
Reimbursements and Bond Proceeds

This report is based upon research conducted by the California Debt and Investment Advisory Commission (CDIAC). The content of the report is the responsibility of CDIAC and not of those who may have contributed to its development or review. Nothing in this report is intended to provide legal advice. To resolve issues of a legal nature, readers should consult an attorney.

Introduction

The California Debt and Investment Advisory Commission (CDIAC) staff recently learned that a number of school and community college districts are being counseled by financial professions about investing bond proceeds in long-term investments as a way to generate general fund revenues. In light of the state's fiscal condition, the desire to do so may be driven by the real possibility that districts will have to curtail or eliminate educational services as a result of insufficient funds. 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 draw out the term of the investment by using funds received from the state to cover the cost of construction and renovation. Doing so, however, may violate the intended use of reimbursement bonds as well as the arbitrage restrictions contained in the Internal Revenue Code (Revenue Code).¹

This report seeks to provide information on reimbursement bonds that may guide issuers in the appropriate use of such bonds.² In addition to describing what issuers are required to do prior to issuing a reimbursement bond, the report includes a case study drawn from school facilities financing. While the case focuses on school districts, other public entities may issue reimbursement bonds and, as a result, benefit from the information presented therein. The report recognizes the possibility that allocations made from reimbursement bond proceeds may be made inappropriately.³ Failing to correctly follow federal reimbursement rules contained in the Revenue Code and Treasury Regulations can ultimately lead an issuer to inappropriately invest bond proceeds as if they were general fund money not subject to arbitrage and rebate regulations. By violating the reimbursement rules, an issuer could place the tax-exemption of its bonds at risk. In addition, issuers may be obligated to rebate illegal arbitrage earnings from their general funds to the Treasury.

Federal Regulation of Reimbursement Bond Proceeds

Treasury Regulation, Section 1.150-2 allows a bond issuer to use the proceeds of its issuance to reimburse a prior expenditure.⁴ 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 Revenue Code. The funds, therefore, may be invested at a higher rate of return than is allowed for bond proceeds under arbitrage limits.

In establishing limits on arbitrage earnings, the federal government sought to deter issuers of tax-exempt bonds from capitalizing on the spread between tax-exempt borrowing rates and taxable rates paid to investors. Indirectly, the federal government also hoped to keep tax-exempt issuers from issuing more bonds than needed to meet public goals, issuing bonds earlier than necessary, or delaying repayment of those bonds. Each of these actions was

perceived to have a negative impact on both the pricing of municipal bonds and the availability of capital (as well as depriving the Treasury of income taxes from the taxable investments investors would otherwise buy).

To limit the unnecessary or abusive issuance of tax-exempt bonds, the Revenue Code places restrictions on the yield issuers may receive from investing bond proceeds. In addition, the Revenue Code requires that issuers “rebate” earnings that exceed these yield limits (i.e., pay such excess earnings over to the Treasury, either through “rebate” payments, or “yield reduction payments” for qualifying issues). Issuers may qualify for exemption from both yield restrictions and rebate requirements under certain conditions. Nonexempt issuers that do not comply with these limits are subject to fines and penalties, and the interest earned by investors on the bonds may be deemed to be taxable.

What is Required Before Issuing Reimbursement Bonds?

Section 1.150-2 provides that, under certain conditions, an issuer may treat an expenditure of bond proceeds as a reimbursement of an original expenditure.^{5,6} Accepting the notion that bond proceeds used to make a reimbursement have been spent, earnings derived from the investment of these funds are not subject to yield restriction. As a result, the issuer is not required to rebate profits obtained by investing funds at a higher rate of return than the interest rate on the bonds issued.

The Revenue Code has deemed proceeds to be spent “only in those circumstances in which the substance of the transaction indicates that the bond proceeds are being used to reimburse prior expenditures.”⁷ In general, an issuer must take the following steps to reimburse a prior expenditure and treat bond proceeds as spent for purposes of yield restriction and arbitrage rebate:⁸

- Declare its intent to spend money on a project and to pay itself back with bond proceeds;
- Spend its own municipal money on the project;
- Issue reimbursement bonds;
- Allocate bond proceeds to pay back the expenditure on its books in the time period permitted; and
- Treat the bond proceeds as “spent,” freeing them from any arbitrage restriction.

More specifically, Section 1.150-2(d) requires that the issuer of a reimbursement bond meet three primary requirements when allocating bond proceeds to a prior expenditure. These requirements are: 1) an official intent requirement; 2) a reimbursement period requirement; and 3) a nature of expenditure requirement.⁹

(1) Official Intent Requirement

The official intent requirement “is designed to ensure that, on or about the date of payment, the issuer **intended** to reimburse the expenditure and that the reimbursements are not an artifice to avoid tax-exempt bond requirements” associated with arbitrage.¹⁰ “The official intent rules require the issuer to declare a **reasonable intention** to reimburse the expenditure with proceeds of a borrowing.”¹¹

The declaration of official intent to reimburse must be made no later than 60 days after the payment of the original expenditure. It may be made in one of several forms, including issuer resolution, legislative authorization, or declaration by an authorized officer, and any reasonable form is acceptable. Although the Internal Revenue Service (IRS) allows that a declaration of official intent may be very broad, blanket declarations are not reasonable, and a pattern of failure to reimburse is evidence of unreasonableness.¹²

An issuer must describe the project in the declaration and state the expected maximum size of the obligations to be issued. A project may include any property, project, or program, such as a school building renovation. Also, a project description will be sufficient if it identifies a fund or account from which the original expenditure is paid, assuming a specific purpose account exists.

(2) Reimbursement Period Requirement

A reimbursement allocation is an allocation in writing, demonstrating use of the proceeds of a reimbursement bond to reimburse the original expenditure. Generally, the reimbursement allocation must take place no later than 18 months after the date of the original expenditure or 18 months after the date the project is either placed in service or abandoned, whichever occurs last. In most cases, this period cannot exceed 3 years after the original expenditure.

The 18-month period is extended to 3 years for certain “small issuers” while not applying to certain others, namely issuers that issue no more than a specified amount of bonds in the calendar year. The reimbursement period requirement exists as a way to ensure that the money paid for the expenditure is not available on a long-term basis. The issuer must make a reimbursement within a set time period. In the absence of a term limit on reimbursement, issuers may be motivated to invest bond proceeds on a long-term basis to achieve higher yields.

(3) Nature of Expenditure Requirement

Finally, the nature of expenditure requirement limits, in general, the use of proceeds to reimburse capital expenditures or the costs of issuing the reimbursement bond. The purpose of this requirement is to keep the proceeds from being used for working capital or to cover the operating costs of a project.

An issuer may reimburse certain preliminary expenditures up to 20 percent of the proceeds of the bonds without regard to the tests and limitations described above. These may include architectural, engineering, surveying, soil testing, reimbursement of bond issuance costs, and similar costs incurred prior to the commencement of acquisition, construction, or rehabilitation of the project. However, land acquisition, site preparation, and similar costs are not included in the preliminary expenditure exception. Accordingly, reimbursements of these latter expenditures require that the issuer satisfy the official intent and reimbursement period requirements.

A reimbursement allocation is not valid if, within one year after the allocation, the allocated proceeds are used to create replacement proceeds.¹³ In such cases, the allocation will not be an expenditure of proceeds and the proceeds still would be restricted to the yield on the reimbursement bonds for the purpose of calculating arbitrage. Likewise, a reimbursement allocation that fails in any way to satisfy the reimbursement rules discussed above does not qualify as an expenditure, and the bond proceeds must continue to be treated as unspent.

Reimbursement Bonds and School Facilities Financing: A Case Study

Based upon information provided to CDIAC staff, school and community college districts may seek to take advantage of the exemption to arbitrage restrictions and yield limits to generate general fund revenues. Although reimbursement bonds may be issued by other public agencies, the following example is derived from the use of these bonds by educational entities. School district financing provides a unique opportunity for issuers to access different sources of funds, freeing bond proceeds for investment purposes while still allowing the district to cover construction or renovation costs. This case study considers the following topics: 1) an overview of school facilities financing in California; 2) rules concerning the investment of bond proceeds; 3) reimbursement bonds proceeds as a part of the flow of funds in a school construction project; and 4) the consequences of misapplying the rules concerning reimbursement bonds to school construction and renovation projects.

(1) School Facilities Financing in California

The funding for school construction and renovation under the California School Facilities Program (SFP) is based on a partnership between local agencies and the state government. State funding comes from voter-approved general obligation bonds and is allocated to school districts by the State Allocation Board pursuant to the Leroy F. Green School Facilities Act of 1998.¹⁴ The SFP provides a funding source in the form of grants for school districts to acquire school sites, construct new school facilities, or modernize existing school facilities.¹⁵ New construction grants are provided on the basis of a 50-50 cost sharing arrangement with the local agency while renovation grants are based on a 60-40 local agency-state split.^{16,17} Local government contributions may be derived from local general obligation bonds, Mello-Roos bonds, developer fees, donations and contributions, or other sources, including certificates of participation (COP). School districts approaching their statutory debt limit may prefer to use COPs rather than bonds because the former are not technically considered debt under California law. Because they may be issued without a vote of the electorate, COPs may be the only source of financing for capital projects or for “bridge” financing need prior to the issuance of bonds.

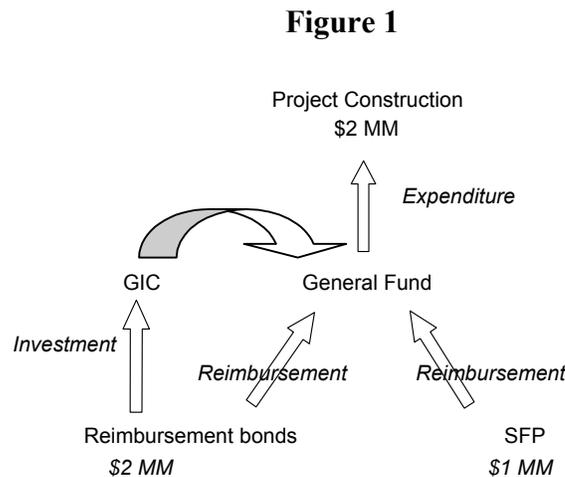
(2) Investing Bond Proceeds

California school districts, like all California public entities, may invest funds not otherwise dedicated to another purpose or required for immediate needs in specified investments. California Government Code Sections 53601, 53601.7, and 53635, which set forth these authorized investments, generally limit the maturity on investments to a maximum of five years.¹⁸ The proceeds derived from the sale of debt securities, however, are treated separately.

The authority to invest bond proceeds is provided by various sections of California statute, including Government Code Sections 5903(e), 5922(d), and 53601(l), which, in general, allow the public agency to follow the controlling provisions governing the issuance of the bonds or the bond resolutions and indentures. In most cases, the decisions related to the investment of bond proceeds, which are contingent upon the intended uses of the proceeds and the repayment plan, have been made before the bonds are sold. Those decisions appear in bond documents, including the trust agreement between the issuer and the trustee. To the extent provided in these documents, bond proceeds may be invested in securities that exceed the five-year limit set forth in Government Code Section 53601.

(3) Reimbursement Bonds and Project Funds Flow

The fact that an issuer may have reimbursable expenditures and be able to invest bond proceeds in securities that exceed a 5-year term limit, provides a nexus of opportunity that may cause the issuer to inappropriately use reimbursement bonds. The following steps, outlined without regard to order of occurrence, depict how a hypothetical school district may seek to generate earnings income through arbitrage (Figure 1).



Assume the district has construction costs of \$2 million. The district initiates the project using general fund monies while meeting all of the requirements for the issuance of reimbursement bonds. The district applies to and receives a reimbursement from the State through the California School Facilities Program (SFP) for 50 percent of the project (40 percent for a renovation project). At the same time, the district issues a reimbursement bond. The amount of the bond may fall somewhere between the full cost of the project, \$2 million, and the district’s share of the project costs, \$1 million, depending on the issuance process. The district, then, invests either the full amount of the bonds or a portion representing the difference between the project’s full costs and the state reimbursement in a 30-year guaranteed investment contract (GIC). The amount of this investment depends upon the issuance process.

An issuer that follows this method benefits in one important way from the use of reimbursement bonds. That is, it can replace prior expenditures from the general fund with bond proceeds and invest those monies free of arbitrage rebate and yield restrictions applied to bond proceeds. Using the reimbursement received from the SFP, as well as available general funds, the issuer is able to complete the project without drawing on the GIC. This flow of funds, however, requires the issuer to time the receipt of the bond proceeds, the receipt of the SFP reimbursement, and the placement of the GIC so as to minimally stress its finances. Failing to do so, may subject the issuer to funding or cash shortfalls in this project as well as other program areas.

(4) The Consequences of Misapplying Section 1.150-2

Compliance with Section 1.150-2 is determined after the fact. The IRS may audit an issuer’s adherence to Section 1.150-2 as part of its ongoing oversight of the tax-exempt market. Based upon discussions with the IRS, CDIAC believes that IRS auditors may use a “substance-over-form” argument in their review of the transaction that seeks to

determine whether or not Section 1.150-2 was circumvented. That argument may incorporate a review of local accounting rules and policies to determine whether the proceeds of the bonds were allocated in accordance with the issuer's own rules and policies. To the extent that the flow of funds conforms to existing rules and policies and the evidence from public documents, including board minutes and public meetings, support the claim that the bonds are, in fact, reimbursement bonds, the issuer is likely to emerge from an IRS review without adverse findings.

If the IRS finds that the issuer has not complied with Section 1.150-2, the issuer faces the risk that the bonds will be declared taxable. The issuer, then, may be forced to pay a settlement amount to the IRS and/or to redeem the bonds. If the IRS' review leads to a settlement that forces the issuer to redeem the bonds, the issuer may be subject to penalties for calling the bonds early. In order to pay-off bondholders, the issuer may have to cash out its investments, which invites a second wave of problems, including early termination penalties and possible capital losses due to market illiquidity. Failing to reach an agreement with the IRS may provoke a bondholder's lawsuit as investors seek compensation for investment losses. Finally, an issuer who inappropriately allocated reimbursement bond proceeds may have additional financial losses, including the inability to recover the cost of issuance.

While the circumstances of each issuance differ, issuers must meet the requirements for issuing reimbursement bonds, including the "nature of the expenditure" requirement, in order to invest the bond proceeds independent of arbitrage limits and yield restrictions. Issuers who seek to supplement their general funds through interest earnings generated with reimbursement bond proceeds may be violating the substance or intent of these requirements. The risk of doing so, including the forced repayment of arbitrage earnings, may outweigh the supposed benefits of such strategies. Should an issuer incur unanticipated costs as a result of punitive actions taken by the IRS or bondholders it may find its fiscal condition in jeopardy and its ability to meet its goals impeded. To avoid such adverse outcomes issuers should closely examine existing laws and regulations when seeking to issue reimbursement bonds.

END NOTES

¹ The United States Code, which includes the Internal Revenue Code, is a consolidation and codification by subject matter of the general and permanent laws of the United States. The Office of the Law Revision Counsel of the U.S. House of Representatives prepares and publishes the United States Code pursuant to section 285(b) of Title 2 of the Code. The Code does not include regulations issued by executive branch agencies, decisions of the Federal courts, treaties, or laws enacted by state or local governments. These appear in the Code of Federal Regulations.

² Treasury Regulation, Section 1.150-2(c) defines a reimbursement bond as the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date of the bonds.

³ 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.

⁴ The Treasury Regulations are contained in the Title 26 of the Code of Federal Regulations, Internal Revenue Service. In the context of this article, all references to Section 1.150-2 or Treasury Regulations shall be references to those regulations.

⁵ For purposes of reimbursement procedures applied to private activity bonds, "issuer" may refer to either the issuer or a conduit borrower.

⁶ Reimbursement procedures do not apply to reimbursements of expenditures paid by another obligation. Such allocations must be analyzed under provisions applicable to refunding bonds under Treasury Regulation Section 1.148-9.

⁷ Internal Revenue Service Private Letter Ruling 8923069.

⁸ *The First Book of Arbitrage – Overview*, Debra Kawecki. Internal Revenue Service, originally printed as a part of the Continuing Professional Education Exempt Organizations Technical Instruction Program for FY 1994 Training 4277-045, p. 261. Available at <http://www.irs.gov/pub/irs-tege/part2g02.pdf>.

⁹ It must be remembered that the reimbursement rules contained in Section 1.150 are federal rules. Issuers also must comply with applicable state laws governing their tax-exempt borrowings. Even if a school district complies with the official intent rules described in Section 1.150, state law may not permit a school district to expend bond funds for costs incurred prior to the approving election. A reimbursement for pre-election expenditures would amount to just that. Although not specifically authorized by state law, some reasonable or unavoidable pre-election expenditures may be paid from bond funds. These include, for example, the costs of conducting the election itself, or the fees of consultants (such as financial advisors and bond counsel) whose services necessarily begin before the bond election and continue afterward, and which are expressly permitted to be paid from bond proceeds (see California Education Code Section 15145). On the other hand, the expenditure of bond funds for the costs of constructing projects yet to be approved by the voters may not be reasonable prior to the election. School districts should consult with their bond counsel regarding what expenditures may be reimbursed, and, assuming appropriate official intent has been declared, how far in advance of a bond election such expenditures may be made.

¹⁰ *The First Book of Arbitrage – Overview*, p. 243 (Emphasis in original).

¹¹ *Ibid.*, p. 243 (Emphasis in original).

¹² Compliance with Income Tax Regulations is the jurisdiction of the Internal Revenue Service.

¹³ Replacement proceeds are defined in Treasury Regulations Section 1.148-1 as funds that have "a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose." Such funds remain subject to the same yield restriction and rebate requirements as the original funds.

¹⁴ Chapter 2.5 of the California Education Code, commencing with Section 17070.10, which was added by Chapter 407, Statutes of 1998 (SB 50).

¹⁵ *School Facility Program Guidebook*, California Office of Public School Construction, 2003.

¹⁶ Some education districts still may have state grant proceeds provided under the prior program structure, which split the cost 80/20 between the state and the district.

¹⁷ In November 1998 and again in November 2002, California voters approved state general obligation bonds for education facilities. In 1998, Proposition 1A authorized a total of \$9.2 billion for new construction and renovation in K-12 schools while Proposition 47, which passed in 2002, authorized \$13.05 billion for the construction and renovation of K-12 and higher education facilities. As of this writing, another \$12.5 billion has been proposed for voter approval on the March 2004 ballot.

¹⁸ California Government Code Section 53601 provides a range of maturities between 180 days and 5 years, depending on the type of investment. Securities underlying a repurchase or reverse repurchase agreement or a securities lending agreement may exceed the five-year maturity limit. There is no limit placed on funds invested in mutual funds or publicly administered pooled accounts. Furthermore, Section 53601 provides that the legislative body of a local agency may grant express authority to make investments that exceed 5 years. For more information on authorized investments for California local agencies, see CDIAC's *Local Agency Investment Guidelines*, available at <http://www.treasurer.ca.gov/cdiac/reports/laiguilines2003.pdf>

This article was written by Mark Campbell, Senior Research Specialist in CDIAC's Policy Research Unit. CDIAC acknowledges the contribution of several individuals, including John Hartenstein, Esq. Orrick, Herrington & Sutcliffe LLP and Robert Barna. Staff members of the Internal Revenue Service's Tax Exempt Bond Division (TEB) staff also contributed to this article. The IRS's Voluntary Closing Agreement Program (VCAP) is available to assist issuers who wish to resolve problems voluntarily and at much lower cost than through an audit. Issuers can remain anonymous while negotiating settlement with the program. Interested issuers can contact Cliff Gannett, Manager, TEB Outreach, Planning & Review at (202) 283-9798 or Charles Anderson, Manager, TEB Field Operations at (410) 962-2269 for information or assistance.

The California Debt and Investment Advisory Commission (CDIAC) provides research, education, and technical assistance to local public agencies and other public finance professionals on the topics of public debt and investment. More information is available on the CDIAC website at www.treasurer.ca.gov/cdiac. CDIAC can be reached at (916) 653-3269 or by e-mail at cdiac@treasurer.ca.gov.

**California Debt and Investment Advisory Commission
915 Capitol Mall Room 400
Sacramento, California 95814
(916) 653-3269**