



## REIMBURSEMENT BONDS: THEIR USES AND MISUSES CONSIDERED IN A SPECIAL CDIAC PUBLICATION

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The California Debt and Investment Advisory Commission (CDIAC) staff has learned that some school and community college districts are being counseled by financial professionals to invest bond proceeds in long-term investments as a way to generate general fund revenues. In light of the state's fiscal condition, the temptation to do so may be result from the real possibility that educational services will be curtailed or eliminated as a result of insufficient funding. In the particular cases brought to CDIAC's attention, school and community college districts are being encouraged to invest the proceeds of reimbursement bonds in long-term investments and extend the term of the investment by using funds received from the state to pay the cost of school construction and renovation. Doing so, however, may violate the conditions and intent of *Treasury Regulation Section 1.150-2*.

CDIAC has prepared a special report, entitled "*Reimbursements and Bond Proceeds*," to provide issuers information on reimbursement bonds that may guide them in their appropriate use of such bonds. The report is being issued as an occasional paper, the first in a new series of publications that intends to address in depth principles and mechanics of debt issuance and public investment.

The report provides a description of what issuers are required to do prior to issuing a reimbursement bond. A reimbursement bond consists of the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date of the bonds.<sup>1</sup> In summarizing the appropriate uses of reimbursement bonds, the report recognizes the possibility that allocations made from reimbursement bond proceeds may be made inappropriately.<sup>2</sup> Failing to correctly follow the reimbursement rules ultimately can lead an issuer to inappropriately invest bond proceeds as if they were general fund revenues not subject to arbitrage and rebate regulations. By intentionally or inadvertently violating the reimbursement rules of Section 1.150-2, an issuer could place the tax-exemption of its bonds at risk, leading to significant adverse consequences. In addition, issuers that have invested the proceeds from what were assumed to be reimbursement bonds and that were subsequently found not to meet the federal criteria defining such bonds would be obligated to rebate arbitrage earnings to the Treasury.

To receive a copy of the report, please call CDIAC at (916) 653-3269 or by e-mail at [CDIAC@treasurer.ca.gov](mailto:CDIAC@treasurer.ca.gov).

<sup>1</sup> Treasury Regulation Section 1.150-2(c).

<sup>2</sup> Pursuant to Treasury Regulation Section 1.150-2(c) a reimbursement allocation means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure.

*Treasury Regulation Section 1.150-2(c)* allows a bond issuer to use the proceeds of its issuance to reimburse a prior expenditure. Provided that the issuer or borrower follows specified operating rules, expenditures that may be reimbursed include capital expenditures, costs of issuance, extraordinary working capital items, grants and certain loans. When bond proceeds qualify as and are actually used for a reimbursement of general funds or other funds of the issuer, the proceeds are treated as spent for the reimbursed expenditure. This means that the reimbursed funds are no longer bond proceeds and may be invested free of the yield restrictions and rebate requirements set forth in the Internal Revenue Code (Revenue Code). The funds, therefore, may be invested at a higher rate of return than is allowed for bond proceeds under arbitrage limits.

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