Lesson 8

Section 149

Rules Applicable to All Tax-Exempt Bonds

Overview

Introduction

This lesson discusses all of the provisions of § 149. Both governmental and qualified private activity bonds are subject to these rules.

Objectives

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

- Identify "registration-required" bonds and determine if registration-required bonds have been properly registered
- Determine if a bond is federally guaranteed and if the interest on a federally guaranteed bond is tax exempt
- Identify bonds whose interest is tax exempt by virtue of provisions other than § 103(a) of the Code
- Identify a refunding issue
- Apply the rules of § 149(d) to advance refunding issues
- Explain the information reporting requirements of bonds
- Identify a hedge bond and determine whether the interest on a hedge bond is tax exempt

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Contents

This lesson contains the following topics:

Legislative History

The Tax Reform Act of 1986 added § 149(a) through (e) to the Code with an effective date of August 15, 1986.

Subsequently, § 149(f) was added by the Technical and Miscellaneous Revenue Act of 1988 with an effective date of October 21, 1988.

Finally, § 149(g) was added by the Omnibus Budget Reconciliation Act of 1989 with an effective date of September 15, 1989.

Prior to being included in §149, these provisions were found in the Code as shown below:

Subject	IRC 1986	IRC 1954
Registration	149(a)	103(j)
Federally guaranteed bonds	149(b)	103(h)
Tax exempt only under this title	149(c)	103(m)
Advance refundings	149(d)	N/A
Information reporting	149(e)	103(l)
Pooled financing bonds	149(f)	N/A
Hedge bonds	149(g)	N/A

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Section 1

Registration

Overview

Introduction

Section 149(a) provides which bonds must be registered in order for the interest to be tax exempt.

Contents

This section contains the following topics:

General Rules

Introduction

Section 149(a) requires that certain bonds be registered in order for the interest to be tax exempt. Section 149(a)(2) provides that the term "registration-required bond" means any bond other than a bond which -

- is not of a type offered to the public, or
- has a maturity (at issue) of not more than one year, or
- is described in section 163(f)(2)(B)

Example

County A issued twenty-year bonds to finance the construction of a sanitary sewer system. The Federal Housing Administration agreed to purchase the bonds. The bonds were transferable by the owner upon presentation and surrender. Even though these bonds were not offered to the public for sale, they are typical of bonds that are offered to the public, and therefore must be registered to be tax exempt.

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Legislative History

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), most bonds were "bearer bonds." The interest on bearer bonds was paid to whomever held the bonds. Each bond came with coupons that were redeemable for the interest. Because there was no requirement to account for who received the interest payments, the IRS was unable to determine the recipients of the interest income. Even though the requirements of TEFRA were directed primarily towards taxable bonds, the amendment also applies to bonds described in §103. Congress included the registration requirements in TEFRA in order to:

- limit the number of bearer bonds that were issued, and to
- help ensure compliance with the federal income tax laws, and to
- prevent bonds from being transferred to another party without the knowledge of the bond trustee

Registration Requirement Upheld by Supreme Court

In *South Carolina* v. *Baker,* 485 U.S. 505, 108 S. Ct. 1355 (1988), South Carolina objected to the Federal Government's restrictions concerning registration of municipal securities. The Supreme Court, however, upheld the TEFRA provisions regarding the registration requirement.

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Types of Systems for Registration

Registered Form

Treasury Regulations § 5f.103-1(c) provides two acceptable systems for the registration of tax-exempt obligations. These two systems can be described as:

- the certificate system, and
- the book entry system

Under the **certificate system**, the obligation is registered with the issuer or its agent, as to both principal and any stated interest. A certificate evidencing the right to such principal and interest is issued to the holder.

The obligation may be transferred when either:

- the current holder surrenders the obligation to the issuer, who then reissues the old instrument to the new holder, OR
- the current holder surrenders the obligation to the issuer, who then redeems the old instrument and issues a new instrument to the new holder

In a **book entry system** the ownership of the bond is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation. The right to principal and interest on a bond may be transferred only through a book entry system maintained by the issuer (or its agent).

Obligations that do not meet either of these requirements are considered to be in bearer form. However, terms can be changed during the life of the bonds to meet the requirements of a book entry system, and the bonds will be considered to be in registered form from that point on.

Book-Entry System vs. Certificate System

Figure 8-1 presents the mechanics of both the book-entry system and the certificate system of bond issuance. It also illustrates the similarities and differences between the two systems.

A description of the system used usually appears in every Official Statement.

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Types of Systems for Registration, Continued

Figure 8-1

Comparison of the Book-Entry System with the Certificate System of Bond Issuance		
Component	**Book-Entry System**	**Certificate System**
Printing	Issuer prints one bond for each maturity (for example, $22,000,000 term bond @ 5% maturing on 7/1/2024).	Issuer prints one bond of a certain denomination for each maturity (for example, 4,400 term bonds worth $5,000 each).
Delivery	One day before closing, bond counsel delivers bonds to the Trustee who delivers them to Depository Trust Company ("DTC").	One day before closing, bond counsel delivers bonds to underwriter.
Closing	Financing is closed when issuer receives purchase price from bondholders and DTC receives the bonds.	Financing is closed when underwriter has delivered purchase price to issuer and underwriter receives the bonds.
Ownership	Purchaser's name is recorded in a register kept by the registrar, usually the trustee.	Purchaser receives a certificate (bond) with his name on it, showing that he is the registered owner. Purchaser's name is recorded in a register kept by the registrar, usually the trustee.
Payments	Purchaser receives interest and principal payments according to bond provisions, and registrar notes the payments in the bond register.	Purchaser receives interest and principal payments according to bond provisions, and registrar notes the payments in the bond register.
Trading	If original purchaser trades (sells) the bond, registrar changes the name of the bondholder in the register.	If traded, the seller surrenders the certificate. The registrar either: • changes the name of the owner on the bond, or • cancels the surrendered bond, and issues a new bond to the new owner with his name on it

Section 2

Federally Guaranteed Bonds

Overview

Introduction

Section 149(b)(1) provides that the interest on bonds which are federally guaranteed is not tax exempt.

Contents

This section contains the following topics:

General Rules

Legislative History

Section 622 of the Deficit Reduction Act of 1984 amended § 103(h) of the 1954 Code to, in general, eliminate the tax exemption for interest on bonds where a substantial portion of the issue was deposited in federally insured deposits or accounts, or where the bonds were guaranteed directly or indirectly by the Federal Government. (House Rep. No. 98-432, Part 2, March 5, 1984, pages 1689 and 1690.)

This legislation was enacted in order to eliminate the advantage provided when a state or local bond is federally guaranteed. Without this provision these investments would be more attractive than either taxable municipal securities or other state and local bonds lacking federal guarantees. They would receive the benefit of the guarantee of the Federal Government plus the federal tax exemption of a state or local obligation.

When Are Bonds Federally Guaranteed?

Section 149(b)(2) provides that bonds are federally guaranteed if:

- The payment of the principal or interest is guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
- The payment of the principal or interest is otherwise indirectly guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
- Five percent or more of the bond proceeds are either:
    - Used to make loans, and the principal and interest payments on the loans are guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
    - Invested (directly or indirectly) in federally insured deposits or accounts

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Federally Insured Deposits or Accounts

Section 149(b)(4)(B) defines "federally insured deposits or accounts" as those deposits or accounts in a financial institution to the extent such deposits or accounts are insured under Federal law by the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation (since abolished), the National Credit Union Administration, or any similar federally chartered corporation.

Instrumentalities

Statutory Definition

Section 149(b)(4)(A) states that any entity with statutory authority to borrow from the United States will be considered to be an instrumentality of the United States. However, the District of Columbia and possessions of the United States will only be considered to be instrumentalities with respect to the following types of bonds:

- exempt facility bonds,
- qualified small issue bonds,
- qualified student loan bonds

Possessions of the United States include the U.S.Virgin Islands, Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico.

Instrumentality Guidance

For guidance on the definition of "instrumentality" see Rev. Rul. 57-128, 1957-1 CB 311 which discusses state and local instrumentalities.

Continued on next page

Instrumentalities, Continued

Instrumentality Guidance

In determining whether or not the organization is an instrumentality of the United States ("U.S."), the following factors should be considered:

- whether the organization is used for a governmental purpose and performs or assists in the performance of a governmental function;
- whether performance of its function is on behalf of one or more states or political subdivisions;
- whether any private interests are involved, or the state or political governmental subdivision involved has the powers and interests of an owner;
- whether control and supervision is vested in a public authority;
- whether authorization is necessary for the creation or use of the organization ;
- the degree of financial autonomy and the source of the organization's operating expenses

Exceptions to the General Rule

Introduction

Interest on bonds described below are still tax exempt, even though they are federally guaranteed.

Exceptions for Certain Federal Insurance Programs

Guarantees by the following federal programs are permitted by § 149(b)(3)(A):

- Federal Housing Administration,
- Veterans' Administration,
- Federal National Mortgage Association,
- Federal Home Loan Mortgage Corporation,
- Government National Mortgage Association,
- any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans,
- any guarantee by the Bonneville Power Authority, pursuant to Northwest Power Act, as in effect as of the date of enactment of the Tax Reform Act of 1984, or
- Subject to § 149(b)(3)(E), any guarantee by a Federal home loan bank made in connection with the original issuance of a bond during July 30, 2008 and ending December 31, 2010 (or as may be extended).

Exceptions to the General Rule, Continued

Exceptions for Certain Investments of Bond Proceeds

Section 149(b)(3)(B) provides that certain bond proceeds may be invested in federally guaranteed deposits or accounts as follows:

- proceeds invested during the initial temporary period,
- investments of a bona fide debt service fund,
- investments of a reserve which meets the requirements of § 148(d), investments in U.S. Treasury bonds; or
- other investments permitted under regulations

The regulations provide that the following investments made after June 30, 1993, may be federally guaranteed:

- pursuant to Treas. Reg. § 1.149(b)-1(b)(2) any investment held in a refunding escrow as defined in § 1.148-1, or
- pursuant to Treasury Regulations § 1.149(b)-1(b)(1), investments in obligations issued pursuant to § 21 B(d)(3) of the Federal Home Loan Bank Act, as amended by § 511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision

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Exceptions to the General Rule, Continued

Example

State K issues bonds in the principal amount of $5MM, depositing the funds as follows:

- $500,000 Reserve Fund
- $50,000 Bona Fide Debt Service Fund
- $4,450,000 Project Fund

All of the funds are invested in government securities, except for the project fund. The project fund proceeds are deposited into a bank's money market account. The proceeds invested in the reserve and debt service funds are federally guaranteed, but meet the exceptions of § 149(b)(3)(B)(ii) and (iii), so the bond interest is tax-exempt.

The project fund, even though insured by the FDIC, meets the exception of § 149(b)(3)(B)(i), but only during the temporary period as provided by Treas. Reg. § 1.148-2(e)(1). At the end of the temporary period the funds remaining in this account would be considered to be federally guaranteed and thus could affect the tax-exemption of the bond interest.

Exceptions for Housing Programs

Section 149(b)(3)(C) provides that the prohibition of a federal guarantee for tax exempt bonds does not apply to the following, unless the proceeds of the bonds are deposited into federally insured deposits or accounts:

- private activity bonds for qualified residential rental projects or housing program obligations under § 11(b) of the United States Housing Act of 1937,
- qualified mortgage bonds issued pursuant to § 143(a),
- qualified veterans' mortgage bonds issued pursuant to § 143(b)

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Exceptions for Loans to, or Guarantees by Financial Institutions

Section 149(b)(3)(D) provides that, except as provided in § 149(b)(2)(B)(ii), a bond which is issued as part of an issue shall not be treated as federally guaranteed merely because the proceeds are used to make loans to a financial institution or there is a guarantee by a financial institution unless such guarantee constitutes a federally insured deposit or account.

In *FDIC* v. *Philadelphia Gear Corp.*, 476 U.S. 426 (1986), the Court determined that a standby letter of credit issued by a bank whose deposits were insured by the FDIC did not constitute an FDIC-insured deposit.

Other Exceptions

Notice 88-54, 1988-1 C.B. 539, provides that capitalization grants awarded by the EPA through its State Water Pollution Control Revolving Fund Program under Title VI of the Water Quality Act of 1987 would not constitute a federal guarantee.

Notice 88-114, 1988-2 C.B. 449, provides that bonds that are insured, reinsured, or guaranteed by the Connie Lee Insurance Company, a wholly owned subsidiary of the College Construction Loan Insurance Association, would not be considered to be federally guaranteed.

Section 3

Tax Exemption Derived Only from this Title

General Rules

Introduction

Section 149(c)(1) provides that with certain exceptions, interest on bonds is exempt from federal tax only if the exemption is provided by the Code, even though an exemption may be provided by another federal statute.

Legislative History

Prior to the Deficit Reduction Act of 1984 ("DRA 1984"), there were two types of tax-exempt bonds on the market:

- those whose exemption was derived directly from § 103(a), and
- those whose exemption was derived from other federal statutes, such as:
  - obligations of the Federal Home Loan Bank,
  - obligations of the Federal Savings and Loan Association, and
  - obligations of the Central Bank of Cooperative

Those bonds whose exemption was derived from § 103(a) were required to comply with all of the provisions of § 103, while bonds whose exemption was derived from other federal statutes were not subject to the provisions of § 103.

The DRA 1984 changed this, requiring generally, that all tax-exempt bonds comply with the provisions of § 103, regardless of the source of their tax-exemption.

Bonds Issued Before 1984

Generally, bonds issued before 1984 whose exemption is derived from statutes other than the Code continue to be treated as bonds described in § 103(a), without having to comply with present §§ 141-150.

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Bonds Issued After 1983

Section 149(c)(2)(B) provides generally that bonds issued after 1983 will NOT be considered to be tax exempt under §103(a) unless they comply with present §§ 141-150.

Exceptions are provided for the following bonds:

1. Section 149(c)(2)(C)(i) provides for any bond issued pursuant to Northwest Power Act, as in effect on July 18, 1984,
2. Section 149(c)(2)(C)(ii) provides for any bond issued pursuant to § 608(a)(6)(A) of Public Law 97-468, as in effect on the date of the enactment of Tax Reform Act of 1986 ("TRA 1986"), pertaining to the transfer of the Alaska Railroad from federal to state control,
3. Section 149(c)(2)(C)(iii) provides for any bond issued before June 19, 1984, under § 11(b) of the United States Housing Act of 1937

Example

County C issues bonds pursuant to § 11(b) of the U.S. Housing Act on June 1, 1992. These bonds must meet all of the provisions of §§ 141-150 in order for the interest on the bonds to be tax-exempt because they were issued after June 19, 1984.

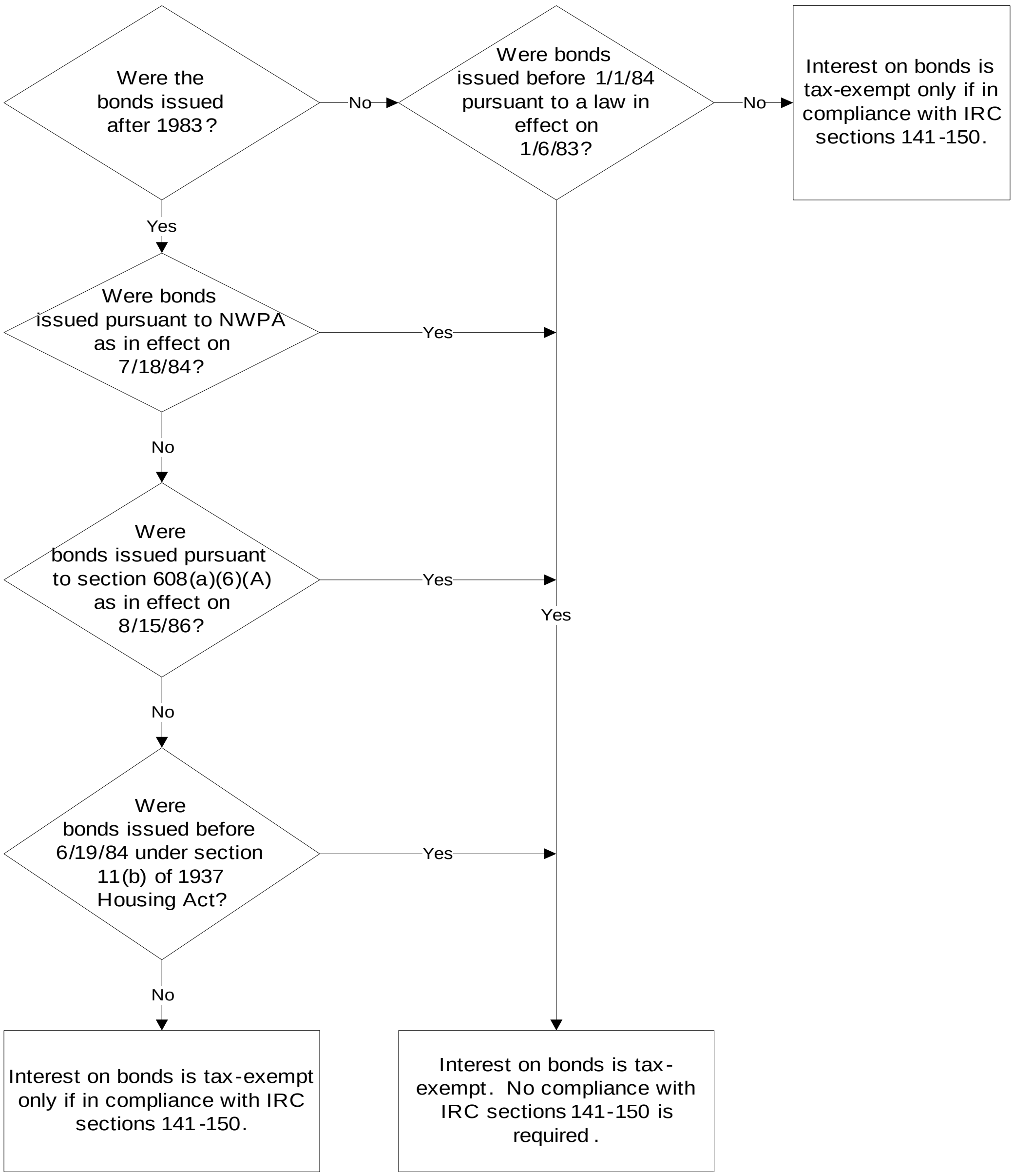
Flowchart

Bonds whose exemption is derived from a statute other than § 103 are required to file an information return, Form 8038 series. Refer to **Figure 8-2** below to determine if the bonds are subject to the provisions of §§ 141-150.

Continued on next page

General Rules, Continued

FIGURE 8-2: DETERMINING WHETHER OR NOT BONDS WHOSE EXEMPTION IS DERIVED FROM **STATUTES OTHER THAN IRC SECTION 103(a)** MUST COMPLY WITH SECTIONS 141-150.



Section 4

Advance Refundings

Overview

Introduction

Section 149(d) provides that the interest paid on bonds that are not properly advance refunded is not tax-exempt. Advance refundings can be complicated and can present problems, particularly where arbitrage is concerned. For this reason, a complete discussion of them has been reserved for Phase II of this course.

Contents

This section contains the following topics

Continued on next page

Prohibited Uses and Limitations on the Number of Advance Refundings

Private Activity Bonds

Section 149(d)(2) prohibits issuing advance refunding bonds for private activity bonds, except for Qualified 501(c)(3) Bonds. Private activity bonds may be advance refunded only with taxable refunding bonds.

Governmental and Qualified 501(c)(3) Bonds

Section 149(d)(3) provides limitations on the number of times a bond may be advance refunded, as shown in the table below:

Limitations

If the original Bond is issued…	Then it can be advance refunded…
Before 1986	Twice
Before 1986 and it was already advance refunded two or more times before March 15, 1986	Once
After 1985	Once

Continued on next page

Example

In 1996, City C had bonds outstanding that were originally issued in 1975. These bonds were advance refunded in 1978, 1981, and 1985. Because these bonds were issued before 1986, and because they were advance refunded at least twice prior to March 15, 1986, the original issue can be advance refunded only one more time. Section 149(d)(6)(B) treats all advance refundings before 1986 as one refunding.

Example

In 1996, City A has outstanding bonds that were originally issued in 1986 and have never been advance refunded. Assume that the bonds are advance refunded in 1997, and the 1986 bonds are retired in 1999. Because the bonds were issued after 1985 they may only be refunded once. Because the original issue was advance refunded in 1997, there may not be another advance refunding of the issue.

First Call Date Requirement

Sections 149(d)(3)(A)(ii) and (iii) provide that if the advance refunding results in present value debt service savings (determined without regard to administrative expenses) to the issuer, then the prior bonds must be called as shown in the table below:

If the original bond is issued…	Then the prior bond must be redeemed not later than…
Before 1986	The earliest date on which the bond may be redeemed: • At par, or • At a premium of 3% or less.
After 1985	The earliest date on which the bond may be redeemed.

Continued on next page

Example

In the example above, City A's bonds would have to be called on the earliest call date if:

- there is present value debt service savings for the issuer, **and**
- if the issuer expects to treat the advance refunding as a tax-exempt issue

Abusive Transactions Prohibited

Section 149(d)(4) provides that the interest on an advance refunding issue will not be excluded from gross income under §103(a) if a device is employed in connection with the issuance of the advance refunding issue to obtain a material financial advantage. The material financial advantage is based on arbitrage concepts under § 148, and does not include savings attributable to lower interest rates.

Treasury Regulations § 1.149(d)-1(b) provides that an advance refunding issue violates § 149(d)(4) if:

- the issue violates any of the anti-abuse rules under Treasury Regulations § 1.148-10,
- if issued after August 31, 1986, the issue fails to meet the rebate requirements under Treasury Regulations § 1.148-3, or
- the proceeds of the issue are invested in a certain type of escrow that contains both non-purpose investments and tax-exempt obligations (See § 1.149(d)-1(b)(3))

Section 5

Information Reporting Requirements

Overview

Introduction

Section 149(e) provides specific reporting requirements for tax exempt issues.

The interest on bonds which do not meet the reporting requirements will not be tax exempt.

Although § 149(e) generally applies to bonds issued after August 15, 1986, the regulations apply to bonds issued after December 31, 1986. Rules for bonds issued after December 31, 1982 and before December 31, 1986 are covered under § 103(1) of the 1954 Code and Treasury Regulations § 5f.103-3.

Contents

This section contains the following topics:

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IRS Has Authority to Designate Information Reporting Requirements

A bond will not be considered to be tax exempt under § 103(a) unless such bond satisfies the information reporting requirements under § 149(e)(2), which requires the issuer to submit not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary of the Treasury may prescribe with respect to any portion of the statement) a statement containing the information described in §149(e)(2). Section 149(e)(3) gives the Secretary authority to grant an extension of time for such filing if the failure to file in a timely fashion is not due to willful neglect.

Regulations

Treasury Regulations § 1.149(e)-1 (a) provides that interest on a bond is included in gross income unless certain information with respect to the issue of which the bond is a part is reported to the IRS.

Continued on next page

Overview, Continued

Who Must File

The issuer is required to file a "completed reporting form prescribed for this purpose" for all tax exempt issues issued after December 31, 1986. Since the regulations specifically require a prescribed form, no letters or issuer-designed forms are permitted.

Prior to December 31, 1986, § 103(l) of the 1954 Code only required issuers of the following types of bonds to file information returns:

- industrial development bonds (known as "private activity bonds" after TRA 1986),
- those used to finance loans to individuals for educational expenses,
- those used by § 501(c)(3) organizations

These reporting requirements also apply to most bond issuances discussed in Section 3, whose tax exemption is derived from non-Code provisions.

Required Forms

Form 8038 Series

The table below shows the appropriate forms to be filed by issuers of tax exempt bonds:

Form Number	Purpose of Form
8038	Information return for all qualified private activity bonds.
8038-G	Information return for all governmental issues with an issue price of $100,000 or more.
8038-GC	Information return for all governmental issues with an issue price of less than $100,000.
8038-B	Information return for Issuers of Build America Bonds (Tax Credit/Direct Pay) and Recovery Zone Economic Development Bonds .
8038-TC	Information Return for Issuers of qualified tax credit bonds.

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What Does "Completed" Mean?

Treas. Reg. § 1.149(e)-1(d)(1) describes when an information reporting form will be considered to be "completed." The issuer must make a good faith effort to complete the form (taking into account the instructions to the form). The completed form must be prepared on the basis of available information and reasonable expectations as of the date of issue, except for consolidated returns. Consolidated returns should be completed based on information readily available to the issuer at the close of the year, supplemented by good faith estimates.

Special Requirements for Form 8038

Treas. Reg. § 1.149(e)-1(b)(2) requires issuers of private activity bonds subject to the volume cap to attach a copy of the certification by a state official which states that the bonds meet the volume cap requirements of § 146.

Form 8038-GC Options

An issuer has two options when reporting several issues of less than $100,000 that were issued during a calendar year. The issuer may file:

- a separate Form 8038-GC for each issue with an issue price of less than $100,000, or
- a consolidated return which includes all issues with issue prices of less than $100,000.

Exceptions

A separate Form 8038-GC must be filed for those issues for which the issuer has elected to pay a penalty in lieu of rebating arbitrage.

The separate return option is not available for issues issued prior to January 1, 1992.

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Example

County X issues the following bonds during the calendar year ending December 31, 1996:

- $2,000,000 for sewer line repairs,
- $6,000,000 qualified hospital bonds,
- $95,000 for transportation repairs,
- $90,000 for new police cars,
- $92,000 for construction of city hall annex

The County has elected to pay the penalty in lieu of rebate for the $92,000 construction bonds.

County X must file the following forms regarding the bond issues:

Bond Issue	Required Form
$2,000,000 for sewer line repairs	8038-G
$6,000,000 for qualified hospital bonds	8038
$92,000 for construction of city hall annex	8038-GC (separate)

County X then has the option to file a separate Form 8038-GC for each of the remaining two issues or it can file a consolidated form 8038-GC which includes both issues.

Filing Dates

Filing Dates: 8038, 8038-G, 8038-GC, 8038-B and 8038-TC

Forms 8038, 8038-G, 8038-GC, 8038-B and 8038-TC filed for a single issue are due by the 15th day of the second calendar month following the close of the calendar quarter in which the bonds were issued.

Consolidated Forms 8038-GC are due by February 15th of the calendar year following the year in which the bonds were issued.

The table below provides a quick reference for determining the filing due dates of Forms 8038, 8038-G, 8038-GC, 8038-B and 8038-TC (see Form 8038 Series due date column). Please note that consolidated 8038-GCs have a different due date.

Month of Issuance	Quarter Ending Date	Form 8038 Series Due Date	Due Date 8038-GC (Consolidated returns only)
January February March	**03-31**	**05-15**	**02-15**
April May June	**06-30**	**08-15**	**02-15**
July August September	**09-30**	**11-15**	**02-15**
October November December	**12-31**	**02-15**	**02-15**

Filing Dates, Continued

Filing Extensions for Forms 8038, F8038-G, 8038-GC, 8038-B and 8038-TC

Revenue Procedure 2002-48, 2002-37 IRB 531 describes the steps that should be taken to obtain an extension to file Forms 8038, 8038-G, 8038-GC, 8038-B or 8038-TC after the filing date has passed. While there are no provisions which allow for a request for an extension prior to the filing date, an issuer may request that the IRS make a determination that the failure to file timely was not due to willful neglect. If granted, then the information reporting requirements are considered to be met, and the interest on the bonds is tax exempt. If the Service is unable to grant the request, then the reporting requirements would not be satisfied and the interest on the bonds would not be excludable from gross income.

Special Extension for Bonds Issued from January 1–June 30, 1992

Information returns for bonds issued between January 1 and June 30, 1992 received an extended filing date to November 16, 1992.

Where to File

All returns are filed with the Ogden Service Center.

Penalties for Failure to File

None of the penalties provided by §§ 6652, 6721, or 6723 apply to the information returns required by § 149(e)(2). Thus, the only sanction for delinquent filings would be that the interest on the bonds would not be excludable from gross income.

Section 6

Treatment of Certain Pooled Financing Bonds

Overview

What are Pooled Financing Bonds?

Section 149(f)(6) provides that for purposes of this subsection “pooled financing bond” means any bond issued as part of an issue more than $5,000,000 of the proceeds of which are reasonably expected (at the time of issuance) to be used (or are intentionally used) directly or indirectly to make or finance loans to two or more ultimate borrowers. IF bonds are subject to the volume cap limitations of § 146 or §143(l)(3) applies to such issue, they are excepted from this definition.

How Pooled Financing Bonds are Used

A pooled financing arrangement occurs when a state or local government issues bonds and subsequently loans the proceeds to multiple borrowers. The borrowers may be governmental or private entities.

Pooled financings occur for various reasons. Municipalities or conduit borrowers may not have a sufficient credit rating to borrow on their own, or they may find that consolidating loans with other borrowers lowers the cost of borrowing. Rather than issuing several smaller bond issues an issuer will agree to issue one large issuance, and subsequently lend the proceeds to several municipalities or other conduit borrowers.

Continued on next page

Section 149(f), in General

Section 149(f) provides that the interest on a pooled financing bond will NOT be tax exempt unless it meets four specific requirements:

1. The reasonable expectation requirement,
2. The cost of issuance payment requirements,
3. The written loan commitment requirement, and
4. The redemption requirement.

There are no regulations to accompany this section. (For more information on Pooled Bonds see – CITE IN OTHER MATERIAL]

Specific Applicability

The provisions of § 149(f) do not apply to all pooled financing bonds. Generally, they apply only to those issues not subject to the volume cap ceiling on private activity bonds generally, governmental or 501(c)(3).

Legislative History

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

- Issuing bonds without immediate need for the funds,
- Issuing bonds without written commitments from potential borrowers to use the funds for governmental purposes,
- Issuing bonds for the sole purpose of "locking in" current low interest rates, OR
- Allowing bonds to remain outstanding longer than necessary.

Section 7

Hedge Bonds

Overview

General Rule

Section 149(g) provides that the interest on hedge bonds will not be tax exempt unless certain requirements are met. The regulations which accompany this section generally apply to bonds issued after June 30, 1993.

Contents

This section contains the following topics:

Legislative History

Prior to § 149(g), municipalities could issue bonds when interest rates were low, even though there was not an immediate need for financing. They were "hedging" against the risk that interest rates would increase in future years. Congress viewed this practice as a drain on the federal treasury because the bonds were outstanding longer than necessary. The hedge bond rules were enacted to ensure that bond issues were reasonably sized and timely issued.

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Hedge Bonds versus Hedged Bonds

There are two terms that are similar, but have different meanings. These differences must be clarified.

Hedge bonds, as defined in § 149(g), refer to bonds which are taxable bonds because they have failed to meet certain requirements regarding the investment and spending of proceeds.

Hedged bonds, as defined in Regulations § 1.148-4(h), refer to bonds where the issuer has entered into a hedge transaction which is used to compute bond yield. A hedge transaction is a contract entered into to modify the interest rate risk, such as a swap or a cap.

The following discussion is in regard to hedge bonds as defined in § 149(g). There will be a discussion of hedged bonds as defined in Regulations § 1.148-4(h) in Phase II of this course.

Hedge Bond Requirements

What is a Hedge Bond?

To avoid being a hedge bond, a bond must meet BOTH of the following tests:

1. The issuer must reasonably expect to spend at least 85 percent of spendable proceeds for the governmental purposes of the issue within 3 years of the issuance date; AND
2. 50 percent or less of the proceeds are invested in non-purpose investments having a substantially guaranteed yield for four years or more.

If either of these tests is NOT met, then the bonds are hedge bonds.

Reasonable Expectations

Treasury Regulations § 1.149(g)-1(a) states that "reasonable expectations" has the same meaning as set forth in Treasury Regulations § 1.148-1, along with the modification described in § 149(f)(2)(B). Section 149(f)(2)(B) concerns pooled financing issues, and provides that expectations regarding changes in interest rates and tax laws cannot be considered when determining whether expectations are reasonable.

What Are Spendable Proceeds?

The term "spendable proceeds," is defined in Treas. Reg. § 1.149(g)-1(a) as "net sale proceeds" as defined in Treas. Reg. § 1.148-1. Net sale proceeds are sale proceeds, and any amounts actually or constructively received from the sale of an issue, including amounts used for underwriter's discount and accrued interest, other than preissuance accrued interest less proceeds placed into a reasonable required reserve and replacement fund and as part of a minor portion under § 148(e). Net sale proceeds include but are not limited to, amounts derived from the sale of a right that is associated with a bond described in Treas. Reg. § 1.148-4(b)(4).

Non-purpose Investments

Non-purpose investments are investments in securities, bank deposits, or other investments which have nothing to do with the purpose of the issue. Guaranteed yields may result from any type of investment. Some examples are guaranteed investment contracts, government securities, or other bonds.

Exception to the General Rule

Exception to Hedge Bond Status

Section 149(g)(3)(B) provides that a bond which otherwise meets the definition of a hedge bond will not be considered a hedge bond if:

- 95 percent of the net proceeds are invested in tax-exempt bonds that are not subject to the Alternative Minimum Tax under § 57,
- amounts in a bona fide debt service fund, and
- amounts held for not more than 30 days pending reinvestment or bond redemption

This test is based on **actual** investments, and not the issuer's expectations.

Definition of "Net Proceeds"

Proceeds is defined in Treasury Regulations § 1.148-1(b) as any sale proceeds, investment proceeds, and transferred proceeds of an issue. Net sale proceeds are defined in Treasury Regulations § 1.148-1(b).

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Bonds Subject to the Alternative Minimum Tax ("AMT Bonds")

"AMT bonds" are those bonds which are considered tax preference items under § 57. Those items included in § 57 are subject to the Alternative Minimum Tax of § 55.

Generally, AMT bonds are private activity bonds issued after August 7, 1986, except for:

- qualified 501(c)(3) bonds,
- certain housing bonds, and
- refunding bonds, if the original bond was issued before August 8, 1986

Therefore, non-AMT bonds would be:

- 501(c)(3) bonds,
- certain housing bonds,
- certain refunding issues, AND
- governmental bonds

Note: ARRA provided certain temporary relief from AMT on tax-exempt interest.

Interest on a Hedge Bond Can still be Tax-Exempt

Two Tests

Section 149(g)(1) provides that if a bond meets the definition of a hedge bond, the interest will be considered to be tax exempt if the bond meets two requirements:

1. Five-year reasonable expectations test described below, and
2. Cost of issuance payment requirements

5-Year Reasonable Expectation Test

Section 149(g)(2) provides that a hedge bond will not be tax-exempt unless the issuer reasonably expects to meet the spending requirements set forth in the table below:

Percentage of Spendable Proceeds	Time Period within which to be spent
10%	1 year
30%	2 years
60%	3 years
85%	5 years

Cost of Issuance Payment Requirements

The cost of issuance payment requirements for purposes of § 149(g) are met with respect to an issue if -

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

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Interest on a Hedge Bond Can still be Tax-Exempt, Continued

Example

City X plans to issue a $59 million bond issue at 6% on January 1, 1994. The proceeds will be used to build a qualified multi-purpose recreational complex. The City is in the process of purchasing the land from several landowners. The negotiations are not complete and are expected to continue for several months. Because the land purchases are not final, architectural plans are also not complete. As a result, on January 1, 1994, the issuance date, the City cannot reasonably expect to substantially finish the project within three years. However, because the city expects to have made significant progress on the project within five years, the bonds are issued anyway. Financial data regarding the issue is as follows:

Proceeds from sale	**$59,000,000 (includes underwriters discount)**
Accrued interest	$ 330,000
Gross proceeds	$59,330,000
Deposit to reserve	$(5,900,000)
Spendable proceeds	$53,430,000
Issuance costs paid by January 31, 1994	$1,135,327

In order to meet the 5-year reasonable expectations test of § 149(g)(2), the City must reasonably expect to spend the proceeds according to the following schedule:

Percentage of Spendable Proceeds	**Amount to be Spent**	**Date**
10%	$5,343,000*	December 31, 1994
30%	$16,029,000	December 31, 1995
60%	$32,058,000	December 31, 1996
85%	$45,415,500	December 31, 1998

Because City X reasonably expects to spend the amounts shown above, and the cost of issuance payment tests were met, the interest on the bonds will be tax exempt, even though the bonds are still considered to be hedge bonds.

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Interest on a Hedge Bond Can still be Tax-Exempt, Continued

Additional Notes about This Section

There is no effect on the bond's status if the actual disbursements do not meet the above spending schedule unless the circumstances surrounding the actual events cast doubt on the reasonable expectations on the issuance date.

The allocation and accounting rules of Treasury Regulations § 1.148-6 apply to expenditures for purposes of § 149(g). There is an exception for certain expenditures which create replacement proceeds. See Treasury Regulations § 1.149(g)-1(b).

Section 149(g)(4)(A) provides that issuers of construction projects which are expected to take longer than five years may request a ruling regarding hedge bond status. The issuer must reasonably expect that the spendable proceeds will be spent over a reasonable construction period, which is specified in the request.

This should be included in class room hand out; not in the text.   Great materials for auditing.

Hedge Bond Rules for Refunding Issues

Overview

A refunding bond is treated as meeting the requirements of the hedge bonds rules if the original bond met such requirements.

A discussion of whether a refunding bond is considered a hedge bond is provided in Phase II.

Summary

Lesson 8 discussed the various provisions of § 149. All tax-exempt municipal bonds are subject to these provisions.

Section 149(a) requires that most tax-exempt municipal bonds be registered. The regulations provide that issuers can use either the certificate or the book-entry system of registration.

Section 149(b) provides that tax-exempt municipal bonds cannot be federally guaranteed. There are many exceptions to this general rule.

Section 149(c) provides that all tax-exempt bonds must comply with § 103, even though tax-exempt status is provided under another federal statute. Most bonds issued after 1983, therefore, must comply with §§ 141-150.

Section149(d) provides the rules for advance refundings. Advance refundings are bonds issued to refund prior bonds, when the proceeds are held more than 90 days in advance of the maturity or call date of the refunded bonds. In a current refunding, the proceeds of refunding bonds are used to repay prior bonds within 90 days of issuance of the refunding bonds.

Section 149(e) provides for the information reporting requirements of municipal bonds. Issuers are required to file one of a series of Forms 8038 when the bonds are issued. Form 8038-T is required to be filed when an issuer makes yield reduction or rebate payments, or is paying an arbitrage penalty.

Section 149(f) provides the rules for pooled financings. These are bonds the proceeds of which are loaned to two or more borrowers.

Section 149(g) provides the rules for hedge bonds. Hedge bonds are bonds which are issued prior to the need for financing. The interest on a hedge bond may or may not be tax-exempt, depending on the circumstances.

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Summary, Continued

Preview of Module 9

Module 9 discusses the private activity bond tests of § 141. If a bond meets the private activity bond tests, the interest on the bonds is not excludable from gross income unless the bond is a qualified private activity bond.

All examinations of governmental bonds will use these tests if there is any evidence of private or disproportionate use of tax-exempt bond-financed property.

Class Exercises   These should be deleted from the text and held for class room handouts.

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