

manner required for the allocation of investments to transferred proceeds under paragraph (c)(1)(ii) of this section.

(3) *References to prior issue.* If the refunded and unrefunded portions of a prior issue are treated as separate issues under this paragraph (i), then, except to the extent that the context clearly requires otherwise (e.g., references to the aggregate prior issue in the mixed escrow rule in paragraph (c)(2) of this section), all references in this section to a prior issue refer only to the refunded portion of that prior issue.

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§ 1.148-10 Anti-abuse rules and authority of Commissioner.

(a) *Abusive arbitrage device*—(1) *In general.* Bonds of an issue are arbitrage bonds under section 148 if an abusive arbitrage device under paragraph (a)(2) of this section is used in connection with the issue. This paragraph (a) is to be applied and interpreted broadly to carry out the purposes of section 148, as further described in § 1.148-0. Except as otherwise provided in paragraph (c) of this section, any action that is expressly permitted by section 148 or §§ 1.148-1 through 1.148-11 is not an abusive arbitrage device (e.g., investment in higher yielding investments during a permitted temporary period under section 148(c)).

(2) *Abusive arbitrage device defined.* Any action is an abusive arbitrage device if the action has the effect of—

(i) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and

(ii) Overburdening the tax-exempt bond market.

(3) *Exploitation of tax-exempt interest rates.* An action may exploit tax-exempt interest rates under paragraph (a)(2) of this section as a result of an investment of any portion of the gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

(4) *Overburdening the tax-exempt market.* An action overburdens the tax-exempt bond market under paragraph (a)(2)(ii) of this section if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under § 1.148-2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under § 1.148-1(c)(4)(i)(B). These factors may be outweighed by other factors, however, such as bona fide cost underruns or long-term financial distress.

(b) *Consequences of overburdening the tax-exempt bond market*—(1) *In general.* An issue that overburdens the tax-exempt bond market (within the meaning of paragraph (a)(4) of this section) is subject to the following special limitations—

(i) *Special yield restriction.* Investments are subject to the definition of *materially higher* yield under § 1.148-2(d) that is equal to one-thousandth of 1 percent. In addition, each investment is treated as a separate class of investments under § 1.148-5(b)(2)(ii), the yield on which may not be blended with that of other investments.

(ii) *Certain regulatory provisions inapplicable.* The provisions of § 1.148-5(c) (relating to yield reduction payments) and § 1.148-5(e) (2) and (3) (relating to recovery of qualified administrative costs) do not apply.

(iii) *Restrictive expenditure rule.* Proceeds are not allocated to expenditures unless the proceeds-spent-last rule under § 1.148-6(d)(3)(i) is satisfied, applied by treating those proceeds as proceeds to be used for restricted working capital expenditures. For this purpose, available amount includes a reasonable working capital reserve as defined in § 1.148-6(d)(3)(iii)(B).

(2) *Application.* The provisions of this paragraph (b) only apply to the portion of an issue that, as a result of actions taken (or actions not taken) after the issue date, overburdens the market for tax-exempt bonds, except that for an issue that is reasonably expected as of the issue date to overburden the market, those provisions apply to all of the gross proceeds of the issue.

(c) *Anti-abuse rules on excess gross proceeds of advance refunding issues—(1) In general.* Except as otherwise provided in this paragraph (c), an abusive arbitrage device is used and bonds of an advance refunding issue are arbitrage bonds if the issue has excess gross proceeds.

(2) *Definition of excess gross proceeds.* Excess gross proceeds means all gross proceeds of an advance refunding issue that exceed an amount equal to 1 percent of sale proceeds of the issue, other than gross proceeds allocable to—

(i) Payment of principal, interest, or call premium on the prior issue;

(ii) Payment of pre-issuance accrued interest on the refunding issue, and interest on the refunding issue that accrues for a period up to the completion date of any capital project for which the prior issue was issued, plus one year;

(iii) A reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund;

(iv) Payment of costs of issuance of the refunding issue;

(v) Payment of administrative costs allocable to repaying the prior issue, carrying and repaying the refunding issue, or investments of the refunding issue;

(vi) Transferred proceeds that will be used or maintained for the governmental purpose of the prior issue;

(vii) Interest on purpose investments;

(viii) Replacement proceeds in a sinking fund for the refunding issue;

(ix) Qualified guarantee fees for the refunding issue or the prior issue; and

(x) Fees for a qualified hedge for the refunding issue.

(3) *Special treatment of transferred proceeds.* For purposes of this paragraph (c), all unspent proceeds of the prior issue as of the issue date of the refunding issue are treated as transferred proceeds of the advance refunding issue.

(4) *Special rule for crossover refundings.* An advance refunding issue is not an issue of arbitrage bonds under this paragraph (c) if all excess gross proceeds of the refunding issue are used to pay interest that accrues on the refunding issue before the prior issue is discharged, and no gross proceeds of any refunding issue are used to pay interest on the prior issue or to replace funds used directly or indirectly to pay such interest (other than transferred proceeds used to pay interest on the prior issue that accrues for a period up to the completion date of the project for which the prior issue was issued, plus one year, or proceeds used to pay principal that is attributable to accrued original issue discount).

(5) *Special rule for gross refundings.* This paragraph (c)(5) applies if an advance refunding issue (the *series B issue*) is used together with one or more other advance refunding issues (the *series A issues*) in a gross refunding of a prior issue, but only if the use of a gross refunding method is required under bond documents that were effective prior to November 6, 1992. These advance refunding issues are not arbitrage bonds under this paragraph (c) if—

(i) All excess gross proceeds of the series B issue and each series A issue are investment proceeds used to pay principal and interest on the series B issue;

(ii) At least 99 percent of all principal and interest on the series B issue is paid with proceeds of the series B and series A issues or with the earnings on other amounts in the refunding escrow for the prior issue;

(iii) The series B issue is discharged not later than the prior issue; and

(iv) As of any date, the amount of gross proceeds of the series B issue allocated to expenditures does not exceed the aggregate amount of expenditures before that date for principal and interest on the series B issue, and administrative costs of carrying and repaying the series B issue, or of investments of the series B issue.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Mortgage sale. In 1982, City issued its revenue issue (the *1982 issue*) and lent the proceeds to Developer to finance a low-income housing project under former section 103(b)(4)(A) of the 1954 Code. In 1994, Developer encounters financial difficulties and negotiates with City to refund the 1982 issue. City issues \$10 million in principal amount of its 8 percent bonds (the *1994 issue*). City lends the proceeds of the 1994 issue to Developer. To evidence Developer's obligation to repay that loan, Developer, as obligor, issues a note to City (the *City note*). Bank agrees to provide Developer with a direct-pay letter of credit pursuant to which Bank will make all payments to the trustee for the 1994 issue necessary to meet Developer's obligations under the City note. Developer pays Bank a fee for the issuance of the letter of credit and issues a note to Bank (the *Bank note*). The Bank note is secured by a mortgage on the housing project and is guaranteed by FHA. The Bank note and the 1994 issue have different prepayment terms. The City does not reasonably expect to treat prepayments of the Bank note as gross proceeds of the 1994 issue. At the same time or pursuant to a series of related transactions, Bank sells the Bank note to Investor for \$9.5 million. Bank invests these monies together with its other funds. In substance, the transaction is a loan by City to Bank, under which Bank enters into a series of transactions that, in effect, result in Bank retaining \$9.5 million in amounts treated as proceeds of the 1994 issue. Those amounts are invested in materially higher yielding investments that provide funds sufficient to equal or exceed the Bank's liability under the let-

ter of credit. Alternatively, the letter of credit is investment property in a sinking fund for the 1994 issue provided by Developer, a substantial beneficiary of the financing. Because, in substance, Developer acquires the \$10 million principal amount letter of credit for a fair market value purchase price of \$9.5 million, the letter of credit is a materially higher yielding investment. Neither result would change if Developer's obligation under the Bank note is contingent on Bank performing its obligation under the letter of credit. Each characterization causes the bonds to be arbitrage bonds.

Example 2. Bonds outstanding longer than necessary for yield-blending device. (i) *Longer bond maturity to create sinking fund.* In 1994, Authority issues an advance refunding issue (the *refunding issue*) to refund a 1982 prior issue (the *prior issue*). Under current market conditions, Authority will have to invest the refunding escrow at a yield significantly below the yield on the refunding issue. Authority issues its refunding issue with a longer weighted average maturity than otherwise necessary primarily for the purpose of creating a sinking fund for the refunding issue that will be invested in a guaranteed investment contract. The weighted average maturity of the refunding issue is less than 120 percent of the remaining average economic life of the facilities financed with the proceeds of the prior issue. The guaranteed investment contract has a yield that is higher than the yield on the refunding issue. The yield on the refunding escrow blended with the yield on the guaranteed investment contract does not exceed the yield on the issue. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds under section 148(a).

(ii) *Refunding of noncallable bonds.* The facts are the same as in paragraph (i) of this *Example 2* except that instead of structuring the refunding issue to enable it to take advantage of sinking fund investments, Authority will also refund other long-term, non-callable bonds in the same refunding issue. There are no savings attributable to the refunding of the non-callable bonds (e.g., a *low-to-high* refunding). The Authority invests the portion of the proceeds of the refunding issue allocable to the refunding of the non-callable bonds in the refunding escrow at a yield that is higher than the yield on the refunding issue, based on the relatively long escrow period for this portion of the refunding. The Authority invests the other portion of the proceeds of the refunding issue in the refunding escrow at a yield lower than the yield on the refunding issue. The blended yield on all the investments in the refunding escrow for the prior issues does not exceed the yield on the refunding issue. The portion of the refunding issue used to refund the noncallable bonds, however, was not

otherwise necessary and was issued primarily to exploit the difference between taxable and tax-exempt rates for that long portion of the refunding escrow to minimize the effect of lower yielding investments in the other portion of the escrow. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds.

(iii) *Governmental purpose.* In paragraphs (i) and (ii) of this *Example 2*, the existence of a governmental purpose for the described financing structures would not change the conclusions unless Authority clearly established that the primary purpose for the use of the particular structure was a bona fide governmental purpose. The fact that each financing structure had the effect of eliminating significant amounts of negative arbitrage is strong evidence of a primary purpose that is not a bona fide governmental purpose. Moreover, in paragraph (i) of this *Example 2*, the structure of the refunding issue coupled with the acquisition of the guaranteed investment contract to lock in the investment yield associated with the structure is strong evidence of a primary purpose that is not a bona fide governmental purpose.

Example 3. Window refunding. (i) Authority issues its 1994 refunding issue to refund a portion of the principal and interest on its outstanding 1985 issue. The 1994 refunding issue is structured using zero-coupon bonds that pay no interest or principal for the 5-year period following the issue date. The proceeds of the 1994 refunding issue are deposited in a refunding escrow to be used to pay only the interest requirements of the refunded portion of the 1985 issue. Authority enters into a guaranteed investment contract with a financial institution, *G*, under which *G* agrees to provide a guaranteed yield on revenues invested by Authority during the 5-year period following the issue date. The guaranteed investment contract has a yield that is no higher than the yield on the refunding issue. The revenues to be invested under this guaranteed investment contract consist of the amounts that Authority otherwise would have used to pay principal and interest on the 1994 refunding issue. The guaranteed investment contract is structured to generate receipts at times and in amounts sufficient to pay the principal and redemption requirements of the refunded portion of the 1985 issue. A principal purpose of these transactions is to avoid transferred proceeds. Authority will continue to invest the unspent proceeds of the 1985 issue that are on deposit in a refunding escrow for its 1982 issue at a yield equal to the yield on the 1985 issue and will not otherwise treat those unspent proceeds as transferred proceeds of the 1994 refunding issue. The 1994 refunding issue is an issue of arbitrage bonds since those bonds involve a transaction or series of transactions that overburdens the market by leaving bonds outstanding longer than is

necessary to obtain a material financial advantage based on arbitrage. Specifically, Authority has structured the 1994 refunding issue to make available for the refunding of the 1985 issue replacement proceeds rather than proceeds so that the unspent proceeds of the 1985 issue will not become transferred proceeds of the 1994 refunding issue.

(ii) The result would be the same in each of the following circumstances:

(A) The facts are the same as in paragraph (i) of this *Example 3* except that Authority does not enter into the guaranteed investment contract but instead, as of the issue date of the 1994 refunding issue, reasonably expects that the released revenues will be available for investment until used to pay principal and interest on the 1985 issue.

(B) The facts are the same as in paragraph (i) of this *Example 3* except that there are no unspent proceeds of the 1985 issue and Authority invests the released revenues at a yield materially higher than the yield on the 1994 issue.

(C) The facts are the same as in paragraph (i) of this *Example 3* except that Authority uses the proceeds of the 1994 issue for capital projects instead of to refund a portion of the 1985 issue.

Example 4. Sale of conduit loan. On January 1, 1994, Authority issues a conduit financing issue (the *1994 conduit financing issue*) and uses the proceeds to purchase from City, an unrelated party, a tax-exempt bond of City (the *City note*). The proceeds of the 1994 conduit financing issue are to be used to advance refund a prior conduit financing issue that was issued in 1988 and used to make a loan to City. The 1994 conduit financing issue and the City note each have a yield of 8 percent on January 1, 1994. On June 30, 1996, interest rates have decreased and Authority sells the City note to D, a person unrelated to either City or Authority. Based on the sale price of the City note and treating June 30, 1996 as the issue date of the City note, the City note has a 6 percent yield. Authority deposits the proceeds of the sale of the City note into an escrow to redeem the bonds of the 1994 conduit financing issue on January 1, 2001. The escrow is invested in nonpurpose investments having a yield of 8 percent. For purposes of section 149(d), City and Authority are related parties and, therefore, the issue date of the City note is treated as being June 30, 1996. Thus, the City note is an advance refunding of Authority's 1994 conduit financing issue. Interest on the City note is not exempt from Federal income tax from the date it is sold to D under section 149(d), because, by investing the escrow investments at a yield of 8 percent instead of a yield not materially higher than 6 percent, the sale of the City note employs a device to obtain a material financial advantage, based on arbitrage, apart from the savings attributable to lower interest rates. In addition,

the City note is not a tax-exempt bond because the note is the second advance refunding of the original bond under section 149(d)(3). The City note also employs an abusive arbitrage device and is an arbitrage bond under section 148.

Example 5. Re-refunding. (i) On January 1, 1984, City issues a tax-exempt issue (the *1984 issue*) to finance the cost of constructing a prison. The 1984 issue has a 7 percent yield and a 30-year maturity. The 1984 issue is callable at any time on or after January 1, 1994. On January 1, 1990, City issues a refunding issue (the *1990 issue*) to advance refund the 1984 issue. The 1990 issue has an 8 percent yield and a 30-year maturity. The 1990 issue is callable at any time on or after January 1, 2000. The proceeds of the 1990 issue are invested at an 8 percent yield in a refunding escrow for the 1984 issue (the *original 1984 escrow*) in a manner sufficient to pay debt service on the 1984 issue until maturity (*i.e.*, an escrow to maturity). On January 1, 1994, City issues a refunding issue (the *1994 issue*). The 1994 issue has a 6 percent yield and a 30-year maturity. City does not invest the proceeds of the 1994 issue in a refunding escrow for the 1990 issue in a manner sufficient to pay a portion of the debt service until, and redeem a portion of that issue on, January 1, 2000. Instead, City invests those proceeds at a 6 percent yield in a new refunding escrow for a portion of the 1984 issue (the *new 1984 escrow*) in a manner sufficient to pay debt service on a portion of the 1984 issue until maturity. City also liquidates the investments allocable to the proceeds of the 1990 issue held in the original 1984 escrow and reinvests those proceeds in an escrow to pay a portion of the debt service on the 1990 issue itself until, and redeem a portion of that issue on, January 1, 2000 (the *1990 escrow*). The 1994 bonds are arbitrage bonds and employ an abusive device under section 149(d)(4). Although, in form, the proceeds of the 1994 issue are used to pay principal on the 1984 issue, this accounting for the use of the proceeds of the 1994 issue is an unreasonable, inconsistent accounting method under § 1.148-6(a). Moreover, since the proceeds of the 1990 issue were set aside in an escrow to be used to retire the 1984 issue, the use of proceeds of the 1994 issue for that same purpose involves a replacement of funds invested in higher yielding investments under section 148(a)(2). Thus, using a reasonable, consistent accounting method and giving effect to the substance of the transaction, the proceeds of the 1994 issue are treated as used to refund the 1990 issue and are allocable to the 1990 escrow. The proceeds of the 1990 issue are treated as used to refund the 1984 issue and are allocable to the investments in the new 1984 escrow. The proceeds of the 1990 issue allocable to the nonpurpose investments in the new 1984 escrow become transferred proceeds of the 1994 issue as principal is paid on the 1990 issue from

amounts on deposit in the 1990 escrow. As a result, the yield on nonpurpose investments allocable to the 1994 issue is materially higher than the yield on the 1994 issue, causing the bonds of the 1994 issue to be arbitrage bonds. In addition, the transaction employs a device under section 149(d)(4) to obtain a material financial advantage based on arbitrage, other than savings attributable to lower interest rates.

(ii) The following changes in the facts do not affect the conclusion that the 1994 issue consists of arbitrage bonds—

- (1) The 1990 issue is a taxable issue;
- (2) The original 1984 escrow is used to pay the 1994 issue (rather than the 1990 issue); or
- (3) The 1994 issue is used to retire the 1984 issue within 90 days of January 1, 1994.

(e) *Authority of the Commissioner to clearly reflect the economic substance of a transaction.* If an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of § 1.148-1 through § 1.148-11 as necessary to clearly reflect the economic substance of the transaction. For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148.

(f) *Authority of the Commissioner to require an earlier date for payment of rebate.* If the Commissioner determines that an issue is likely to fail to meet the requirements of § 1.148-3 and that a failure to serve a notice of demand for payment on the issuer will jeopardize the assessment or collection of tax on interest paid or to be paid on the issue,

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the date that the Commissioner serves notice on the issuer is treated as a required computation date for payment of rebate for that issue.

(g) *Authority of the Commissioner to waive regulatory limitations.* Notwithstanding any specific provision in §§1.148-1 through 1.148-11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under section 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of section 148.

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§ 1.148-11 Effective dates.

(a) *In general.* Except as otherwise provided in this section, §§1.148-1 through 1.148-11 apply to bonds sold on or after July 8, 1997.

(b) *Elective retroactive application in whole—(1) In general.* Except as otherwise provided in this section, and subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply the provisions of §§1.148-1 through 1.148-11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954, in lieu of otherwise applicable regulations under those sections.

(2) *No elective retroactive application for 18-month spending exception.* The provisions of §1.148-7(d) (relating to the 18-month spending exception) may not be applied to any issue issued on or before June 30, 1993.

(3) *No elective retroactive application for hedges of fixed rate issues.* The provisions of §1.148-4(h)(2)(i)(B) (relating to hedges of fixed rate issues) may not be applied to any bond sold on or before July 8, 1997.

(4) *No elective retroactive application for safe harbor for establishing fair market value for guaranteed investment con-*

tracts and investments purchased for a yield restricted defeasance escrow. The provisions of §§1.148-5(d)(6)(iii) (relating to the safe harbor for establishing fair market value of guaranteed investment contracts and yield restricted defeasance escrow investments) and 1.148-5(e)(2)(iv) (relating to a special rule for yield restricted defeasance escrow investments) may not be applied to any bond sold before December 30, 1998.

(c) *Elective retroactive application of certain provisions and special rules—(1) Retroactive application of overpayment recovery provisions.* An issuer may apply the provisions of §1.148-3(i) to any issue that is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954.

(2) *Certain allocations of multipurpose issues.* An allocation of bonds to a refunding purpose under §1.148-9(h) may be adjusted as necessary to reflect allocations made between May 18, 1992, and August 15, 1993, if the allocations satisfied the corresponding prior provision of §1.148-11(j)(4) under applicable prior regulations.

(3) *Special limitation.* The provisions of §1.148-9 apply to issues issued before August 15, 1993, only if the issuer in good faith estimates the present value savings, if any, associated with the effect of the application of that section on refunding escrows, using any reasonable accounting method, and applies those savings, if any, to redeem outstanding tax-exempt bonds of the applicable issue at the earliest possible date on which those bonds may be redeemed or otherwise retired. These savings are not reduced to take into account any administrative costs associated with applying these provisions retroactively.

(d) *Transition rule excepting certain state guarantee funds from the definition of replacement proceeds—(1) Certain perpetual trust funds.* A guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if—

(i) Substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests;