6(d) apply for purposes of allocating proceeds of an issue to bond-financed property for purposes of compliance with the private activity rules of § 141. Proposed regulations issued on September 26, 2006, revise § 1.141-6 to expand on this premise.

Consistency Requirement Under the proposed rules, consistency between allocations for arbitrage purposes and private use purposes are still required.

Proceeds The proposed regulations provide rules for allocating bond proceeds and other sources of funds to mixed-use projects, and would permit certain reallocations over the private activity measurement period.

Payments The proposed regulations also provide rules for allocating private payments between sources of funds for a project.

Effective Date Issuers may not rely on the proposed rules.

Section 9

Reimbursement Allocations

Overview

Introduction

This section discusses the federal tax laws applicable to reimbursement allocations made from tax-exempt bond proceeds. These rules must be satisfied when an issuer allocates proceeds of an issue to reimburse itself for prior expenditures paid with funds other than bond proceeds. This section explains how to identify reimbursement allocations and apply the appropriate regulations.

What is a Reimbursement Bond?

A reimbursement bond is a tax-exempt bond the proceeds of which are allocated to prior expenditures originally paid from sources other than bond proceeds. A proper reimbursement allocation results in the proceeds being treated as spent for the governmental purpose of the original expenditures even though the actual moneys are used to replenish the funds originally used to pay the expenditures.

Example 1

County A intends to issue \$1,000,000 in tax-exempt bonds to finance capital improvements to make a courthouse handicap accessible. The issuer intends to issue the bonds on June 1, 2010. On April 15, 2010, the issuer pays \$100,000 for initial project construction expenditures out of its general funds. The bonds are issued on June 1, 2010 and the issuer allocates \$100,000 of the proceeds to reimburse its general fund for the prior expenditures.

Applying the Appropriate Regulations

The rules applicable to reimbursement bonds have evolved over time through the issuance of several sets of regulations. Thus, it is important to determine the appropriate regulations to be applied during the course of examining an issue of reimbursement bonds.

Introduction

Why do we Care?

In making a reimbursement allocation, the issuer seeks to treat the bond proceeds as spent for a governmental purpose that has already been funded. Therefore, a tracing of the proceeds will likely show that the proceeds are used to acquire investments yielding an amount materially higher than the yield of the reimbursement issue, or are spent on another purpose, which may or may not qualify under § 103. Thus, generally speaking, if the issue does not satisfy the applicable reimbursement rules, it will be deemed to be an issue of taxable arbitrage bonds, and might also be nonqualified private activity bonds.

Background

The current reimbursement regulations arose largely as a response to the potential abuse of arbitrage motivated reimbursement transactions. Essentially, an issuer could identify a bounty of old and cold governmental expenditures paid out of its general funds and then issue tax-exempt bonds to “reimburse” those funds. Since the tax-exempt proceeds would be deemed spent on those governmental purposes, the moneys could be freely invested for the purpose of generating arbitrage profits. Such arbitrage-motivated transactions were coined “pyramid bonds,” reflecting the theoretical ability of modern day Egypt issuing bonds to reimburse itself for the costs incurred in constructing the pyramids.

This concept was illustrated in PLR 8923069, where the County Board of Commissioners decided to forego issuing tax-exempt bonds and self-financed the construction costs associated with expanding a jail facility. The County completed all but a small portion of the total project before proposing to issue tax-exempt bonds to finance the remaining construction and reimburse its capital improvement fund for the costs already incurred. The County represented its intention to invest all the moneys in its capital improvement fund (including the proposed bond proceeds) without regard to the arbitrage yield restriction and rebate requirements. The Service held that the County did not originally intend to finance the project with a reimbursement allocation, but rather that the substance of the transaction was to use over \$20,000,000 of tax-exempt bond proceeds to earn arbitrage profits.

Introduction, continued

General Rule

Regulations § 1.150-2(d) generally provides that a reimbursement allocation is treated as an expenditure of proceeds of a reimbursement bond for the governmental purpose of the original expenditure on the date of the reimbursement allocation if the following three requirements are satisfied. Failure to comply with the reimbursement rules results in the bond proceeds as having not been spent. Consequently arbitrage and rebate are applicable, and other qualification problems may be present.

- The issuer must timely adopt an **official intent** that the original expenditures will be reimbursed with proceeds of a debt obligation.
 - The reimbursement allocation must be made within the **reimbursement period**.
 - The original expenditures must be of a certain **nature**.
-

Definitions

Definitions

For purposes of applying these rules, Regulations § 1.150-2(c) provides several definitions, including the following:

“Reimbursement bond” means the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date.

“Reimbursement allocation” means an allocation in writing that evidences an issuer’s use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.

“Issuer” means:

- For any private activity bond (excluding a qualified 501(c)(3) bond, qualified student loan bond, qualified mortgage revenue bond, or qualified veterans’ mortgage bond), the entity that actually issues the reimbursement bond.
- For any bond not described above, either the entity that actually issues the reimbursement bond or, to the extent that the reimbursement bond proceeds are to be loaned to a conduit borrower, that conduit borrower.

“Original expenditure” means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond.

Official Intent

General Rule Regulations § 1.150-2(c) defines “**official intent**” as an issuer’s declaration of intent to reimburse an original expenditure with proceeds of an obligation.

The official intent to reimburse an original expenditure must be properly and timely adopted in order for the issuer to make a valid reimbursement allocation. Otherwise, the allocation will be deemed invalid and the bond proceeds will be treated as unspent. Consequently, any investment of the proceeds would have to be yield restricted to prevent the issue from becoming an issue of arbitrage bonds.

The requirements for a proper and timely declaration of official intent are found in Regulations §§ 1.150-2(d)(1) and (e).

Who must adopt the Official Intent?

The general rule stated above provides that the official intent is declared by the “**issuer.**” However, recall from the Definitions above that in Regulations § 1.150-2(c) the term “issuer” can include the conduit borrower of bond proceeds for reimbursement issues that consist of governmental bonds and certain types of qualified private activity bond issues.

As a result, an official intent may be adopted by either the issuer **or** conduit borrower for the following types of tax-exempt bond issues:

- Governmental bonds;
- Qualified 501(c)(3) bonds;
- Qualified student loan bonds;
- Qualified mortgage bonds;
- Qualified veterans’ mortgage bonds; and
- Qualified volunteer fire department bonds.

An official intent may be adopted **only** by the issuer for the following types of tax-exempt bond issues:

- All types of exempt facility bonds (including enterprise zone facility bonds);
 - Qualified small issue bonds;
 - Qualified redevelopment bonds; and
 - Qualified scholarship funding bonds (note that the not-for-profit corporation using the bond proceeds actually issues the bonds).
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Official Intent, Continued

When must an Official Intent to reimburse be Adopted?

Under Regulations § 1.150-2(d)(1), an issuer must timely adopt an official intent that an original expenditure will be reimbursed with the proceeds of a subsequent reimbursement bond issue.

This declaration of official intent must not be later than 60 days after payment of the original expenditure. Thus, if an issuer fails to adopt a proper official intent within 60 days of the date payment is made for the original expenditure from a source of the issuer's funds, the expenditure may not be reimbursed from an allocation of reimbursement bond proceeds.

Example 2

On March 1, 2009, School District uses moneys from its general fund to pay for \$200,000 in capital expenditures on various school facilities. On May 20, 2009, School Board adopts an official intent to reimburse those original expenditures. On June 15, 2009, School District issues \$200,000 in bonds. On July 20, 2009, School District allocates the proceeds of the issue in accordance with the official intent and uses the \$200,000 to acquire materially higher yielding investments. The reimbursement allocation is invalid due to an untimely declaration of official intent. Consequently, due to the proceeds being used in a manner violating the yield restriction rules, the entire \$200,000 of proceeds are treated as arbitrage bonds.

Form of Official Intent

Under Regulations § 1.150-2(e)(1), the official intent must be adopted in a reasonable form. Reasonable form includes the following:

- Issuer resolution;
- Action by a person authorized or designated to declare official intent on behalf of the issuer; or
- Specific legislative authorization for the issuance of obligations for a particular project.

Official intent will typically be adopted through passage of a resolution at an official meeting of the issuer or conduit borrower's governing body (*i.e.*, council or corporate board of directors), as applicable. Frequent issuers might designate an official (*e.g.*, the Treasurer) to indicate reimbursement intent at the time of expenditures.

Continued on next page

Official Intent, Continued

Project Description

Under Regulations § 1.150-2(e)(2), the official intent must **both**:

- Provide a general description of the project for which the original expenditure is paid; **and**
- State the maximum principal amount of bonds expected to be issued for the project.

A project description is sufficient if it identifies the property or program encompassing the project (e.g., highway capital improvement program, hospital equipment acquisition, or school building renovation). With respect to fund accounting, the project description may identify, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., parks and recreation fund-recreational facility capital improvement program).

Deviations between the project described in the official intent and the actual project ultimately financed with reimbursement bonds are permitted, so long as the actual project is reasonably related in function to the described project.

Example 3

City adopts a resolution evidencing an official intent to reimburse \$100,000 in expenditures incurred during a capital improvement program for the city park. The resolution states that City expects that no more than \$1,000,000 will be issued with respect to the project. City issues the reimbursement bonds and allocates \$20,000 of the proceeds to the cost of purchasing new riding lawn mowers for park maintenance. This is a reasonable deviation in the project description since the lawn mowers are reasonably related in function to the capital improvement program for the park.

Example 4

The facts are the same as above, except City also allocates \$60,000 of the proceeds of the reimbursement bonds to the cost of purchasing and outfitting a new police car to be used in patrolling an area encompassing the city park. This is not a reasonable deviation in the project description and the allocation of proceeds to this cost will not be recognized.

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Official Intent, Continued

Reasonableness of Official Intent

On the date that an issuer declares its official intent to reimburse an original expenditure, the issuer must have a reasonable expectation that it will in fact reimburse that expenditure with proceeds of a reimbursement bond. *See Regulations § 1.150-2(e)(3).*

A declaration of official intent is **not** reasonable if it is made either simply as a matter of course or in a substantially excessive amount relative to the described project. Likewise, an historical pattern of failure to reimburse actual original expenditures covered by official intents generally is evidence of unreasonableness.

Note: An official intent declared pursuant to a specific legislative authorization is presumed to be reasonable. However, this presumption may be successfully rebutted based upon the facts and circumstances.

Reasonable Expectations

For purposes of determining the reasonableness of an official intent, the definition of “reasonable expectations” provided in Regulations § 1.148-1(b) applies.

Under Regulations § 1.148-1(b), an issuer’s expectations are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations, based on all the objective facts and circumstances.

Factors to be considered in determining whether expectations are reasonable include:

- The 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; and
 - The existence of enforceable covenants that require implementation of specific expectations
-

Reimbursement Period

General Rule Under Regulations § 1.150-2(d)(2)(i), the reimbursement allocation must be made not later than 18 months after the later of:

- The date the original expenditure is paid; **or**
- The date the project is either placed in service or abandoned

However, in no event may the reimbursement allocation be made more than 3 years after the date the original expenditure is paid.

Example 5 On February 25, 2008, County paid \$100,000 in original expenditures as part of a road improvement project. On March 10, 2008, County's Board of Commissioners adopted a valid official intent to reimburse expenditures incurred for that project. County completed the project on January 25, 2010. On July 1, 2010, County issued the reimbursement bonds and, on July 25, 2010, allocated \$100,000 of the proceeds to the expenditures. The allocation was within the reimbursement period since it was made approximately 6 months after the date the road improvement project was completed. This is true even though the allocation occurred 29 months after the date the original expenditures were paid.

Example 6 Same facts as above, except County made the reimbursement allocation on March 1, 2011. Here, the allocation is not permitted because more than 3 years had passed since the date the original expenditures were paid. This is true even though the allocation was only a little over 13 months later than the date the road improvement project was completed.

Special Rule for Small Issuers An exception applies to the above general rule for reimbursement bonds that also satisfy the small issuer exception to rebate under § 148(f)(4)(D)(i). For such bonds, the "18 month" limitation is changed to "3 years" and the "3-year" maximum reimbursement period is disregarded.

See Regulations § 1.150-2(d)(2)(ii).

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Reimbursement Period, Continued

**Special Rule for
Long-Term
Construction
Projects**

An exception applies to the above general rule for reimbursement bonds that finance certain long-term construction projects. For such bonds, the maximum reimbursement period is extended from “3 years” to “5 years.”

This exception only applies to construction projects for which both the issuer and either a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project. *See Regulations § 1.150-2(d)(2)(iii)*. Compare this to the similar rule in Regulations § 1.148-2(e)(2)(ii), which grants a 5-year construction temporary period in certain circumstances

Nature of Expenditure

Allowable Purposes of Original Expenditure

Under Regulations § 1.150-2(d)(3), a reimbursement allocation is only permitted for the following types of expenditures:

- Capital expenditures
- Costs of issuance
- Certain extraordinary working capital expenditures incurred before issuance of the reimbursement bond (as described in Regulations § 1.148-6(d)(3)(ii)(B))
- Grants (as defined in Regulations § 1.148-6(d)(4))
- Qualified student loans (as described in § 144(b))
- Qualified mortgage loans (as described in § 143(a))
- Qualified veterans' mortgage loans (as described in § 143(b))

A reimbursement allocation is **not** permitted for any original expenditure other than those listed above.

Extraordinary Working Capital Expenditures

Extraordinary working capital expenditures are expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues. Examples of such expenditures include casualty losses or extraordinary legal judgments in amounts exceeding reasonable insurance coverage.

See Regulations § 1.148-6(d)(3)(ii)(B).

Exceptions to the General Rules

In General

Regulations § 1.150-2(f) provides 2 exceptions to the general requirements that the issuer adopt an official intent to reimburse the original expenditure under Regulations § 1.150-2(d)(1) and that the reimbursement allocation be made within the reimbursement period under Regulations § 1.150-2(d)(2). The 2 exceptions are the **de minimis exception** and the **preliminary expenditures exception**.

Note: The original expenditure must still meet the nature of expenditure requirement under Regulations § 1.150-2(d)(3).

De Minimis Exception

This exception applies for original expenditures in an amount not in excess of the lesser of \$100,000 or 5 percent of the proceeds of the issue. In addition, this exception applies to “payment” of the costs of issuance of any bond.

Preliminary Expenditures Exception

This exception applies for preliminary expenditures up to an amount not in excess of 20 percent of the aggregate issue price of the issue(s) that finance or are reasonably expected to finance the project for which the preliminary expenditures were incurred.

Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to the commencement of acquisition, construction, or rehabilitation of a project. Preliminary expenditures may **not** consist of land acquisition, site preparation, and similar costs incident to commencement of construction.

Other Rules

**Refunding
Issue v.
Reimbursement
Issue**

An issue must be analyzed as a refunding issue, and not a reimbursement issue, when the proceeds of the issue are allocated either to pay the principal or interest on an outstanding obligation or to reimburse an original expenditure already paid by another obligation. *See Regulations § 1.150-2(g)(1)*.

In applying this principle, “obligation” means any valid evidence of indebtedness (tax-exempt or otherwise) under general Federal income tax principles. *See Regulations § 1.150-1(b)*.

Example 7

City financed certain preliminary expenditures of a downtown sidewalk improvement program with a tax-exempt loan from the local bank. City then allocated proceeds from a subsequent tax-exempt bond issue to reimburse its general fund for these expenditures. This reimbursement allocation is invalid because the original expenditures were already financed by another obligation of City.

Example 8

Authority issued qualified 501(c)(3) bonds and loaned the proceeds to University, a 501(c)(3) organization. University used the proceeds to retire a taxable short-term loan which was undertaken to finance several capital projects. As a result of the accounting treatment used by University, the retirement of the loan with the bond proceeds created a deficit in the Current Fund which had to be “reimbursed.” The Service held that the taxable loan was a “valid evidence of indebtedness and thus does constitute an ‘obligation.’” Thus, since the bond proceeds were used to redeem the loan, the bonds were a refunding issue. *See TAM 9831003*.

Allocations made with the proceeds of a refunding issue are subject to the rules under Regulations § 1.148-9.

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Other Rules, Continued

Refunding of Reimbursement Bonds

In the case of a refunding issue where the prior issue consists (in whole or in part) of reimbursement bonds, the proceeds of the prior issue that were purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was valid under the applicable law in effect on the issue date of the prior issue.

See Regulations § 1.150-2(g)(2).

Example 9

In November 2009, Hospital, a 501(c)(3) organization, used a taxable loan to replenish its general fund for an expenditure it made in July 2009 to pay for land that it planned to use for an expansion. The board had authorized the expenditure in July, but had not specified any other accounting for payment for the land. In May 2010, Authority issues qualified 501(c)(3) bonds for Hospital to fund the expansion on the land. Included in the bond issue is an amount to pay off the taxable loan attributable to the land cost. Because the use of the taxable loan for the land was not made pursuant to an effective reimbursement allocation, the refinancing of the taxable loan will result in the general fund moneys from the taxable loan being considered as unspent proceeds of the taxable loan (and will therefore become unspent transferred proceeds of the bonds upon payment of the taxable loan).

Anti-Abuse Rules

Two anti-abuse rules are provided under Regulations § 1.150-2(h).

1. Under the first anti-abuse rule, a reimbursement allocation is not to be treated as a permissible expenditure of proceeds if the allocation employs an abusive arbitrage device under Regulations § 1.148-10 to avoid the arbitrage restrictions or to avoid the restrictions under §§ 142 through 147.
 2. Under the second anti-abuse rule, a purported reimbursement allocation is invalid if, within 1 year after the allocation, funds corresponding to the proceeds used for the reimbursement allocation are used in a manner that results in the creation of replacement proceeds of that issue or another issue. This rule does **not** apply to amounts deposited in a bona fide debt service fund. An example illustrating this rule is provided in Regulations § 1.150-2(h)(2)(ii).
-

Effective Dates

In General

The general rules applicable to reimbursement bonds are found in Regulations § 1.150-2. These rules are applicable to reimbursement bonds issued after June 30, 1993 (the “1993 Regulations”).

The 1993 Regulations replaced the prior rules, found in withdrawn Regulations § 1.103-18, which were effective for reimbursement bonds issued after March 2, 1992.

Prior to March 3, 1992, reimbursements were analyzed under Regulations § 1.103-8(a)(5). This “inducement resolution” requirement, applied directly to industrial development bonds, and was applied by analogy to other bonds.

Transitional Rules

Under Regulations § 1.150-2(j)(2)(i), an official intent is treated as satisfying the official intent requirements under §§ 1.150-2(d)(1) and (e) if the official intent was **either**:

- Declared prior to July 1, 1993, and satisfied the applicable provisions of Regulations § 1.103-8(a)(5) as in effect prior to that date; **or**
- Declared between January 27, 1992 and June 30, 1993, and satisfied the applicable provisions of withdrawn Regulations § 1.103-18 as in effect during that period.

Under Regulations § 1.150-2(j)(2)(ii), the requirements under Regulations § 1.103-8(a)(5) as found in T.D. 7199, 1972-2 C.B. 45, may be applied in lieu of the requirements under § 1.150-2 for any expenditures originally paid prior to August 15, 1993 that would have qualified for expenditure by reimbursement from the proceeds of a private activity bond under § 1.103-8(a)(5).

Prior Rules Under § 1.103-18

Effective Dates This section discusses the rules under former Regulations § 1.103-18 which applied to reimbursement bonds issued before July 1, 1993, but after March 2, 1992.

See T.D. 8394, 1002-1 C.B. 21.

General Rules Regulations § 1.103-18(c) provided the general rules for reimbursement allocations for governmental bonds, qualified 501(c)(3) bonds, and private activity bonds financing facilities owned by a governmental unit. This regulatory regime is similar to that found in Regulations § 1.150-2 of the 1993 Regulations.

Regulation § 1.103-18(d) provided that, with respect to reimbursement allocations for exempt facility bonds (other than those for facilities owned by governmental units) and qualified small issue bonds, the allocation is valid if the requirements under then Regulations § 1.103-8(a)(5) are satisfied and the anti-abuse rules under section 1.103-18(k) are not violated. The requirements under Regulations § 1.103-8(a)(5) are discussed on the last page of this section.

Definitions Regulations § 1.103-18(e) provided definitions for the terms “**reimbursement bond**” and “**reimbursement allocation.**” The rules are similar to the rules found in the 1993 Regulations.

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Prior Rules Under Section 1.103-18, Continued

Other Rules Regulations §§ 1.103-18(f), (g), (i) and (k) provided rules concerning the procedures for an issuer's declaration of an intention to reimburse an expenditure, the reasonableness of official intent, exceptions to the general rule, and anti-abuse rules.

Transitional Rules Under Regulations § 1.103-18(l), certain transitional rules apply to allocations of reimbursement bonds issued after March 2, 1992, when either the expenditure is paid or the official intent is declared prior to March 3, 1992.

Prior Rules Under § 1.103-8(a)(5)

Effective Date This section discusses the rules under former Regulations § 1.103-8(a)(5) which applied to reimbursement bonds issued before March 2, 1992.

Overview The regulatory regime found in former Regulations § 1.103-8(a)(5) is significantly different than the subsequent reimbursement allocation regimes discussed earlier in this section. Former Regulations § 1.103-8(a)(5) is fundamentally a qualifying rule for exempt facility bonds and small issue industrial development bonds, so an improper reimbursement allocation of more than a minor amount results in the entire bond issue being nonqualified.

In comparison, the result of an improper reimbursement allocation under Regulations §§ 1.150-2 or 1.103-18 result in the proceeds allocated to such expenditures as not being spent and thus continue to be subject to the arbitrage and rebate rules, and may be spent in a manner that results in disqualification for tax-exemption.

Generally, the rule to be applied under Regulations § 1.103-8(a)(5) is dependent upon whether a bond resolution or similar official action was taken by the actual issuer prior to the commencement of the construction, reconstruction or acquisition of the facility being financed. For existing facilities acquired by the user, additional restrictions apply. These additional restrictions are similar to the rule found in Regulations § 1.142-4(c).

Section 10

Allocations of Investments

Overview

Introduction

Until proceeds are properly allocated to an expenditure, they will be invested (actually or constructively) to earn a return for the issuer. These investments made preceding the expenditure of the proceeds for the governmental purpose of the issue, referred to as “nonpurpose investments,” may be acquired with multiple sources of funds. Once proceeds and bonds are identified and properly allocated to an issue, the allocable proceeds must be properly allocated to expenditures and investments. Once these allocations have been verified, determinations regarding whether or not the investment restrictions of § 148 have been met can be made.

This section covers the rules governing such allocations.

Commingled Funds

Special Rules for Allocations

As mentioned above, issuers frequently commingle gross proceeds of an issue with other funds. This is done to invest the funds more efficiently. Regulations § 1.148-6(e) imposes additional accounting rules for commingled funds:

- Under Regulations § 1.148-1(b), a commingled fund means any fund or account (other than an open-end regulated investment company) that contains both gross proceeds of an issue and amounts in excess of \$25,000 that are not gross proceeds of the issue, if the amounts are invested and accounted for collectively without regard to source.
- Regulations § 1.148-6(e)(2) requires all payments and receipts with respect to investments in a commingled fund be allocated to each investor at the close of each fiscal period using a "consistently applied, reasonable ratable allocation method." The fiscal period must be a consistent fiscal period that does not exceed three months. The fiscal year is the calendar year unless the fund adopts another fiscal year.
- If a ratable allocation method is used to allocate expenditures from the commingled fund, the same ratable allocation method must be used to allocate payments and receipts on investments in the commingled fund.
- To illustrate, if the issuer commingles funds, it cannot simply allocate any lower yielding investments to the gross proceeds portion of the funds without allocating a ratable portion to the other sources of funds.
- For purposes of these rules, the term "investor" means each different source of funds. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, the fund is treated as having two investors.

Continued on next page

Commingled Funds, continued

Safe Harbor Allocation Methods

Regulations § 1.148-6(e)(2)(ii) sets forth safe harbor ratable allocation methods for allocating items (e.g., expenditures, investments) in commingled funds in proportion to either-

1. The average daily balances of the amounts in the commingled fund from different investors during a fiscal period; or
 2. The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.
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Special Mark-to-Market Requirement for Internal Commingled Funds

Regulations § 1.148-6(e)(5) provides a special mark-to-market requirement for allocating to investors in an internal commingled fund their allocable portions.

- An internal commingled fund is a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund.
 - The fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.
 - The mark-to-market requirement does not apply to (1) a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer or (2) a commingled fund where the investments consist solely of obligations (i.e., debt rather than stock) and the remaining weighted average maturity of the investments does not exceed 18 months.
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Commingled Funds, continued, continued

Commingled Reserve Allocations

Regulations § 1.148-6(e)(6) defines a commingled reserve as a commingled fund that serves as a common reserve fund, replacement fund, or sinking fund for two or more issues. The regulation provides that, after making reasonable adjustments to account for proceeds allocated under the one-issue and universal cap rules, investments held by a commingled reserve must be allocated ratably among the issues served by the fund in accordance with one of the following methods:

1. The relative value of the bonds of the issues;
2. The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or
3. The relative original stated principal amounts of the outstanding issues.

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

Section 11

History of Allocations under the Regulations

Introduction

Introduction

The current allocation and accounting regulations attempt to provide a workable approach to account for expenditures and investments and prevent abuses of the tax-exempt market. Many of the principles contained in Regulations § 1.148-6 originated in prior regulations. This section will trace the historical development of these principles.

1979 Regulations

Reasonable Allocation Methods

Section 1.103-13(f)(1) of the 1979 Regulations, T.D. 7627, 1979-2 C.B. 45, was an attempt to solve the specific problem of tracing the proceeds of bonds into acquired obligations. The term "acquired obligations" was defined as securities and obligations allocated to proceeds of an issue of governmental obligations during the period of time such issue is outstanding. *See Regulations § 1.103-13(b)(4)(i).*

- Specific tracing was viewed, however, as an administrative burden. The problem was most acute in cases where a municipality issued multiple bond issues and there was no requirement under local law or the bond indentures that the issuer separately account for the proceeds of each separate issue.
- Regulations § 1.103-13(f)(1) attempted to address the limitations of specific tracing. It provides that the governmental unit which issues numerous obligations or which commingles the proceeds of bonds with other revenues may allocate acquired obligations to the available proceeds of issued obligations using any reasonable method chosen by the issuer.

Limits on Reasonable Methods

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

- all allocations had to be consistent with one another;
- obligations purchased with the original proceeds of a refunding issue had to be allocated to such proceeds;
- obligations not purchased with original proceeds of a refunding issue may not be allocated to such proceeds;
- obligations purchased with amounts treated as proceeds under the sinking fund rules of Regulations § 1.103-13(g) must be allocated to those proceeds; and
- if an obligation is allocated to two or more sources of funds, each receipt of principal or interest on the obligation must be allocated ratably among the several sources of funds.

1989 Regulations

**Focus on
Rebate
Provisions**

On May 15, 1989, the Service issued temporary regulations (the “1989 Regulations”) interpreting the rebate provisions of § 148(f). *See T.D. 8252, 1989-1 C.B. 25.*

- In general, these regulations applied to governmental bonds issued after August 31, 1986, and to private activity bonds issued after December 31, 1985.
 - Regulations § 1.148-4T(a) contained the general rule for the allocation and accounting of investments made with bond proceeds. Specifically, an investment was considered allocated to an issue for the period:
 - that begins on the date such gross proceeds are allocated to the issue and to the investment; and
 - that ends on the date such gross proceeds cease to be allocated to the issue or to the investment.
 - The 1989 Regulations also introduced the concept of the universal cap. The 1989 Regulations only applied this rule to refunding issues.
 - Many of the definitions and rules relating to allocation and accounting were reserved in the 1989 Regulations. The Service amended the 1989 Regulations on April 25, 1991, 1991-1 C.B. 839.
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1992 Regulations

Introduction

On May 18, 1992, the Service published final regulations to replace the 1989 Regulations, T.D. 8418, 1992-1 C.B. 29 (the “1992 Regulations”). The 1992 Regulations were a modified version of three sets of proposed regulations published on January 30, 1992 (§ 1.148-4), and February 12, 1992 (§§ 1.148-6 and 1.148-11). The Service amended the 1992 Regulations on September 30 and October 5, 1992.

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

As a result of the 1992 Regulations, § 1.103-13(f) of the 1979 Regulations was withdrawn.

Facts and Circumstances

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

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

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

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

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

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1992 Regulations, Continued

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

- The limitation equaled the outstanding value of the issue.

Regulations § 1.148-4(b)(3)(vii) also contained an anti-abuse rule that prohibited issuers from allocating investments in such a manner as to avoid application of the universal cap.

Current Regulations

1993 Arbitrage Regulations and Amendments

The 1993 Regulations were published on June 18, 1993, T.D. 8476. The 1993 Regulations provide the detailed allocation and accounting rules found in Regulations § 1.148-6. The § 1.148-6 regulations were corrected and amended on August 23, 1993, May 10, 1994, January 16, 1997, and again on May 9, 1997. The 1993 Regulations generally apply to bonds issued after June 30, 1993, with permissive retroactive application of the regulations, **in whole, but not in part**, to outstanding issues issued prior to July 1, 1993.

1997 Private Activity Bond Regulations and Amendments

Private activity bond regulations were published on January 16, 1997 (the “1997 PAB Regulations”). The 1997 PAB Regulations contain the allocation rules for the private activity bond tests, found in Regulations § 1.141-6. On September 26, 2006, significant proposed revisions to the allocation regulation were published. Issuers may **not** rely on the proposed revisions prior to publication of final regulations.

Summary of Lesson 6

Review of Lesson 6

“Proceeds” may have different meanings depending on the context. There are also many variations of the term “proceeds,” such as net proceeds, gross proceeds, investment proceeds, etc. These terms may be broader or narrower than the relevant definition of proceeds that is applicable.

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

1. allocating bonds to the issue;
2. allocating proceeds to bonds of the issue; and
3. allocating proceeds of the issue to expenditures and investments.

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

Preview of Lesson 7

In Lesson 7, you will examine situations where there has been a change in the original use of the proceeds. The lesson will cover the important question of whether the bonds continue to be eligible for tax exemption without further action. It will also describe various actions the issuer may take to retain the tax exemption for the bonds if inaction is not appropriate. Finally, the lesson will cover certain rules under Section 150(b) that may cause the loss of other tax benefits in addition to the loss of tax exemption when a change in use of the bond proceeds occurs.
