Chapter 3

GENERAL FEDERAL TAX REQUIREMENTS

INTRODUCTION

This chapter provides an overview of the basic federal tax concepts and rules applicable to public finance. Federal tax concepts that relate in a unique way or are only applicable to a particular type of bond are discussed in **Chapter 6, Types of Financing Obligations** in the applicable section.

Under the Internal Revenue Code of 1986, as amended (the "tax code"), bonds issued by states and local governmental units generally bear interest that is excluded from gross income for federal income tax purposes. The term "bond" includes any evidence of indebtedness, and covers notes, installment sale agreements, or financing leases. Although exempt from federal income tax, interest on bonds may be taken into account in determining other federal income tax consequences, such as personal or corporate alternative minimum tax, interest expense deductions, taxation of Social Security benefits, and the like.

In general, interest on bonds is taxable if:

- The bonds are not treated as obligations of a state or political subdivision of a state (see below)
- The bonds are arbitrage bonds
- The bonds are hedge bonds
- The bonds violate various other prohibitions contained in the tax code

Furthermore, nongovernmental bonds such as private activity bonds used to finance projects that substantially benefit private businesses, generally are not tax-exempt. Certain qualified private activity bonds can be tax-exempt.

The discussion below sets forth the principal federal tax rules in enough detail to give the reader a basic understanding of the concepts and limitations listed above. In addition to the requirements covered in this chapter, the following universal requirements apply to all tax-exempt bonds:

- An information return (Form 8038) must be filed for the bonds
- Bonds must be issued in registered form

- Bonds may not be directly or indirectly guaranteed by the federal government

In many cases, but typically with bonds issued to fund public infrastructure and payable from general governmental revenues, the tax rules discussed in this chapter will not have a significant effect on the way a bond issue is structured—at least from the issuer's perspective. Bond counsel will analyze the requirements and take steps to help the issuer comply, but the tax aspects of the transaction will not be particularly difficult. In other financings, such as qualified private activity bonds or financings (e.g. single-family housing bonds) involving underlying loans, the tax rules are critical to the structuring and success of the transaction, and much of the effort of the financing team will be devoted to ensuring compliance with these complex requirements. In all financings, care must be taken to comply with all of the requirements of the tax code.

OBLIGATIONS OF A STATE OR POLITICAL SUBDIVISION

In order to be tax-exempt, bonds must be issued by or on behalf of a state or a political subdivision of a state. Political subdivisions are public agencies that can independently exercise a substantial amount of one or more of the following governmental powers:

- Eminent domain
- Police power
- Taxing power

Public agencies such as joint powers authorities that are not political subdivisions but that issue bonds at the direction of, or are completely controlled by, a political subdivision typically are treated as issuing bonds on behalf of a political subdivision. Tax lawyers sometimes refer to these issuers as "on behalf of" issuers. Additionally, under some circumstances bonds issued by nonprofit corporations are treated as bonds issued on behalf of a political subdivision. See the **Special Federal Tax Issues** discussion in **Chapter 6, Types of Financing Obligations – Public Lease Revenue Bonds**.

DEFINITIONS

The following definitions are crucial to an understanding of how the tax law applies to public finance. The reader may wish to refer back to this section as these concepts arise in later discussion.

Issue of Bonds. In general, the various federal tax limitations and requirements apply to an "issue" of bonds rather than to individual bonds. In other words, to determine whether bonds are private activity bonds, arbitrage bonds, or hedge bonds, one must first determine which bonds are part of the same issue. Bonds are part of the same issue if the bonds are sold at substantially the same time (i.e. less than 15 days apart), are reasonably expected to be paid from substantially the same source of funds and are sold pursuant to the same financing plan.

Typically, all of the bonds that are sold pursuant to the same Official Statement are part of the same issue.

Proceeds. Just as the federal tax rules primarily apply to an issue of bonds, the application of the federal tax law requires an analysis of the investment and ultimate use of the "proceeds" of a bond issue. For example, it is the timing and manner of the ultimate use of proceeds that determines whether bonds are private activity bonds, qualified private activity bonds, or hedge bonds. Proceeds are comprised of the following:

- **Sale Proceeds.** The amounts actively or constructively received by an issuer from the original purchasers for the bonds. Receipt includes amounts paid as underwriter's discount or other compensation and accrued interest on the bonds from their date to the date of delivery, if any.

- **Investment Proceeds.** The amounts constructively received from investing the proceeds of a bond issue.

- **Transferred Proceeds.** When the proceeds of a refunding issue are used to make payments of principal on refunded bonds, any remaining proceeds of the refunded bonds, i.e. the unspent proceeds, "transfer over" to the refunding issue based on a formula set forth in the U.S. Treasury regulations.

- **Replacement Proceeds. I**ncludes money held by the issuer or a "substantial beneficiary" of the bonds if such amounts have a sufficiently direct relationship to the bond issue or a governmental purpose of a bond issue and the amount invested would be used for a governmental purpose.

- **Gross Proceeds.** All proceeds (sale proceeds, investment proceeds, replacement proceeds, and transferred proceeds) plus amounts that are reasonably expected to be used to repay the bonds, such as revenues deposited in a debt service fund, and amounts that are pledged as security for the repayment of the bonds.

- **Disposition Proceeds**. Proceeds that result from the sale of all or a portion of a bond-financed facility with cash. For arbitrage purposes, disposition proceeds are treated as gross proceeds.

- **Net Proceeds.** The proceeds of the bonds less the amount of a reasonably required reserve or replacement fund.

Expenditure of Gross Proceeds. Understanding whether funds held by an issuer are "proceeds" at any given time requires a comprehension of how funds related to a bond issue are treated as having been spent. The following concepts are important to an understanding of expenditures:

- **Expenditures Related to Purpose of Issue.** Generally, proceeds may be spent only on capital costs of facilities and costs of issuing the bonds and establishing a reserve fund. Once proceeds are allocated to an ultimate expenditure, the use and nature of any facility paid for with the proceeds is tracked for private activity bond and qualified private activity bond purposes. If the purpose of the bonds is to finance working capital expenditures, U.S. Treasury regulations provide that proceeds are spent only at times in which the issuer has no other monies on hand available to cover those working capital expenses (see **Chapter 6, Types of Financing Obligations – Tax and Revenue Anticipation Notes (TRANs)**).

- **Investments.** Gross proceeds are considered not spent if they are used to acquire investment securities. They are simply allocated to those investments temporarily and return to the issuer for ultimate use or reinvestment as the investment securities mature or are sold. During the time gross proceeds are allocated to investment securities they are tracked for arbitrage purposes, as well as to determine the amount of investment proceeds that has accumulated.

- **Payment of Debt Service.** Generally, gross proceeds that are not sale, investment, or transferred proceeds are spent only when they are used to pay debt service on the bonds.

- **Reimbursements.** Issuers and conduit borrowers often wish to use bond proceeds to reimburse themselves for costs paid prior to the issuance of the bonds. Bond proceeds allocated to such "reimbursement costs" will be treated as "spent" only if certain requirements are satisfied (see text box at right). If these requirements are not satisfied, any bond proceeds that the issuer or conduit borrower attempts to allocate to the reimbursement costs will not be treated as spent and will continue to be subject to the arbitrage yield restriction rules and the rebate requirement discussed in more detail below.

Reimbursement Rules

Intent. The issuer must demonstrate that an intent to use bonds to reimburse itself existed at or around the time the cost was paid.

- ✓ The issuer must adopt an official intent resolution no later than 60 days after the reimbursement cost in question was paid.
- ✓ The official intent resolution must contain a description of the project, the maximum amount of bonds expected to be issued for the project, and state the issuer's reasonable expectation to reimburse itself.

Reimbursable Costs. Generally, reimbursement costs are limited to capital expenditures and cost of issuance items.

Timing of Reimbursement. Reimbursements must be made no later than 18 months after the later of (i) the date the cost is paid, or (ii) the date the project is placed in service or abandoned (but in no event more than 3 years after the cost is paid).

Preliminary Expenditures Exception. "Soft costs" (such as architectural, engineering, surveying, soil testing, costs of issuance, and similar costs) may always be reimbursed whether or not a resolution was adopted and regardless of the timing of the reimbursement.

Yield. The yield on a bond issue is the discount rate or interest rate that allows all of the payments of principal and interest on the bonds (net of payments or receipts from certain interest rate hedging transactions such as swap agreements), plus any payments for credit

enhancement, to equal, on a present value basis and as of the date the bonds are issued, the aggregate amount paid by the original bond holders for the bonds. It is important to remember that an underwriter's discount or fees do not affect the aggregate amount paid by the original bond holders for the bonds and, therefore, do not affect the calculation of yield on the bonds. In other words, although from the issuer's perspective the payment of an underwriter's discount increases borrowing costs, it does not increase the yield on the bonds.

PRIVATE ACTIVITY BONDS

Interest on a private activity bond, cannot be excluded from gross income unless it meets the requirements for one of the categories of qualified private activity bonds. This section describes the conditions under which a bond will be determined to be a private activity bond. The following section describes the categories of qualified private activity bonds.

Basic Private Activity Bond Tests

An issue is considered a private activity bond if the issuer reasonably expects, as of the date of issuance, that either the Private Business Tests or the Private Loan Test is satisfied.

Private Business Use Test. More than 10 percent of the proceeds of the issue are used for any private business use. Any activity carried on by a person (other than a natural person) is treated as a trade or business. Both actual and beneficial use by a nongovernmental person may be treated as private business use. However, in most cases, the Private Business Use Test is satisfied only if a nongovernmental person has special legal entitlements to use the property with bonds proceeds under an arrangement with the issuer. For example, if a nongovernmental person's use is in a business or trade, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and then leased to a governmental person, or leased to a governmental person and then leased to a person.

Private Security or Payment Test. The direct or indirect payment of principal or interest on more than 10 percent of the bond issue is to be secured by or derived from payments in respect of property used for a private business use.

If a facility is used disproportionately by a private business or is used by a private business in a manner that is unrelated to the governmental entity's use, the 10 percent limitation of the Private Business Tests is reduced to a 5 percent limitation.

Private Loan Test. Even if the Private Business Tests are not satisfied, an issue will nevertheless be an issue of private activity bonds if the lesser of 5 percent of the proceeds or $5 million are used to make or finance loans to persons other than governmental units.

Reasonable Expectations. Generally, the determination of whether an issue of bonds is an issue of private activity bonds is based upon the issuer's reasonable expectations as of the

date the bonds are issued. With certain limited exceptions, it is important that issuers reasonably expect to own and use a bond-financed facility for at least either of the following:

- The shorter of the entire economic useful life of the facility
- The term of the bonds

If the issuer does not have these expectations, special mandatory call provisions may be required, providing for a redemption of bonds at the time of sale or other change in use of the financed property. The average maturity of bonds generally cannot exceed 120 percent of the reasonably expected average useful life of the financed property.

Notwithstanding an issuer's reasonable expectations of governmental use, certain deliberate actions by an issuer or independent actions by third parties may cause the Private Business Use Tests or the Private Loan Test to be satisfied with respect to an issue. A more detailed description of these rules is in the section on **Change in Use** in this chapter.

Private Business Use

Interest on a private activity bond cannot be excluded from gross income under the Internal Revenue Code if more than 10 percent of the proceeds of the bond issue are to be used for any private business use. "Private business use" is defined as any use, both actual and beneficial, in a trade or business carried on by any nongovernmental person. For the purpose of this definition, any activity carried on by any person other than a "natural person" is treated as a trade or a business.

The trade or business use of proceeds or of facilities financed with bond proceeds by a nongovernmental person through indirect means constitutes private business use. Beneficial use is established only if the nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. These entitlements include ownership, actual or beneficial use pursuant to a lease and certain management or service contracts, output contracts, or research contracts.

Use by an employee of the issuer or an individual who is not carrying on a trade or business is not private business use. In addition, use by the general public (e.g. use by individuals and business on the same basis) is not private business use. U.S. Treasury regulations provide useful guidance about facilities that have a close connection to privately-used facilities but with respect to which there is no special legal entitlement by a nongovernmental person—for example, private business use of a governmentally owned and operated parking garage adjacent to an airport, a sports stadium, or a shopping center.

To the extent that no private business user has a special legal entitlement to the facility (e.g. a lease, a management contract, or a priority use right) and the facility is intended to be available and, in fact, is reasonably available to the general public, actual use of the facility by

nongovernmental persons will not constitute private business use. Use by the general public contemplates use by individuals not acting in a trade or business. Any fees charged for such use must be generally applied. Monthly or longer arrangements for use (such as a monthly parking pass) can satisfy this requirement, so long as the term of the arrangement does not exceed 180 days of use, and the arrangement is not required to be renewed at the end of its term.

To the extent a facility is not intended to be available or is not reasonably available to the general public, but no private business user has a special legal entitlement to the facility, the analysis shifts to whether any private business receives a special economic benefit from the facility. Factors taken into account to make this determination include the proximity of the facility to and functional relationship of the facility with any activities of a private business, as well as the number of private businesses receiving any special economic benefits.

De Minimis Private Business Use Exceptions

Certain minor or insignificant (so-called de minimis) private business uses of bond-financed facilities are not deemed to be sufficient to satisfy the Private Business Use Test. The following sections describe these de minimis exceptions:

One Hundred-Day Arrangements with Nongovernmental Persons. Use by a nongovernmental person pursuant to a lease or contract does not constitute private business use if:

- The term of the lease or contract is less than 100 days
- Similar arrangements are generally available to, and expected to be executed with, private businesses on a nondiscriminatory, rate scale basis
- The facility is not financed for the principal purpose of providing it for use by a nongovernmental person

Fifty-Day Use with Nongovernmental Persons. Use by a nongovernmental person is private business use if all of the following are true:

- The term of the use, including all renewal options, is not more than 50 days
- The arrangement is negotiated at arms-length, compensation is at fair market value
- The facility is not financed for a principal purpose of providing it for use by a nongovernmental person

Temporary Use by a Developer. As described in **Chapter 6, Types of Financing Obligations – Assessment Bonds**, certain temporary uses by developers of facilities financed with special tax or assessment bonds are disregarded.

Use by Agents. Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person.

Use Incidental to Financing. Use by a nongovernmental person that is solely incidental to the financing (e.g. bond trustees, loan services, and guarantors are generally not treated as private business users).

Incidental Use. Use that does not exceed 2.5 percent of the proceeds of the bond issue is disregarded if:

- The use does not involve a transfer to nongovernmental persons of possession or control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, except this prohibition does not apply to vending machines, pay telephones, and similar uses
- The same person does not functionally relate the nonpossessory uses of the facility to any other use of the facility
- All the nonpossessory uses of the facility, in aggregate, involve use of 2.5 percent or less of the facility

Qualified Improvements. If bond proceeds are used to make improvements owned by the governmental unit to a building also owned by the governmental unit, then the proceeds are not used for private business if:

- The building was placed in service more than a year prior to the date construction or acquisition of the improvement commenced
- The improvement is not exclusively for private business use
- No portion of the building or any of the payments with respect to the improved building are taken into account under the Private Security Test
- No more than 15 percent of the building is used for a private business use

Anti-abuse Rule. U.S. Treasury Regulations section 1.141-3(g2)(iv) prevents abuse of the Private Business Tests. These regulations permit the IRS to determine the amount of private business use according to the greater percentage of private business use in any one-year period. The issuer establishes the term of the bond issue:

- For a period that is longer than reasonably necessary for the government purpose of the bond issue
- For the principal purpose of increasing the permitted amount of private business use

Measuring Private Business Use

As described above, the Private Business Use Test is met if more than 10 percent (in some cases 5 percent) of the proceeds of the issue are used directly or indirectly in trades or businesses carried on by nongovernmental persons. Private business use generally is measured by determining the average percentage of private business use of the property that occurs during the period of time beginning on the later of the date the bonds are issued or the date the financed facility is placed in service, and ending on the earlier of the date the bonds mature or the end of the reasonably expected useful life of the facility. Average private business use of the facility for any given year is equal to the amount (i.e. number of days) of private business use during that year divided by the amount (i.e. number of days) of total use (private use and governmental use) of the facility during that year. However, uses may need to be weighted if the fair market value of the uses varies. Periods of nonuse are disregarded for the purpose of computing percentage use.

Private Business Use Example

A state uses the proceeds from a bond issue with a 20-year term to reimburse itself for the acquisition of a 10-story office building. The facility is used solely for governmental purposes for 18 years. At the end of the 18th year, state officials lease the entire building for two years to a corporation for its private business use. Two years of 100 percent private business use averages over the 20-year measurement period only to 10 percent private business use, and thus the Private Business Use Test is not satisfied. However, if the state sold the building to the corporation, the private business use of the building would be equal to the greatest percentage of private business use for any one-year period. Thus, the facility will have 100 percent private business use for its entire life and will therefore satisfy the Private Business Use Test.

Simultaneous private business use and governmental use may require more complicated methods of measuring the amount of private business use. Private business use that takes place before or after the measurement period described above is ignored. Special rules exist for measuring the amount of private business use attributable to certain contractual rights to the output of electric and gas generation, transmission and related facilities, and certain water facilities.

If the private business use of a financed facility is the result of ownership of the facility by a private business, then the amount of private business use is determined based on the highest percentage of private business use during any of the annual periods that make up the general measurement period.

Management or Service Provider Contracts

Any contract between a governmental entity and a private business providing services with respect to a bond-financed facility is a potential source of private business use and must be examined when determining whether the 10 percent private business use limitation has been or will be exceeded. Generally, the determination of whether a service contract between a governmental person and a service provider gives rise to private business use is based upon all the facts and circumstances of the arrangement.

Private Business Use Contracts. Two types of contracts almost always result in private business use:

- A contract that provides for compensation based upon net profits of the bond-financed facility
- A contract under which the service provider is considered the lessee or owner of the bond-financed facility for federal tax purposes

Exempted Contracts. U.S. Treasury regulations provide a list of arrangements that are not considered management contracts. The following contracts are explicitly not included within the definition of management contracts:

- Contracts for services that are solely incidental to the primary governmental function of the facility (e.g. janitorial contracts, equipment repair contracts, contracts for billing services)
- Granting of admitting privileges by a hospital to doctors, even if conditioned on the provision of de minimis services, if available to all qualified physicians in the area consistent with the size and nature of the facilities
- Contracts relating to the operation of public utility property where the only compensation is reimbursement of direct actual and direct expenses of the service provider and reasonable administrative overhead expenses
- Contracts to provide services where the only compensation is reimbursement to the service provider for actual and direct expenses to unrelated third parties

Safe Harbors for Certain Compensation Arrangements

There are certain "safe harbors" for compensation arrangements in management or service contracts. In order to meet the safe harbors, the compensation to the service provider under the contract must not be based on net profits, the service provider must not be in a position to limit the governmental entity's rights under the contract, and the contract must fall within one of the following six categories:

What is a Safe Harbor?

A "safe harbor" is a set of requirements that, if satisfied, protect the arrangement from being determined by the IRS from violating a given rule. Being outside the "safe harbor" does not necessarily mean that the rule has been violated, but most tax counsel will not give an unqualified opinion regarding an arrangement that is outside the safe harbor absent obtaining a specific ruling from the IRS.

- **95 percent Fixed Fee Contracts.** At least 95 percent of the compensation is based on a periodic fixed fee, and the contract term does not exceed the lesser of 15 years or 80 percent of the reasonably expected useful life of the managed facility. A one-time, fixed incentive payment based on gross revenue or expense targets is allowed to be paid to the service provider without affecting the fixed fee payment requirement.

- **80 percent Fixed-Fee Contracts.** At least 80 percent of the compensation is based on a periodic fixed fee, and the contract term does not exceed the lesser of 10 years or 80 percent of the reasonably expected useful life of the managed facility. A one-time, fixed incentive payment based on gross revenue or expense targets is allowed to be paid to the service provider without affecting the fixed-fee payment requirement.

- **Public Utility Property.** If the facility is predominantly public utility property, the 15 year and 10 year requirements described above are substituted with a 20 year requirement.

- **50 percent Fixed-Fee or Capitation Contracts.** Fifty percent of the compensation is based on a periodic fixed fee, or 100 percent is based on a capitation (per person) fee or a combination of the two, and the contract term does not exceed five years. The issuer must have the power to terminate the contract without penalty after three years.

- **Per-Unit Fee Contracts.** One hundred percent of the compensation is based on a per-unit fee, or a combination of a per-unit fee and a periodic fixed fee, and the contract term does not exceed three years. The issuer must have the power to terminate the contract without penalty after two years.

- **Percentage of Revenue or Expense Contracts.** Applies only to contracts under which the service provider primarily provides service to third parties (e.g. a radiologist) or during the start-up phase of a new facility. One hundred percent of the compensation is based on a percentage of fees charged, or a combination of a per-unit fee and a percentage of revenue or expense fee, and the contract term does not exceed two years. The issuer must have the ability to terminate the contract without penalty after one year.

Renewal Options. For purposes of the six categories above, renewal options by the service provider that are enforceable against the issuer are counted in the term limitation. Renewal options by the issuer and automatic renewal provisions subject to cancellation by either party do not count.

Indexing. The payments under the fixed-fee contract may change over time if tied to an objective external standard, such as the Consumer Price Index.

Prohibited Relationships. The service provider must not have any relationship with the governmental entity that, in effect, substantially limits the governmental entity's ability to exercise its rights under the contract. A safe harbor from this relationship limitation is provided if all of the following three requirements are satisfied:

- The service provider does not control more than 20 percent of the voting power of the board of the governmental entity

- Overlapping board members do not include the chief executive officers of either party
- The service provider and the governmental entity are not related parties

Change in Use

As described above, the private activity bond analysis at the time bonds are issued focuses on the issuer's expectations as to private business use. However, once bonds are outstanding, voluntary or "deliberate" actions by an issuer that allow for the Private Business Tests to be satisfied can cause the bonds to have a retroactive loss of tax-exempt status. A number of specific remedies have been provided for such a "change in use" problem. In general, and subject to a number of detailed limitations, issuers can redeem or defease bonds, can make sure that the new use of the project qualifies for tax-exempt financing on some alternate basis, or, in the case of a sale of the project, can use any consideration paid for the project to finance a new facility that does not satisfy the Private Business Tests.

Private Security or Payment Test

This is the second part of the Private Business Tests. Both the Private Business Use Test and Private Security or Payment Test must be satisfied for a bond to be a private activity bond.

As its name implies, the Private Security or Payment Test looks at the source of the monies paid toward debt service (directly or indirectly) and the security provided for the bonds by nongovernmental persons. The Private Security or Payment Test is met if the aggregate present value of the private payments and private security exceeds 10 percent of the present value of the debt service on the bonds, with certain adjustments. Absent deliberate actions by the issuer, satisfaction of the Private Security or Payment Test is based upon reasonable expectations as of the date on which the bonds are issued. Present values are computed using the yield on the bonds as a discount rate.

Private Payments Example

A state issues 20-year general obligation bonds to finance a new office building which is not pledged to secure the bonds and which is used exclusively by the state through the 18th year. During years 19 and 20, the entire building is leased to a nongovernmental person. If the annual rents during years 19 and 20 equal annual debt service plus annual operating expenses during those two years, the Private Payment or Security Test will not be met because the present value of adjusted lease rentals in years 19 and 20 should be far less than 10 percent of the present value of the debt service on the bonds. What if the rental payments during years 19 and 20 is enough so that the present value of those payments exceeds 10 percent of the present value of the debt service on the bonds? The total percentage of average annual private business use is 10 percent, and the payments to be taken into account under the Private Payment or Security Test are therefore limited to 10 percent of the debt service on the bonds. Thus the Private Payment or Security Test is not satisfied.

Private Security

U.S. Treasury regulations provide only limited guidance in interpreting the private security provisions of the Private Payment or Security Test. They do reiterate that pledged property provided by a user of the proceeds of the bonds need not be financed by the bonds and clarify

that property used by nongovernmental persons is to be valued at its fair market value (rather than its historical cost), as of the date when the property first secures the bonds.

Private Payments

In general, U.S. Treasury regulations seem to take into account all payments to the issuer or to any related entity by any nongovernmental person that uses the bond proceeds or bond-financed facilities, even if the payments are made by nongovernmental persons who use the property as members of the general public, to the extent the payments either:

- Are to be used to pay debt service on the bonds, or
- Are to be made in respect of bond-financed facilities

However, the amount of the payments is decreased by the allocable operating and maintenance expenses paid by the issuer with respect to the financed facilities. In addition, the amount of private payments to be taken into account is limited to the amount of private business use.

Exception for Generally Applicable Taxes. Payments of generally applicable taxes are disregarded for purposes of the Private Payment or Security Test. This includes both payments of taxes and "payments in lieu of taxes," to the extent such taxes are imposed at a uniform rate and are applied to all persons of the same classification in the jurisdiction. Real property assessments, Mello-Roos taxes (with the possible exception of Mello-Roos taxes spread over a large area like an entire city), and payments for a special privilege granted or service rendered generally are not applicable taxes. The amount of payments made by nongovernmental persons required to be taken into account is limited to the amount of debt service attributable to the portion of the bond-financed facility used by such nongovernmental persons.

Private Loan Test

An issue of bonds qualifies as a private activity bond issue if it satisfies either the Private Business Tests or the Private Loan Test.

The Private Loan Test is met if more than the lesser of 5 percent or $5 million of the proceeds of the issue is used to make or finance loans to nongovernmental persons. In determining if the Private Loan Test is met, all loans must be identified. A loan is any transaction that is characterized as a loan under general federal income tax principles. The substance of the transaction is determinative. For example, a lease or a management contract might be considered a loan if federal tax ownership of the facility is transferred to the lessee or manager. Likewise, an output contract might be considered a loan if the agreement shifts significant burdens and benefits of ownership to the output purchaser. An arrangement is not a loan for purposes of the Private Loan Test if:

- It arises from the imposition of a mandatory tax or other assessment of general application
- The assessment is imposed for essential governmental functions, and
- An equal basis requirement is met

See **Chapter 6, Types of Financial Obligations – Assessment Bonds** for a detailed discussion of the rules relating to assessment bonds.

QUALIFIED PRIVATE ACTIVITY BONDS

As described above, the interest on private activity bonds is not excluded from federal gross income unless such bonds are qualified private activity bonds. There are a number of different types of qualified private activity bonds. Each type is based on the specific manner in which the proceeds of the bonds are used. Most of the types of qualified private activity bonds are comprised of:

- Exempt facility bonds
- Mortgage revenue bonds
- Qualified small issue bonds
- Qualified 501(c)(3) bonds

Exempt Facility Bonds. Exempt facility bonds are bonds of which at least 95 percent of the net proceeds are to be used to finance capital costs of facilities that serve, or are available on a regular basis, for general public use, or are part of a facility that is so used. Exempt facilities are defined as:

- Airport facilities
- Docks and wharves
- Mass commuting facilities
- Facilities for the furnishing of water
- Sewage facilities
- Solid waste disposal facilities
- Qualified residential rental projects
- Facilities for the local furnishing of electric energy or gas

- Local district heating or cooling facilities
- Qualified hazardous waste facilities
- High-speed intercity rail facilities
- Environmental enhancements of hydroelectric generating facilities or qualified public education facilities

Net proceeds are comprised of all proceeds, less amounts in a debt service reserve fund and less investment proceeds earned after completion of the project. Qualified residential rental projects are discussed in detail in **Chapter 6, Types of Financing Obligations – Conduit Revenue Bonds – Multifamily Housing Revenue Bonds**. U.S. Treasury regulations contain specific rules and definitions covering each of these exempt facility categories. In the case of the first three categories listed above, the facilities must be owned by a governmental unit.

Mortgage Revenue Bonds. Mortgage revenue bonds are bonds, the proceeds of which are loaned to certain home-buyers as acquisition financing for an owner-occupied personal residence. A detailed discussion of the federal tax requirements for the various types of mortgage revenue bonds can be found in **Chapter 6, Types of Financing Obligations – Single-Family Mortgage Revenue Bonds**.

Student Loan Bonds. Student loan bonds are bonds, of which at least 90 percent of the proceeds are used to make loans to students for educational purposes. A number of detailed federal tax limitations apply to student loan bonds. Since student loan bonds are not frequently issued and are highly specialized, they are not discussed in detail in this book.

Qualified Small Issue Bonds. Qualified small issue bonds are also known as industrial development bonds (IDBs). They are bonds issued in the aggregate face amount of $1 million or less and at least 95 percent of the net proceeds are used to finance a manufacturing operation and at least 75 percent of the net proceeds are used to acquire, construct, or improve land or depreciable property or to redeem bonds previously used for such purposes and provide the actual production facilities of the manufacturing operation, as opposed to office and warehouse structures and equipment. A complicated set of requirements, which applies to IDBs, are discussed in some detail in **Chapter 6, Types of Financing Obligations – Conduit Revenue Bonds – Economic Development Bonds**.

Qualified 501(c)(3) Bonds. Qualified 501(c)(3) bonds are bonds the proceeds of which are used to finance facilities owned by an exempt organization described in section 501(c)(3) of the tax code. The most common use of these bonds is to finance health care and higher education facilities. Qualified 501(c)(3) bonds also are used to finance low-income housing projects and various other charitable facilities.

The primary requirements for qualified 501(c)(3) bonds are that any financed facilities must be owned by a public agency or a 501(c)(3) corporation and the Private Business Tests must not be satisfied. For purposes of the Private Business Tests in connection with 501(c)(3) bonds:

- 501(c)(3) corporations are treated as governmental units to the extent their use of the financed facilities is not an "unrelated trade or business" use
- The allowable amount of private business use or private payments or security is limited to 5 percent rather than 10 percent

Additional Requirements Applicable to Qualified Private Activity Bonds

A number of miscellaneous restrictions apply to some or all of the qualified private activity bond categories.

Volume Cap. In general, the aggregate amount of all tax-exempt qualified private activity bonds, including qualified enterprise-zone facility bonds, issued annually by all issuers in a state may not exceed the so-called volume cap. The volume cap for each state is calculated annually and is equal to $50 multiplied by the population of the state (approximately $2.8 billion for California in 2005). In order to issue tax-exempt qualified private activity bonds, every issuer must apply to the California Debt Limit Allocation Committee to be assigned a portion of this state ceiling, i.e. the volume cap. See **Appendix A – Working with State Agencies – California Debt Limit Allocation Committee** for more information on CDLAC and its application requirements.

Cities, counties, state agencies, and joint powers authorities (JPAs) may apply directly to CDLAC for an allocation for their own use. Other local agency issuers (such as Industrial Development Authorities) must apply to CDLAC through the city or county of which they are a part for an allocation for each project to be financed by them. For more information, see **Appendix A – Working with State Agencies – California Debt Limit Allocation Committee**.

Exemptions. The following types of qualified private activity bonds do not require a volume cap:

- Any qualified veteran's mortgage bond
- Any qualified 501(c)(3) bond
- Bonds used for airports, docks and wharves, environmental enhancements to hydroelectric generation facilities, and qualified educational facilities
- 100 percent of any high-speed intercity rail facility bonds, but only if owned by a governmental unit

- 75 percent of any high-speed intercity rail facility bonds, but only if owned by a nongovernmental unit

- Any bond used for solid waste disposal facilities but only if it is owned by a governmental unit

- Bonds issued pursuant to a valid carry-forward election and within three years of the year in which the carry-forward closes

- Bonds issued by Indian tribal governments but only if at least 95 percent of the net proceeds are used for a manufacturing facility and certain other requirements are satisfied

TEFRA Public Hearing Requirements. Prior to the issuance of any qualified private activity bond, a public hearing must be held by or on behalf of an applicable elected public official or elected legislative body. Reasonable public notice must be given in advance, containing certain basic information regarding the nongovernmental borrower, the project to be financed (such as purpose and location), and the amount of bonds to be issued. The notice must be published in a newspaper of general circulation in the locality of the project at least 14 days prior to the scheduled hearing. After the hearing, the elected official or body must formally approve the bond issue. For State of California issuing authorities, this approval is given by the State Treasurer or the Governor and for local agencies, the elected legislative body (city council or board or supervisors) typically gives the approval.

A TEFRA hearing and governmental approval are not necessary for an issue of current refunding bonds unless the average maturity date of the refunding issue is later than the average maturity date of the bonds being refunded. See section on **Refunding Bonds** in this chapter.

Substantial User Restriction. Any private activity bond (other than a qualified 501(c)(3) bond) will cease to be a qualified private activity bond and will lose its tax-exempt status during any period in which such bond is owned by a "substantial user" of the financed facility or by a "related person" of such substantial user. A substantial user is an owner or lessee of the financed facility.

Useful Life Limitations. The average maturity of an issue of qualified private activity bonds may not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with such an issue.

Land and Used Property Limits. No more than 25 percent of the net proceeds of a qualified private activity bond issue (other than an issue of qualified 501(c)(3) bonds) may be used directly or indirectly for the acquisition of land or any interest therein, and no part of the net proceeds of any such issue may be used for the acquisition of previously used property or any interest therein. The latter restriction does not apply, however, with respect to any building (and equipment) if rehabilitation expenditures with respect to the building (and

equipment) are at least equal to 15 percent of the cost of acquiring the building (and equipment) financed with the net proceeds of the issue.

Cost of Issuance Limit. No more than two percent of the aggregate face amount of any qualified private activity bond issue may be used to finance the costs of issuance associated with the bonds. Certain costs, such as letter of credit commitment fees, are not treated as costs of issuance for purposes of this limitation. This limitation is particularly important in the case of smaller issues because the actual costs of issuance may often exceed the two percent threshold. In these cases, the issuer or conduit borrower will have to pay the excess amount out of cash or a separate, taxable borrowing.

Certain Prohibited Facilities. None of the proceeds of qualified private activity bonds may be used to provide any of the following:

- Airplane
- Skybox or other private luxury box
- Health club facility
- Facility primarily used for gambling
- Store, the principal business of which is the sale of alcoholic beverages for consumption off-premises

The prohibition against financing health club facilities does not apply to qualified 501(c)(3) bonds.

ARBITRAGE BONDS

Arbitrage Yield Restrictions

An arbitrage bond is a bond that the issuer reasonably expects, at the time of issuance, that all or a portion of the proceeds will be used to:

- Acquire securities or obligations with a yield materially higher than the yield on such bonds, or
- Replace funds used to acquire such higher yielding securities or obligations

A bond can also be deemed an arbitrage bond if the issuer intentionally uses the proceeds for the above purposes. The tax code generally restricts the rate of return on investments purchased with gross proceeds to a yield that is not materially higher than the yield on the bonds. As with the rebate requirement, in connection with any analysis of the arbitrage yield restrictions, the issuer must be assured that the fair market value rules are applied to determine the yield on any investment. See **Fair Market Value Rules** section in this chapter.

The exceptions to arbitrage yield restrictions only apply to “non-purpose investments.” However, “purpose investments” are allowed to yield either 1/8 percent or 1.5 percent higher than the yield on the bonds depending on certain factors. Furthermore, purpose investments are not subject to the rebate requirements, so that issuers may retain any excess investment return derived from the allowable 1/8 percent or 1.5 percent spread.

Arbitrage Yield Restriction Exceptions

There are several important exceptions to the arbitrage yield restriction rule. Almost all bond issues take advantage of one or more of these exceptions. As a result of the reasonably required reserve or replacement fund exception, the three-year temporary period exception, and the bona fide debt service fund exception, none of the proceeds of a typical, “new money” governmental financing will be subject, at least initially, to an arbitrage yield restriction.

Reserve Funds. A debt service reserve fund will be considered to be a “reasonably required reserve or replacement fund” only if the amount of bond proceeds used to provide the fund is limited to the lesser of:

- Maximum annual debt service on the bonds
- 10 percent of the proceeds of the bonds
- 125 percent of average annual debt service on the bonds

If a reserve fund qualifies as a reasonably required reserve or replacement fund, then amounts on deposit in such a fund may be invested without regard to the arbitrage yield restriction. (However, as described later in this chapter, unless an exception to the rebate requirement is satisfied, the issuer will have to pay 100 percent of any excess earnings (over the bond yield) to the federal government as rebate.)

Three-Year Temporary Period. Perhaps the most important arbitrage exception is the “three-year temporary period,” during which the arbitrage yield restriction does not apply to the proceeds of bonds to be used to finance the project and to pay the costs of issuing the bonds. The issuer gets a three-year period (from the date of issuance of the bonds) during which proceeds may be invested without regard to yield so long as the issuer reasonably expects to meet the following requirements:

- Spend 5 percent of the net proceeds in six months
- Spend 85 percent of the net proceeds in three years
- Diligently work to complete the project and spend the net proceeds

Net proceeds are the proceeds net of qualified reserve funds. The 5 percent in six months requirement can be satisfied either by expenditure or by entering into a binding contract. To

the extent proceeds, other than those held in a qualifying reserve fund, remain unexpended after the end of the three-year period, such proceeds generally may not be invested at a yield in excess of 1/8 percent above the yield on the bonds.

Bona Fide Debt Service Funds. Another significant temporary period is the 13-month temporary period for amounts deposited in a "bona fide debt service fund." A bona fide debt service fund is one that is used primarily to achieve a proper matching of revenues and debt service during each year by depositing revenues in the fund until they are needed to pay debt service. The fund must be depleted at least once each year, except for a carryover amount not to exceed one month's debt service on the bonds or one year's earnings on the fund.

Other Temporary Periods. As described in **Chapter 6, Types of Financing Obligations – Tax and Revenue Anticipation Notes (TRANs),** different temporary period rules apply to proceeds of a working capital borrowing. Additionally, more restrictive temporary period rules apply to certain types of refundings, where the bond proceeds are to be used to retire previously issued bonds (see below). Regardless of the application of a temporary period, the rebate requirement applies to all gross proceeds, including all proceeds, unless an exception is satisfied.

Exemption for Tax-Exempt Investments. Regardless of the availability of any of the arbitrage yield restriction exceptions described in the previous section, gross proceeds generally may be invested in other tax-exempt bonds without regard to the yield on the tax-exempt investments.

Yield Reduction Payments

Yield reduction payments are similar to rebate requirement payments, but may be allowed in additional situations where investing bond proceeds at an unrestricted yield would not otherwise be permitted, thus freeing the issuer from having to artificially restrict the yield on investments. Bond proceeds qualifying for yield reduction payments include proceeds of an issue which initially qualified for one of the temporary periods, but for which the temporary period has expired, amounts held in reserve funds in excess of the limitations described previously, and certain limited types of proceeds arising in refunding transactions.

REBATE REQUIREMENT

Generally, the tax code requires that, to the extent gross proceeds are invested on an aggregate, blended basis, in non-purpose investments at a yield in excess of the bond yield, such excess, often referred to as "arbitrage earnings," must be rebated to the federal government.

Simplified Rebate Example

(Actual payment will be larger due to future valuing of effects)

Bond yield = 6%

$100,000 proceeds invested at 6.5% for 5 years

Investment earnings = $32,500

Rebate Payment = $32,500 (actual earnings)

30,000 (earnings at bond yield)

$ 2,500

The rebate requirement also applies to arbitrage earnings on investments held in qualifying reserve funds. Periods during which gross proceeds are invested at a yield below the yield on the bonds offset gross arbitrage earnings. Thus, even though, certain exceptions to the arbitrage yield restriction requirement permit gross proceeds to be invested at an unrestricted yield during certain times or when held in certain funds, the rebate requirement generally requires that all net arbitrage earnings be paid to the federal government.

Rebate Exceptions

There are four important exceptions to the rebate requirement that should be carefully considered by the issuer and bond counsel when structuring a bond issue.

Small Issuer Exception. The small issuer exception allows a public agency to retain all arbitrage earnings realized from the investment of the gross proceeds of certain bond issues that are not qualified private activity bonds. The small issuer exception is available only to issuers that possess general taxing powers (even if those powers may only be exercised after voter approval of the tax). The exception may be applied to a bond issue if the amount of such issue, together with the amount of any other bonds issued or expected to be issued by the issuer and all closely related public agencies during the same calendar year, does not exceed $5 million. Additionally, the issuer must expect to spend at least 95 percent of the net proceeds of the bonds for the governmental purpose for which the bonds are issued. A recent amendment to the tax code raised the $5 million limit to $10 million to the extent the additional bonds are issued to finance construction of public school facilities.

Six-Month Expenditure Exception. Under the six-month expenditure exception, proceeds are not subject to the rebate requirement if the issuer actually spends all proceeds of the issue within six months of the date the bonds are issued. The six-month exception is based on actual expenditures. Solely for purposes of determining compliance with the six-month expenditure exception, amounts held in a qualifying reserve fund are not treated as proceeds. Therefore, the normal rebate requirement applies to amounts held in a reserve fund. The six-month expenditure exception is most likely to apply to acquisition financings (where the project is being acquired rather than constructed), to TRAN financings, to reimbursement financings, and to current refundings.

Eighteen-Month Expenditure Exception. As with the six-month exception, proceeds of an issue that are not held in a reserve fund are not subject to the rebate requirement if all such proceeds (including investment proceeds) are expended within 18 months from the issue date, provided that at least:

- 15 percent of such proceeds are spent within six months
- 60 percent are spent within 12 months, and
- 100 percent are spent within 18 months

Compliance with the 18-month exception, like compliance with the six-month exception, is based on actual expenditures, although the 15 percent and 60 percent expenditure requirements are measured based on the sale proceeds plus the aggregate investment proceeds expected to be earned during the 18-month period, in accordance with the issuer's reasonable estimate of investment earnings at closing. Additionally, as with the six-month exception, amounts held in a reserve fund are not treated as proceeds for purposes of satisfying the expenditure requirements. The 18-month expenditure exception does not apply to refundings.

Two-Year Expenditure Exception. Under the two-year rule, an issue is not subject to the rebate requirement if all proceeds (including investment proceeds) except for amounts held in a reserve fund are expended within two years from the issue date, provided that at least:

- 10 percent of the such proceeds are spent within six months
- 45 percent are spent within 12 months
- 75 percent are spent within 18 months, and
- 100 percent are spent within 24 months

Compliance with the two-year exception, like compliance with the six-month exception, is based on actual expenditures, although the 10 percent, 45 percent, and 75 percent expenditure requirements are measured based on the sale proceeds plus the aggregate investment proceeds expected to be earned during the two-year period. Additionally, as with the other expenditure exceptions, amounts held in a reserve fund are not treated as bond proceeds for purposes of satisfying the expenditure requirements. The two-year expenditure exception does not apply to refundings.

In order to qualify for the two-year expenditure exception, at least 75 percent of the proceeds of the bond issue must be expected to be expended for construction costs, as opposed to acquisition or refinancing costs. If the 75 percent construction cost requirement is not expected to be met by the bond issue as a whole, the tax code allows the issuer to treat the bond issue as two separate issues. If one of such issues, the construction portion, meets the 75 percent construction cost requirement, then the construction portion is eligible for the two-year expenditure exception. The six-month expenditure exception (but not the 18-month expenditure exception) or the normal rebate requirements would apply to the remaining portion. Special rules apply to pooled financings.

Penalty in Lieu of Rebate. If the proceeds of a construction issue (or construction portion) are not spent as required within the two-year period, the issuer generally will be required to rebate all arbitrage earnings under the normal rebate requirement. However, the tax code allows the issuer to pay a penalty in lieu of such a rebate, if the issuer elects to do so at the time its bonds are issued. The penalty is 1.5 percent of the amount of proceeds of the bond issue that, as of the close of each six-month period, are not spent in accordance with the

expenditure schedule. For example, if the issuer was required to spend $450,000 within 12 months (45 percent), but has spent only $400,000, the issuer would pay a penalty of 1.5 percent of $50,000, or $750. The penalty must be paid within 90 days of the end of the relevant six-month period.

The election to pay the penalty in lieu of rebate may be useful for issuers wishing to avoid the complications normally encountered in calculating rebate. Also, the penalty election permits issuers to retain arbitrage earnings during the temporary period, which may exceed the amount of the penalty even if the proceeds are not spent entirely within the expenditure schedule specified by the two-year expenditure exception. However, the benefit to be gained by balancing penalty payments against potential arbitrage earnings depends entirely on issuer's ability to invest proceeds at interest rates above the bond yield. A delay in construction expenditure together with a drop in interest rates can result in significant penalty payments every six months in a circumstance where no arbitrage earnings are achieved. Extreme caution is therefore advised and issuers should consult with their bond counsel and financial or investment advisor in deciding whether to elect the penalty in lieu of the normal rebate requirement.

FAIR MARKET VALUE RULES

One fundamental requirement of all of the yield related limitations (e.g. the arbitrage yield restriction and the rebate requirement) is that non-purpose investments must be purchased by issuers at a fair market value price. Without this fair market value requirement, issuers could simply direct prohibited investment profits, or profits that would otherwise be paid to the federal government, to entities other than the United States. The process of purchasing investments at an inflated price, known as "yield burning," has received significant attention and enforcement efforts from federal authorities. Issuers must be careful to comply with the fair market value requirement. Reliance on a fair market value certificate of the seller of securities, in circumstances where the seller will profit from an inflated price and the issuer will not be harmed, is inherently suspect.

The federal government has established a special program through the Bureau of Public Debt in which issuers can purchase special U.S. Treasury obligations—State and Local Government Series (SLGS)—at below-market yields in order to comply with the arbitrage yield restriction. SLGS purchased with a below-market yield are deemed to have been purchased at fair market value.

HEDGE BOND RESTRICTIONS

The tax code prohibits tax-exempt bonds from being issued far in advance of the time money is required to construct or acquire the assets to be financed. The temporary period rules exceptions to the rebate requirement (described previously) often provide good reason to issue bonds close to the time when the proceeds will be spent. Similarly, economics dictate this

result whenever the short-term interest rates at which proceeds may be invested are lower than the long-term rates at which the bonds accrue interest.

In general, bonds will be considered hedge bonds and will not be tax-exempt unless the issuer reasonably expects either:

- To spend at least 85 percent of the net sale proceeds—generally, sale proceeds less any amounts deposited into a debt service reserve fund—within three years of the issuance of the bonds, and
- 50 percent or less of the proceeds are invested in non-purpose investments with a guaranteed yield format for at least four years. Non-purpose investments are investments in securities, bank deposits, or other investments that have nothing to do with the governmental purpose of the bond.

General Exception. A bond that otherwise satisfies the hedge fund bond test will not be considered a hedge bond if at least 95 percent of the net proceeds are invested in non-Alternative Minimum Tax (AMT) bonds. Amounts in a bona fide debt service fund and amounts held for fewer than 30 days pending reinvestment or redemption are treated as invested in non-AMT bonds. This test is based upon actual investments and not on the reasonable expectations of the issuer.

These expenditure requirements do not apply to refundings, and they do not apply to new money bonds in which virtually all of the proceeds of the bonds are invested in other tax-exempt bonds until such proceeds are expended.

REFUNDING BONDS

Refunding bonds are bonds, the proceeds of which will be used to pay principal, interest, or redemption price on another prior issue of bonds. Refunding bonds often involve complex federal tax issues and invoke a number of technical requirements. Although a complete description of these requirements is beyond the scope of this *Primer*, some of the more important concepts are described generally in this section.

Types of Refundings

For federal tax purposes, there are two important categories of refunding bonds:

- **Advance Refunding.** Refunding bonds issued more than 90 days before the bonds being refunded will be retired

Advance Refunding Example

City X issued bonds to finance a new library in 1980. City X advance refunded those bonds in 1982, in 1984, and again in 1992. City X may not issue any further advance refunding bonds for this project since it has used up its allowable two advance refundings—the 1982 and 1984 refundings count as the first and the 1992 refunding counts as the second. If the 1992 refunding had instead been completed in 1985, City X would still have one more advance refunding left, since the 1982, 1984, and 1985 refundings would count as only one advance refunding.

- **Current Refunding.** Refunding bonds issued within 90 days of the date the bonds being refunded will be retired

Limitation on Number of Refundings

In general, issuers are limited to only one advance refunding of any particular bond issue. This is one of the main reasons that issuers should be concerned about the total savings they are receiving in a refunding, because they only get one opportunity.

For bonds originally issued prior to January 1, 1986, an issuer gets up to two advance refundings, and for this purpose, all advance refundings issued prior to March 15, 1986 are counted as one.

There are no limitations on the number of current refundings. In general, qualified private activity bonds may not be advance refunded at all with tax-exempt bonds. However, private activity bonds may be advance refunded only with taxable refunding bonds.

Limitation on Refunding Noncallable Bonds

In an advance refunding, the tax law generally does not permit refunding any portion of the issue being refunded which is not callable prior to maturity. This is because, except for savings resulting from exploiting the difference between taxable and tax-exempt interest rates, there can be no economic savings from refunding noncallable bonds, since the higher rate of interest they bear will have to be paid to their full maturity. An exception to this rule allows noncallable bonds to be advance refunded for independent business reasons, for example, the need to eliminate a restrictive covenant contained in the indenture for the refunded bonds which can only be eliminated if all bonds issued under that indenture are defeased.

First Call Date Rule

For advance refundings issued for the purpose of debt service savings, the refunded bonds must be paid off with the proceeds of the refunding bonds no later than the first date that they may be redeemed at the option of the issuer. For pre-1986 bonds, this is defined to be the first date at which they can be refunded at a premium of 3 percent or less. Thus if bonds being refunded may be redeemed at a premium of 2 percent on January 1, 2008, 1 percent on January 1, 2009, and 0 percent on January 1, 2010 and thereafter, the proceeds of the refunding bonds must be used to redeem the bonds no later than January 1, 2008. This is true even if it would be financially advantageous to the issuer to wait until January 1, 2010 to avoid paying the 2 percent penalty. The policy behind this rule is to have tax-exempt bonds (in this case the refunded bonds) in the market for the least amount of time possible.

Arbitrage Yield Restriction

Unlike new money financings, refunding transactions—in particular advance refundings—typically pose significant arbitrage yield restriction issues. Proceeds of an advance refunding

held in an escrow are not allowed to be invested at a yield that exceeds the yield on the advance refunding bonds. Often, however, the yield of investments purchased in the open market at fair market value will exceed the yield of the advance refunding bonds. This is because even though these investments are typically of a shorter maturity (which tends to lower yield) they are also typically taxable investments, which increases yield—sometimes above the tax-exempt yield on the refunding bonds. For that reason, advance refunding escrows provide significant opportunities for yield burning. (See the discussion under **Fair Market Value Rules** earlier in this chapter.) In order to avoid any yield burning concerns, many issuers purchase SLGS for their advance refunding.