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Tax-Exempt Bonds:
A Quick Guide to Yield Restriction and Rebate Exceptions

State and local governments often use tax-exempt bonds to finance capital improvements and infrastructure and, in limited circumstances, to meet working capital needs. The tax exemption on the bonds provides the governmental issuer (the "Issuer") with lower interest rates than comparable taxable debt. In order to qualify for the tax exemption, the Issuer must comply with various requirements with respect to the investment and use of proceeds, as well as the use of the bond-financed facilities. Section 148 of the Internal Revenue Code of 1986, as amended (the "Code"), limits the Issuer's ability to exploit the difference between tax-exempt and taxable interest rates, also known as arbitrage.

The Importance of Avoiding Arbitrage Bonds

Under Section 148 of the Code, interest on "arbitrage bonds" will not be exempt from federal income taxes. Absent an applicable exception, tax-exempt bonds will become arbitrage bonds if any proceeds of the bonds are reasonably expected to be used, or are intentionally used, directly or indirectly, to acquire investments that have a materially higher yield than the yield on the bonds ("higher-yielding investments"), or to replace funds that are used to acquire higher-yielding investments. The yield restriction rules in Section 148(a) of the Code, and the related Treasury Regulations, dictate whether the Issuer has impermissibly invested bond proceeds in higher-yielding investments. In addition, in some circumstances where the Issuer is permitted to invest bond proceeds in higher-yielding investments, bonds will become arbitrage bonds if any applicable arbitrage is not rebated or paid when due to the United States. The rebate rules in Section 148(f) of the Code, and the related Treasury Regulations, dictate whether the Issuer owes rebate and how and when rebate amounts need to be paid.

In short, the yield restriction rules focus on whether the Issuer is allowed to earn arbitrage and the rebate rules focus on whether the issuer is allowed to keep any arbitrage that is permitted to be earned. The two sets of rules each apply to bond issues independently and must be analyzed separately. In both cases, the analysis starts with determining what amounts are subject to the rules.

Amounts Subject to Yield Restriction and Rebate

The yield restriction rules and the rebate rules apply to the "gross proceeds" of the bond issue. Gross proceeds include:

1. Sale Proceeds: generally equal to the par amount of the bonds plus or minus the net original issue premium or discount, and typically used to pay underwriter's discount, costs of issuance, qualified guarantee fees (such as bond insurance), capitalized interest, project costs and deposits to refunding escrows or reserve funds, if applicable.
2. Investment Proceeds: amounts received from investment of bond proceeds.

3. Transferred Proceeds: a related portion of the unspent proceeds (such as a reserve fund or project fund) of bonds being refunded will become proceeds of a refunding issue on the date all or a portion of the refunded bonds are paid off.
4. Replacement Proceeds: amounts pledged to the bonds or expected to be used for payment of the bonds or for costs of the bond-financed projects, defined more specifically in the Treasury Regulations as amounts that have a sufficiently direct nexus to the issue or its governmental purpose of the issue to conclude that such amounts would have been used for that purpose if the proceeds of the issue were not available, including:
    a. Sinking funds: amounts reasonably expected to be used directly or indirectly to pay debt service on the bonds.
    b. Pledged funds: amounts formally pledged to pay debt service, including funds held by the Issuer or a substantial beneficiary of the bonds, or to secure a credit enhancer for the Issuer's obligations under a credit facility.
    c. Negative pledges: amounts the Issuer pledges not to spend, making them effectively assured of being available to pay debt service.

Once all of the gross proceeds of an issue have been identified, the Issuer must determine if any exemptions or exceptions to the yield restriction and rebate rules apply.

Yield Restriction Rules

Temporary Periods. Under the yield restriction rules, proceeds may be invested at a higher yield for permitted temporary periods without causing tax-exempt bonds to be "arbitrage bonds." These temporary periods are helpful tools that often allow the Issuer to invest bond proceeds without yield restriction.

Sale and investment proceeds to be expended for capital projects qualify for a temporary period of three years after issuance if the Issuer reasonably expects that (i) 85% of the sale and investment proceeds will be spent within that period, (ii) substantial binding commitments to spend 5% of said proceeds are made within 6 months after issuance, and (iii) completion of the capital projects financed with bond proceeds will proceed with due diligence. The three-year period may be extended to up to five years if both the Issuer and a licensed architect or engineer certify that a longer period is necessary to complete the capital project.

Sale and investment proceeds deposited in an escrow fund to refund another issue of bonds generally qualify for a temporary period of 90 days from the issue date.

Bona fide debt service funds qualify for a temporary period of 13 months. "Bona fide debt service fund" is defined in the Treasury Regulations as a fund that (1) Is used primarily to achieve a proper matching of

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revenues with principal and interest payments within each bond year; and (2) Is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of: (i) the earnings on the fund for the immediately preceding bond year or (ii) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Other temporary periods include a 13-month temporary period for proceeds to be used for working capital expenditures. For this purpose, in a financing for new capital projects (as opposed to a refunding or a working capital financing), working capital excludes costs of issuance, guarantee fees, capitalized interest, and certain operating expenditures that are directly related to the capital project (which qualify for the three-year temporary period).

Investment proceeds have a temporary period of one year beginning on the date of receipt, and replacement proceeds and other gross proceeds have a temporary period of 30 days beginning on the date of receipt.

Reserve Funds.

Reasonably Required Reserve Funds. Under the yield restriction rules, amounts in a "Reasonably Required Reserve Fund" are not subject to yield restriction. Whether a reserve fund is reasonably required usually depends upon whether the reserve fund is necessary in order to market the bonds at the interest rates that the bonds bear or otherwise to enable sale of the bonds. At closing, the Issuer will generally receive a certification from an underwriter, financial advisor or bank (in a private placement) that the reserve fund was reasonably required. Generally, a reserve fund for unlimited tax general obligation bonds is not reasonably required.

Under the Treasury Regulations, there are two limitations that apply to a reasonably required reserve fund: a funding limitation and a yield restriction limitation.

Funding Limitation. When sale proceeds will be used to fund a reserve fund, the sale proceeds deposited to the reserve fund cannot be more than 10% of the principal amount (or issue price, which is determined at closing, if there is more than 2% original issue discount or premium). A reserve may be funded in excess of the funding limitation with sources other than bond proceeds.

Yield Restriction Limitation. In order to avoid yield restriction, total sizing (bond proceeds and other sources) of a reserve cannot exceed the least of:

- 10% of the stated principal amount or issue price, as applicable,
- Maximum annual principal and interest requirements ("MADS"), or
- 125% of the average annual principal and interest requirements ("AADS").

Amounts in a reserve in excess of the above sizing limitation are subject to yield restriction.

For a parity reserve, the Issuer may choose to measure the sizing limitation separately by bond issue or on an aggregate basis, but should consistently apply the same measurement approach over time.

Minor Portion. An amount not exceeding the lesser of 5% of the sale proceeds of the issue or $100,000 can be invested without yield restriction without causing the bonds to be "arbitrage bonds."

Rebate Rules

Once an Issuer has determined the yield restriction rules allow the Issuer to earn arbitrage on the bond proceeds, the rebate rules must be consulted to determine if the Issuer may keep any of the arbitrage earned. Subject to certain exceptions, the arbitrage earnings on investments allocable to gross proceeds must be rebated to the United States Treasury. The rebate amount is equal to the difference between the amount actually earned and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

Small Issuer Exemption. The small issuer exception applies if:

1. The Issuer is a governmental unit with general taxing powers;
2. No bonds of the issue are private activity bonds;
3. 95% of proceeds are used for local governmental purposes; and
4. The Issuer reasonably expects, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it and "subordinate entities" during the same calendar year will not exceed $5,000,000.

When calculating the $5,000,000 size limitation, tax-exempt private activity (i.e., non-governmental) bonds are not counted, current refunding bonds are generally not counted, and the Issuer must apply the (often confusing) aggregation rules. Because of the consequences of a miscalculation, involving bond and tax counsel when determining if this limitation has been met is generally prudent.

If a bond issue meets the requirements for the small issue exemption, all of the proceeds of the bond issue are exempt from the rebate requirement (but not necessarily from yield restriction).

Debt Service Funds. Any investment earnings in a bona fide debt service fund will not be subject to rebate if:

1. No bonds of the issue are private activity bonds;
2. The average maturity of the issue is at least five years; and
3. The interest rates on the bonds do not vary (i.e. they are fixed rate bonds).

If a bona fide debt service fund does not meet the above requirements, gross earnings of up to $100,000 in a bond year may be ignored. The Treasury Regulations provide that an issue with an average annual

debt service that does not exceed $2,500,000 may be treated as satisfying the $100,000 gross earnings exception.

Reserve Funds. There is no specific rebate exception for reserve funds. Even if a reserve fund is a Reasonably Required Reserve Fund and is not subject to yield restriction, the earnings on the reserve fund will be subject to rebate (unless the small issuer exemption applies to the bond issue).

Spending Exceptions. The rebate rules provide three spending exceptions for a portion of the bond proceeds. These exceptions apply to proceeds awaiting expenditure for the governmental purpose of the issue – generally capital project expenditures, but sometimes refunding or working capital expenditures. The spending exceptions generally do not apply to or affect proceeds on deposit in a debt service fund or debt service reserve fund. Those proceeds do not have to be spent in the specified time frame, and they are not covered by the spending exceptions. As stated above, bona fide debt service funds are generally exempt from rebate, but if a reserve fund is included in the issue, arbitrage earned on amounts in the reserve fund will be subject to rebate.

Use of the spending exceptions is not mandatory. For example, if bond proceeds in the project fund are expected to earn negative arbitrage (i.e. interest will be earned at a yield below the bond yield), an Issuer may choose not to apply a spending exception in order to off-set expected arbitrage in a reserve fund that is subject to rebate.

6-Month Spending Exception. Generally if all bond proceeds are spent within 6 months after the issue date, the rebate requirement is met and no rebate is due. The 6-month spending exception applies to all types of tax-exempt bonds, including 501(c)(3) bonds and other private activity bonds and applies to refunding as well as new money issues. It is the only spending exception for refunding issues. Special rules apply for tax and revenue anticipations notes or bonds.

Governmental and 501(c)(3) bonds have the benefit of a carry-over provision and can expend 5% of proceeds over an additional 6 months. Private activity bonds do not have a similar carry-over provision under the 6-month exception.

18-Month Spending Exception. Generally if all proceeds are spent within 18 months after the issue date, the rebate requirement is met and no rebate is due. The 18-month spending exception applies to all types of tax-exempt bonds, including 501(c)(3) bonds and other private activity bonds, issued to finance capital projects.

In order to meet the 18-month spending exception:

1. The bond proceeds must qualify for the three-year temporary period exception from yield restriction.
2. Available proceeds (which includes interest earnings) must be spent for the governmental purpose within 18 months after issue date according to following progress benchmarks:

a. At least 15% within 6 months;
b. At least 60% within 12 months; and
c. 100% within 18 months.

However, the issuer is allowed an additional 12 months to spend "reasonable retainage," which is an amount not exceeding 5% of available proceeds that is retained for reasonable business purposes relating to the capital project. For example, a reasonable retainage may include a retention to ensure or promote compliance with a construction contract in circumstances in which the retained amount is not yet payable, or in which the Issuer reasonably determines that a dispute exists regarding completion or payment. A *de minimis* exception, equal to the lesser of 3% of available proceeds or $250,000, is also available if the Issuer exercises due diligence to complete the project.

When calculating the amount of investment earnings included in available proceeds, the estimated earnings, based on reasonable expectations at closing, are used for the first two benchmarks. The estimated earnings are treated as earned upfront for purposes of calculating the 6-month spending benchmarks. Actual earnings must be used for the last benchmark.

2-Year Spending Exception. The general rule is that if all proceeds are spent within two years (24 months) after the issue date, the rebate requirement is met and no rebate is due. The 2-year spending exception only applies to governmental bonds, 501(c)(3) bonds and certain private activity bonds issued for governmentally-owned projects.

In order to meet the 2-year spending exception:

1. The bond issue must be a "construction issue" (described in more detail below).
2. Available construction proceeds (which includes interest earnings) must be spent for the governmental purpose within 24 months after the issue date according to following progress benchmarks:
    a. At least 10% within 6 months;
    b. At least 45% within 12 months;
    c. At least 75% within 18 months; and
    d. 100% within 24 months

For an issue to qualify as a construction issue, the Issuer must reasonably expect that 75% of available construction proceeds will be spent on construction expenditures for property owned by a governmental unit or 501(c)(3) organization. "Construction expenditures" are capital expenditures for the cost of real property (other than acquisition of land or other existing real property), such as buildings, improvements to land, other inherently permanent structures, including wiring, plumbing, HVAC, pipes, ducts, elevators, escalators installed in a building, paved parking areas, roads, wharves and docks, bridges, and sewage lines. Construction expenditures can also include expenditures for

constructed personal property, such as subway cars, if (1) a substantial portion is complete more than 6 months after construction began or the contract was entered into, (2) the Issuer could not have reasonably expected, with exercise of due diligence, completion to have occurred within that 6 months, and (3) if the Issuer does the work itself, not more than 75% of capitalizable cost is for acquisition of components, raw materials, or supplies.

The 2-year spending exception also provides for a 12-month extension to spend "reasonable retainage" and a *de minimis* exception, as described above with respect to the 18-month spending exception.

Interest earnings included in available construction proceeds for the first three benchmarks are the "estimated earnings," based on reasonable expectations at closing, with the estimated earnings treated as earned upfront. Actual earnings must be used for the last benchmark. However, in the case of the 2-year exception, the Issuer may elect on or before the issue date to use actual earnings for all benchmarks. Interest earnings on a reserve fund during the 2-year period will be included in available construction proceeds unless the Issue elects on or before the issue date to exclude them. After the 2-year period, the Issuer must pay rebate on the reserve fund earnings.

Multipurpose Issues. If bond proceeds will be expended both on new money projects and on refunding prior obligations, the issue is generally called a "multipurpose issue." The Issuer may bifurcate the issue by electing to treat the new money portion and the refunding portion as separate issues for purposes of meeting the rebate spending exceptions. This election must be made on or prior to the issue date, and allows the refunding portion to use the 6-month exception and the new money portion to use either the 18-month exception or the 2-year exception.

Conclusion.

Because Issuers have been unlikely to earn positive arbitrage in the low investment rate environment that has persisted for years, the yield restriction and rebate rules applicable to tax-exempt bonds have received little attention. As investment rates increase, however, the likelihood of positive arbitrage increases. Issuers will need to focus on the arbitrage and rebate requirements outlined in the federal tax certificate executed at closing and monitor for compliance with these requirements. This article provides a general overview of the arbitrage and rebate requirements; however, the specific provisions applicable to the bonds will be outlined in the federal tax certificate and should always be reviewed carefully. Issuers are also encouraged to adopt post-issuance compliance procedures with respect to the yield restriction and rebate rules.

If you have any questions regarding the arbitrage and rebate requirements for tax-exempt bonds, please contact any of our public finance attorneys.

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