

Arbitrage Treatment of Certain Guarantee Funds

Notice 2023-39

SECTION 1. PURPOSE

This notice describes proposed amendments to the Income Tax Regulations (26 CFR part 1) under § 148 of the Internal Revenue Code (Code)¹ that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue (forthcoming proposed regulations) regarding an exception to the arbitrage investment restrictions under § 148 applicable to bonds the interest on which is excludable from gross income under § 103(a) (tax-exempt bonds). Specifically, the forthcoming proposed regulations will amend § 1.148-11(d)(1)(i)(F) regarding whether certain perpetual trust funds created and controlled by States that are pledged as credit enhancement to guarantee tax-exempt bonds will be treated as replacement proceeds of the guaranteed bonds for purposes of the arbitrage investment restrictions on tax-exempt bonds under § 148.

SECTION 2. BACKGROUND

.01 Arbitrage restrictions generally

In general, the interest on bonds issued by State and local governments is

¹ Unless otherwise specified, all “section” or “§” references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

excludable from gross income under § 103(a) if certain requirements are met. Section 148 imposes arbitrage investment restrictions on tax-exempt bonds that limit the investment of proceeds of tax-exempt bonds in higher-yielding investments and that require issuers to rebate certain excess earnings above the yield on tax-exempt bonds to the United States Government.² The arbitrage restrictions apply to ordinary proceeds derived from the sale of tax-exempt bonds and investment earnings thereon. In addition, the arbitrage restrictions apply to a special type of tax-exempt bond proceeds, known as “replacement proceeds,” as a result of their use as security for tax-exempt bonds or other nexus to tax-exempt bonds. These special replacement proceeds include, among other things, certain “pledged funds” that are pledged to secure repayment of tax-exempt bonds with a reasonable assurance of availability for such purpose. One special exception to the treatment of pledged funds as replacement proceeds covers certain perpetual trust funds under certain parameters and under a specified size limitation, as described further in section 2.03 of this notice.

.02 Statutory and regulatory arbitrage restriction rules

Section 148(a) defines an “arbitrage bond” as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that a bond is an arbitrage

² Under § 1.148-3(g), rebate payments (1) must be paid no later than 60 days after the computation date to which the payment relates, (2) are considered paid when the payment is filed with the IRS as designated by the Commissioner of Internal Revenue (Commissioner), and (3) must be accompanied by the form provided by the Commissioner for this purpose (currently, Form 8038-T, *Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate*).

bond if an issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part to acquire higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments. In addition, § 148(f) requires that issuers rebate certain excess earnings on proceeds of tax-exempt bonds to the United States Government. Under §§ 1.148-2(a) and 1.148-3(a), “proceeds” for these purposes means “gross proceeds” of an issue. Section 1.148-1(b) defines “gross proceeds” to include proceeds and replacement proceeds of an issue.

Section 1.148-1(c)(1) defines “replacement proceeds” as amounts that have a sufficiently direct nexus to a tax-exempt bond issue or to the governmental purpose of a tax-exempt bond issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the bond issue were not used or to be used for that governmental purpose. Section 1.148-1(c)(1) further provides that replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in § 1.148-1(c)(4) to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. Section 1.148-1(c)(1) defines a “substantial beneficiary” of an issue to include the issuer of such issue, any related party to the issuer and, if the issuer is not a State, the State in which the issuer is located. Section 1.148-1(c)(1) further provides, however, that a person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

Section 1.148-1(c)(3)(i) defines a “pledged fund” as any amount that is directly or indirectly pledged to pay principal or interest on the issue. Although a pledge need not be cast in any particular form, it must, in substance, provide reasonable assurance that

the amount will be available to pay principal or interest on the issue even if the issuer encounters financial difficulties.

.03 Exception for certain perpetual trust funds

Section § 1.148-11(d)(1)(i) provides a special exception to the treatment of funds as pledged funds for arbitrage purposes for certain perpetual trust funds if the requirements and limitations enumerated in §§ 1.148-11(d)(1)(i)(A) through (F) are satisfied. Specifically, § 1.148-11(d)(1)(i) provides that a guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if:

(A) substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests; (B) the corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers or public elementary and public secondary schools; (C) substantially all of the available income of the fund is required to be applied annually to support designated functions; (D) the issue guaranteed consists of obligations that are not private activity bonds (other than qualified 501(c)(3) bonds) substantially all of the proceeds of which are to be used for designated functions; (E) the fund satisfied each of the requirements in §§ 1.148-11(d)(1)(i) through (iii) on August 16, 1986; and (F) as of the sale date of the bonds to be guaranteed, the amount of the bonds to be guaranteed by the fund plus the then-outstanding amount of bonds previously guaranteed by the fund does not exceed a total amount equal to 500 percent of the total costs of the assets held by the fund as of December 16, 2009. (The references in (E) to §§ 1.148-11(d)(1)(i) through (iii) should

be to §§ 1.148-11(d)(1)(i)(A) through (C).)

Bond guarantees enable issuers to obtain lower bond interest rates. The demand for public school bond guarantees continues to grow as student populations expand and existing school buildings age. As a result, certain perpetual trust funds that otherwise could provide credit enhancement under the special exception to the arbitrage restrictions for eligible pledged funds under § 1.148-11(d)(1)(i) will soon be limited in their capacity to provide guarantees for tax-exempt bonds at a time when there is a significant need for such guarantees.

SECTION 3. SCOPE AND APPLICATION

The Treasury Department and the IRS intend to issue the forthcoming proposed regulations to amend § 1.148-11(d)(1)(i)(F) to provide that, as of the sale date of the bonds to be guaranteed, the amount of the bonds to be guaranteed by the fund plus the then-outstanding amount of bonds previously guaranteed by the fund does not exceed a total amount equal to 500 percent of the total costs of the assets held by the fund.

SECTION 4. RELIANCE ON THIS NOTICE

This notice may be relied upon for bonds sold on or after May 10, 2023, and before the applicability date of future regulations or other published guidance under § 148 addressing or otherwise affecting funds described in § 1.148-11(d)(1)(i) and this notice.

SECTION 5. REQUEST FOR COMMENTS

.01 Comments Regarding Guidance in this Notice. The Treasury Department and the IRS request comments on any questions arising from the interim guidance set forth in this notice.

.02 Procedures for Submitting Comments.

(1) Deadline. Written comments should be submitted by July 31, 2023.

Consideration will be given, however, to any written comment submitted after July 31, 2023, if such consideration will not delay the issuance of the forthcoming proposed regulations.

(2) Form and manner. The subject line for the comments should include a reference to Notice 2023-39. All commenters are strongly encouraged to submit comments electronically. However, comments may be submitted in one of two ways:

(a) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2023-0020 in the search field on the regulations.gov homepage to find this notice and submit comments); or

(b) By mail to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2023-39), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044.

(3) Publication of comments. The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket on www.regulations.gov.

SECTION 6. DRAFTING INFORMATION

The principal author of this notice is Johanna Som de Cerff, Office of the Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice, contact Johanna Som de Cerff at (202) 317-6980 (not a toll-free call).