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TAX EXEMPTION REQUIREMENTS FOR STATE AND LOCAL BONDS

§ 1.141–1 Definitions and rules of general application.

(a) *In general.* For purposes of §§ 1.141–0 through 1.141–16, the following definitions and rules apply: The definitions in this section, the definitions in § 1.150–1, the definition of placed in service in § 1.150–2(c), the definition of reasonably required reserve or replacement fund in § 1.148–2(f), and the definitions in § 1.148–1 of bond year, commingled fund, fixed yield issue, higher yielding investments, investment, investment proceeds, issue price, issuer, nonpurpose investment, purpose investment, qualified guarantee, qualified hedge, reasonable expectations or reasonableness, rebate amount, replacement proceeds, sale proceeds, variable yield issue and yield.

(b) *Certain general definitions.*

Common areas means portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

Consistently applied means applied uniformly to account for proceeds and other amounts.

Deliberate action is defined in §1.141–2(d)(3).

Discrete portion means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls, partitions, or other physical barriers are examples of a discrete portion.

Disposition is defined in §1.141–12(c)(1).

Disposition proceeds is defined in §1.141–12(c)(1).

Essential governmental function is defined in §1.141–5(d)(4)(ii).

Financed means constructed, reconstructed, or acquired with proceeds of an issue.

Governmental bond has the same meaning as in §1.150–1(b), except that, for purposes of §1.141–13, governmental bond is defined in §1.141–13(b)(2)(iv).

Governmental person means a state or local governmental unit as defined in §1.103–1 or any instrumentality thereof. It does not include the United States or any agency or instrumentality thereof.

Hazardous waste remediation bonds is defined in §1.141–4(f)(1).

Measurement period is defined in §1.141–3(g)(2).

Nongovernmental person means a person other than a governmental person.

Output facility means electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

Private business tests means the private business use test and the private security or payment test of section 141(b).

Proceeds means the sale proceeds of an issue (other than those sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund). Proceeds also include any investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period). Disposition proceeds of an issue are treated as proceeds to the extent provided in §1.141–12. The Commissioner may treat any replaced amounts as proceeds.

Project period means the period beginning on the issue date and ending on the date that the project is placed in service. In the case of a multipurpose issue, the issuer may elect to treat the project period for the entire issue as ending on either the expiration of the temporary period described in §1.148–2(e)(2) or the end of the fifth bond year after the issue date.

Public utility property means public utility property as defined in section 168(i)(10).

Qualified bond means a qualified bond as defined in section 141(e).

Renewal option means a provision under which either party has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for 1-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

Replaced amounts means replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds.

Weighted average maturity is determined under section 147(b).

Weighted average reasonably expected economic life is determined under section 147(b). The reasonably expected economic life of property may be determined by reference to the class life of the property under section 168.

(c) *Elections.* Elections must be made in writing on or before the issue date and retained as part of the bond documents, and, once made, may not be revoked without the permission of the Commissioner.

(d) *Related parties.* Except as otherwise provided, all related parties are treated as one person and any reference to ''person'' includes any related party.

(e) *Partnerships.* A partnership (as defined in section 7701(a)(2)) is treated as an aggregate of its partners, rather than as an entity.

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§ 1.141–2 Private activity bond tests.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. The purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. The regulations under section 141 may not be applied in a manner that is inconsistent with these purposes.

(b) *Scope.* Sections 1.141–0 through 1.141–16 apply generally for purposes of the private activity bond limitations under section 141.

(c) *General definition of private activity bond.* Under section 141, bonds are private activity bonds if they meet either the private business use test and private security or payment test of section 141(b) or the private loan financing test of section 141(c). The private business use and private security or payment tests are described in §§ 1.141–3 and 1.141–4. The private loan financing test is described in § 1.141–5.

(d) *Reasonable expectations and deliberate actions*—(1) *In general.* An issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met.

(2) *Reasonable expectations test*—(i) *In general.* In general, the reasonable expectations test must take into account reasonable expectations about events and actions over the entire stated term of an issue.

(ii) *Special rule for issues with mandatory redemption provisions.* An action that is reasonably expected, as of the issue date, to occur after the issue date and to cause either the private business tests or the private loan financing test to be met may be disregarded for purposes of those tests if—

(A) The issuer reasonably expects, as of the issue date, that the financed property will be used for a governmental purpose for a substantial period before the action;

(B) The issuer is required to redeem all nonqualifying bonds (regardless of the amount of disposition proceeds actually received) within 6 months of the date of the action;

(C) The issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that specific action; and

(D) The mandatory redemption of bonds meets all of the conditions for remedial action under § 1.141–12(a).

(3) *Deliberate action defined*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3), a deliberate action is any action taken by the issuer that is within its control. An intent to violate the requirements of section 141 is not necessary for an action to be deliberate.

(ii) *Safe harbor exceptions.* An action is not treated as a deliberate action if—

(A) It would be treated as an involuntary or compulsory conversion under section 1033; or

(B) It is taken in response to a regulatory directive made by the federal government. See § 1.141–7(g)(4).

(4) *Special rule for dispositions of personal property in the ordinary course of an established governmental program*—(i) *In general*. Dispositions of personal property in the ordinary course of an established governmental program are not treated as deliberate actions if—

(A) The weighted average maturity of the bonds financing that personal property is not greater than 120 percent of the reasonably expected actual use of that property for governmental purposes;

(B) The issuer reasonably expects on the issue date that the fair market value of that property on the date of disposition will be not greater than 25 percent of its cost; and

(C) The property is no longer suitable for its governmental purposes on the date of disposition.

(ii) *Reasonable expectations test*. The reasonable expectation that a disposition described in paragraph (d)(4)(i) of this section may occur in the ordinary course while the bonds are outstanding will not cause the issue to meet the private activity bond tests if the issuer is required to deposit amounts received from the disposition in a commingled fund with substantial tax or other governmental revenues and the issuer reasonably expects to spend the amounts on governmental programs within 6 months from the date of commingling.

(iii) *Separate issue treatment*. An issuer may treat the bonds properly allocable to the personal property eligible for this exception as a separate issue under § 1.150–1(c)(3).

(5) *Special rule for general obligation bond programs that finance a large number of separate purposes*. The determination of whether bonds of an issue are private activity bonds may be based solely on the issuer's reasonable expectations as of the issue date if all of the requirements of paragraphs (d)(5)(i) through (vii) of this section are met.

(i) The issue is an issue of general obligation bonds of a general purpose governmental unit that finances at least 25 separate purposes (as defined in § 1.150–1(c)(3)) and does not predominantly finance fewer than 4 separate purposes.

(ii) The issuer has adopted a fund method of accounting for its general governmental purposes that makes tracing the bond proceeds to specific expenditures unreasonably burdensome.

(iii) The issuer reasonably expects on the issue date to allocate all of the net proceeds of the issue to capital expenditures within 6 months of the issue date and adopts reasonable procedures to verify that net proceeds are in fact so expended. A program to randomly spot check that 10 percent of the net proceeds were so expended generally is a reasonable verification procedure for this purpose.

(iv) The issuer reasonably expects on the issue date to expend all of the net proceeds of the issue before expending proceeds of a subsequent issue of similar general obligation bonds.

(v) The issuer reasonably expects on the issue date that it will not make any loans to nongovernmental persons with the proceeds of the issue.

(vi) The issuer reasonably expects on the issue date that the capital expenditures that it could make during the 6-month period beginning on the issue date with the net proceeds of the issue that would not meet the private business tests are not less than 125 percent of the capital expenditures to be financed with the net proceeds of the issue.

(vii) The issuer reasonably expects on the issue date that the weighted average maturity of the issue is not greater than 120 percent of the weighted average reasonably expected economic life of the capital expenditures financed with the issue. To determine reasonably expected economic life for this purpose an issuer may use reasonable estimates based on the type of expenditures made from a fund.

(e) *When a deliberate action occurs*. A deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

(f) *Certain remedial actions*. See § 1.141–12 for certain remedial actions that prevent a deliberate action with respect to property financed by an issue from causing that issue to meet the private business use test or the private loan financing test.

(g) *Examples.* The following examples illustrate the application of this section:

Example 1 Involuntary action. City B issues bonds to finance the purchase of land. On the issue date, B reasonably expects that it will be the sole user of the land for the entire term of the bonds. Subsequently, the federal government acquires the land in a condemnation action. B sets aside the condemnation proceeds to pay debt service on the bonds but does not redeem them on their first call date. The bonds are not private activity bonds because B has not taken a deliberate action after the issue date. See, however, §1.141–14(b), *Example 2.*

Example 2 Reasonable expectations test—involuntary action. The facts are the same as in *Example 1,* except that, on the issue date, B reasonably expects that the federal government will acquire the land in a condemnation action during the term of the bonds. On the issue date, the present value of the amount that B reasonably expects to receive from the federal government is greater than 10 percent of the present value of the debt service on the bonds. The terms of the bonds do not require that the bonds be redeemed within 6 months of the acquisition by the federal government. The bonds are private activity bonds because the issuer expects as of the issue date that the private business tests will be met.

Example 3 Reasonable expectations test—mandatory redemption. City C issues bonds to rehabilitate an existing hospital that it currently owns. On the issue date of the bonds, C reasonably expects that the hospital will be used for a governmental purpose for a substantial period. On the issue date, C also plans to construct a new hospital, but the placed in service date of that new hospital is uncertain. C reasonably expects that, when the new hospital is placed in service, it will sell or lease the rehabilitated hospital to a private hospital corporation. The bond documents require that the bonds must be redeemed within 6 months of the sale or lease of the rehabilitated hospital (regardless of the amount actually received from the sale). The bonds meet the reasonable expectations requirement of the private activity bond tests if the mandatory redemption of bonds meets all of the conditions for a remedial action under §1.141–12(a).

Example 4 Dispositions in the ordinary course of an established governmental program. City D issues bonds with a weighted average maturity of 6 years for the acquisition of police cars. D reasonably expects on the issue date that the police cars will be used solely by its police department, except that, in the ordinary course of its police operations, D sells its police cars to a taxicab corporation after 5 years of use because they are no longer suitable for police use. Further, D reasonably expects that the value of the police cars when they are no longer suitable for police use will be no more than 25 percent of cost. D subsequently sells 20 percent of the police cars after only 3 years of actual use. At that time, D deposits the proceeds from the sale of the police cars in a commingled fund with substantial tax revenues and reasonably expects to spend the proceeds on governmental programs within 6 months of the date of deposit. D does not trace the actual use of these commingled amounts. The sale of the police cars does not cause the private activity bond tests to be met because the requirements of paragraph (d)(4) of this section are met.

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§ 1.141–3 Definition of private business use.

(a) *General rule*—(1) *In general.* The private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of section 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business. Unless the context or a provision clearly requires otherwise, this section also applies to the private business use test under sections 141(b)(3) (unrelated or disproportionate use), 141(b)(4) ($15 million limitation for certain output facilities), and 141(b)(5) (the coordination with the volume cap where the nonqualified amount exceeds $15 million).

(2) *Indirect use.* In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business. Similarly, the issuer's use of the proceeds to engage

in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

(3) *Aggregation of private business use.* The use of proceeds by all nongovernmental persons is aggregated to determine whether the private business use test is met.

(b) *Types of private business use arrangements*—(1) *In general.* Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

(2) *Ownership.* Except as provided in paragraph (d)(1) or (d)(2) of this section, ownership by a nongovernmental person of financed property is private business use of that property. For this purpose, ownership refers to ownership for federal income tax purposes.

(3) *Leases.* Except as provided in paragraph (d) of this section, the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all of the facts and circumstances, including the following factors—

(i) The degree of control over the property that is exercised by a nongovernmental person; and

(ii) Whether a nongovernmental person bears risk of loss of the financed property.

(4) *Management contracts*—(i) *Facts and circumstances test.* Except as provided in paragraph (d) of this section, a management contract (within the meaning of paragraph (b)(4)(ii) of this section) with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(ii) *Management contract defined.* For purposes of this section, a management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

(iii) *Arrangements generally not treated as management contracts.* The arrangements described in paragraphs (b)(4)(iii)(A) through (D) of this section generally are not treated as management contracts that give rise to private business use.

(A) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services).

(B) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities.

(C) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

(D) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(iv) *Management contracts that are properly treated as other types of private business use.* A management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(5) *Output contracts.* See §1.141–7 for special rules for contracts for the purchase of output of output facilities.

(6) *Research agreements*—(i) *Facts and circumstances test.* Except as provided in paragraph (d) of this section, an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

(ii) *Research agreements that are properly treated as other types of private business use.* A research agreement with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(7) *Other actual or beneficial use*—(i) *In general.* Any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements described in paragraphs (b)(2), (3), (4), (5), or (6) of this section results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

(ii) *Special rule for facilities not used by the general public.* In the case of financed property that is not available for use by the general public (within the meaning of paragraph (c) of this section), private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property. In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including one or more of the following factors—

(A) Whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person;

(B) Whether only a small number of nongovernmental persons receive the special economic benefit; and

(C) Whether the cost of the financed property is treated as depreciable by any nongovernmental person.

(c) *Exception for general public use*—(1) *In general.* Use as a member of the general public (general public use) is not private business use. Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

(2) *Use on the same basis.* In general, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. For this purpose, rates may be treated as generally applicable and uniformly applied even if—

(i) Different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable; or

(ii) A specially negotiated rate arrangement is entered into, but only if the user is prohibited by federal law from paying the generally applicable rates, and the rates established are as comparable as reasonably possible to the generally applicable rates.

(3) *Long-term arrangements not treated as general public use.* An arrangement is not treated as general public use if the term of the use under the arrangement, including all renewal options, is greater than 200 days. For this purpose, a right of first refusal to renew use under the arrangement is not treated as a renewal option if—

(i) The compensation for the use under the arrangement is redetermined at generally applicable, fair market value rates that are in effect at the time of renewal; and

(ii) The use of the financed property under the same or similar arrangements is predominantly by natural persons who are not engaged in a trade or business.

(4) *Relation to other use.* Use of financed property by the general public does not prevent the proceeds from being used for a private business use because of other use under this section.

(d) *Other exceptions*—(1) *Agents.* Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person is not private business use. For example, use by a nongovernmental person that issues obligations on behalf of a governmental person is not private business use to the extent the nongovernmental person's use of proceeds is in its capacity as an agent of the governmental person.

(2) *Use incidental to financing arrangements.* Use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. A use is solely incidental to a financing arrangement only if the nongovernmental person has no substantial rights to use bond proceeds or financed property other than as an agent of the bondholders. For example, a nongovernmental person that acts solely as an owner of title in a sale and leaseback financing transaction with a city generally is not a private business user of the property leased to the city, provided that the nongovernmental person has assigned all of its rights to use the leased facility to the trustee for the bondholders upon default by the city. Similarly, bond trustees, servicers, and guarantors are generally not treated as private business users.

(3) *Exceptions for arrangements other than arrangements resulting in ownership of financed property by a nongovernmental person*—(i) *Arrangements not available for use on the same basis by natural persons not engaged in a trade or business.* Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 100 days;

(B) The arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(ii) *Negotiated arm's-length arrangements.* Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 50 days;

(B) The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(4) *Temporary use by developers.* Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the issuer and the developer reasonably expect on the issue date to proceed

with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

(5) *Incidental use*—(i) *General rule*. Incidental uses of a financed facility are disregarded, to the extent that those uses do not exceed 2.5 percent of the proceeds of the issue used to finance the facility. A use of a facility by a nongovernmental person is incidental if—

(A) Except for vending machines, pay telephones, kiosks, and similar uses, the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, such as a night gate affixed to a structural component of a building (a nonpossessory use);

(B) The nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); and

(C) All nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility.

(ii) *Illustrations*. Incidental uses may include pay telephones, vending machines, advertising displays, and use for television cameras, but incidental uses may not include output purchases.

(6) *Qualified improvements*. Proceeds that provide a governmentally owned improvement to a governmentally owned building (including its structural components and land functionally related and subordinate to the building) are not used for a private business use if—

(i) The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;

(ii) The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;

(iii) No portion of the improved building or any payments in respect of the improved building are taken into account under section 141(b)(2)(A) (the private security test); and

(iv) No more than 15 percent of the improved building is used for a private business use.

(e) *Special rule for tax assessment bonds*. In the case of a tax assessment bond that satisfies the requirements of §1.141–5(d), the loan (or deemed loan) of the proceeds to the borrower paying the assessment is disregarded in determining whether the private business use test is met. However, the use of the loan proceeds is not disregarded in determining whether the private business use test is met.

(f) *Examples*. The following examples illustrate the application of paragraphs (a) through (e) of this section. In each example, assume that the arrangements described are the only arrangements with nongovernmental persons for use of the financed property.

Example 1. Nongovernmental ownership. State A issues 20-year bonds to purchase land and equip and construct a factory. A then enters into an arrangement with Corporation X to sell the factory to X on an installment basis while the bonds are outstanding. The issue meets the private business use test because a nongovernmental person owns the financed facility. See also §1.141–2 (relating to the private activity bond tests), and §1.141–5 (relating to the private loan financing test).

Example 2 Lease to a nongovernmental person. (i) The facts are the same as in *Example 1*, except that A enters into an arrangement with X to lease the factory to X for 3 years rather than to sell it to X. The lease payments will be made annually and will be based on the tax-exempt interest rate on the bonds. The issue meets the private business use test because a nongovernmental person leases the financed facility. See also §1.141–14 (relating to anti-abuse rules).

(ii) The facts are the same as in *Example 2(i)*, except that the annual payments made by X will equal fair rental value of the facility and exceed the amount necessary to pay debt service on the bonds for the 3 years of the lease. The issue meets the private business use test because a nongovernmental person leases the financed facility and the test does not require that the benefits of tax-exempt financing be passed through to the nongovernmental person.

Example 3. Management contract in substance a lease. City L issues 30-year bonds to finance the construction of a city hospital. L enters into a 15-year contract with M, a nongovernmental person that operates a health maintenance organization relating to the treatment of M's members at L's hospital. The contract provides for reasonable fixed compensation to M for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the hospital. However, the contract also provides that 30 percent of the capacity of the hospital will be exclusively available to M's members and M will bear the risk of loss of that portion of the capacity of the hospital so that, under all of the facts and circumstances, the contract is properly characterized as a lease for federal income tax purposes. The issue meets the private business use test because a nongovernmental person leases the financed facility.

Example 4. Ownership of title in substance a leasehold interest. Nonprofit Corporation R issues bonds on behalf of City P to finance the construction of a hospital. R will own legal title to the hospital. In addition, R will operate the hospital, but R is not treated as an agent of P in its capacity as operator of the hospital. P has certain rights to the hospital that establish that it is properly treated as the owner of the property for federal income tax purposes. P does not have rights, however, to directly control operation of the hospital while R owns legal title to it and operates it. The issue meets the private business use test because the arrangement provides a nongovernmental person an interest in the financed facility that is comparable to a leasehold interest. See paragraphs (a)(2) and (b)(7)(i) of this section.

Example 5. Rights to control use of property treated as private business use—parking lot. Corporation C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory. Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest. See paragraph (b)(7)(i) of this section.

Example 6. Other actual or beneficial use—hydroelectric enhancements. J, a political subdivision, owns and operates a hydroelectric generation plant and related facilities. Pursuant to a take or pay contract, J sells 15 percent of the output of the plant to Corporation K, an investor-owned utility. K is treated as a private business user of the plant. Under the license issued to J for operation of the plant, J is required by federal regulations to construct and operate various facilities for the preservation of fish and for public recreation. J issues its obligations to finance the fish preservation and public recreation facilities. K has no special legal entitlements for beneficial use of the financed facilities. The fish preservation facilities are functionally related to the operation of the plant. The recreation facilities are available to natural persons on a short-term basis according to generally applicable and uniformly applied rates. Under paragraph (c) of this section, the recreation facilities are treated as used by the general public. Under paragraph (b)(7) of this section, K's use is not treated as private business use of the recreation facilities because K has no special legal entitlements for beneficial use of the recreation facilities. The fish preservation facilities are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under all of the facts and circumstances (including the functional relationship of the fish preservation facilities to property used in K's trade or business) under paragraph (b)(7)(ii) of this section, K derives a special economic benefit from the fish preservation facilities. Therefore, K's private business use may be established solely on the basis of that special economic benefit, and K's use of the fish preservation facilities is treated as private business use.

Example 7. Other actual or beneficial use—pollution control facilities. City B issues obligations to finance construction of a specialized pollution control facility on land that it owns adjacent to a factory owned by Corporation N. B will own and operate the pollution control facility, and N will have no special legal entitlements to use the facility. B, however, reasonably expects that N will be the only user of the facility. The facility will not be reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under paragraph (b)(7)(ii) of this section, because under all of the facts and circumstances the facility is functionally related and is physically proximate to property used in N's trade or business, N derives a special economic benefit from the facility. Therefore, N's private business use may be established solely on the basis of that special economic benefit, and N's use is treated as private business use of the facility. See paragraph (b)(7)(ii) of this section.

Example 8. General public use—airport runway. (i) City I issues bonds and uses all of the proceeds to finance construction of a runway at a new city-owned airport. The runway will be available for take-off and landing by any operator of an aircraft desiring to use the airport, including general aviation operators who are natural persons not engaged in a trade or business. It is reasonably expected that most of the actual use of the runway will be by private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. These leases for the use of terminal space provide no priority rights or other preferential benefits to the air carriers for use of the runway. Moreover, under the leases the lease payments are determined without taking into account the revenues generated by runway landing fees (that is, the lease payments are not determined on a "residual" basis). Although the lessee air carriers receive a special economic benefit from the use of the runway, this economic benefit is not sufficient to cause the air carriers to be private business users, because the runway is available for general public use. The issue does not meet the private business use test. See paragraphs (b)(7)(ii) and (c) of this section.

(ii) The facts are the same as in *Example 8(i)*, except that the runway will be available for use only by private air carriers. The use by these private air carriers is not for general public use, because the runway is not reasonably available for use on the same basis by natural persons not engaged in a trade or business. Depending on all of the facts and circumstances, including whether there are only a small number of lessee private air carriers, the issue may meet the private business use test solely because the private air carriers receive a special economic benefit from the runway. See paragraph (b)(7)(ii) of this section.

(iii) The facts are the same as in *Example 8(i)*, except that the lease payments under the leases with the private air carriers are determined on a residual basis by taking into account the net revenues generated by runway landing fees. These leases cause the private business use test to be met with respect to the runway because they are arrangements that convey special legal entitlements to the financed facility to nongovernmental persons. See paragraph (b)(7)(i) of this section.

Example 9. General public use—airport parking garage. City S issues bonds and uses all of the proceeds to finance construction of a city-owned parking garage at the city-owned airport. S reasonably expects that more than 10 percent of the actual use of the parking garage will be by employees of private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. The air carriers' use of the parking garage, however, will be on the same basis as passengers and other members of the general public using the airport. The leases for the use of the terminal space provide no priority rights to the air carriers for use of the parking garage, and the lease payments are determined without taking into account the revenues generated by the parking garage. Although the lessee air carriers receive a special economic benefit from the use of the parking garage, this economic benefit is not sufficient to cause the air carriers to be private business users, because the parking garage is available for general public use. The issue does not meet the private business use test. See paragraphs (b)(7)(ii) and (c) of this section.

Example 10. Long-term arrangements not treated as general public use—insurance fund. Authority T deposits all of the proceeds of its bonds in its insurance fund and invests all of those proceeds in tax-exempt bonds. The insurance fund provides insurance to a large number of businesses and natural persons not engaged in a trade or business. Each participant receives insurance for a term of 1 year. The use by the participants, other than participants that are natural persons not engaged in a trade or business, is treated as private business use of the proceeds of the bonds because the participants have special legal entitlements to the use of bond proceeds, even though the contractual rights are not necessarily properly characterized as ownership, leasehold, or similar interests listed in paragraph (b) of this section. Use of the bond proceeds is not treated as general public use because the term of the insurance is greater than 200 days. See paragraphs (b)(7)(i) and (c)(3) of this section.

Example 11. General public use—port road. Highway Authority W uses all of the proceeds of its bonds to construct a 25-mile road to connect an industrial port owned by Corporation Y with existing roads owned and operated by W. Other than the port, the nearest residential or commercial development to the new road is 12 miles away. There is no reasonable expectation that development will occur in the area surrounding the new road. W and Y enter into no arrangement (either by contract or ordinance) that conveys special legal entitlements to Y for the use of the road. Use of the road will be available without restriction to all users, including natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because the road is treated as used only by the general public.

Example 12. General public use of governmentally owned hotel. State Q issues bonds to purchase land and construct a hotel for use by the general public (that is, tourists, visitors, and business travelers). The bond documents provide that Q will own and operate the project for the term of the bonds. Q will not enter into a lease or license with any user for use of rooms for a period longer than 200 days (although users may actually use rooms for consecutive periods in excess of 200 days). Use of the hotel by hotel guests who are travelling in connection with trades or businesses of nongovernmental persons is not a private business use of the hotel by these persons because the hotel is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business. See paragraph (c)(1) of this section.

Example 13. General public use with rights of first refusal. Authority V uses all of the proceeds of its bonds to construct a parking garage. At least 90 percent of the spaces in the garage will be available to the general public on a monthly first-come, first-served basis. V reasonably expects that the spaces will be predominantly leased to natural persons not engaged in a trade or business who have priority rights to renew their spaces at then current fair market value rates. More than 10 percent of the spaces will be leased to nongovernmental persons acting in a trade or business. These leases are not treated as arrangements with a term of use greater than 200 days. The rights to renew are not treated as renewal options because the compensation for the spaces is redetermined at generally applicable, fair market value rates that will be in effect at the time of renewal and the use of the spaces under similar arrangements is predominantly by natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because at least 90 percent of the use of the parking garage is general public use. See paragraph (c)(3) of this section.

Example 14. General public use with a specially negotiated rate agreement with agency of United States. G, a sewage collection and treatment district, operates facilities that were financed with its bonds. F, an agency of the United States, has a base located within G. Approximately 20 percent of G's facilities are used to treat sewage produced by F under a specially negotiated rate agreement. Under the specially negotiated rate agreement, G uses its best efforts to charge F as closely as possible the same amount for its use of G's services as its other customers pay for the same amount of services, although those other customers pay for services based on standard district charges and tax levies. F is prohibited by federal law from paying for the services based on those standard district charges and tax levies. The use of G's facilities by F is on the same basis as the general public. See paragraph (c)(2)(ii) of this section.

Example 15. Arrangements not available for use by natural persons not engaged in a trade or business—federal use of prisons. Authority E uses all of the proceeds of its bonds to construct a prison. E contracts with federal agency F to house federal prisoners on a space-available, first-come, first-served basis, pursuant to which F will be charged approximately the same amount for each prisoner as other persons that enter into similar transfer agreements. It is reasonably expected that other persons will enter into similar agreements. The term of the use under the contract is not longer than 100 days, and F has no right to renew, although E reasonably expects to renew the contract indefinitely. The prison is not financed for a principal purpose of providing the prison for use by F. It is reasonably expected that during the term of the bonds, more than 10 percent of the prisoners at the prison will be federal prisoners. F's use of the facility is not general public use because this type of use (leasing space for prisoners) is not available for use on the same basis by natural persons not engaged in a trade or business. The issue does not meet the private business use test, however, because the leases satisfy the exception of paragraph (d)(3)(i) of this section.

Example 16. Negotiated arm's-length arrangements—auditorium reserved in advance. (i) City Z issues obligations to finance the construction of a municipal auditorium that it will own and operate. The use of the auditorium will be open to anyone who wishes to use it for a short period of time on a rate-scale basis. Z reasonably expects that the auditorium will be used by schools, church groups, sororities, and numerous commercial organizations. Corporation H, a nongovernmental person, enters into an arm's-length arrangement with Z to use the auditorium for 1 week for each year for a 10-year period (a total of 70 days), pursuant to which H will be charged a specific price reflecting fair market value. On the date the contract is entered into, Z has not established generally applicable rates for future years. Even though the auditorium is not financed for a principal purpose of providing use of the auditorium to H, H is not treated as using the auditorium as a member of the general public because its use is not on the same basis as the general public. Because the term of H's use of the auditorium is longer than 50 days, the arrangement does not meet the exception under paragraph (d)(3)(ii) of this section.

(ii) The facts are the same as in *Example 16(i)*, except that H will enter into an arm's-length arrangement with Z to use the auditorium for 1 week for each year for a 4-year period (a total of 28 days), pursuant to which H will be charged a specific price reflecting fair market value. H is not treated as a private business user of the auditorium because its contract satisfies the exception of paragraph (d)(3)(ii) of this section for negotiated arm's-length arrangements.

(g) *Measurement of private business use*—(1) *In general.* In general, the private business use of proceeds is allocated to property under §1.141–6. The amount of private business use of that property is determined according to the average percentage of private business use of that property during the measurement period.

(2) *Measurement period*—(i) *General rule.* Except as provided in this paragraph (g)(2), the measurement period of property financed by an issue begins on the later of the issue date of that issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date.

(ii) *Special rule for refundings of short-term obligations.* For an issue of short-term obligations that the issuer reasonably expects to refund with a long-term financing (such as bond anticipation notes), the measurement period is based on the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates).

(iii) *Special rule for reasonably expected mandatory redemptions.* If an issuer reasonably expects on the issue date that an action will occur during the term of the bonds to cause either the private business tests or the private loan financing test to be met and is required to redeem bonds to meet the reasonable expectations test of §1.141–2(d)(2), the measurement period ends on the reasonably expected redemption date.

(iv) *Special rule for ownership by a nongovernmental person.* The amount of private business use resulting from ownership by a nongovernmental person is the greatest percentage of private business use in any 1-year period.

(v) *Special rule for partners that are nongovernmental persons*—(A) The amount of private business use by a nongovernmental person resulting from the use of property by a partnership in which that nongovernmental person is a partner is that nongovernmental partner's share of the amount of use of the property by the partnership. For this purpose, except as otherwise provided in paragraph (g)(2)(v)(B) of this section, a nongovernmental partner's share of the partnership's use of the property is the nongovernmental partner's greatest percentage share under section 704(b) of any partnership item of income, gain, loss, deduction, or credit attributable to the period that the partnership uses the property during the measurement period. For example, if a partnership has a nongovernmental partner and that partner's share of partnership items varies, with the greatest share being 25 percent, then that nongovernmental partner's share of the partnership's use of property is 25 percent.

(B) An issuer may determine a nongovernmental partner's share of the partnership's use of the property under guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(vi) *Anti-abuse rule.* If an issuer establishes the term of an issue for a period that is longer than is reasonably necessary for the governmental purposes of the issue for a principal purpose of increasing the permitted amount of private business use, the Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any 1-year period.

(3) *Determining average percentage of private business use.* The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. Appropriate adjustments must be made for beginning and ending periods of less than 1 year.

(4) *Determining the average amount of private business use for a 1-year period*—(i) *In general.* The percentage of private business use of property for any 1-year period is the average private business use during that year. This average is determined by comparing the amount of private business use during the year to the total amount of private business use and use that is not private business use (government use) during that year. Paragraphs (g)(4) (ii) through (v) of this section apply to determine the average amount of private business use for a 1-year period.

(ii) *Uses at different times.* For a facility in which actual government use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. In determining the total amount of actual use, periods during which the facility is not in use are disregarded.

(iii) *Simultaneous use.* In general, for a facility in which government use and private business use occur simultaneously, the entire facility is treated as having private business use. For example, a governmentally owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use. If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (for example, reasonably expected fair market value of use). For example, the average amount of private business use of a garage with unassigned spaces that is used for government use and private business use is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

(iv) *Discrete portion.* For purposes of this paragraph (g), measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility.

(v) *Relationship to fair market value.* For purposes of paragraphs (g)(4) (ii) through (iv) of this section, if private business use is reasonably expected as of the issue date to have a significantly greater fair market value than government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use. This determination of relative fair market value may be made as of the date the property is acquired or placed in service if making this determination as of the issue date is not reasonably possible (for example, if the financed property is not identified on the issue date). In general, the relative reasonably expected fair market value for a period must be determined by taking into account the amount of reasonably expected payments for private business use for the period in a manner that properly reflects the proportionate benefit to be derived from the private business use.

(5) *Common areas.* The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit.

(6) *Allocation of neutral costs.* Proceeds that are used to pay costs of issuance, invested in a reserve or replacement fund, or paid as fees for a qualified guarantee or a qualified hedge must be allocated ratably among the other purposes for which the proceeds are used.

(7) *Commencement of measurement of private business use.* Generally, private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if an issuer enters into an arrangement for private business use a substantial period before the right to actual private business use commences and the arrangement transfers ownership or is an arrangement for other long-term use (such as a lease for a significant portion of the remaining economic life of financed property), private business use commences on the date the arrangement is entered into, even if the right to actual use commences after the measurement period. For this purpose, 10 percent of the measurement period is generally treated as a substantial period.

(8) *Examples.* The following examples illustrate the application of this paragraph (g):

Example 1. Research facility. University U, a state owned and operated university, owns and operates a research facility. U proposes to finance general improvements to the facility with the proceeds of an issue of bonds.

U enters into sponsored research agreements with nongovernmental persons that result in private business use because the sponsors will own title to any patents resulting from the research. The governmental research conducted by U and the research U conducts for the sponsors take place simultaneously in all laboratories within the research facility. All laboratory equipment is available continuously for use by workers who perform both types of research. Because it is not possible to predict which research projects will be successful, it is not reasonably practicable to estimate the relative revenues expected to result from the governmental and nongovernmental research. U contributed 90 percent of the cost of the facility and the nongovernmental persons contributed 10 percent of the cost. Under this section, the nongovernmental persons are using the facility for a private business use on the same basis as the government use of the facility. The portions of the costs contributed by the various users of the facility provide a reasonable basis that properly reflects the proportionate benefit to be derived by the users of the facility. The nongovernmental persons are treated as using 10 percent of the proceeds of the issue.

Example 2. Stadium. (i) City L issues bonds and uses all of the proceeds to construct a stadium. L enters into a long-term contract with a professional sports team T under which T will use the stadium 20 times during each year. These uses will occur on nights and weekends. L reasonably expects that the stadium will be used more than 180 other times each year, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of T's uses when compared to the other uses of the stadium, taking into account the payments that T is reasonably expected to make for its use. Assuming no other private business use, the issue does not meet the private business use test because not more than 10 percent of the use of the facility is for a private business use.

(ii) The facts are the same as in *Example 2(i)*, except that L reasonably expects that the stadium will be used not more than 60 other times each year, none of which will give rise to private business use. The issue meets the private business use test because 25 percent of the proceeds are used for a private business use.

Example 3. Airport terminal areas treated as common areas. City N issues bonds to finance the construction of an airport terminal. Eighty percent of the leasable space of the terminal will be leased to private air carriers. The remaining 20 percent of the leasable space will be used for the term of the bonds by N for its administrative purposes. The common areas of the terminal, including waiting areas, lobbies, and hallways are treated as 80 percent used by the air carriers for purposes of the private business use test.

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§ 1.141–4 Private security or payment test.

(a) *General rule*—(1) *Private security or payment.* The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use. For additional rules for output facilities, see § 1.141–7.

(2) *Aggregation of private payments and security.* For purposes of the private security or payment test, payments taken into account as private payments and payments or property taken into account as private security are aggregated. However, the same payments are not taken into account as both private security and private payments.

(3) *Underlying arrangement.* The security for, and payment of debt service on, an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in a private business use, the issue meets the private security or payment test.

(b) *Measurement of private payments and security*—(1) *Scope*. This paragraph (b) contains rules that apply to both private security and private payments.

(2) *Present value measurement*—(i) *Use of present value*. In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

(ii) *Debt service*—(A) *Debt service paid from proceeds*. Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. For example, debt service does not include payments of capitalized interest funded with proceeds.

(B) *Adjustments to debt service*. Debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of section 148(f). For example, debt service includes fees paid for qualified guarantees under §1.148–4(f) and is adjusted to take into account payments and receipts on qualified hedges under §1.148–4(h).

(iii) *Computation of present value*—(A) *In general*. Present values are determined by using the yield on the issue as the discount rate and by discounting all amounts to the issue date. See, however, §1.141–13 for special rules for refunding bonds.

(B) *Fixed yield issues*. For a fixed yield issue, yield is determined on the issue date and is not adjusted to take into account subsequent events.

(C) *Variable yield issues*. The yield on a variable yield issue is determined over the term of the issue. To determine the reasonably expected yield as of any date, the issuer may assume that the future interest rate on a variable yield bond will be the then-current interest rate on the bonds determined under the formula prescribed in the bond documents. A deliberate action requires a recomputation of the yield on the variable yield issue to determine the present value of payments under that arrangement. In that case, the issuer must use the yield determined as of the date of the deliberate action for purposes of determining the present value of payments under the arrangement causing the deliberate action. See paragraph (g) of this section, *Example 3*.

(iv) *Application to private security*. For purposes of determining the present value of debt service that is secured by property, the property is valued at fair market value as of the first date on which the property secures bonds of the issue.

(c) *Private payments*—(1) *In general*. This paragraph (c) contains rules that apply to private payments.

(2) *Payments taken into account*—(i) *Payments for use*—(A) *In general*. Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments are taken into account as private payments only to the extent that they are made for the period of time that proceeds are used for a private business use. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market value compensation for that other use. See paragraph (g) of this section, *Example 4* and *Example 5*. See also paragraph (c)(3) of this section for rules relating to allocation of payments to the source or sources of funding of property.

(B) *Payments not to exceed use*. Payments with respect to proceeds that are used for a private business use are not taken into account to the extent that the present value of those payments exceeds the present value of debt service on those proceeds. Payments need not be directly derived from a private business user, however, to be taken into account. Thus, if 7 percent of the proceeds of an issue is used by a person over the measurement period, payments with respect to the property financed with those proceeds are taken into account as private payments only to the extent that the present value of those payments does not exceed the present value of 7 percent of the debt service on the issue.

(C) *Payments for operating expenses.* Payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses (as defined under section 162) directly attributable to the operation and maintenance of the financed property used by that person. For this purpose, general overhead and administrative expenses are not directly attributable to those operations and maintenance. For example, if an issuer receives $5,000 rent during the year for use of space in a financed facility and during the year pays $500 for ordinary and necessary expenses properly allocable to the operation and maintenance of that space and $400 for general overhead and general administrative expenses properly allocable to that space, $500 of the $5,000 received would not be considered a payment for the use of the proceeds allocable to that space (regardless of the manner in which that $500 is actually used).

(ii) *Refinanced debt service.* Payments of debt service on an issue to be made from proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue. For example, if all the debt service on a note is paid with proceeds of a refunding issue, the note meets the private security or payment test if (and to the same extent that) the refunding issue meets the private security or payment test. This paragraph (c)(2)(ii) does not apply to payments that arise from deliberate actions that occur more than 3 years after the retirement of the prior issue that are not reasonably expected on the issue date of the refunding issue. For purposes of this paragraph (c)(2)(ii), whether an issue is a refunding issue is determined without regard to §1.150–1(d)(2)(i) (relating to certain payments of interest).

(3) *Allocation of payments*—(i) *In general.* Private payments for the use of property are allocated to the source or different sources of funding of property. The allocation to the source or different sources of funding is based on all of the facts and circumstances, including whether an allocation is consistent with the purposes of section 141. In general, a private payment for the use of property is allocated to a source of funding based upon the nexus between the payment and both the financed property and the source of funding. For this purpose, different sources of funding may include different tax-exempt issues, taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

(ii) *Payments for use of discrete property.* Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.

(iii) *Allocations among two or more sources of funding.* In general, except as provided in paragraphs (c)(3)(iv) and (v) of this section, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property. If an issuer has not retained records of amounts expended on the property (for example, records of costs of a building that was built 30 years before the allocation), an issuer may use reasonable estimates of those expenditures. For this purpose, costs of issuance and other similar neutral costs are allocated ratably among expenditures in the same manner as in §1.141–3(g)(6). A payment for the use of property may be allocated to two or more issues that finance property according to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if that allocation reasonably reflects the economic substance of the arrangement. In general, allocations of payments according to relative debt service reasonably reflect the economic substance of the arrangement if the maturity of the bonds reasonably corresponds to the reasonably expected economic life of the property and debt service payments on the bonds are approximately level from year to year.

(iv) *Payments made under an arrangement entered into in connection with issuance of bonds.* A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue. Whether an arrangement is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances. An arrangement is ordinarily treated as entered into in connection with the issuance of an issue if—

(A) The issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and

(B) The amount of payments reflects all or a portion of debt service on the issue.

(v) *Allocations to equity.* A private payment for the use of property may be allocated to equity before payments are allocated to an issue only if—

(A) Not later than 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to §1.150–2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and

(B) The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

(d) *Private security*—(1) *In general.* This paragraph (d) contains rules that relate to private security.

(2) *Security taken into account.* The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with proceeds. For example, unimproved land or investment securities used, directly or indirectly, in a private business use that secures an issue provides private security. Private security (other than financed property and private payments) for an issue is taken into account under section 141(b), however, only to the extent it is provided, directly or indirectly, by a user of proceeds of the issue.

(3) *Pledge of unexpended proceeds.* Proceeds qualifying for an initial temporary period under §1.148–2(e)(2) or (3) or deposited in a reasonably required reserve or replacement fund (as defined in §1.148–2(f)(2)(i)) are not taken into account under this paragraph (d) before the date on which those amounts are either expended or loaned by the issuer to an unrelated party.

(4) *Secured by any interest in property or payments.* Property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase any interest in is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments.

(5) *Payments in respect of property.* The payments taken into account as private security are payments in respect of property used or to be used for a private business use. Except as otherwise provided in this paragraph (d)(5) and paragraph (d)(6) of this section, the rules in paragraphs (c)(2)(i)(A) and (B) and (c)(2)(ii) of this section apply to determine the amount of payments treated as payments in respect of property used or to be used for a private business use. Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

(6) *Allocation of security among issues.* In general, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.

(e) *Generally applicable taxes*—(1) *General rule.* For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use).

(2) *Definition of generally applicable taxes.* A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental or public purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.

(3) *Special charges.* A special charge (as defined in this paragraph (e)(3)) is not a generally applicable tax. For this purpose, a special charge means a payment for a special privilege granted or regulatory function (for example, a license fee), a service rendered (for example, a sanitation services fee), a use of property (for example, rent), or a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons based on benefits received from the capital improvements financed with the assessment. Thus, a special assessment to finance infrastructure improvements in a new industrial park (such as sidewalks, streets, streetlights, and utility infrastructure improvements) that is imposed on a limited class of persons composed of property owners within the industrial park who benefit from those improvements is a special charge. By contrast, an otherwise qualified generally applicable tax (such as a generally applicable ad valorem tax on all real property within a governmental taxing jurisdiction) or an eligible PILOT under paragraph (e)(5) of this section that is based on such a generally applicable tax is not treated as a special charge merely because the taxes or PILOTs received are used for governmental or public purposes in a manner which benefits particular property owners.

(4) *Manner of determination and collection*—(i) *In general.* A tax does not have a generally applicable manner of determination and collection to the extent that one or more taxpayers make any impermissible agreements relating to payment of those taxes. An impermissible agreement relating to the payment of a tax is taken into account whether or not it is reasonably expected to result in any payments that would not otherwise have been made. For example, if an issuer uses proceeds to make a grant to a taxpayer to improve property, agreements that impose reasonable conditions on the use of the grant do not cause a tax on that property to fail to be a generally applicable tax. If an agreement by a taxpayer causes the tax imposed on that taxpayer not to be treated as a generally applicable tax, the entire tax paid by that taxpayer is treated as a special charge, unless the agreement is limited to a specific portion of the tax.

(ii) *Impermissible agreements.* The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to be personally liable on a tax that does not generally impose personal liability, to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls; an agreement regarding the minimum market value of property subject to property tax; and an agreement not to challenge or seek deferral of the tax.

(iii) *Permissible agreements.* The following are examples of agreements that do not cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to use a grant for specified purposes (whether or not that agreement is secured); a representation regarding the expected value of the property following the improvement; an agreement to insure the property and, if damaged, to restore the property; a right of a grantor to rescind the grant if property taxes are not paid; and an agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose. For example, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

(5) *Payments in lieu of taxes.* A tax equivalency payment or other payment in lieu of a tax (''PILOT'') is treated as a generally applicable tax if it meets the requirements of paragraphs (e)(5)(i) through (iv) of this section—

(i) *Maximum amount limited by underlying generally applicable tax.* The PILOT is not greater than the amount imposed by a statute for a generally applicable tax in each year.

(ii) *Commensurate with a generally applicable tax.* The PILOT is commensurate with the amount imposed by a statute for a generally applicable tax in each year under the commensurate standard set forth in this paragraph (e)(5)(ii). For this purpose, except as otherwise provided in this paragraph (e)(5)(ii), a PILOT is commensurate with a generally applicable tax only if it is equal to a fixed percentage of the generally applicable tax that would otherwise apply in each year or it reflects a fixed adjustment to the generally applicable tax that would otherwise apply in each year. A PILOT based on a property tax does not fail to be commensurate with the property tax as a result of changes in the level of the percentage of or adjustment to that property tax for a reasonable phase-in period ending when the subject property is placed in service (as defined in §1.150–2(c)). A PILOT based on a property tax must take into account the current assessed value of the property for property tax purposes for each year in which the PILOT is paid and that assessed value must be determined in the same manner and with the same frequency as property subject to the property tax. A PILOT is not commensurate with a generally applicable tax, however, if the PILOT is set at a fixed dollar amount (for example, fixed debt service on a bond issue) that cannot vary with changes in the level of the generally applicable tax on which it is based.

(iii) *Use of PILOTs for governmental or public purposes.* The PILOT is to be used for governmental or public purposes for which the generally applicable tax on which it is based may be used.

(iv) *No special charges.* The PILOT is not a special charge under paragraph (e)(3) of this section.

(f) *Certain waste remediation bonds*—(1) *Scope.* This paragraph (f) applies to bonds issued to finance hazardous waste clean-up activities on privately owned land (hazardous waste remediation bonds).

(2) *Persons that are not private users.* Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site are not taken into account as private security. This paragraph (f)(2) applies to payments that secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds. This paragraph (f)(2) applies only if the payments are made pursuant to either a generally applicable state or local taxing statute or a state or local statute that regulates or restrains activities on an industry-wide basis of persons who are engaged in generating or handling hazardous waste, or in refining, producing, or transporting petroleum, provided that those payments do not represent, in substance, payment for the use of proceeds. For this purpose, a state or local statute that imposes payments that have substantially the same character as those described in Chapter 38 of the Code are treated as generally applicable taxes.

(3) *Persons that are private users.* If payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds, the payments are not taken into account as private payments. This paragraph (f)(3) applies only if at the time the bonds are issued the payments from those nongovernmental persons are not material to the security for the bonds. For this purpose, payments are not material to the security for the bonds if—

(i) The payments are not required for the payment of debt service on the bonds;

(ii) The amount and timing of the payments are not structured or designed to reflect the payment of debt service on the bonds;

(iii) The receipt or the amount of the payment is uncertain (for example, as of the issue date, no final judgment has been entered into against the nongovernmental person);

(iv) The payments from those nongovernmental persons, when and if received, are used either to redeem bonds of the issuer or to pay for costs of any hazardous waste remediation project; and

(v) In the case when a judgment (but not a final judgment) has been entered by the issue date against a nongovernmental person, there are, as of the issue date, costs of hazardous waste remediation other than those financed with the bonds that may be financed with the payments.

(g) *Examples*. The following examples illustrate the application of this section:

Example 1. Aggregation of payments. State B issues bonds with proceeds of $10 million. B uses $9.7 million of the proceeds to construct a 10-story office building. B uses the remaining $300,000 of proceeds to make a loan to Corporation Y. In addition, Corporation X leases 1 floor of the building for the term of the bonds. Under all of the facts and circumstances, it is reasonable to allocate 10 percent of the proceeds to that 1 floor. As a percentage of the present value of the debt service on the bonds, the present value of Y's loan repayments is 3 percent and the present value of X's lease payments is 8 percent. The bonds meet the private security or payment test because the private payments taken into account are more than 10 percent of the present value of the debt service on the bonds.

Example 2. Indirect private payments. J, a political subdivision of a state, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. Under all of the facts and circumstances, the private business use test will be met with respect to each issue that will be used for the rehabilitation and construction of buildings that will be leased or sold to nongovernmental persons for use in their trades or businesses. Nongovernmental persons will make payments for these sales and leases. There is no limitation either on the number of issues or the aggregate amount of bonds that may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal of, and the interest on, each issue. Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements. The payments relating to these leases and sales are taken into account as private payments to determine whether each issue of bonds meets the private security or payment test.

Example 3. Computation of payment in variable yield issues. (i) City M issues general obligation bonds with proceeds of $10 million to finance a 5-story office building. The bonds bear interest at a variable rate that is recomputed monthly according to an index that reflects current market yields. The yield that the interest index would produce on the issue date is 6 percent. M leases 1 floor of the office building to Corporation T, a nongovernmental person, for the term of the bonds. Under all of the facts and circumstances, T is treated as using more than 10 percent of the proceeds. Using the 6 percent yield as the discount rate, M reasonably expects on the issue date that the present value of lease payments to be made by T will be 8 percent of the present value of the total debt service on the bonds. After the issue date of the bonds, interest rates decline significantly, so that the yield on the bonds over their entire term is 4 percent. Using this actual 4 percent yield as the discount rate, the present value of lease payments made by T is 12 percent of the present value of the actual total debt service on the bonds. The bonds are not private activity bonds because M reasonably expected on the issue date that the bonds would not meet the private security or payment test and because M did not take any subsequent deliberate action to meet the private security or payment test.

(ii) The facts are the same as *Example 3(i)*, except that 5 years after the issue date M leases a second floor to Corporation S, a nongovernmental person, under a long-term lease. Because M has taken a deliberate action, the present value of the lease payments must be computed. On the date this lease is entered into, M reasonably expects that the yield on the bonds over their entire term will be 5.5 percent, based on actual interest rates to date and the then-current rate on the variable yield bonds. M uses this 5.5 percent yield as the discount rate. Using this 5.5 percent yield as the discount rate, as a percentage of the present value of the debt service on the bonds, the present value of the lease payments made by S is 3 percent. The bonds are private activity bonds because the present value of the aggregate private payments is greater than 10 percent of the present value of debt service.

Example 4. Payments not in respect of financed property. In order to further public safety, City Y issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by City Y on the customers of the utility. Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Y by the utility company for the undergrounding are, however, taken into account as private payments.

Example 5. Payments from users of proceeds that are not private business users taken into account. City P issues general obligation bonds to finance the renovation of a hospital that it owns. The hospital is operated for P by D, a nongovernmental person, under a management contract that results in private business use under §1.141–3. P will use the revenues from the hospital (after the required payments to D and the payment of operation and maintenance expenses) to pay the debt service on the bonds. The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

Example 6. Limitation of amount of payments to amount of private business use not determined annually. City Q issues bonds with a term of 15 years and uses the proceeds to construct an office building. The debt service on the bonds is level throughout the 15-year term. Q enters into a 5-year lease with Corporation R under which R is treated as a user of 11 percent of the proceeds. R will make lease payments equal to 20 percent of the annual debt service on the bonds for each year of the lease. The present value of R's lease payments is equal to 12 percent of the present value of the debt service over the entire 15-year term of the bonds. If, however, the lease payments taken into account as private payments were limited to 11 percent of debt service paid in each year of the lease, the present value of these payments would be only 8 percent of the debt service on the bonds over the entire term of the bonds. The bonds meet the private security or payment test, because R's lease payments are taken into account as private payments in an amount not to exceed 11 percent of the debt service of the bonds.

Example 7. Allocation of payments to funds not derived from a borrowing. City Z purchases property for $1,250,000 using $1,000,000 of proceeds of its tax increment bonds and $250,000 of other revenues that are in its redevelopment fund. Within 60 days of the date of purchase, Z declared its intent to sell the property pursuant to a redevelopment plan and to use that amount to reimburse its redevelopment fund. The bonds are secured only by the incremental property taxes attributable to the increase in value of the property from the planned redevelopment of the property. Within 18 months after the issue date, Z sells the financed property to Developer M for $250,000, which Z uses to reimburse the redevelopment fund. The property that M uses is financed both with the proceeds of the bonds and Z's redevelopment fund. The payments by M are properly allocable to the costs of property financed with the amounts in Z's redevelopment fund. See paragraphs (c)(3) (i) and (v) of this section.

Example 8. Allocation of payments to different sources of funding—improvements. In 1997, City L issues bonds with proceeds of $8 million to finance the acquisition of a building. In 2002, L spends $2 million of its general revenues to improve the heating system and roof of the building. At that time, L enters into a 10-year lease with Corporation M for the building providing for annual payments of $1 million to L. The lease payments are at fair market value, and the lease payments do not otherwise have a significant nexus to either the issue or to the expenditure of general revenues. Eighty percent of each lease payment is allocated to the issue and is taken into account under the private payment test because each lease payment is properly allocated to the sources of funding in a manner that reasonably corresponds to the relative amounts of the sources of funding that are expended on the building.

Example 9. Security not provided by users of proceeds not taken into account. County W issues certificates of participation in a lease of a building that W owns and covenants to appropriate annual payments for the lease. A portion of each payment is specified as interest. More than 10 percent of the building is used for private business use. None of the proceeds of the obligations are used with respect to the building. W uses the proceeds of the obligations to make a grant to Corporation Y for the construction of a factory that Y will own. Y makes no payments to W, directly or indirectly, for its use of proceeds, and Y has no relationship to the users of the leased building. If W defaults under the lease, the trustee for the holders of the certificates of participation has a limited right of repossession under which the trustee may not foreclose but may lease the property to a new tenant at fair market value. The obligations are secured by an interest in property used for a private business use. However, because the property is not provided by a private business user and is not financed property, the obligations do not meet the private security or payment test.

Example 10. Allocation of payments among issues. University L, a political subdivision, issued three separate series of revenue bonds during 1989, 1991, and 1993 under the same bond resolution. L used the proceeds to construct facilities exclusively for its own use.

Bonds issued under the resolution are equally and ratably secured and payable solely from the income derived by L from rates, fees, and charges imposed by L for the use of the facilities. The bonds issued in 1989, 1991, and 1993 are not private activity bonds. In 1997, L issues another series of bonds under the resolution to finance additional facilities. L leases 20 percent of the new facilities for the term of the 1997 bonds to nongovernmental persons who will use the facilities in their trades or businesses. The present value of the lease payments from the nongovernmental users will equal 15 percent of the present value of the debt service on the 1997 bonds. L will commingle all of the revenues from all its bond-financed facilities in its revenue fund. The present value of the portion of the lease payments from nongovernmental lessees of the new facilities allocable to the 1997 bonds under paragraph (d) of this section is less than 10 percent of the present value of the debt service on the 1997 bonds because the bond documents provide that the bonds are equally and ratably secured. Accordingly, the 1997 bonds do not meet the private security test. The 1997 bonds meet the private payment test, however, because the private lease payments for the new facility are properly allocated to those bonds (that is, because none of the proceeds of the prior issues were used for the new facilities). See paragraph (c) of this section.

Example 11. Generally applicable tax. (i) Authority N issues bonds to finance the construction of a stadium. Under a long-term lease, Corporation X, a professional sports team, will use more than 10 percent of the stadium. X will not, however, make any payments for this private business use. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium. The portion of the ticket tax attributable to tickets purchased by persons attending X's events will, on a present value basis, exceed 10 percent of the present value of the debt service on N's bonds. The bonds meet the private security or payment test. The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to X's events, the taxes are payments in respect of property used for a private business use.

(ii) The facts are the same as *Example 11(i)*, except that the ticket tax is imposed by N on tickets purchased for events at a number of large entertainment facilities within the N's jurisdiction (for example, other stadiums, arenas, and concert halls), some of which were not financed with tax-exempt bonds. The ticket tax is a generally applicable tax and therefore the revenues from this tax are not payments in respect of property used for a private business use. The receipt of the ticket tax does not cause the bonds to meet the private security or payment test.

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§ 1.141–5 Private loan financing test.

(a) *In general.* Bonds of an issue are private activity bonds if more than the lesser of 5 percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. Section 1.141–2(d) applies in determining whether the private loan financing test is met. In determining whether the proceeds of an issue are used to make or finance loans, indirect, as well as direct, use of the proceeds is taken into account.

(b) *Measurement of test.* In determining whether the private loan financing test is met, the amount actually loaned to a nongovernmental person is not discounted to reflect the present value of the loan repayments.

(c) *Definition of private loan*—(1) *In general.* Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this section. In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form. For example, a lease or other contractual arrangement (for example, a management contract or an output contract) may in substance constitute a loan if the arrangement transfers tax ownership of the facility to a nongovernmental person. Similarly, an output contract or a management contract with respect to a financed facility generally is not treated as a loan of proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the nongovernmental purchaser or manager of the facility.

(2) *Application only to purpose investments*—(i) *In general.* A loan may be either a purpose investment or a nonpurpose investment. A loan that is a nonpurpose investment does not cause the private loan financing test to be met. For example, proceeds invested in

loans, such as obligations of the United States, during a temporary period, as part of a reasonably required reserve or replacement fund, as part of a refunding escrow, or as part of a minor portion (as each of those terms are defined in §1.148–1 or §1.148–2) are generally not treated as loans under the private loan financing test.

(ii) *Certain prepayments treated as loans.* Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if—

(A) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(B) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(C) The prepayment meets the requirements of §1.148–1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

(iii) *Customary prepayments.* The determination of whether a prepayment satisfies paragraph (c)(2)(ii)(A) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (c)(2)(ii)(A) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iv) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

(3) *Grants*—(i) *In general.* A grant of proceeds is not a loan. Whether a transaction may be treated as a grant or a loan depends on all of the facts and circumstances.

(ii) *Tax increment financing*—(A) *In general.* Generally, a grant using proceeds of an issue that is secured by generally applicable taxes attributable to the improvements to be made with the grant is not treated as a loan, unless the grantee makes any impermissible agreements relating to the payment that results in the taxes imposed on that taxpayer not to be treated as generally applicable taxes under §1.141–4(e).

(B) *Amount of loan.* If a grant is treated as a loan under this paragraph (c)(3), the entire grant is treated as a loan unless the impermissible agreement is limited to a specific portion of the tax. For this purpose, an arrangement with each unrelated grantee is treated as a separate grant.

(4) *Hazardous waste remediation bonds.* In the case of an issue of hazardous waste remediation bonds, payments from nongovernmental persons that are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not establish that the transaction is a loan for purposes of this section. This paragraph (c)(4) applies only if those payments do not secure the payment of principal of, or interest on, the bonds (directly or indirectly), under the terms of the bonds and those payments are not taken into account under the private payment test pursuant to §1.141–4(f)(3).

(d) *Tax assessment loan exception*—(1) *General rule.* For purposes of this section, a tax assessment loan that satisfies the requirements of this paragraph (d) is not a loan for purposes of the private loan financing test.

(2) *Tax assessment loan defined.* A tax assessment loan is a loan that arises

when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies each of the requirements of paragraphs (d) (3) through (5) of this section.

(3) *Mandatory tax or other assessment.* The tax or assessment must be an enforced contribution that is imposed and collected for the purpose of raising revenue to be used for a specific purpose (that is, to defray the capital cost of an improvement). Taxes and assessments do not include fees for services. The tax or assessment must be imposed pursuant to a state law of general application that can be applied equally to natural persons not acting in a trade or business and persons acting in a trade or business. For this purpose, taxes and assessments that are imposed subject to protest procedures are treated as enforced contributions.

(4) *Specific essential governmental function*—(i) *In general.* A mandatory tax or assessment that gives rise to a tax assessment loan must be imposed for one or more specific, essential governmental functions.

(ii) *Essential governmental functions.* For purposes of paragraph (d) of this section, improvements to utilities and systems that are owned by a governmental person and that are available for use by the general public (such as sidewalks, streets and street-lights; electric, telephone, and cable television systems; sewage treatment and disposal systems; and municipal water facilities) serve essential governmental functions. For other types of facilities, the extent to which the service provided by the facility is customarily performed (and financed with governmental bonds) by governments with general taxing powers is a primary factor in determining whether the facility serves an essential governmental function. For example, parks that are owned by a governmental person and that are available for use by the general public serve an essential governmental function. Except as otherwise provided in this paragraph (d)(4)(ii), commercial or industrial facilities and improvements to property owned by a nongovernmental person do not serve an essential governmental function. Permitting installment payments of property taxes or other taxes is not an essential governmental function.

(5) *Equal basis requirement*—(i) *In general.* Owners of both business and nonbusiness property benefiting from the financed improvements must be eligible, or required, to make deferred payments of the tax or assessment giving rise to a tax assessment loan on an equal basis (the equal basis requirement). A tax or assessment does not satisfy the equal basis requirement if the terms for payment of the tax or assessment are not the same for all taxed or assessed persons. For example, the equal basis requirement is not met if certain property owners are permitted to pay the tax or assessment over a period of years while others must pay the entire tax or assessment immediately or if only certain property owners are required to prepay the tax or assessment when the property is sold.

(ii) *General rule for guarantees.* A guarantee of debt service on bonds, or of taxes or assessments, by a person that is treated as a borrower of bond proceeds violates the equal basis requirement if it is reasonable to expect on the date the guarantee is entered into that payments will be made under the guarantee.

(6) *Coordination with private business tests.* See §§1.141–3 and 1.141–4 for rules for determining whether tax assessment loans cause the bonds financing those loans to be private activity bonds under the private business use and the private security or payment tests.

(e) *Examples.* The following examples illustrate the application of this section:

Example 1. Turnkey contract not treated as a loan. State agency Z and federal agency H will each contribute to rehabilitate a project owned by Z. H can only provide its funds through a contribution to Z to be used to acquire the rehabilitated project on a turnkey basis from an approved developer. Under H's turnkey program, the developer must own the project while it is rehabilitated. Z issues its notes to provide funds for construction. A portion of the notes will be retired using the H contribution, and the balance of the notes will be retired through the issuance by Z of long-term bonds. Z lends the proceeds of its notes to Developer B as construction financing and transfers title to B for a nominal amount. The conveyance is made on condition that B rehabilitate the property and reconvey it upon completion, with Z retaining the right to force reconveyance if these conditions are not satisfied. B must name Z as an additional insured on all insurance. Upon completion, B must transfer title to the project back to Z at a set price, which price reflects B's costs and profit, not fair market value. Further, this price is adjusted downward to reflect any cost-underruns. For purposes of section 141(c), this transaction does not involve a private loan.

Example 2. Essential government function requirement not met. City D creates a special taxing district consisting of property owned by nongovernmental persons that requires environmental clean-up. D imposes a special tax on each parcel within the district in an amount that is related to the expected environmental clean-up costs of that parcel. The payment of the tax over a 20-year period is treated as a loan by the property owners for purposes of the private loan financing test. The special district issues bonds, acting on behalf of D, that are payable from the special tax levied within the district, and uses the proceeds to pay for the costs of environmental clean-up on the property within the district. The bonds meet the private loan financing test because more than 5 percent of the proceeds of the issue are loaned to nongovernmental persons. The issue does not meet the tax assessment loan exception because the improvements to property owned by a nongovernmental person are not an essential governmental function under section 141(c)(2). The issue also meets the private business tests of section 141(b).

[T.D. 8712, 62 FR 2296, Jan. 16, 1997, as amended by T.D. 9085, 68 FR 45775, Aug. 4, 2003]

§ 1.141–6 Allocation and accounting rules.

(a) *Allocations of proceeds to expenditures, projects, and uses in general*—(1) *Allocations to expenditures.* The allocations of proceeds and other sources of funds to expenditures under § 1.148–6(d) apply for purposes of §§ 1.141–1 through 1.141–15.

(2) *Allocations of sources to a project and its uses.* Except as provided in paragraph (b) of this section (regarding an eligible mixed-use project), if two or more sources of funding (including two or more tax-exempt issues) are allocated to capital expenditures (as defined in § 1.150–1(b)) for a project (as defined in paragraph (a)(3) of this section), those sources are allocated throughout that project to the governmental use and private business use of the project in proportion to the relative amounts of those sources of funding spent on the project.

(3) *Definition of project*—(i) *In general.* For purposes of this section, *project* means one or more facilities or capital projects, including land, buildings, equipment, or other property, financed in whole or in part with proceeds of the issue.

(ii) *Output facilities.* If an output facility has multiple undivided ownership interests (respectively owned by governmental persons or by both governmental and nongovernmental persons), each owner's interest in the facility is treated as a separate facility for purposes of this section, provided that all owners of the undivided ownership interests share the ownership and output in proportion to their contributions to the capital costs of the output facility.

(b) *Special allocation rules for eligible mixed-use projects*—(1) *In general.* The sources of funding allocated to capital expenditures for an eligible mixed-use project (as defined in paragraph (b)(2) of this section) are allocated to undivided portions of the eligible mixed-use project and the governmental use and private business use of the eligible mixed-use project in accordance with this paragraph (b). Qualified equity (as defined in paragraph (b)(3) of this section) is allocated first to the private business use of the eligible mixed-use project and then to governmental use, and proceeds are allocated first to the governmental use and then to private business use, using the percentages of the eligible mixed-use project financed with the respective sources and the percentages of the respective uses. Thus, if the percentage of the eligible mixed-use project financed with qualified equity is less than the percentage of private business use of the project, all of the qualified equity is allocated to the private business use. Proceeds are allocated to the balance of the private business use of the project. Similarly, if the percentage of the eligible mixed-use project financed with proceeds is less than the percentage of governmental use of the project, all of the proceeds are allocated to the governmental use, and qualified equity is allocated to the balance of the governmental use of the project. Further, if proceeds of more than one issue finance the eligible mixed-use project, proceeds of each issue are allocated ratably to the uses to which proceeds are allocated in proportion to the relative amounts of the proceeds of such issues allocated to the eligible mixed-use project. For private business use measured under §1.141–3(g), qualified equity and proceeds are allocated to the uses of the eligible mixed-use project in each one-year period under §1.141–3(g)(4). *See Example 1* of paragraph (f) of this section.

(2) *Definition of eligible mixed-use project. Eligible mixed-use project* means a project (as defined in paragraph (a)(3) of this section) that is financed with proceeds of bonds that, when issued, purported to be governmental bonds (as defined in §1.150–1(b)) (the applicable bonds) and with qualified equity pursuant to the same plan of financing (within the meaning of §1.150–1(c)(1)(ii)). An eligible mixed-use project must be wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner.

(3) *Definition of qualified equity.* For purposes of this section, *qualified equity* means proceeds of bonds that are not tax-advantaged bonds and funds that are not derived from proceeds of a borrowing that are spent on the same eligible mixed-use project as the proceeds of the applicable bonds. Qualified equity does not include equity interests in real property or tangible personal property. Further, qualified equity does not include funds used to redeem or repay governmental bonds. *See* §§1.141–2(d)(2)(ii) and 1.141–12(i) (regarding the effects of certain redemptions as remedial actions).

(4) *Same plan of financing.* Qualified equity finances a project under the same plan of financing that includes the applicable bonds if the qualified equity pays for capital expenditures of the project on a date that is no earlier than a date on which such expenditures would be eligible for reimbursement by proceeds of the applicable bonds under §1.150–2(d)(2) (regardless of whether the applicable bonds are reimbursement bonds) and, except for a reasonable retainage (within the meaning of §1.148–7(h)), no later than the date on which the measurement period begins.

(c) *Allocations of private payments.* Except as provided in this paragraph (c), private payments for a project are allocated in accordance with §1.141–4. Payments under an output contract that result in private business use of an eligible mixed-use project are allocated to the same source of funding (notwithstanding §1.141–4(c)(3)(v) (regarding certain allocations of private payments to equity)) allocated to the private business use from such contract under paragraph (b) of this section.

(d) *Allocations of proceeds to common costs of an issue.* Proceeds used for expenditures for common costs (for example, issuance costs, qualified guarantee fees, or reasonably required reserve or replacement funds) are allocated in accordance with §1.141–3(g)(6). Proceeds, as allocated under §1.141–3(g)(6) to an eligible mixed-use project, are allocated to the uses of the project in the same proportions as the proceeds allocated to the uses under paragraph (b) of this section.

(e) *Allocations of proceeds to bonds.* In general, proceeds are allocated to bonds in accordance with the rules for allocations of proceeds to bonds for separate purposes of multipurpose issues in §1.141–13(d). For an issue that is not a multipurpose issue (or is a multipurpose issue for which the issuer has not made a multipurpose allocation), proceeds are allocated to bonds ratably in a manner similar to the allocation of proceeds to projects under paragraph (a)(2) of this section.

(f) *Examples.* The following examples illustrate the application of this section:

Example 1. Mixed-use project. City A issues $70x of bonds (the Bonds) and finances the construction of a 10-story office building costing $100x (the Project) with proceeds of the Bonds and $30x of qualified equity (the Qualified Equity). To the extent that the private business use of the Project does not exceed 30 percent in any particular year, the Qualified Equity is allocated to the private business use. If private business use of the Project were, for example, 44 percent in a year, the Qualified Equity would be allocated to 30 percent ($30x) private business use and proceeds of the Bonds would be allocated to the excess (that is, 14 percent or

$14x), resulting in private business use of the Bonds in that year of 20 percent ($14x/$70x). Conversely, if private business use of the Project were 20 percent, Qualified Equity would be allocated to that 20 percent. The remaining Qualified Equity (that is, 10 percent or $10x) would be allocated to the governmental use in excess of the 70 percent to which the proceeds of the Bonds would be allocated.

Example 2. Mixed-use output facility. Authority A is a governmental person that owns and operates an electric transmission facility. Several years ago, Authority A used its equity to pay capital expenditures of $1000x for the facility. Authority A wants to make capital improvements to the facility in the amount of $100x (the Project). Authority A reasonably expects that, after completion of the Project, it will sell 46 percent of the available output of the facility, as determined under § 1.141–7, under output contracts that result in private business use and it will sell 54 percent of the available output of the facility for governmental use. On January 1, 2017, Authority A issues $60x of bonds (the Bonds) and uses the proceeds of the Bonds and $40x of qualified equity (the Qualified Equity) to finance the Project. The Qualified Equity is allocated to 40 of the 46 percent private business use resulting from the output contracts. Proceeds of the Bonds are allocated to the 54 percent governmental use and thereafter to the remaining 6 percent private business use.

Example 3. Subsequent improvements and replacements. County A owns a hospital, which opened in 2001, that it financed entirely with proceeds of bonds it issued in 1998 (the 1998 Bonds). In 2017, County A finances the cost of an addition to the hospital with proceeds of bonds (the 2017 Bonds) and qualified equity (the 2017 Qualified Equity). The original hospital is a project (the 1998 Project) and the addition is a project (the 2017 Project). Proceeds of the 2017 Bonds and the 2017 Qualified Equity are allocated to the 2017 Project. The 2017 Qualified Equity is allocated first to the private business use of the 2017 Project and then to the governmental use of the 2017 Project. Proceeds of the 2017 Bonds are allocated first to the governmental use of the 2017 Project and then to the private business use of that project. Neither proceeds of the 2017 Bonds nor 2017 Qualified Equity is allocated to the uses of the 1998 Project. Proceeds of the 1998 Bonds are not allocated to uses of the 2017 Project.

[T.D. 9741, 80 FR 65643, Oct. 27, 2015]

§ 1.141–7 Special rules for output facilities.

(a) *Overview.* This section provides special rules to determine whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. For this purpose, unless otherwise stated, water facilities are treated as output facilities. Sections 1.141–3 and 1.141–4 generally apply to determine whether other types of arrangements for use of an output facility cause an issue to meet the private business tests.

(b) *Definitions.* For purposes of this section and § 1.141–8, the following definitions and rules apply:

(1) *Available output.* The available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for that issue.

(i) *Generating facilities.* The number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or the equivalent (or where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserves, maintenance or other unutilized capacity.

(ii) *Transmission and other output facilities*—(A) *In general.* For transmission, distribution, cogeneration, and other output facilities, available output must be measured in a reasonable manner to reflect capacity.

(B) *Electric transmission facilities.* Measurement of the available output of all or a portion of electric transmission facilities may be determined in a manner consistent with the reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC). For example, for a transmission network, the use of aggregate load and load share ratios in a manner consistent with the requirements of the FERC may be reasonable. In addition, depending on the facts and circumstances, measurement of the available output of transmission facilities using thermal capacity or transfer capacity may be reasonable.

(iii) *Special rule for facilities with significant unutilized capacity.* If an issuer reasonably expects on the issue date that persons that are treated as private business users will purchase more than

30 percent of the actual output of the facility financed with the issue, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate or other capacity, such as the average expected annual output of the facility. For example, the Commissioner may determine the available output of a financed peaking electric generating unit by reference to the reasonably expected annual output of that unit if the issuer reasonably expects, on the issue date of bonds that finance the unit, that an investor-owned utility will purchase more than 30 percent of the actual output of the facility during the measurement period under a take or pay contract, even if the amount of output purchased is less than 10 percent of the available output determined by reference to nameplate capacity. The reasonably expected annual output of the generating facility must be consistent with the capacity reported for prudent reliability purposes.

(iv) *Special rule for facilities with a limited source of supply*. If a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by reasonably taking into account those constraints. For this purpose, a limited source of supply shall include a physical limitation (for example, flow of water), but not an economic limitation (for example, cost of coal or gas). For example, the available output of a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

(2) *Measurement period*. The measurement period of an output facility financed by an issue is determined under §1.141–3(g).

(3) *Sale at wholesale*. A sale at wholesale means a sale of output to any person for resale.

(4) *Take contract and take or pay contract*. A *take contract* is an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output. A *take or pay contract* is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output.

(5) *Requirements contract*. A *requirements contract* is an output contract, other than a take contract or a take or pay contract, under which a nongovernmental person agrees to purchase all or part of its output requirements.

(6) *Nonqualified amount*. The nonqualified amount with respect to an issue is determined under section 141(b)(8).

(c) *Output contracts*—(1) *General rule*. The purchase pursuant to a contract by a nongovernmental person of available output of an output facility (output contract) financed with proceeds of an issue is taken into account under the private business tests if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the benefits and burdens test). See paragraph (c)(4) of this section for the treatment of an output contract that is properly characterized as a lease for Federal income tax purposes. See paragraphs (d) and (e) of this section for rules regarding measuring the use of, and payments of debt service for, an output facility for determining whether the private business tests are met. See also §1.141–8 for rules for when an issue that finances an output facility (other than a water facility) meets the private business tests because the nonqualified amount of the issue exceeds $15 million.

(2) *Take contract or take or pay contract*. The benefits and burdens test is met if a nongovernmental person agrees pursuant to a take contract or a take or pay contract to purchase available output of a facility.

(3) *Requirements contract*—(i) *In general*. A requirements contract may satisfy the benefits and burdens test under paragraph (c)(3)(ii) or (iii) of this section. See §1.141–15(f)(2) for special effective dates for the application of this paragraph (c)(3) to issues financing facilities subject to requirements contracts.

(ii) *Requirements contract similar to take contract or take or pay contract*. A requirements contract generally meets the benefits and burdens test to the extent that it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser or that obligate the purchaser to have output requirements. For example, a requirements contract with an industrial purchaser meets the benefits and burdens test if the purchaser enters into additional contractual obligations with the issuer or another governmental unit not to cease operations. A requirements contract does not meet the benefits and burdens test, however, by reason of a provision that requires the purchaser to pay reasonable and customary damages (including liquidated damages) in the event of a default, or a provision that permits the purchaser to pay a specified amount to terminate the contract while the purchaser has requirements, in each case if the amount of the payment is reasonably related to the purchaser's obligation to buy requirements that is discharged by the payment.

(iii) *Wholesale requirements contract*—(A) *In general*. A requirements contract that is a sale at wholesale (a *wholesale requirements contract*) may satisfy the benefits and burdens test, depending on all the facts and circumstances.

(B) *Significant factors*. Significant factors that tend to establish that a wholesale requirements contract meets the benefits and burdens test include, but are not limited to—

(*1*) The term of the contract is substantial relative to the term of the issue or issues that finance the facility; and

(*2*) The amount of output to be purchased under the contract represents a substantial portion of the available output of the facility.

(C) *Safe harbors*. A wholesale requirements contract does not meet the benefits and burdens test if—

(*1*) The term of the contract, including all renewal options, does not exceed the lesser of 5 years or 30 percent of the term of the issue; or

(*2*) The amount of output to be purchased under the contract (and any other requirements contract with the same purchaser or a related party with respect to the facility) does not exceed 5 percent of the available output of the facility.

(iv) *Retail requirements contract*. Except as otherwise provided in this paragraph (c)(3), a requirements contract that is not a sale at wholesale does not meet the benefits and burdens test.

(4) *Output contract properly characterized as a lease*. Notwithstanding any other provision of this section, an output contract that is properly characterized as a lease for Federal income tax purposes shall be tested under the rules contained in §§1.141–3 and 1.141–4 to determine whether it is taken into account under the private business tests.

(d) *Measurement of private business use*. If an output contract results in private business use under this section, the amount of private business use generally is the amount of output purchased under the contract.

(e) *Measurement of private security or payment*. The measurement of payments made or to be made by nongovernmental persons under output contracts as a percent of the debt service of an issue is determined under the rules provided in §1.141–4.

(f) *Exceptions for certain contracts*—(1) *Small purchases of output*. An output contract for the use of a facility is not taken into account under the private business tests if the average annual payments to be made under the contract do not exceed 1 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

(2) *Swapping and pooling arrangements*. An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the output facility owned by the governmental person to the extent that—

(i) The swapped output is reasonably expected to be approximately equal in value (determined over periods of three years or less); and

(ii) The purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.

(3) *Short-term output contracts.* An output contract with a nongovernmental person is not taken into account under the private business tests if—

(i) The term of the contract, including all renewal options, is not longer than 3 years;

(ii) The contract either is a negotiated, arm's-length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and

(iii) The output facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(4) *Certain conduit parties disregarded.* A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person.

(g) *Special rules for electric output facilities used to provide open access*—(1) *Operation of transmission facilities by nongovernmental persons*—(i) *In general.* The operation of an electric transmission facility by a nongovernmental person may result in private business use of the facility under §1.141–3 and this section based on all the facts and circumstances. For example, a transmission facility is generally used for a private business use if a nongovernmental person enters into a contract to operate the facility and receives compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(ii) *Certain use by independent transmission operators.* A contract for the operation of an electric transmission facility by an independent entity, such as a regional transmission organization or an independent system operator (*independent transmission operator*), does not constitute private business use of the facility if—

(A) The facility is owned by a governmental person;

(B) The operation of the facility by the independent transmission operator is approved by the FERC under one or more provisions of the Federal Power Act (16 U.S.C. 791a through 825r) (or by a state authority under comparable provisions of state law);

(C) No portion of the compensation of the independent transmission operator is based on a share of net profits from the operation of the facility; and

(D) The independent transmission operator does not bear risk of loss of the facility.

(2) *Certain use by nongovernmental persons under output contracts*—(i) *Transmission facilities.* The use of an electric transmission facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if—

(A) The facility is owned by a governmental person;

(B) The facility is operated by an independent transmission operator in a manner that satisfies paragraph (g)(1)(ii) of this section; and

(C) The facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(ii) *Distribution facilities.* The use of an electric distribution facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if—

(A) The facility is owned by a governmental person;

(B) The facility is available for use on a nondiscriminatory, open access basis by buyers and sellers of electricity in accordance with rates that are generally applicable and uniformly applied within the meaning of §1.141–3(c)(2); and

(C) The facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person (other than a retail end-user).

(3) *Ancillary services.* The use of an electric output facility to provide ancillary services required to be offered as part of an open access transmission tariff under rules promulgated by the FERC under the Federal Power Act (16 U.S.C. 791a through 825r) (or by a state regulatory authority under comparable provisions of state law) does not result in private business use.

(4) *Exceptions to deliberate action rules*—(i) *Mandated wheeling.* Entering into a contract for the use of electric transmission or distribution facilities is not treated as a deliberate action under § 1.141–2(d) if—

(A) The contract is entered into in response to (or in anticipation of) an order by the United States under sections 211 and 212 of the Federal Power Act (16 U.S.C. 824j and 824k) (or a state regulatory authority under comparable provisions of state law); and

(B) The terms of the contract are bona fide and arm's-length, and the consideration paid is consistent with the provisions of section 212(a) of the Federal Power Act.

(ii) *Actions taken to implement non-discriminatory, open access.* An action is not treated as a deliberate action under § 1.141–2(d) if it is taken to implement the offering of non-discriminatory, open access tariffs for the use of electric transmission or distribution facilities in a manner consistent with rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e) (or comparable provisions of state law). This paragraph (g)(4)(ii) does not apply, however, to the sale, exchange, or other disposition (within the meaning of section 1001(a)) of transmission or distribution facilities to a nongovernmental person.

(iii) *Application of reasonable expectations test to certain current refunding bonds.* An action taken or to be taken with respect to electric transmission or distribution facilities refinanced by an issue is not taken into account under the reasonable expectations test of § 1.141–2(d) if—

(A) The action is described in paragraph (g)(4)(i) or (ii) of this section;

(B) The bonds of the issue are current refunding bonds that refund bonds originally issued before February 23, 1998; and

(C) The weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

(5) *Additional transactions as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which the use of electric output facilities in a restructured electric industry does not constitute private business use.

(h) *Allocations of output facilities and systems*—(1) *Facts and circumstances analysis.* Whether output sold under an output contract is allocated to a particular facility (for example, a generating unit), to the entire system of the seller of that output (net of any uses of that system output allocated to a particular facility), or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to financed property are the following:

(i) The extent to which it is physically possible to deliver output to or from a particular facility or system.

(ii) The terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources).

(iii) Whether a contract is entered into as part of a common plan of financing for a facility.

(iv) The method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

(2) *Illustrations.* The following illustrate the factors set forth in paragraph (h)(1) of this section:

(i) *Physical possibility.* Output from a generating unit that is fed directly into a low voltage distribution system of the owner of that unit and that cannot physically leave that distribution system generally must be allocated to those receiving electricity through that distribution system. Output may be allocated without regard to physical limitations, however, if exchange or similar agreements provide output to a purchaser where, but for the exchange agreements, it would not be possible for the seller to provide output to that purchaser.

(ii) *Contract terms relating to performance.* A contract to provide a specified amount of electricity from a system, but only when at least that amount of electricity is being generated by a particular unit, is allocated to that unit. For example, a contract to buy 20 MW of system power with a right to take up to 40 percent of the actual output of a specific 50 MW facility whenever total system output is insufficient to meet all of the seller's obligations generally is allocated to the specific facility rather than to the system.

(iii) *Common plan of financing.* A contract entered into as part of a common plan of financing for a facility generally is allocated to the facility if debt service for the issue of bonds is reasonably expected to be paid, directly or indirectly, from payments under the contract.

(iv) *Pricing method.* Pricing based on the capital and generating costs of a particular turbine tends to indicate that output under the contract is properly allocated to that turbine.

(3) *Transmission and distribution contracts.* Whether use under an output contract for transmission or distribution is allocated to a particular facility or to a transmission or distribution network is based on all the facts and circumstances, in a manner similar to paragraphs (h)(1) and (2) of this section. In general, the method used to determine payments under a contract is a more significant contract term for this purpose than nominal contract path. In general, if reasonable and consistently applied, the determination of use of transmission or distribution facilities under an output contract may be based on a method used by third parties, such as reliability councils.

(4) *Allocation of payments.* Payments for output provided by an output facility financed with two or more sources of funding are generally allocated under the rules in § 1.141–4(c).

(i) *Examples.* The following examples illustrate the application of this section:

Example 1 Joint ownership. Z, an investor-owned electric utility, and City H agree to construct an electric generating facility of a size sufficient to take advantage of the economies of scale. H will issue $50 million of its 24-year bonds, and Z will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. H's bonds will be secured by H's ownership interest in the facility and by revenues to be derived from its share of the annual output of the facility. H will need only 50 percent of its share of the annual output of the facility during the first 20 years of operations. It agrees to sell 10 percent of its share of the annual output to Z for a period of 20 years pursuant to a contract under which Z agrees to take that power if available. The facility will begin operation, and Z will begin to receive power, 4 years after the H bonds are issued. The measurement period for the property financed by the issue is 20 years. H also will sell the remaining 40 percent of its share of the annual output to numerous other private utilities under contracts of three years or less that satisfy the exception under paragraph (f)(3) of this section. No other contracts will be executed obligating any person to purchase any specified amount of the power for any specified period of time. No person (other than Z) will make payments that will result in a transfer of the burdens of paying debt service on bonds used directly or indirectly to provide H's share of the facilities. The bonds are not private activity bonds, because H's one-third interest in the facility is not treated as used by the other owners of the facility. Although 10 percent of H's share of the annual output of the facility will be used in the trade or business of Z, a nongovernmental person, under this section, that portion constitutes not more than 10 percent of the available output of H's ownership interest in the facility.

Example 2 Wholesale requirements contract. (i) City J issues 20-year bonds to acquire an electric generating facility having a reasonably expected economic life substantially greater than 20 years and a nameplate capacity of 100 MW. The available output of the facility under paragraph (b)(1) of this section is approximately 17,520,000 MWh (100 MW × 24 hours × 365 days × 20 years). On the issue date, J enters into a contract with T, an investor-owned utility, to provide T with all of its power requirements for a period of 10 years, commencing on the issue date. J reasonably expects that T will actually purchase an average of 30 MW over the 10-year period. The contract is taken into account under the private business tests pursuant to paragraph (c)(3) of this section because the term of the contract is substantial relative to the term of the issue and the amount of output to be purchased is a substantial portion of the available output.

(ii) Under paragraph (d) of this section, the amount of reasonably expected private business use under this contract is approximately 15 percent (30 MW × 24 hours × 365 days × 10 years, or 2,628,000 MWh) of the available output. Accordingly, the issue meets the private business use test. J reasonably expects that the amount to be paid for an average of 30 MW of power (less the operation and maintenance costs directly attributable to generating that 30 MW of power), will be more than 10 percent of debt service on the issue on a present-value basis. Accordingly, the issue meets the private security or payment test because J reasonably expects that payment of more than 10 percent of the debt service will be indirectly derived from payments by T. The bonds are private activity bonds under paragraph (c) of this section. Further, if 15 percent of the sale proceeds of the issue is greater than $15 million and the issue meets the private security or payment test with respect to the $15 million output limitation, the bonds are also private activity bonds under section 141(b)(4). See §1.141–8.

Example 3 Retail contracts. (i) State Agency M, a political subdivision, issues bonds in 2003 to finance the construction of a generating facility that will be used to furnish electricity to M's retail customers. In 2007, M enters into a 10-year contract with industrial corporation I. Under the contract, M agrees to supply I with all of its power requirements during the contract term, and I agrees to pay for that power at a negotiated price as it is delivered. The contract does not require I to pay for any power except to the extent I has requirements. In addition, the contract requires I to pay reasonable and customary liquidated damages in the event of a default by I, and permits I to terminate the contract while it has requirements by paying M a specified amount that is a reasonable and customary amount for terminating the contract. Any damages or termination payment by I will be reasonably related to I's obligation to buy requirements that is discharged by the payment. Under paragraph (c)(3) of this section, the contract does not meet the benefits and burdens test. Thus, it is not taken into account under the private business tests.

(ii) The facts are the same as in paragraph (i) of this *Example 3,* except that the contract requires I to make guaranteed minimum payments, regardless of I's requirements, in an amount such that the contract does not meet the exception for small purchases in paragraph (f)(1) of this section. Under paragraph (c)(3)(ii) of this section, the contract meets the benefits and burdens test because it obligates I to make payments that are not contingent on its output requirements. Thus, it is taken into account under the private business tests.

Example 4 Allocation of existing contracts to new facilities. Power Authority K, a political subdivision created by the legislature in State X to own and operate certain power generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in 1999, under which the four systems are required to take or pay for specified portions of the total power output until the year 2029. Existing facilities supply all of the present needs of the four utility systems, but their future power requirements are expected to increase substantially beyond the capacity of K's current generating system. K issues 20-year bonds in 2004 to construct a large generating facility. As part of the financing plan for the bonds, a fifth private utility system contracts with K to take or pay for 15 percent of the available output of the new facility. The balance of the output of the new facility will be available for sale as required, but initially it is not anticipated that there will be any need for that power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 10 percent of the debt service on the bonds (determined on a present value basis). The balance, which will exceed 10 percent of the debt service on the bonds, will be paid from revenues derived from the contracts with the four systems initially from sale of power produced by the old facilities. The output contracts with all the private utilities are allocated to K's entire generating system. See paragraphs (h)(1) and (2) of this section. Thus, the bonds meet the private business use test because more than 10 percent of the proceeds will be used in the trade or business of a nongovernmental person. In addition, the bonds meet the private security or payment test because payment of more than 10 percent of the debt service, pursuant to underlying arrangements, will be derived from payments in respect of property used for a private business use.

Example 5 Allocation to displaced resource. Municipal utility MU, a political subdivision, purchases all of the electricity required to meet the needs of its customers (1,000 MW) from B, an investor-owned utility that operates its own electric generating facilities, under a 50-year take or pay contract. MU does not anticipate that it will require additional electric resources, and any new resources would produce electricity at a higher cost to MU than its cost under its contract with B. Nevertheless, B encourages MU to construct a new generating plant sufficient to meet MU's requirements. MU issues obligations to construct facilities that will produce 1,000 MW of electricity. MU, B, and I, another investor-owned utility, enter into an agreement under which MU assigns to I its rights under MU's take or pay contract with B. Under this arrangement, I will pay MU, and MU will continue to pay B, for the 1,000 MW. I's payments to MU will at least equal the amounts required to pay debt service on MU's bonds. In addition, under paragraph (h)(1)(iii) of this section, the contract among MU, B, and I is entered into as part of a common plan of financing of the MU facilities. Under all the facts and circumstances, MU's assignment to I of its rights under the original take or pay contract is allocable to MU's new facilities under paragraph (h) of this section. Because I is a nongovernmental person, MU's bonds are private activity bonds.

Example 6 Operation of transmission facilities by regional transmission organization. (i) Public Power Agency D is a political subdivision that owns and operates electric generation, transmission and distribution facilities. In 2003, D transfers operating control of its transmission system to a regional transmission organization (RTO), a nongovernmental person, pursuant to an operating agreement that is approved by the FERC under sections 205 and 206 of the Federal Power Act. D retains ownership of its facilities. No portion of the RTO's compensation is based on a share of net profits from the operation of D's facilities, and the RTO does not bear any risk of loss of those facilities. Under paragraph (g)(1)(ii) of this section, the RTO's use of D's facilities does not constitute a private business use.

(ii) Company A is located in D's service territory. In 2004, Power Supplier E, a nongovernmental person, enters into a 10-year contract with A to supply A's electricity requirements. The electricity supplied by E to A will be transmitted over D's transmission and distribution facilities. D's distribution facilities are available for use on a nondiscriminatory, open access basis by buyers and sellers of electricity in accordance with rates that are generally applicable and uniformly applied within the meaning of §1.141–3(c)(2). D's facilities are not financed for a principal purpose of providing the facilities for use by E. Under paragraph (g)(2) of this section, the contract between A and E does not result in private business use of D's facilities.

Example 7 Certain actions not treated as deliberate actions. The facts are the same as in *Example 6* of this paragraph (i), except that the RTO's compensation is based on a share of net profits from operating D's facilities. In addition, D had issued bonds in 1994 to finance improvements to its transmission system. At the time D transfers operating control of its transmission system to the RTO, D chooses to apply the private activity bond regulations of §§1.141–1 through 1.141–15 to the 1994 bonds. The operation of D's facilities by the RTO results in private business use under §1.141–3 and paragraph (g)(1)(i) of this section. Under the special exception in paragraph (g)(4)(ii) of this section, however, the transfer of control is not treated as a deliberate action. Accordingly, the transfer of control does not cause the 1994 bonds to meet the private activity bond tests.

Example 8 Current refunding. The facts are the same as in *Example 7* of this paragraph (i), and in addition D issues bonds in 2004 to currently refund the 1994 bonds. The weighted average maturity of the 2004 bonds is not greater than the remaining weighted average maturity of the 1994 bonds. D chooses to apply the private activity bond regulations of §§1.141–1 through 1.141–15 to the refunding bonds. In general, reasonable expectations must be separately tested on the date that refunding bonds are issued under §1.141–2(d). Under the special exception in paragraph (g)(4)(iii) of this section, however, the transfer of the financed facilities to the RTO need not be taken into account in applying the reasonable expectations test to the refunding bonds.

[T.D. 9016, 67 FR 59759, Sept. 23, 2002; 67 FR 70845, Nov. 27, 2002]

§ 1.141–8 $15 million limitation for output facilities.

(a) *In general*—(1) *General rule.* Section 141(b)(4) provides a special private activity bond limitation (the $15 million output limitation) for issues 5 percent or more of the proceeds of which are to be used to finance output facilities (other than a facility for the furnishing of water). Under this rule, an issue consists of private activity bonds under the private business tests of section 141(b)(1) and (2) if the nonqualified amount with respect to output facilities financed by the proceeds of the issue exceeds $15 million. The $15 million output limitation applies in addition to the private business tests of section 141(b)(1) and (2). Under section 141(b)(4) and paragraph (a)(2) of this section, the $15 million output limitation is reduced in certain cases. Specifically, an issue meets the test in section 141(b)(4) if both of the following tests are met:

(i) More than $15 million of the proceeds of the issue to be used with respect to an output facility are to be used for a private business use. Investment proceeds are disregarded for this purpose if they are not allocated disproportionately to the private business use portion of the issue.

(ii) The payment of the principal of, or the interest on, more than $15 million of the sale proceeds of the portion of the issue used with respect to an output facility is (under the terms of the issue or any underlying arrangement) directly or indirectly—

(A) Secured by any interest in an output facility used or to be used for a private business use (or payments in respect of such an output facility); or

(B) To be derived from payments (whether or not to the issuer) in respect of an output facility used or to be used for a private business use.

(2) *Reduction in $15 million output limitation for outstanding issues*—(i) *General rule.* In determining whether an issue 5 percent or more of the proceeds of which are to be used with respect to an output facility consists of private activity bonds under the $15 million output limitation, the $15 million limitation on private business use and private security or payments is applied by taking into account the aggregate nonqualified amounts of any outstanding bonds of other issues 5 percent or more of the proceeds of which are or will be used with respect to that output facility or any other output facility that is part of the same project.

(ii) *Bonds taken into account.* For purposes of this paragraph (a)(2), in applying the $15 million output limitation to an issue (the later issue), a tax-exempt bond of another issue (the earlier issue) is taken into account if—

(A) That bond is outstanding on the issue date of the later issue;

(B) That bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of that bond by the later issue; and

(C) 5 percent or more of the sale proceeds of the earlier issue financed an output facility that is part of the same project as the output facility that is financed by 5 percent or more of the sale proceeds of the later issue.

(3) *Benefits and burdens test applicable*—(i) *In general.* In applying the $15 million output limitation, the benefits and burdens test of §1.141–7 applies, except that ''$15 million'' is applied in place of ''10 percent'', or ''5 percent'' as appropriate.

(ii) *Earlier issues for the project.* If bonds of an earlier issue are outstanding and must be taken into account under paragraph (a)(2) of this section, the nonqualified amount for that earlier issue is multiplied by a fraction, the numerator of which is the adjusted issue price of the earlier issue as of the issue date of the later issue, and the denominator of which is the issue price of the earlier issue. Pre-issuance accrued interest as defined in §1.148–1(b) is disregarded for this purpose.

(b) *Definition of project*—(1) *General rule.* For purposes of paragraph (a)(2) of this section, *project* has the meaning provided in this paragraph. Facilities that are functionally related and subordinate to a project are treated as part of that same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. For example, the following are generally not part of the same project—

(i) Generation, transmission and distribution facilities;

(ii) Separate facilities designed to serve wholesale customers and retail customers; and

(iii) A peaking unit and a baseload unit (regardless of the location of the units).

(2) *Separate ownership.* Except as otherwise provided in this paragraph (b)(2), facilities that are not owned by the same person are not part of the same project. If different governmental persons act in concert to finance a project, however (for example as participants in a joint powers authority), their interests are aggregated with respect to that project to determine whether the $15 million output limitation is met. In the case of undivided ownership interests in a single output facility, property that is not owned by different persons is treated as separate projects only if the separate interests are financed—

(i) With bonds of different issuers; and

(ii) Without a principal purpose of avoiding the limitation in this section.

(3) *Generating property*—(i) *Property on same site.* In the case of generation and related facilities, *project* means property located at the same site.

(ii) *Special rule for generating units.* Separate generating units are not part of the same project if one unit is reasonably expected, on the issue date of each issue that finances the units, to be placed in service more than 3 years before the other. Common facilities or property that will be functionally related to more than one generating unit must be allocated on a reasonable basis. If a generating unit already is constructed or is under construction (the first unit) and bonds are to be issued to finance an additional generating unit (the second unit), all costs for any common facilities paid or incurred before the earlier of the issue date of bonds to finance the second unit or the commencement of construction of the second unit are allocated to the first unit. At the time that bonds are issued to finance the second unit (or, if earlier, upon commencement of construction of that unit), any remaining costs of the common facilities may be allocated between the first and second units so that in the aggregate the allocation is reasonable.

(4) *Transmission and distribution.* In the case of transmission or distribution facilities, *project* means functionally related or contiguous property. Separate transmission or distribution facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the facilities, to be placed in service more than 2 years before the other.

(5) *Subsequent improvements*—(i) In general. An improvement to generation, transmission or distribution facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service.

(ii) *Special rule for transmission and distribution facilities.* An improvement to transmission or distribution facilities that is not part of the original design of that property is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction, or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

(6) *Replacement property.* For purposes of this section, property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless—

(i) The need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property; and

(ii) The bonds that finance (and refinance) the output facility have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the facility.

(c) *Example.* The application of the provisions of this section is illustrated by the following example:

Example. (i) Power Authority K, a political subdivision, intends to issue a single issue of tax-exempt bonds at par with a stated principal amount and sale proceeds of $500 million to finance the acquisition of an electric generating facility. No portion of the facility will be used for a private business use, except that L, an investor-owned utility, will purchase 10 percent of the output of the facility under a take contract and will pay 10 percent of the debt service on the bonds. The nonqualified amount with respect to the bonds is $50 million.

(ii) The maximum amount of tax-exempt bonds that may be issued for the acquisition of an interest in the facility in paragraph (i) of this *Example* is $465 million (that is, $450 million for the 90 percent of the facility that is governmentally owned and used plus a nonqualified amount of $15 million).

[T.D. 9016, 67 FR 59763, Sept. 23, 2002]

§ 1.141–9 Unrelated or disproportionate use test.

(a) *General rules*—(1) *Description of test.* Under section 141(b)(3) (the unrelated or disproportionate use test), an issue meets the private business tests if the amount of private business use and private security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue. For this purpose, the private business use test is applied by taking into account only use that is not related to any government use of proceeds of the issue (unrelated use) and use that is related but disproportionate to any government use of those proceeds (disproportionate use).

(2) *Application of unrelated or disproportionate use test*—(i) *Order of application.* The unrelated or disproportionate use test is applied by first determining whether a private business use is related to a government use. Next, private business use that relates to a government use is examined to determine whether it is disproportionate to that government use.

(ii) *Aggregation of unrelated and disproportionate use.* All the unrelated use and disproportionate use financed with the proceeds of an issue are aggregated to determine compliance with the unrelated or disproportionate use test. The amount of permissible unrelated and disproportionate private business use is not reduced by the amount of private business use financed with the proceeds of an issue that is neither unrelated use nor disproportionate use.

(iii) *Deliberate actions.* A deliberate action that occurs after the issue date does not result in unrelated or disproportionate use if the issue meets the conditions of § 1.141–12(a).

(b) *Unrelated use*—(1) *In general.* Whether a private business use is related to a government use financed with the proceeds of an issue is determined on a case-by-case basis, emphasizing the operational relationship between the government use and the private business use. In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.

(2) *Use for the same purpose as government use.* Use of a facility by a nongovernmental person for the same purpose as use by a governmental person is not treated as unrelated use if the government use is not insignificant. Similarly, a use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use does not result in unrelated use if the related use is not insignificant. For example, a privately owned pharmacy in a governmentally owned hospital does not ordinarily result in unrelated use solely because the pharmacy also serves individuals not using the hospital. In addition, use of parking spaces in a garage by a nongovernmental person is not treated as unrelated use if more than an insignificant portion of the parking spaces are used for a government use (or a private business use that is related to a government use), even though the use by the nongovernmental person is not directly related to that other use.

(c) *Disproportionate use*—(1) *Definition of disproportionate use.* A private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use. For example, a private use of $100 of proceeds that is related to a government use of $70 of proceeds results in $30 of disproportionate use.

(2) *Aggregation of related uses.* If two or more private business uses of the proceeds of an issue relate to a single government use of those proceeds, those private business uses are aggregated to apply the disproportionate use test.

(3) *Allocation rule.* If a private business use relates to more than a single use of the proceeds of the issue (for example, two or more government uses of the proceeds of the issue or a government use and a private use), the amount of any disproportionate use may be determined by—

(i) Reasonably allocating the proceeds used for the private business use among the related uses;

(ii) Aggregating government uses that are directly related to each other; or

(iii) Allocating the private business use to the government use to which it is primarily related.

(d) *Maximum use taken into account.* The determination of the amount of unrelated use or disproportionate use of a facility is based on the maximum amount of reasonably expected government use of a facility during the measurement period. Thus, no unrelated use or disproportionate use arises solely because a facility initially has excess capacity that is to be used by a nongovernmental person if the facility will be completely used by the issuer during the term of the issue for more than an insignificant period.

(e) *Examples.* The following examples illustrate the application of this section:

Example 1. School and remote cafeteria. County X issues bonds with proceeds of $20 million and uses $18.1 million of the proceeds for construction of a new school building and $1.9 million of the proceeds for construction of a privately operated cafeteria in its administrative office building, which is located at a remote site. The bonds are secured, in part, by the cafeteria. The $1.9 million of proceeds is unrelated to the government use (that is, school construction) financed with the bonds and exceeds 5 percent of $20 million. Thus, the issue meets the private business tests.

Example 2. Public safety building and courthouse. City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($32 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y's use of the $3 million for the privately operated cafeteria does not meet the unrelated or disproportionate use test because these expenditures are neither unrelated use nor disproportionate use.

Example 3. Unrelated garage. City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($30.5 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y also uses $1.5 million of the proceeds to construct a privately operated parking garage adjacent to a private office building. The private business use of the parking garage is unrelated to any government use of proceeds of the issue. Since the proceeds used for unrelated uses and disproportionate uses do not exceed 5 percent of the proceeds, the unrelated or disproportionate use test is not met.

Example 4. Disproportionate use of garage. County Z issues bonds with proceeds of $20 million for construction of a hospital with no private business use ($17 million); renovation of an office building with no private business use ($1 million); and construction of a garage that is entirely used for a private business use ($2 million). The use of the garage is related to the use of the office building but not to the use of the hospital. The private business use of the garage results in $1 million of disproportionate use because the proceeds used for the garage ($2 million) exceed the proceeds used for the related government use ($1 million). The bonds are not private activity bonds, however, because the disproportionate use does not exceed 5 percent of the proceeds of the issue.

Example 5. Bonds for multiple projects. (i) County W issues bonds with proceeds of $80 million for the following purposes: (1) $72 million to construct a County-owned and operated waste incinerator; (2) $1 million for a County-owned and operated facility for the temporary storage of hazardous waste prior to final disposal; (3) $1 million to construct a privately owned recycling facility located at a remote site; and (4) $6 million to build a garage adjacent to the County-owned incinerator that will be leased to Company T to store and repair trucks that it owns and uses to haul County W refuse. Company T uses 75 percent of its trucks to haul materials to the incinerator and the remaining 25 percent of its trucks to haul materials to the temporary storage facility.

(ii) The $1 million of proceeds used for the recycling facility is used for an unrelated use. The garage is related use. In addition, 75 percent of the use of the $6 million of proceeds used for the garage is allocable to the government use of proceeds at the incinerator. The remaining 25 percent of the proceeds used for the garage ($1.5 million) relates to the government use of proceeds at the temporary storage facility. Thus, this portion of the proceeds used for the garage exceeds the proceeds used for the temporary storage facility by $0.5 million and this excess is disproportionate use (but not unrelated use). Thus, the aggregate amount of unrelated use and disproportionate use financed with the proceeds of the issue is $1.5 million. Alternatively, under paragraph (c)(3)(iii) of this section, the entire garage may be treated as related to the government use of the incinerator and, under that allocation, the garage is not disproportionate use. In either event, section 141(b)(3) limits the aggregate unrelated use and disproportionate use to $4 million. Therefore, the bonds are not private activity bonds under this section.

[T.D. 8712, 62 FR 2297, Jan. 16, 1997]

§ 1.141–10 Coordination with volume cap. [Reserved]

§ 1.141–11 Acquisition of nongovernmental output property. [Reserved]

§ 1.141–12 Remedial actions.

(a) *Conditions to taking remedial action.* An action that causes an issue to meet the private business tests or the private loan financing test is not treated as a deliberate action if the issuer takes a remedial action described in paragraph (d), (e), or (f) of this section with respect to the nonqualified bonds and if all of the requirements in paragraphs (a) (1) through (5) of this section are met.

(1) *Reasonable expectations test met.* The issuer reasonably expected on the issue date that the issue would meet neither the private business tests nor the private loan financing test for the entire term of the bonds. For this purpose, if the issuer reasonably expected on the issue date to take a deliberate action prior to the final maturity date of the issue that would cause either the private business tests or the private loan financing test to be met, the term of the bonds for this purpose may be determined by taking into account a redemption provision if the provisions of § 1.141–2(d)(2)(ii) (A) through (C) are met.

(2) *Maturity not unreasonably long.* The term of the issue must not be longer than is reasonably necessary for the governmental purposes of the issue (within the meaning of § 1.148–1(c)(4)). Thus, this requirement is met if the weighted average maturity of the bonds of the issue is not greater than 120 percent of the average reasonably expected economic life of the property financed with the proceeds of the issue as of the issue date.

(3) *Fair market value consideration.* Except as provided in paragraph (f) of this section, the terms of any arrangement that results in satisfaction of either the private business tests or the private loan financing test are bona fide and arm's-length, and the new user pays fair market value for the use of the financed property. Thus, for example, fair market value may be determined in a manner that takes into account restrictions on the use of the financed property that serve a bona fide governmental purpose.

(4) *Disposition proceeds treated as gross proceeds for arbitrage purposes.* The issuer must treat any disposition proceeds as gross proceeds for purposes of section 148. For purposes of eligibility for temporary periods under section 148(c) and exemptions from the requirement of section 148(f) the issuer may treat the date of receipt of the disposition proceeds as the issue date of the bonds and disregard the receipt of disposition proceeds for exemptions based on expenditure of proceeds under § 1.148–7 that were met before the receipt of the disposition proceeds.

(5) *Proceeds expended on a governmental purpose.* Except for a remedial action under paragraph (d) of this section, the proceeds of the issue that are affected by the deliberate action must have been expended on a governmental purpose before the date of the deliberate action.

(b) *Effect of a remedial action*—(1) *In general.* The effect of a remedial action is to cure use of proceeds that causes the private business use test or the private loan financing test to be met. A remedial action does not affect application of the private security or payment test.

(2) *Effect on bonds that have been advance refunded.* If proceeds of an issue were used to advance refund another bond, a remedial action taken with respect to the refunding bond proportionately reduces the amount of proceeds of the advance refunded bond that is taken into account under the private business use test or the private loan financing test.

(c) *Disposition proceeds*—(1) *Definition. Disposition proceeds* are any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition (disposition) of property (other than investments) financed with the proceeds of an issue.

(2) *Allocating disposition proceeds to an issue.* In general, if the requirements of paragraph (a) of this section are met, after the date of the disposition, the proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds rather than the transferred property. If a disposition is made pursuant to an installment sale, the proceeds of the issue continue to be allocated to the transferred property. If an issue does not meet the requirements for remedial action in paragraph (a) of this section or the issuer does not take an appropriate remedial action, the proceeds of the issue are allocable to either the transferred property or the disposition proceeds, whichever allocation produces the greater amount of private business use and private security or payments.

(3) *Allocating disposition proceeds to different sources of funding.* If property

has been financed by different sources of funding, for purposes of this section, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funding not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of the outstanding bonds that are allocable to that property. For purposes of this paragraph (c)(3), principal amount has the same meaning as in §1.148–9(b)(2) and outstanding bonds do not include advance refunded bonds.

(d) *Redemption or defeasance of nonqualified bonds*—(1) *In general.* The requirements of this paragraph (d) are met if all of the nonqualified bonds of the issue are redeemed. Proceeds of tax-exempt bonds must not be used for this purpose, unless the tax-exempt bonds are qualified bonds, taking into account the purchaser's use of the facility. Except as provided in paragraph (d)(3) of this section, if the bonds are not redeemed within 90 days of the date of the deliberate action, a defeasance escrow must be established for those bonds within 90 days of the deliberate action.

(2) *Special rule for dispositions for cash.* If the consideration for the disposition of financed property is exclusively cash, the requirements of this paragraph (d) are met if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds at the earliest call date after the deliberate action. If the bonds are not redeemed within 90 days of the date of the deliberate action, the disposition proceeds must be used to establish a defeasance escrow for those bonds within 90 days of the deliberate action.

(3) *Anticipatory remedial action.* The requirements of paragraphs (d)(1) and (2) of this section for redemption or defeasance of the nonqualified bonds within 90 days of the deliberate action are met if the issuer declares its official intent to redeem or defease all of the bonds that would become nonqualified bonds in the event of a subsequent deliberate action that would cause the private business tests or the private loan financing test to be met and redeems or defeases such bonds prior to that deliberate action. The issuer must declare its official intent on or before the date on which it redeems or defeases such bonds, and the declaration of intent must identify the financed property or loan with respect to which the anticipatory remedial action is being taken and describe the deliberate action that potentially may result in the private business tests being met (for example, sale of financed property that the buyer may then lease to a nongovernmental person). Rules similar to those in §1.150–2(e) (regarding official intent for reimbursement bonds) apply to declarations of intent under this paragraph (d)(3), including deviations in the descriptions of the project or loan and deliberate action and the reasonableness of the official intent.

(4) *Notice of defeasance.* The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(5) *Special limitation.* The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (d) if the period between the issue date and the first call date of the bonds is more than 10½ years.

(6) *Defeasance escrow defined.* A defeasance escrow is an irrevocable escrow established to redeem bonds on their earliest call date in an amount that, together with investment earnings, is sufficient to pay all the principal of, and interest and call premium on, bonds from the date the escrow is established to the earliest call date. The escrow may not be invested in higher yielding investments or in any investment under which the obligor is a user of the proceeds of the bonds.

(e) *Alternative use of disposition proceeds*—(1) *In general.* The requirements of this paragraph (e) are met if—

(i) The deliberate action is a disposition for which the consideration is exclusively cash;

(ii) The issuer reasonably expects to expend the disposition proceeds within two years of the date of the deliberate action;

(iii) The disposition proceeds are treated as proceeds for purposes of section 141 and are used in a manner that does not cause the issue to meet either the private business tests or the private loan financing test, and the issuer does not take any action subsequent to the date of the deliberate action to cause either of these tests to be met; and

(iv) If the issuer does not use all of the disposition proceeds for an alternative use described in paragraph (e)(1)(iii) of this section, the issuer uses those remaining disposition proceeds for a remedial action that meets paragraph (d) of this section.

(2) *Special rule for use by 501(c)(3) organizations.* If the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must in addition be treated as reissued for purposes of sections 141, 145, 147, 149, and 150 and, under this treatment, satisfy all of the applicable requirements for qualified 501(c)(3) bonds. Thus, beginning on the date of the deliberate action, nonqualified bonds that satisfy these requirements must be treated as qualified 501(c)(3) bonds for all purposes, including sections 145(b) and 150(b).

(f) *Alternative use of facility.* The requirements of this paragraph (f) are met if—

(1) The facility with respect to which the deliberate action occurs is used in an alternative manner (for example, used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization rather than a governmental person);

(2) The nonqualified bonds are treated as reissued, as of the date of the deliberate action, for purposes of sections 55 through 59 and 141, 142, 144, 145, 146, 147, 149 and 150, and under this treatment, the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds;

(3) The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds; and

(4) Any disposition proceeds other than those arising from an agreement to provide services (including disposition proceeds from an installment sale) resulting from the deliberate action are used to pay the debt service on the bonds on the next available payment date or, within 90 days of receipt, are deposited into an escrow that is restricted to the yield on the bonds to pay the debt service on the bonds on the next available payment date.

(g) *Rules for deemed reissuance.* For purposes of determining whether bonds that are treated as reissued under paragraphs (e) and (f) of this section are qualified bonds—

(1) The provisions of the Code and regulations thereunder in effect as of the date of the deliberate action apply; and

(2) For purposes of paragraph (f) of this section, section 147(d) (relating to the acquisition of existing property) does not apply.

(h) *Authority of Commissioner to provide for additional remedial actions.* The Commissioner may, by publication in the FEDERAL REGISTER or the Internal Revenue Bulletin, provide additional remedial actions, including making a remedial payment to the United States, under which a subsequent action will not be treated as a deliberate action for purposes of § 1.141–2.

(i) *Effect of remedial action on continuing compliance.* Solely for purposes of determining whether deliberate actions that are taken after a remedial action cause an issue to meet the private business tests or the private loan financing test—

(1) If a remedial action is taken under paragraph (d) of this section, the amount of private business use or private loans resulting from the deliberate action that is taken into account for purposes of determining whether the bonds are private activity bonds is that portion of the remaining bonds that is used for private business use or private loans (as calculated under paragraph (j) of this section);

(2) If a remedial action is taken under paragraph (e) or (f) of this section, the amount of private business use or private loans resulting from the deliberate action is not taken into account for purposes of determining

whether the bonds are private activity bonds; and

(3) After a remedial action is taken, the amount of disposition proceeds is treated as equal to the proceeds of the issue that had been allocable to the transferred property immediately prior to the disposition. See paragraph (k) of this section, *Example 5*.

(j) *Nonqualified bonds*—(1) *Amount of nonqualified bonds*. The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business use test or private loan financing test, as applicable. For this purpose, the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the one-year period in which the deliberate action occurs.

(2) *Allocation of nonqualified bonds*. Allocations of nonqualified bonds must be made on a pro rata basis, except that, for purposes of paragraph (d) of this section (relating to redemption or defeasance), an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer in accordance with this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

(k) *Examples*. The following examples illustrate the application of this section:

Example 1 Disposition proceeds less than outstanding bonds used to retire bonds. On June 1, 1997, City C issues 30-year bonds with an issue price of $10 million to finance the construction of a hospital building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C sells the building to Corporation P for $5 million. The sale price is the fair market value of the building, as verified by an independent appraiser. C uses all of the $5 million disposition proceeds to immediately retire a pro rata portion of the bonds. The sale does not cause the bonds to be private activity bonds because C has taken a remedial action described in paragraph (d) of this section so that P is not treated as a private business user of bond proceeds.

Example 2. Lease to nongovernmental person. The facts are the same as in *Example 1*, except that instead of selling the building, C, 6 years after the issue date, leases the building to P for 7 years and uses other funds to redeem all of the $10 million outstanding bonds within 90 days of the deliberate act. The bonds are not treated as private activity bonds because C has taken the remedial action described in paragraph (d) of this section.

Example 3. Sale for less than fair market value. The facts are the same as in *Example 1*, except that the fair market value of the building at the time of the sale to P is $6 million. Because the transfer was for less than fair market value, the bonds are ineligible for the remedial actions under this section. The bonds are private activity bonds because P is treated as a user of all of the proceeds and P makes a payment ($6 million) for this use that is greater than 10 percent of the debt service on the bonds, on a present value basis.

Example 4. Fair market value determined taking into account governmental restrictions. The facts are the same as in *Example 1*, except that the building was used by C only for hospital purposes and C determines to sell the building subject to a restriction that it be used only for hospital purposes. After conducting a public bidding procedure as required by state law, the best price that C is able to obtain for the building subject to this restriction is $4.5 million from P. C uses all of the $4.5 million disposition proceeds to immediately retire a pro rata portion of the bonds. The sale does not cause the bonds to be private activity bonds because C has taken a remedial action described in paragraph (d) of this section so that P is not treated as a private business user of bond proceeds.

Example 5. Alternative use of disposition proceeds. The facts are the same as in *Example 1*, except that C reasonably expects on the date of the deliberate action to use the $5 million disposition proceeds for another governmental purpose (construction of governmentally owned roads) within two years of receipt, rather than using the $5 million to redeem outstanding bonds. C treats these disposition proceeds as gross proceeds for purposes of section 148. The bonds are not private activity bonds because C has taken a remedial action described in paragraph (e) of this section. After the date of the deliberate action, the proceeds of all of the outstanding bonds are treated as used for the construction of the roads, even though only $5 million of disposition proceeds was actually used for the roads.

Example 6. Alternative use of financed property. The facts are the same as in *Example 1,* except that C determines to lease the hospital building to Q, an organization described in section 501(c)(3), for a term of 10 years rather than to sell the building to P. In order to induce Q to provide hospital services, C agrees to lease payments that are less than fair market value. Before entering into the lease, an applicable elected representative of C approves the lease after a noticed public hearing. As of the date of the deliberate action, the issue meets all the requirements for qualified 501(c)(3) bonds, treating the bonds as reissued on that date. For example, the issue meets the two percent restriction on use of proceeds of finance issuance costs of section 147(g) because the issue pays no costs of issuance from disposition proceeds in connection with the deemed reissuance. C and Q treat the bonds as qualified 501(c)(3) bonds for all purposes commencing with the date of the deliberate action. The bonds are treated as qualified 501(c)(3) bonds commencing with the date of the deliberate action.

Example 7. Deliberate action before proceeds are expended on a governmental purpose. County J issues bonds with proceeds of $10 million that can be used only to finance a correctional facility. On the issue date of the bonds, J reasonably expects that it will be the sole user of the bonds for the useful life of the facility. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the facility. After the issue date of the bonds, but before the facility is placed in service, J enters into a contract with the federal government pursuant to which the federal government will make a fair market value, lump sum payment equal to 25 percent of the cost of the facility. In exchange for this payment, J provides the federal government with priority rights to use of 25 percent of the facility. J uses the payment received from the federal government to defease the nonqualified bonds. The agreement does not cause the bonds to be private activity bonds because J has taken a remedial action described in paragraph (d) of this section. See paragraph (a)(5) of this section.

Example 8. Compliance after remedial action. In 2007, City G issues bonds with proceeds of $10 million to finance a courthouse. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the courthouse. City G enters into contracts with nongovernmental persons that result in private business use of 10 percent of the courthouse per year. More than 10 percent of the debt service on the issue is secured by private security or payments. In 2019, in a bona fide and arm's length arrangement, City G enters into a management contract with a nongovernmental person that results in private business use of an additional 40 percent of the courthouse per year during the remaining term of the bonds. City G immediately redeems the nonqualified bonds, or 44.44 percent of the outstanding bonds. This is the portion of the outstanding bonds that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business use test, treating the amount of private business use as the greatest percentage of private business use in any one-year period commencing with the one-year period in which the deliberate action occurs (50 percent). This percentage is computed by dividing the percentage of the facility used for a government use (50 percent) by the minimum amount of government use required (90 percent), and subtracting the resulting percentage (55.56 percent) from 100 percent (44.44 percent). For purposes of subsequently applying section 141 to the issue, City G may continue to use all of the proceeds of the outstanding bonds in the same manner (that is, for the courthouse and the private business use) without causing the issue to meet the private business use test. The issue continues to meet the private security or payment test. The result would be the same if City G, instead of redeeming the bonds, established a defeasance escrow for those bonds, provided that the requirement of paragraph (d)(5) of this section is met. If City G takes a subsequent deliberate action that results in further private business use, it must take into account 10 percent of private business use in addition to that caused by the second deliberate act.

[T.D. 8712, 62 FR 2298, Jan. 16, 1997, as amended by T.D. 9741, 80 FR 65644, Oct. 27, 2015]

§ 1.141–13 Refunding issues.

(a) *In general.* Except as provided in this section, a refunding issue and a prior issue are tested separately under section 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds.

(b) *Application of private business use test and private loan financing test*—(1) *Allocation of proceeds.* In applying the private business use test and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the proceeds of the prior issue.

(2) *Determination of amount of private business use*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, the amount of private business use of a refunding issue is determined under §1.141–3(g), based on the measurement period for that issue (for example, without regard to any private business use that occurred prior to the issue date of the refunding issue).

(ii) *Refundings of governmental bonds.* In applying the private business use test to a refunding issue that refunds a prior issue of governmental bonds, the amount of private business use of the refunding issue is the amount of private business use—

(A) During the combined measurement period; or

(B) At the option of the issuer, during the period described in paragraph (b)(2)(i) of this section, but only if, without regard to the reasonable expectations test of §1.141–2(d), the prior issue does not satisfy the private business use test, based on a measurement period that begins on the first day of the combined measurement period and ends on the issue date of the refunding issue.

(iii) *Combined measurement period*—(A) *In general.* Except as provided in paragraph (b)(2)(iii)(B) of this section, the *combined measurement period* is the period that begins on the first day of the measurement period (as defined in §1.141–3(g)) for the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) and ends on the last day of the measurement period for the refunding issue.

(B) *Transition rule for refundings of bonds originally issued before May 16, 1997.* If the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) was issued before May 16, 1997, then the issuer, at its option, may treat the combined measurement period as beginning on the date (the transition date) that is the earlier of December 19, 2005 or the first date on which the prior issue (or an earlier issue in the case of a series of refundings of governmental bonds) became subject to the 1997 regulations (as defined in §1.141–15(b)). If the issuer treats the combined measurement period as beginning on the transition date in accordance with this paragraph (b)(2)(iii)(B), then paragraph (c)(2) of this section shall be applied by treating the transition date as the issue date of the earliest issue, by treating the bonds as reissued on the transition date at an issue price equal to the value of the bonds (as determined under §1.148–4(e)) on that date, and by disregarding any private security or private payments before the transition date.

(iv) *Governmental bond.* For purposes of this section, the term *governmental bond* means any bond that, when issued, purported to be a governmental bond, as defined in §1.150–1(b), or a qualified 501(c)(3) bond, as defined in section 145(a).

(v) *Special rule for refundings of qualified 501(c)(3) bonds with governmental bonds.* For purposes of applying this paragraph (b)(2) to a refunding issue that refunds a qualified 501(c)(3) bond, any use of the property refinanced by the refunding issue before the issue date of the refunding issue by a 501(c)(3) organization with respect to its activities that do not constitute an unrelated trade or business under section 513(a) is treated as government use.

(c) *Application of private security or payment test—(1) Separate issue treatment.* If the amount of private business use of a refunding issue is determined based on the measurement period for that issue in accordance with paragraph (b)(2)(i) or (b)(2)(ii)(B) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue as a separate issue.

(2) *Combined issue treatment.* If the amount of private business use of a refunding issue is determined based on the combined measurement period for that issue in accordance with paragraph (b)(2)(ii)(A) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue and all

earlier issues taken into account in determining the combined measurement period as a combined issue. For this purpose, the present value of the private security and private payments is compared to the present value of the debt service on the combined issue (other than debt service paid with proceeds of any refunding bond). Present values are computed as of the issue date of the earliest issue taken into account in determining the combined measurement period (the earliest issue). Except as provided in paragraph (c)(3) of this section, present values are determined by using the yield on the combined issue as the discount rate. The yield on the combined issue is determined by taking into account payments on the refunding issue and all earlier issues taken into account in determining the combined measurement period (other than payments made with proceeds of any refunding bond), and based on the issue price of the earliest issue. In the case of a refunding of only a portion of the original principal amount of a prior issue, the refunded portion of the prior issue is treated as a separate issue and any private security or private payments with respect to the prior issue are allocated ratably between the combined issue and the unrefunded portion of the prior issue in a consistent manner based on relative debt service. See paragraph (b)(2)(iii)(B) of this section for special rules relating to certain refundings of governmental bonds originally issued before May 16, 1997.

(3) *Special rule for arrangements not entered into in contemplation of the refunding issue.* In applying the private security or payment test to a refunding issue that refunds a prior issue of governmental bonds, the issuer may use the yield on the prior issue to determine the present value of private security and private payments under arrangements that were not entered into in contemplation of the refunding issue. For this purpose, any arrangement that was entered into more than 1 year before the issue date of the refunding issue is treated as not entered into in contemplation of the refunding issue.

(d) *Multipurpose issue allocations*—(1) *In general.* For purposes of section 141, unless the context clearly requires otherwise, §1.148–9(h) applies to allocations of multipurpose issues (as defined in §1.148–1(b)), including allocations involving the refunding purposes of the issue. An allocation under this paragraph (d) may be made at any time, but once made, may not be changed. An allocation is not reasonable under this paragraph (d) if it achieves more favorable results under section 141 than could be achieved with actual separate issues. Each of the separate issues under the allocation must consist of one or more tax-exempt bonds. Allocations made under this paragraph (d) and §1.148–9(h) must be consistent for purposes of sections 141 and 148.

(2) *Exceptions.* This paragraph (d) does not apply for purposes of sections 141(c)(1) and 141(d)(1).

(e) *Application of reasonable expectations test to certain refunding bonds.* An action that would otherwise cause a refunding issue to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of §1.141–2(d) if—

(1) The action is not a deliberate action within the meaning of §1.141–2(d)(3); and

(2) The weighted average maturity of the refunding bonds is not greater than the weighted average reasonably expected economic life of the property financed by the prior bonds.

(f) *Special rule for refundings of certain general obligation bonds.* Notwithstanding any other provision of this section, a refunding issue does not consist of private activity bonds if—

(1) The prior issue meets the requirements of §1.141–2(d)(5) (relating to certain general obligation bond programs that finance a large number of separate purposes); or

(2) The refunded portion of the prior issue is part of a series of refundings of all or a portion of an issue that meets the requirements of §1.141–2(d)(5).

(g) *Examples.* The following examples illustrate the application of this section:

Example 1. Measuring private business use. In 2002, Authority A issues tax-exempt bonds that mature in 2032 to acquire an office building. The measurement period for the 2002 bonds under §1.141–3(g) is 30 years. At the time A acquires the building, it enters into a 10-year lease with a nongovernmental person under which the nongovernmental person will use 5 percent of the building in its trade or business during each year of the lease term. In 2007, A issues bonds to refund the 2002 bonds. The 2007 bonds mature on the same date as the 2002 bonds and have a measurement period of 25 years under §1.141–3(g). Under paragraph (b)(2)(ii)(A) of this section, the amount of private business use of the proceeds of the 2007 bonds is 1.67 percent, which equals the amount of private business use during the combined measurement period (5 percent of ⅓ of the 30-year combined measurement period). In addition, the 2002 bonds do not satisfy the private business use test, based on a measurement period beginning on the first day of the measurement period for the 2002 bonds and ending on the issue date of the 2007 bonds, because only 5 percent of the proceeds of the 2002 bonds are used for a private business use during that period. Thus, under paragraph (b)(2)(ii)(B) of this section, A may treat the amount of private business use of the 2007 bonds as 1 percent (5 percent of ⅕ of the 25-year measurement period for the 2007 bonds). The 2007 bonds do not satisfy the private business use test.

Example 2. Combined issue yield computation. (i) On January 1, 2000, County B issues 20-year bonds to finance the acquisition of a municipal auditorium. The 2000 bonds have a yield of 7.7500 percent, compounded annually, and an issue price and par amount of $100 million. The debt service payments on the 2000 bonds are as follows:

Date	Debt service
1/1/01	$9,996,470
1/1/02	9,996,470
1/1/03	9,996,470
1/1/04	9,996,470
1/1/05	9,996,470
1/1/06	9,996,470
1/1/07	9,996,470
1/1/08	9,996,470
1/1/09	9,996,470
1/1/10	9,996,470
1/1/11	9,996,470
1/1/12	9,996,470
1/1/13	9,996,470
1/1/14	9,996,470
1/1/15	9,996,470
1/1/16	9,996,470
1/1/17	9,996,470
1/1/18	9,996,470
1/1/19	9,996,470
1/1/20	9,996,470
	199,929,400

(ii) On January 1, 2005, B issues 15-year bonds to refund all of the outstanding 2000 bonds maturing after January 1, 2005 (in the aggregate principal amount of $86,500,000). The 2005 bonds have a yield of 6.0000 percent, compounded annually, and an issue price and par amount of $89,500,000. The debt service payments on the 2005 bonds are as follows:

Date	Debt service
1/1/06	$9,215,167
1/1/07	9,215,167
1/1/08	9,215,167
1/1/09	9,215,167
1/1/10	9,215,167
1/1/11	9,215,167
1/1/12	9,215,167
1/1/13	9,215,167
1/1/14	9,215,167
1/1/15	9,215,167
1/1/16	9,215,167
1/1/17	9,215,167
1/1/18	9,215,167
1/1/19	9,215,167
1/1/20	9,215,167
	138,227,511

(iii) In accordance with §1.141–15(h), B chooses to apply §1.141–13 (together with the other provisions set forth in §1.141–15(h)), to the 2005 bonds. For purposes of determining the amount of private security and private payments with respect to the 2005 bonds, the 2005 bonds and the refunded portion of the 2000 bonds are treated as a combined issue under paragraph (c)(2) of this section. The yield on the combined issue is determined in accordance with §§1.148–4, 1.141–4(b)(2)(iii) and 1.141–13(c)(2). Under this methodology, the yield on the combined issue is 7.1062 percent per year compounded annually, illustrated as follows:

Date	Previous debt service on refunded portion of prior issue	Refunding debt service	Total debt service	Present value on 1/1/00
1/1/00				($86,500,000.00)
1/1/01	6,689,793		6,689,793	6,245,945.33
1/1/02	6,689,793		6,689,793	5,831,545.62
1/1/03	6,689,793		6,689,793	5,444,640.09
1/1/04	6,689,793		6,689,793	5,083,404.58
1/1/05	6,689,793		6,689,793	4,746,135.95
1/1/06		9,215,167	9,215,167	6,104,023.84
1/1/07		9,215,167	9,215,167	5,699,040.20
1/1/08		9,215,167	9,215,167	5,320,926.00
1/1/09		9,215,167	9,215,167	4,967,898.55
1/1/10		9,215,167	9,215,167	4,638,293.40

Date	Previous debt service on refunded portion of prior issue	Refunding debt service	Total debt service	Present value on 1/1/00
1/1/11		9,215,167	9,215,167	4,330,556.57
1/1/12		9,215,167	9,215,167	4,043,237.15
1/1/13		9,215,167	9,215,167	3,774,980.51
1/1/14		9,215,167	9,215,167	3,524,521.90
1/1/15		9,215,167	9,215,167	3,290,680.46
1/1/16		9,215,167	9,215,167	3,072,353.70
1/1/17		9,215,167	9,215,167	2,868,512.26
1/1/18		9,215,167	9,215,167	2,678,195.09
1/1/19		9,215,167	9,215,167	2,500,504.89
1/1/20		9,215,167	9,215,167	2,334,603.90
	33,448,965	138,227,511	171,676,4760.00	0.00

Example 3. Determination of private payments allocable to combined issue. The facts are the same as in *Example 2.* In addition, on January 1, 2001, B enters into a contract with a nongovernmental person for the use of the auditorium. The contract results in a private payment in the amount of $500,000 on each January 1 beginning on January 1, 2001, and ending on January 1, 2020. Under paragraph (c)(2) of this section, the amount of the private payments allocable to the combined issue is determined by treating the refunded portion of the 2000 bonds ($86,500,000 principal amount) as a separate issue, and by allocating the total private payments ratably between the combined issue and the unrefunded portion of the 2000 bonds ($13,500,000 principal amount) based on relative debt service, as follows:

Date	Private payments	Debt service on unrefunded portion of prior issue	Debt service on combined issue	Percentage of private payments allocable to combined issue	Amount of private payments allocable to combined issue
1/1/01	$500,000	$3,306,677	$6,689,793	66.92	$334,608
1/1/02	500,000	3,306,677	6,689,793	66.92	334,608
1/1/03	500,000	3,306,677	6,689,793	66.92	334,608
1/1/04	500,000	3,306,677	6,689,793	66.92	334,608
1/1/05	500,000	3,306,677	6,689,793	66.92	334,608
1/1/06	500,000		9,215,167	100.00	500,000
1/1/07	500,000		9,215,167	100.00	500,000
1/1/08	500,000		9,215,167	100.00	500,000
1/1/09	500,000		9,215,167	100.00	500,000
1/1/10	500,000		9,215,167	100.00	500,000
1/1/11	500,000		9,215,167	100.00	500,000
1/1/12	500,000		9,215,167	100.00	500,000
1/1/13	500,000		9,215,167	100.00	500,000
1/1/14	500,000		9,215,167	100.00	500,000
1/1/15	500,000		9,215,167	100.00	500,000
1/1/16	500,000		9,215,167	100.00	500,000
1/1/17	500,000		9,215,167	100.00	500,000
1/1/18	500,000		9,215,167	100.00	500,000
1/1/19	500,000		9,215,167	100.00	500,000
1/1/20	500,000		9,215,167	100.00	500,000
	$10,000,000	$16,533,385	$171,676,476		$9,173,039

Example 4. Refunding taxable bonds and qualified bonds. (i) In 1999, City C issues taxable bonds to finance the construction of a facility for the furnishing of water. The bonds are secured by revenues from the facility. The facility is managed pursuant to a management contract with a nongovernmental person that gives rise to private business use. In 2007, C terminates the management contract and takes over the operation of the facility. In 2009, C issues bonds to refund the 1999 bonds. On the issue date of the 2009 bonds, C reasonably expects that the facility will not be used for a private business use during the term of the 2009 bonds. In addition, during the term of the 2009 bonds, the facility is not used for a private business use. Under paragraph (b)(2)(i) of this section, the 2009 bonds do not satisfy the private business use test because the amount of private business use is based on the measurement period for those bonds and therefore does not take

into account any private business use that occurred pursuant to the management contract.

(ii) The facts are the same as in paragraph (i) of this *Example 4*, except that the 1999 bonds are issued as exempt facility bonds under section 142(a)(4). The 2009 bonds do not satisfy the private business use test.

Example 5. Multipurpose issue. (i) In 2017, State D issues bonds to finance the construction of two office buildings, Building 1 and Building 2. D expends an equal amount of the proceeds on each building. D enters into arrangements that result in private business use of 8 percent of Building 1 and 12 percent of Building 2 during the measurement period under §1.141–3(g) and private payments of 4 percent of the 2017 bonds in respect of Building 1 and 6 percent of the 2017 bonds in respect of Building 2. These arrangements result in a total of 10 percent of the proceeds of the 2017 bonds being used for a private business use and total private payments of 10 percent. In 2022, D purports to make a multipurpose issue allocation under paragraph (d) of this section of the outstanding 2017 bonds, allocating the issue into two separate issues of equal amounts with one issue allocable to Building 1 and the second allocable to Building 2. An allocation is unreasonable under paragraph (d) of this section if it achieves more favorable results under section 141 than could be achieved with actual separate issues. D's allocation is unreasonable because, if permitted, it would allow more favorable results under section 141 for the 2017 bonds (that is, private business use and private payments that exceed 10 percent for the 2017 bonds allocable to Building 2) than could be achieved with actual separate issues. In addition, if D's purported allocation was intended to result in two separate issues of tax-exempt governmental bonds (versus tax-exempt private activity bonds), the allocation would violate paragraph (d) of this section in the first instance because the allocation to the separate issue for Building 2 would fail to qualify separately as an issue of tax-exempt governmental bonds as a result of its 12 percent of private business use and private payments.

(ii) The facts are the same as in paragraph (i) of this *Example 5*, except that D enters into arrangements only for Building 1, and it expects no private business use of Building 2. In 2022, D allocates an equal amount of the outstanding 2017 bonds to Building 1 and Building 2. D selects particular bonds for each separate issue such that the allocation does not achieve a more favorable result than could have been achieved by issuing actual separate issues. D uses the same allocation for purposes of both sections 141 and 148. D's allocation is reasonable.

(iii) The facts are the same as in paragraph (ii) of this *Example 5*, except that as part of the same issue, D issues bonds for a privately used airport. The airport bonds, if issued as a separate issue, would be qualified private activity bonds. The remaining bonds, if issued separately from the airport bonds, would be governmental bonds. Treated as one issue, however, the bonds are taxable private activity bonds. Therefore, D makes its allocation of the bonds under paragraph (d) of this section and §1.150–1(c)(3) into 3 separate issues on or before the issue date. Assuming all other applicable requirements are met, the bonds of the respective issues will be tax-exempt qualified private activity bonds or governmental bonds.

Example 6. Non-deliberate action. In 1998, City E issues bonds to finance the purchase of land and construction of a building (the prior bonds). On the issue date of the prior bonds, E reasonably expects that it will be the sole user of the financed property for the entire term of the bonds. In 2003, the federal government acquires the financed property in a condemnation action. In 2006, E issues bonds to refund the prior bonds (the refunding bonds). The weighted average maturity of the refunding bonds is not greater than the reasonably expected economic life of the financed property. In general, under §1.141–2(d) and this section, reasonable expectations must be separately tested on the issue date of a refunding issue. Under paragraph (e) of this section, however, the condemnation action is not taken into account in applying the reasonable expectations test to the refunding bonds because the condemnation action is not a deliberate action within the meaning of §1.141–2(d)(3) and the weighted average maturity of the refunding bonds is not greater than the weighted average reasonably expected economic life of the property financed by the prior bonds. Thus, the condemnation action does not cause the refunding bonds to be private activity bonds.

Example 7. Non-transitioned refunding of bonds subject to 1954 Code. In 1985, County F issues bonds to finance a court house. The 1985 bonds are subject to the provisions of the Internal Revenue Code of 1954. In 2006, F issues bonds to refund all of the outstanding 1985 bonds. The weighted average maturity of the 2006 bonds is longer than the remaining weighted average maturity of the 1985 bonds. In addition, the 2006 bonds do not satisfy any transitional rule for refundings in the Tax Reform Act of 1986, 100 Stat. 2085 (1986). Section 141 and this section apply to determine whether the 2006 bonds are private activity bonds including whether, for purposes of §1.141–13(b)(2)(ii)(B), the 1985 bonds satisfy the private business use test based on a measurement period that begins on the first day of the combined measurement period for the 2006 bonds and ends on the issue date of the 2006 bonds.

[T.D. 9234, 70 FR 75032, Dec. 19, 2006, as amended by T.D. 9741, 80 FR 65645, Oct. 27, 2015]

§ 1.141–14 Anti-abuse rules.

(a) *Authority of Commissioner to reflect substance of transactions.* If an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons (other than as members of the general public) significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141, the Commissioner may take any action to reflect the substance of the transaction or series of transactions, including—

(1) Treating separate issues as a single issue for purposes of the private activity bond tests;

(2) Reallocating proceeds to expenditures, property, use, or bonds;

(3) Reallocating payments to use or proceeds;

(4) Measuring private business use on a basis that reasonably reflects the economic benefit in a manner different than as provided in § 1.141–3(g); and

(5) Measuring private payments or security on a basis that reasonably reflects the economic substance in a manner different than as provided in § 1.141–4.

(b) *Examples.* The following examples illustrate the application of this section:

Example 1. Reallocating proceeds to indirect use. City C issues bonds with proceeds of $20 million for the stated purpose of financing improvements to roads that it owns. As a part of the same plan of financing, however, C also agrees to make a loan of $7 million to Corporation M from its general revenues that it otherwise would have used for the road improvements. The interest rate of the loan corresponds to the interest rate on a portion of the issue. A principal purpose of the financing arrangement is to transfer to M significant benefits of the tax-exempt financing. Although C actually allocates all of the proceeds of the bonds to the road improvements, the Commissioner may reallocate a portion of the proceeds of the bonds to the loan to M because a principal purpose of the financing arrangement is to transfer to M significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141. The bonds are private activity bonds because the issue meets the private loan financing test. The bonds also meet the private business tests. See also §§ 1.141–3(a)(2), 1.141–4(a)(1), and 1.141–5(a), under which indirect use of proceeds and payments are taken into account.

Example 2. Taking into account use of amounts derived from proceeds that would be otherwise disregarded. County B issues bonds with proceeds of $10 million to finance the purchase of land. On the issue date, B reasonably expects that it will be the sole user of the land. Subsequently, the federal government acquires the land for $3 million in a condemnation action. B uses this amount to make a loan to Corporation M. In addition, the interest rate on the loan reflects the tax-exempt interest rate on the bonds and thus is substantially less than a current market rate. A principal purpose of the arrangement is to transfer to M significant benefits of the tax-exempt financing. Although the condemnation action is not a deliberate action, the Commissioner may treat the condemnation proceeds as proceeds of the issue because a principal purpose of the arrangement is to transfer to M significant benefits of tax-exempt financing in a manner inconsistent with the purposes of section 141. The bonds are private activity bonds.

Example 3. Measuring private business use on an alternative basis. City F issues bonds with a 30-year term to finance the acquisition of an industrial building having a remaining reasonably expected useful economic life of more than 30 years. On the issue date, F leases the building to Corporation G for 3 years. F reasonably expects that it will be the sole user of the building for the remaining term of the bonds. Because of the local market conditions, it is reasonably expected that the fair rental value of the industrial building will be significantly greater during the early years of the term of the bonds than in the later years. The annual rental payments are significantly less than fair market value, reflecting the interest rate on the bonds. The present value of these rental payments (net of operation and maintenance expenses) as of the issue date, however, is approximately 25 percent of the present value of debt service on the issue. Under § 1.141–3, the issue does not meet the private business tests, because only 10 percent of the proceeds are used in a trade or business by a nongovernmental person. A principal purpose of the issue is to transfer to G significant benefits of tax-exempt financing in a manner inconsistent with the purposes of section 141. The method of measuring private business use over the reasonably expected useful economic life of financed property is for the administrative convenience of issuers of state and local bonds. In cases where this method is used in a manner inconsistent with the purposes of section 141, the Commissioner may measure private business use on another basis that reasonably reflects economic benefit, such as in this case on an annual basis. If the Commissioner measures private business use on an annual basis, the bonds are private activity bonds because the private payment test is met and more than 10 percent of the proceeds are used in a trade or business by a nongovernmental person.

Example 4. Treating separate issues as a single issue. City D enters into a development agreement with Corporation T to induce T to locate its headquarters within D's city limits. Pursuant to the development agreement, in 1997 D will issue $20 million of its general obligation bonds (the 1997 bonds) to purchase land that it will grant to T. The development agreement also provides that, in 1998, D will issue $20 million of its tax increment bonds (the 1998 bonds), secured solely by the increase in property taxes in a special taxing district. Substantially all of the property within the special taxing district is owned by T or D. T will separately enter into an agreement to guarantee the payment of tax increment to D in an amount sufficient to retire the 1998 bonds. The proceeds of the 1998 bonds will be used to finance improvements owned and operated by D that will not give rise to private business use. Treated separately, the 1997 issue meets the private business use test, but not the private security or payment test; the 1998 issue meets the private security or payment test, but not the private business use test. A principal purpose of the financing plan, including the two issues, is to transfer significant benefits of tax-exempt financing to T for its headquarters. Thus, the 1997 issue and the 1998 issue may be treated by the Commissioner as a single issue for purposes of applying the private activity bond tests. Accordingly, the bonds of both the 1997 issue and the 1998 issue may be treated as private activity bonds.

Example 5. Reallocating proceeds. City E acquires an electric generating facility with a useful economic life of more than 40 years and enters into a 30-year take or pay contract to sell 30 percent of the available output to investor-owned utility M. E plans to use the remaining 70 percent of available output for its own governmental purposes. To finance the entire cost of the facility, E issues $30 million of its series A taxable bonds at taxable interest rates and $70 million series B bonds, which purport to be tax-exempt bonds, at tax-exempt interest rates. E allocates all of M's private business use to the proceeds of the series A bonds and all of its own government use to the proceeds of the series B bonds. The series A bonds have a weighted average maturity of 15 years, while the series B bonds have a weighted average maturity of 26 years. M's payments under the take or pay contract are expressly determined by reference to 30 percent of M's total costs (that is, the sum of the debt service required to be paid on both the series A and the series B bonds and all other operating costs). The allocation of all of M's private business use to the series A bonds does not reflect economic substance because the series of transactions transfers to M significant benefits of the tax-exempt interest rates paid on the series B bonds. A principal purpose of the financing arrangement is to transfer to M significant benefits of the tax-exempt financing. Accordingly, the Commissioner may allocate M's private business use on a pro rata basis to both the series B bonds as well as the series A bonds, in which case the series B bonds are private activity bonds.

Example 6. Allocations respected. The facts are the same as in *Example 5*, except that the debt service component of M's payments under the take or pay contract is based exclusively on the amounts necessary to pay the debt service on the taxable series A bonds. E's allocation of all of M's private business use to the series A bonds is respected because the series of transactions does not actually transfer benefits of tax-exempt interest rates to M. Accordingly, the series B bonds are not private activity bonds. The result would be the same if M's payments under the take or pay contract were based exclusively on fair market value pricing, rather than the tax-exempt interest rates on E's bonds. The result also would be the same if the series A bonds and the series B bonds had substantially equivalent weighted average maturities and E and M had entered into a customary contract providing for payments based on a ratable share of total debt service. E would not be treated by the Commissioner in any of these cases as entering into the contract with a principal purpose of transferring the benefits of tax-exempt financing to M in a manner inconsistent with the purposes of section 141.

[T.D. 8712, 62 FR 2301, Jan. 16, 1997]

§ 1.141–15 Effective/applicability dates.

(a) *Scope.* The effective dates of this section apply for purposes of §§ 1.141–1 through 1.141–14, 1.145–1 through 1.145–2, and 1.150–1(a)(3) and the definition of bond documents contained in § 1.150–1(b).

(b) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, §§ 1.141–0 through 1.141–6(a), 1.141–9 through 1.141–12, 1.141–14, 1.145–1 through 1.145–2(c), and the definition of bond documents contained in § 1.150–1(b) (the 1997 regulations) apply to bonds issued on or after May 16, 1997, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(2) *Certain short-term arrangements.* The provisions of § 1.141–3 that refer to

arrangements for 200 days, 100 days, or 50 days apply to any bond sold on or after November 20, 2001 and may be applied to any bond outstanding on November 20, 2001 to which § 1.141–3 applies.

(3) *Certain prepayments.* Except as provided in paragraph (c) of this section, paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of § 1.141–5 apply to bonds sold on or after October 3, 2003. Issuers may apply paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of § 1.141–5, in whole but not in part, to bonds sold before October 3, 2003 that are subject to § 1.141–5.

(4) *Certain remedial actions*—(i) *General rule.* For bonds subject to § 1.141–12, the provisions of § 1.141–12(d)(3), (i), (j), and (k), *Example 8*, apply to deliberate actions that occur on or after January 25, 2016.

(ii) *Special rule for allocations of nonqualified bonds.* For purposes of § 1.141–12(j)(2), in addition to the allocation methods permitted in § 1.141–12(j)(2), an issuer may treat bonds with the longest maturities (determined on a bond-by-bond basis) as the nonqualified bonds, but only for bonds sold before January 25, 2016.

(c) *Refunding bonds.* Except as otherwise provided in this section, the 1997 regulations (defined in paragraph (b)(1) of this section) do not apply to any bonds issued on or after May 16, 1997, to refund a bond to which those regulations do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds; or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(d) *Permissive application of regulations.* Except as provided in paragraph (e) of this section, the 1997 regulations (defined in paragraph (b)(1) of this section) may be applied in whole, but not in part, to actions taken before February 23, 1998, with respect to—

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997, that are subject to 141.

(e) *Permissive application of certain sections*—(1) *In general.* The following sections may each be applied by issuers to any bonds:

(i) Section 1.141–3(b)(4);

(ii) Section 1.141–3(b)(6); and

(iii) Section 1.141–12.

(2) *Transition rule for pre-effective date bonds.* For purposes of paragraphs (e)(1) and (h) of this section, issuers may apply § 1.141–12 to bonds issued before May 16, 1997, without regard to paragraph (d)(5) thereof with respect to deliberate actions that occur on or after April 21, 2003.

(f) *Effective dates for certain regulations relating to output facilities*—(1) *General rule.* Except as otherwise provided in this section, §§ 1.141–7 and 1.141–8 apply to bonds sold on or after November 22, 2002, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(2) *Transition rule for requirements contracts.* For bonds otherwise subject to §§ 1.141–7 and 1.141–8, § 1.141–7(c)(3) applies to output contracts entered into on or after September 19, 2002. An output contract is treated as entered into on or after that date if it is amended on or after that date, but only if the amendment results in a change in the parties to the contract or increases the amount of requirements covered by the contract by reason of an extension of the contract term or a change in the method for determining such requirements. For purposes of this paragraph (f)(2)—

(i) The extension of the term of a contract causes the contract to be treated as entered into on the first day of the additional term;

(ii) The exercise by a party of a legally enforceable right that was provided under a contract before September 19, 2002, on terms that were fixed and determinable before such date, is not treated as an amendment of the contract. For example, the exercise by a purchaser after September 19, 2002 of a renewal option that was provided under a contract before that date, on terms identical to the original contract, is not treated as an amendment of the contract; and

(iii) An amendment that increases the amount of requirements covered by the contract by reason of a change in the method for determining such requirements is treated as a separate contract that is entered into as of the effective date of the amendment, but only with respect to the increased output to be provided under the contract.

(g) *Refunding bonds for output facilities.* Except as otherwise provided in paragraph (h) or (i) of this section, §§1.141–7 and 1.141–8 do not apply to any bonds sold on or after November 22, 2002, to refund a bond to which §§1.141–7 and 1.141–8 do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds; or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(h) *Permissive retroactive application.* Except as provided in paragraphs (d), (e) or (i) of this section, §§1.141–1 through 1.141–6(a), 1.141–7 through 1.141–14, 1.145–1 through 1.145–2, 1.149(d)–1(g), 1.150–1(a)(3), the definition of bond documents contained in §1.150–1(b) and §1.150–1(c)(3)(ii) may be applied by issuers in whole, but not in part, to—

(1) Outstanding bonds that are sold before February 17, 2006, and subject to section 141; or

(2) Refunding bonds that are sold on or after February 17, 2006, and subject to section 141.

(i) *Permissive application of certain regulations relating to output facilities.* Issuers may apply each of the following sections to any bonds used to finance output facilities:

(1) Section 1.141–6;

(2) Section 1.141–7(f)(3); and

(3) Section 1.141–7(g).

(j) *Effective dates for certain regulations relating to refundings.* Except as otherwise provided in this section, §§1.141–13, 1.145–2(d), 1.149(d)–1(g), 1.150–1(a)(3) and 1.150–1(c)(3)(ii) apply to bonds that are sold on or after February 17, 2006, and that are subject to the 1997 regulations (defined in paragraph (b)(1) of this section).

(k) *Effective/applicability dates for certain regulations relating to generally applicable taxes and payments in lieu of tax*—(1) *In general.* Except as otherwise provided in paragraphs (k)(2) and (k)(3) of this section, revised §§1.141–4(e)(2), 1.141–4(e)(3) and 1.141–4(e)(5) apply to bonds sold on or after October 24, 2008 that are otherwise subject to the 1997 Regulations (defined in paragraph (b)(1) of this section).

(2) *Transitional rule for certain refundings.* Paragraph (k)(1) does not apply to bonds that are issued to refund bonds if—

(i) Either—

(A) The refunded bonds (or the original bonds in a series of refundings) were sold before October 24, 2008, or

(B) The refunded bonds (or the original bonds in a series of refundings) satisfied the transitional rule for projects substantially in progress under paragraph (k)(3) of this section; and

(ii) The weighted average maturity of the refunding bonds does not exceed the remaining weighted average maturity of the refunded bonds.

(3) *Transitional rule for certain projects substantially in progress.* Paragraph (k)(1) of this section does not apply to bonds issued for projects for which all of the following requirements are met:

(i) A governmental person (as defined in §1.141–1) took official action evidencing its preliminary approval of the project before October 19, 2006, and the plan of finance for the project in place at that time contemplated financing the project with tax-exempt bonds to be paid or secured by PILOTs.

(ii) Before October 19, 2006, significant expenditures were paid or incurred with respect to the project or a contract was entered into to pay or incur significant expenditures with respect to the project.

(iii) The bonds for the project (excluding refunding bonds) are issued on or before December 31, 2009.

(l) *Applicability date for certain regulations relating to allocation and accounting*—(1) *In general.* Except as otherwise provided in this section, §§1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, 1.141–13(d), and 1.145–2(b)(4), (b)(5), and (c)(2) apply to bonds that are sold on or after January 25, 2016, and to which the 1997 regulations (as defined in paragraph (b)(1) of this section) apply.

(2) *Refunding bonds.* Except as otherwise provided in this section, §§1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, and 1.145–2(b)(4), (5), and (c)(2) do not apply to any bonds sold on or after January 25, 2016, to refund a bond to which these sections do not apply, provided that the weighted average maturity of the refunding bonds is no longer than—

(i) The remaining weighted average maturity of the refunded bonds; or

(ii) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed.

(3) *Permissive application.* Except as otherwise provided in this section, issuers may apply §§1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, and 1.145–2(b)(4), (b)(5), and (c)(2), in whole but not in part, to bonds to which the 1997 regulations apply.

(m) *Permissive retroactive application of certain regulations.* Issuers may apply §1.141–13(d) to bonds to which §1.141–13 applies.

(n) *Effective/applicability dates for certain regulations relating to certain definitions.* §1.141–1(a) applies to bonds that are sold on or after October 17, 2016.

[T.D. 8757, 63 FR 3265, Jan. 22, 1998, as amended by T.D. 8941, 66 FR 4670, Jan. 18, 2001; T.D. 8967, 66 FR 58062, Nov. 20, 2001; T.D. 9016, 67 FR 59765, Sept. 23, 2002; T.D. 9085, 68 FR 45775, Aug. 4, 2003; T.D. 9234, 70 FR 75035, Dec. 19, 2005; 71 FR 1971, Jan. 12, 2006; T.D. 9429, 73 FR 63375, Oct. 24, 2008; T.D. 9741, 80 FR 65645, Oct. 27, 2015; 80 FR 74678, Nov. 30, 2015; T.D. 9777, 81 FR 46592, July 18, 2016]

§ 1.141–16 Effective dates for qualified private activity bond provisions.

(a) *Scope.* The effective dates of this section apply for purposes of §§1.142–0 through 1.142–2, 1.144–0 through 1.144–2, 1.147–0 through 1.147–2, and 1.150–4.

(b) *Effective dates.* Except as otherwise provided in this section, the regulations designated in paragraph (a) of this section apply to bonds issued on or after May 16, 1997 (the effective date).

(c) *Permissive application.* The regulations designated in paragraph (a) of this section may be applied by issuers in whole, but not in part, to bonds outstanding on the effective date. For this purpose, issuers may apply §1.142–2 without regard to paragraph (c)(3) thereof to failures to properly use proceeds that occur on or after April 21, 2003.

(d) *Certain remedial actions*—(1) *General rule.* The provisions of §1.142–2(e) apply to failures to properly use proceeds that occur on or after August 13, 2004 and may be applied by issuers to failures to properly use proceeds that occur on or after May 14, 2004, provided that the bonds are subject to §1.142–2.

(2) *Special rule for allocations of nonqualified bonds.* For purposes of §1.142–2(e)(2), in addition to the allocation methods permitted in §1.142–2(e)(2), an issuer may treat bonds with the longest maturities (determined on a bond-by-bond basis) as the nonqualified bonds, but only with respect to failures to properly use proceeds that occur on or after May 14, 2004, with respect to bonds sold before August 13, 2004.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997, as amended by T.D. 9150, 69 FR 50066, Aug. 13, 2004]

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§ 1.142–2 Remedial actions.

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§ 1.142–3 Refunding issues. [Reserved]

[T.D. 8712, 62 FR 2302, Jan. 16, 1997, as amended by T.D. 9150, 69 FR 50066, Aug. 13, 2004]

§ 1.142–1 Exempt facility bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(A), an exempt facility bond issued under section 142 may be a qualified bond.

Under section 142(a), an exempt facility bond is any bond issued as a part of an issue using 95 percent or more of the proceeds for certain exempt facilities.

(b) *Scope.* Sections 1.142–0 through 1.142–3 apply for purposes of the rules for exempt facility bonds under section 142, except that, with respect to net proceeds that have been spent, § 1.142–2 does not apply to bonds issued under section 142(d) (relating to bonds issued to provide qualified residential rental projects) and section 142(f) (2) and (4) (relating to bonds issued to provide local furnishing of electric energy or gas).

(c) *Effective dates.* For effective dates of §§ 1.142–0 through 1.142–2, see § 1.141–16.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997]

§ 1.142–2 Remedial actions.

(a) *General rule.* If less than 95 percent of the net proceeds of an exempt facility bond are actually used to provide an exempt facility, and for no other purpose, the issue will be treated as meeting the use of proceeds requirement of section 142(a) if the issue meets the condition of paragraph (b) of this section and the issuer takes the remedial action described in paragraph (c) of this section.

(b) *Reasonable expectations requirement.* The issuer must have reasonably expected on the issue date that 95 percent of the net proceeds of the issue would be used to provide an exempt facility and for no other purpose for the entire term of the bonds (disregarding any redemption provisions). To meet this condition the amount of the issue must have been based on reasonable estimates about the cost of the facility.

(c) *Redemption or defeasance*—(1) *In general.* The requirements of this paragraph (c) are met if all of the nonqualified bonds of the issue are redeemed on the earliest call date after the date on which the failure to properly use the proceeds occurs under paragraph (d) of this section. Proceeds of tax-exempt bonds (other than those described in paragraph (d)(1) of this section) must not be used for this purpose. If the bonds are not redeemed within 90 days of the date on which the failure to properly use proceeds occurs, a defeasance escrow must be established for those bonds within 90 days of that date.

(2) *Notice of defeasance.* The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

(3) *Special limitation.* The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (c) if the period between the issue date and the first call date is more than 10½ years.

(4) *Special rule for dispositions of personal property.* For dispositions of personal property exclusively for cash, the requirements of this paragraph (c) are met if the issuer expends the disposition proceeds within 6 months of the date of the disposition to acquire replacement property for the same qualifying purpose of the issue under section 142.

(5) *Definitions.* For purposes of paragraph (c)(4) of this section, *disposition proceeds* means disposition proceeds as defined in § 1.141–12(c).

(d) *When a failure to properly use proceeds occurs*—(1) *Proceeds not spent.* For net proceeds that are not spent, a failure to properly use proceeds occurs on the earlier of the date on which the issuer reasonably determines that the financed facility will not be completed or the date on which the financed facility is placed in service.

(2) *Proceeds spent.* For net proceeds that are spent, a failure to properly use proceeds occurs on the date on which

an action is taken that causes the bonds not to be used for the qualifying purpose for which the bonds were issued.

(e) *Nonqualified bonds*—(1) *Amount of nonqualified bonds.* For purposes of this section, the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility. If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds.

(2) *Allocation of nonqualified bonds.* Allocations of nonqualified bonds must be made on a pro rata basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer to meet the requirements of paragraph (c) of this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997, as amended by T.D. 9150, 69 FR 50067, Aug. 13, 2004]

§ 1.142–3 Refunding Issues. [Reserved]

§ 1.142–4 Use of proceeds to provide a facility.

(a) *In general.* [Reserved]

(b) *Reimbursement allocations.* If an expenditure for a facility is paid before the issue date of the bonds to provide that facility, the facility is described in section 142(a) only if the expenditure meets the requirements of § 1.150–2 (relating to reimbursement allocations). For purposes of this paragraph (b), if the proceeds of an issue are used to pay principal of or interest on an obligation other than a State or local bond (for example, temporary construction financing of the conduit borrower), that issue is not a refunding issue, and, thus, § 1.150–2(g) does not apply.

(c) *Limitation on use of facilities by substantial users*—(1) *In general.* If the original use of a facility begins before the issue date of the bonds to provide the facility, the facility is not described in section 142(a) if any person that was a substantial user of the facility at any time during the 5-year period before the issue date or any related person to that user receives (directly or indirectly) 5 percent or more of the proceeds of the issue for the user's interest in the facility and is a substantial user of the facility at any time during the 5-year period after the issue date, unless—

(i) An official intent for the facility is adopted under § 1.150–2 within 60 days after the date on which acquisition, construction, or reconstruction of that facility commenced; and

(ii) For an acquisition, no person that is a substantial user or related person after the acquisition date was also a substantial user more than 60 days before the date on which the official intent was adopted.

(2) *Definitions.* For purposes of paragraph (c)(1) of this section, *substantial user* has the meaning used in section 147(a)(1), *related person* has the meaning used in section 144(a)(3), and a user that is a governmental unit within the meaning of § 1.103–1 is disregarded.

(d) *Effective date*—(1) *In general.* This section applies to bonds sold on or after July 8, 1997. See § 1.103–8(a)(5) for rules applicable to bonds sold before that date.

(2) *Elective retroactive application.* An issuer may apply this section to any bond sold before July 8, 1997.

[T.D. 8718, 62 FR 25506, May 9, 1997]

§ 1.142(a)(5)–1 Exempt facility bonds: Sewage facilities.

(a) *In general.* Under section 103(a), a private activity bond is a tax-exempt bond only if it is a qualified bond. A qualified bond includes an exempt facility bond, defined as any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide a facility specified in section 142. One type of facility specified in section 142(a) is a sewage facility. This section defines the term *sewage facility* for purposes of section 142(a).

(b) *Definitions*—(1) *Sewage facility defined*. A sewage facility is property—

(i) Except as provided in paragraphs (b)(2) and (d) of this section, used for the secondary treatment of wastewater; however, for property treating wastewater reasonably expected to have an average daily raw wasteload concentration of biochemical oxygen demand (BOD) that exceeds 350 milligrams per liter as oxygen (measured at the time the influent enters the facility) (the *BOD limit*), this paragraph (b)(1)(i) applies only to the extent the treatment is for wastewater having an average daily raw wasteload concentration of BOD that does not exceed the BOD limit;

(ii) Used for the preliminary and/or primary treatment of wastewater but only to the extent used in connection with secondary treatment (without regard to the BOD limit described in paragraph (b)(1)(i) of this section);

(iii) Used for the advanced or tertiary treatment of wastewater but only to the extent used in connection with and after secondary treatment;

(iv) Used for the collection, storage, use, processing, or final disposal of—

(A) Wastewater, which property is necessary for such preliminary, primary, secondary, advanced, or tertiary treatment; or

(B) Sewage sludge removed during such preliminary, primary, secondary, advanced, or tertiary treatment (without regard to the BOD limit described in paragraph (b)(1)(i) of this section);

(v) Used for the treatment, collection, storage, use, processing, or final disposal of septage (without regard to the BOD limit described in paragraph (b)(1)(i) of this section); and

(vi) Functionally related and subordinate to property described in this paragraph (b)(1), such as sewage disinfection property.

(2) *Special rules and exceptions*—(i) *Exception to BOD limit*. A facility treating wastewater with an average daily raw wasteload concentration of BOD exceeding the BOD limit will not fail to qualify as a sewage facility described in paragraph (b)(1) of this section to the extent that the failure to satisfy the BOD limit results from the implementation of a federal, state, or local water conservation program (for example, a program designed to promote water use efficiency that results in BOD concentrations beyond the BOD limit).

(ii) *Anti-abuse rule for BOD limit*. A facility does not satisfy the BOD limit if there is any intentional manipulation of the BOD level to circumvent the BOD limit (for example, increasing the volume of water in the wastewater before the influent enters the facility with the intention of reducing the BOD level).

(iii) *Authority of Commissioner*. In appropriate cases upon application to the Commissioner, the Commissioner may determine that facilities employing technologically advanced or innovative treatment processes qualify as sewage facilities if it is demonstrated that these facilities perform functions that are consistent with the definition of sewage facilities described in paragraph (b)(1) of this section.

(3) *Other applicable definitions*—(i) *Advanced or tertiary treatment* means the treatment of wastewater after secondary treatment. Advanced or tertiary treatment ranges from biological treatment extensions to physical-chemical separation techniques such as denitrification, ammonia stripping, carbon adsorption, and chemical precipitation.

(ii) *Nonconventional pollutants* are any pollutants that are not listed in 40 CFR 401.15, 401.16, or appendix A to part 423.

(iii) *Preliminary treatment* means treatment that removes large extraneous matter from incoming wastewater and renders the incoming wastewater more amenable to subsequent treatment and handling.

(iv) *Pretreatment* means a process that preconditions wastewater to neutralize or remove toxic, priority, or nonconventional pollutants that could adversely affect sewers or inhibit a preliminary, primary, secondary, advanced, or tertiary treatment operation.

(v) *Primary treatment* means treatment that removes material that floats or will settle, usually by screens or settling tanks.

(vi) *Priority pollutants* are those pollutants listed in appendix A to 40 CFR part 423.

(vii) *Secondary treatment* means the stage in sewage treatment in which a bacterial process (or an equivalent process) consumes the organic parts of wastes, usually by trickling filters or an activated sludge process.

(viii) *Sewage sludge* is defined in 40 CFR 122.2 and includes septage.

(ix) *Toxic pollutants* are those pollutants listed in 40 CFR 401.15.

(c) *Other property not included in the definition of a sewage facility.* Property other than property described in paragraph (b)(1) of this section is not a sewage facility. Thus, for example, property is not a sewage facility, or functionally related and subordinate property, if the property is used for pretreatment of wastewater (whether or not this treatment is necessary to perform preliminary, primary, secondary, advanced, or tertiary treatment), or the related collection, storage, use, processing, or final disposal of the wastewater. In addition, property used to treat, process, or use wastewater subsequent to the time the wastewater can be discharged into navigable waters, as defined in 33 U.S.C. 1362, is not a sewage facility.

(d) *Allocation of costs.* In the case of property that has both a use described in paragraph (b)(1) of this section (a sewage treatment function) and a use other than sewage treatment, only the portion of the cost of the property allocable to the sewage treatment function is taken into account as an expenditure to provide sewage facilities. The portion of the cost of property allocable to the sewage treatment function is determined by allocating the cost of that property between the property's sewage treatment function and any other uses by any method which, based on all the facts and circumstances, reasonably reflects a separation of costs for each use of the property.

(e) *Effective date*—(1) *In general.* This section applies to issues of bonds issued after February 21, 1995.

(2) *Refundings.* In the case of a refunding bond issued to refund a bond to which this section does not apply, the issuer need not apply this section to that refunding bond. This paragraph (e)(2) applies only if the weighted average maturity of the refunding bonds, as described in section 147(b), is not greater than the remaining weighted average maturity of the refunded bonds.

[T.D. 8576, 59 FR 66163, Dec. 23, 1994, as amended by T.D. 9546, Aug. 19, 2011]

§ 1.142(a)(6)–1 Exempt facility bonds: solid waste disposal facilities.

(a) *In general.* This section defines the term solid waste disposal facility for purposes of section 142(a)(6).

(b) *Solid waste disposal facility.* The term *solid waste disposal facility* means a facility to the extent that the facility—

(1) Processes solid waste (as defined in paragraph (c) of this section) in a qualified solid waste disposal process (as defined in paragraph (d) of this section);

(2) Performs a preliminary function (as defined in paragraph (f) of this section); or

(3) Is functionally related and subordinate (within the meaning of § 1.103–8(a)(3)) to a facility described in paragraph (b)(1) or (b)(2) of this section.

(c) *Solid waste*—(1) *In general.* Except to the extent excluded under paragraph (c)(2) of this section, for purposes of section 142(a)(6), the term *solid waste* means garbage, refuse, and other solid material derived from any agricultural, commercial, consumer, governmental, or industrial operation or activity if the material meets the requirements of both paragraph (c)(1)(i) and paragraph (c)(1)(ii) of this section. For purposes of this section, material is solid if it is solid at ambient temperature and pressure.

(i) *Used material or residual material.* Material meets the requirements of this paragraph (c)(1)(i) if it is either used material (as defined in paragraph (c)(1)(i)(A)) of this section or residual material (as defined in paragraph (c)(1)(i)(B) of this section).

(A) *Used material.* The term *used material* means any material that is a product of any agricultural, commercial, consumer, governmental, or industrial operation or activity, or a component of any such product or activity, and that has been used previously. Used material also includes animal waste produced by animals from a biological process.

(B) *Residual material.* The term *residual material* means material that meets the requirements of this paragraph (c)(1)(i)(B). The material must be a residual byproduct or excess raw material that results from or remains after the completion of any agricultural, commercial, consumer, governmental, or industrial production process or activity or from the provision of any service. In the case of multiple processes constituting an integrated manufacturing or industrial process, the material must result from or remain after the completion of such integrated process. As of the issue date of the bonds used to finance the solid waste disposal facility, the material must be reasonably expected to have a fair market value that is lower than the value of all of the products made in that production process or lower than the value of the service that produces such residual material.

(ii) *Reasonably expected introduction into a qualified solid waste disposal process.* Material meets the requirements of this paragraph (c)(1)(ii) if it is reasonably expected by the person who generates, purchases, or otherwise acquires it to be introduced within a reasonable time after such generation, purchase or acquisition into a qualified solid waste disposal process described in paragraph (d) of this section.

(2) *Exclusions from solid waste.* The following materials do not constitute solid waste:

(i) *Virgin material.* Except to the extent that virgin material constitutes an input to a final disposal process or residual material, solid waste excludes any virgin material. The term *virgin material* means material that has not been processed into an agricultural, commercial, consumer, governmental, or industrial product, or a component of any such product. Further, for this purpose, material continues to be virgin material after it has been grown, harvested, mined, or otherwise extracted from its naturally occurring location and cleaned, divided into component elements, modified, or enhanced, as long as further processing is required before it becomes an agricultural, commercial, consumer, or industrial product, or a component of any such product.

(ii) *Solids within liquids and liquid waste.* Solid waste excludes any solid or dissolved material in domestic sewage or other significant pollutant in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants, and liquid or gaseous waste.

(iii) *Precious metals.* Except to the extent that a precious metal constitutes an input to a final disposal process and/ or an unrecoverable trace of the particular precious metal, solid waste excludes gold, silver, ruthenium, rhodium, palladium, osmium, iridium, platinum, gallium, rhenium, and any other precious metal material as may be identified by the Internal Revenue Service in future public administrative guidance.

(iv) *Hazardous material.* Solid waste excludes any hazardous material that must be disposed of at a facility that is subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act as in effect on the date of the enactment of the Tax Reform Act of 1986 (which is October 22, 1986). See section 142(h)(1) of the Internal Revenue Code for the definition of qualified hazardous waste facilities.

(v) *Radioactive material.* Solid waste excludes any radioactive material subject to regulation under the Nuclear Regulatory Act (10 CFR 1.1 *et seq.*), as in effect on the issue date of the bonds.

(d) *Qualified solid waste disposal process.* The term *qualified solid waste disposal process* means the processing of solid waste in a final disposal process (as defined in paragraph (d)(1) of this section), an energy conversion process (as defined in paragraph (d)(2) of this section), or a recycling process (as defined in paragraph (d)(3) of this section). Absent an express restriction to the contrary in this section, a qualified solid waste disposal process may employ any biological, engineering, industrial, or technological method.

(1) *Final disposal process.* The term *final disposal process* means the placement of solid waste in a landfill (including, for this purpose, the spreading

of solid waste over land in an environmentally compliant and safe manner with no intent to remove such solid waste), the incineration of solid waste without capturing any useful energy, or the containment of solid waste with a reasonable expectation as of the date of issue of the bonds that the containment will continue indefinitely and that the solid waste has no current or future beneficial use.

(2) *Energy conversion process.* The term *energy conversion process* means a thermal, chemical, or other process that is applied to solid waste to create and capture synthesis gas, heat, hot water, steam, or other useful energy. The energy conversion process begins at the point of the first application of such process. The energy conversion process ends at the point at which the useful energy is first created, captured, or incorporated into the form of synthesis gas, heat, hot water, or other useful energy and before any transfer or distribution of such synthesis gas, heat, hot water or other useful energy, regardless of whether such synthesis gas, heat, hot water, or other useful energy constitutes a first useful product within the meaning of paragraph (e) of this section.

(3) *Recycling process*—(i) *In general.* The term *recycling process* means reconstituting, transforming, or otherwise processing solid waste into a useful product. The recycling process begins at the point of the first application of a process to reconstitute or transform the solid waste into a useful product, such as decontamination, melting, repulping, shredding, or other processing of the solid waste to accomplish this purpose. The recycling process ends at the point of completion of production of the first useful product from the solid waste.

(ii) *Refurbishment, repair, or similar activities.* The term *recycling process* does not include refurbishment, repair, or similar activities. The term *refurbishment* means the breakdown and reassembly of a product if such activity is done on a product-by-product basis and if the finished product contains more than 30 percent of its original materials or components.

(e) *First useful product.* The term *first useful product* means the first product produced from the processing of solid waste in a solid waste disposal process that is useful for consumption in agricultural, consumer, commercial, governmental, or industrial operation or activity and that could be sold for such use, whether or not actually sold. A useful product includes both a product useful to an individual consumer as an ultimate end-use consumer product and a product useful to an industrial user as a material or input for processing in some stage of a manufacturing or production process to produce a different end-use consumer product. The determination of whether a useful product has been produced may take into account operational constraints that affect the point in production when a useful product reasonably can be extracted or isolated and sold independently. For this purpose, the costs of extracting, isolating, storing, and transporting the product to a market may only be taken into account as operational constraints if the product is not to be used as part of an integrated manufacturing or industrial process in the same location as that in which the product is produced.

(f) *Preliminary function.* A *preliminary function* is a function to collect, separate, sort, store, treat, process, disassemble, or handle solid waste that is preliminary to and directly related to a qualified solid waste disposal process.

(g) *Mixed-use facilities*—(1) *In general.* If a facility is used for both a qualified solid waste disposal function (including a qualified solid waste disposal process or a preliminary function) and a nonqualified function (a mixed-use facility), then the costs of the facility allocable to the qualified solid waste disposal function are determined using any reasonable method, based on all the facts and circumstances. See §1.103–8(a)(1) for allocation rules on amounts properly allocable to an exempt facility. Facilities qualify as functionally related and subordinate to a qualified solid waste disposal function only to the extent that they are functionally related and subordinate to the portion of the mixed-use facility that is used for one or more qualified solid waste disposal functions (including a qualified solid waste disposal process or a preliminary function).

(2) *Mixed inputs*—(i) *In general.* Except as otherwise provided in paragraph (g)(2)(ii) of this section, for each facility (or a portion of a mixed-use facility) performing a qualified solid waste disposal process or a preliminary function, the percentage of the costs of the property used for such process that are allocable to a qualified solid waste disposal process or a preliminary function cannot exceed the average annual percentage of solid waste processed in that qualified solid waste disposal process or that preliminary function while the issue is outstanding. The annual percentage of solid waste processed in that qualified solid waste disposal process or preliminary function for any year is the percentage, by weight or volume, of the total materials processed in that qualified solid waste disposal process or preliminary function that constitute solid waste for that year.

(ii) *Special rule for mixed-input processes if at least 65 percent of the materials processed are solid waste*—(A) *In general.* Except as otherwise provided in paragraph (g)(2)(ii)(B) of this section, for each facility (or a portion of a mixed-use facility) performing a qualified solid waste disposal process or preliminary function, if the annual percentage of solid waste processed in that qualified solid waste disposal process or preliminary function for each year that the issue is outstanding (beginning with the date such facility is placed in service within the meaning of §1.150–2(c)) equals at least 65 percent of the materials processed in that qualified solid waste disposal process or preliminary function, then all of the costs of the property used for such process are treated as allocable to a qualified solid waste disposal process. The annual percentage of solid waste processed in such qualified solid waste disposal process or preliminary function for any year is the percentage, by weight or volume, of the total materials processed in that qualified solid waste disposal process or preliminary function that constitute solid waste for that year.

(B) *Special rule for extraordinary events.* In the case of an extraordinary event that is beyond the control of the operator of a solid waste disposal facility (such as a natural disaster, strike, major utility disruption, or governmental intervention) and that causes a solid waste disposal facility to be unable to meet the 65 percent test under paragraph (g)(2)(ii)(A) of this section for a particular year, the percentage of solid waste processed for that year equals—

(*1*) The sum of the amount of solid waste processed in the solid waste disposal facility for the year affected by the extraordinary event and the amount of solid waste processed in the solid waste disposal facility during the following two years in excess of the amount required to meet the general 65 percent threshold for the facility during each of such two years; divided by

(*2*) The total materials processed in the solid waste disposal facility during the year affected by the extraordinary event. If the resulting measure of solid waste processed for the year affected by the extraordinary event equals at least 65 percent, then the facility is treated as meeting the requirements of the 65 percent test under paragraph (g)(2)(ii)(A) of this section for such year.

(iii) *Facilities functionally related and subordinate to mixed-input facilities.* Except to the extent that facilities are functionally related and subordinate to a mixed-input facility that meets the 65 percent test under paragraph (g)(2)(ii) of this section, facilities qualify as functionally related and subordinate to a mixed-input facility only to the extent that they are functionally related and subordinate to the qualified portion of the mixed-input facility that is used for one or more qualified solid waste disposal functions (including a qualified solid waste disposal process or a preliminary function).

(h) *Examples.* The following examples illustrate the application of this section:

Example 1. Nonqualified Unused Material—Cloth. Company A takes wool and weaves it into cloth and then sells the cloth to a manufacturer to manufacture clothing. The cloth is material that has not been used previously as a product of or otherwise used in an agricultural, commercial, consumer, governmental, or industrial operation or activity, or as a component of any such product or activity. Accordingly, the cloth is not solid waste.

Example 2. Residual Material—Waste Coal. Company B mines coal. Some of the ore mined is a low quality byproduct of coal mining commonly known as waste coal, which cannot be converted to energy under a normal energy-production process because the BTU content is too low. Waste coal has the lowest fair market value of any product produced in Company B's coal mining process. Waste coal is solid waste because it is residual material within the meaning of paragraph (c)(1)(i)(B) of this section and Company B reasonably expects to introduce the waste coal into a solid waste disposal process.

Example 3. Virgin Material—Logs. Company C cuts down trees and sells the logs to another company, which further processes the logs into lumber. In order to facilitate shipping, Company C cuts the trees into uniform logs. The trees are not solid waste because they are virgin material within the meaning of paragraph (c)(2)(i) of this section that are not being introduced into a final disposal process within the meaning of paragraph (d)(1) of this section. The division of such trees into uniform logs does not change the status of the trees as virgin material.

Example 4. Qualified Solid Waste Disposal Process—Landfill. Company D plans to construct a landfill. The landfill will not be subject to the final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on the date of enactment of the Tax Reform Act of 1986). As of the issue date, Company D expects that the landfill will be filled entirely with material that will qualify as solid waste within the meaning of paragraph (c) of this section. Placing solid waste into a landfill is a qualified solid waste disposal process. The landfill is a qualified solid waste disposal facility.

Example 5. Qualified Solid Waste Disposal Process—Recycling Tires. Company E owns a facility that converts used tires into roadbed material. The used tires are used material within the meaning of paragraph (c)(1)(i)(A) of this section that qualifies as solid waste. Between the introduction of the old tires into the roadbed manufacturing process and the completion of the roadbed material, the facility does not create any interim useful products. The process for the manufacturing of the roadbed material from the old tires is a qualified solid waste disposal process as a recycling process and the facility that converts the tires into roadbed material is a qualified solid waste disposal facility. This conclusion would be the same if the recycling process took place at more than one plant.

Example 6. Qualified Solid Waste Disposal Process—Energy Conversion Process. Company F receives solid waste from a municipal garbage collector. Company F burns that solid waste in an incinerator to remove exhaust gas and to produce heat. Company F further processes the heat in a heat exchanger to produce steam. Company F further processes the steam to generate electricity. The energy conversion process ends with the production of steam. The facilities used to burn the solid waste and to capture the steam as useful energy are qualified solid waste disposal facilities because they process solid waste in an energy conversion process. The generating facilities used to process the steam further to generate electricity are not engaged in the energy conversion process and are not qualified solid waste disposal facilities.

Example 7. Nonqualified Refurbishment. Company G purchases used cars and restores them. This restoration process includes disassembly, cleaning, and repairing of the cars. Parts that cannot be repaired are replaced. The restored cars contain at least 30 percent of the original parts. While the cars are used material, the refurbishing process is not a qualified solid waste disposal process. Accordingly, Company G's facility is not a qualified solid waste disposal facility.

Example 8. Qualified Solid Waste Disposal Facility—First Useful Product Rule—Paper Recycling. (i) Company H employs an integrated process to re-pulp discarded magazines, clean the pulp, and produce retail paper towel products. Operational constraints on Company H's process do not allow for reasonable extraction, isolation, and sale of the cleaned paper pulp independently without degradation of the pulp. Company H further processes the paper pulp into large industrial-sized rolls of paper which are approximately 12 feet in diameter. At this point in the process, Company H could either sell such industrial-sized rolls of paper to another company for further processing to produce retail paper products or it could produce those retail products itself. In general, paper pulp is a useful product that is bought and sold on the market as a material for input into manufacturing or production processes. The discarded magazines are used material within the meaning of paragraph (c)(1)(i)(A) of this section. Company H's facility is engaged in a recycling process within the meaning of paragraph (d)(3) of this section to the extent that it repulps and cleans the discarded magazines generally and further to the extent that it produces industrial-sized rolls of paper under the particular circumstances here. Specifically, taking into account the operational constraints on Company H's facility that limit its ability reasonably to extract, isolate, and sell the paper pulp independently, the first useful products within the meaning of paragraph (e) of this section from Company H's recycling process are the industrial-sized rolls of paper. The portion of Company H's facility that processes the discarded magazines and produces industrial-sized rolls of paper is a qualified solid waste disposal facility, and the portion of Company

H's facility that further processes the industrial-sized rolls of paper into retail paper towels is not a qualified solid waste facility.

(ii) The facts are the same as in paragraph (i) of this *Example 8*, except that Company H is able reasonably to extract the cleaned paper pulp from the process without degradation of the pulp and to sell the cleaned paper pulp at its dock for a price that exceeds its costs of extracting the pulp from the process. Therefore, the paper pulp is the first useful product within the meaning of paragraph (e) of this section. As a result, the portion of Company H's facility that processes the discarded magazines is a qualified solid waste disposal facility, and the portion of Company H's facility that produces industrial-sized rolls of paper is not a qualified solid waste disposal facility. If, however, the only reasonable way Company H could sell the pulp was to transport the pulp to a distant market, then the costs of storing and transporting the pulp to the market may be taken into account in determining whether the pulp is the first useful product.

Example 9. Preliminary Function—Energy Conversion Process. (i) Company I owns a paper mill. At the mill, logs from nearby timber operations are processed through a machine that removes bark. The stripped logs are used to manufacture paper. The stripped bark has the lowest fair market value of any product produced from the paper mill. The stripped bark falls onto a conveyor belt that transports the bark to a storage bin that is used to store the bark briefly until Company I feeds the bark into a boiler. The conveyor belt and storage bin are used only for these purposes. The boiler is used only to create steam by burning the bark, and the steam is used to generate electricity. The stripped bark is solid waste because it is residual material within the meaning of paragraph (c)(1)(i)(B) of this section and Company I expects to introduce the bark into an energy conversion process within a reasonable period of time. The creation of steam from the stripped bark is an energy conversion process that starts with the incineration of the stripped bark. The energy conversion process is a qualified solid waste disposal process. The conveyor belt performs a collection activity that is preliminary and that is directly related to the solid waste disposal function. The storage bin performs a storage function that is preliminary and that is directly related to the solid waste disposal function. Thus, the conveyor belt and storage bin are solid waste disposal facilities. The bark removal process is not a preliminary function because it is not directly related to the energy conversion process and it does not become so related merely because it results in material that is solid waste.

(ii) The facts are the same as in paragraph (i) of this *Example 9*, except that the stripped bark represents only 55 percent by weight and volume of the materials that are transported by the conveyor belt. The remaining 45 percent of the materials transported by the conveyor belt are not solid waste and these other materials are sorted from the conveyor belt by a sorting machine immediately before the stripped bark arrives at the storage bin. Fifty-five percent of the costs of the conveyor belt and the sorting machine are allocable to solid waste disposal functions.

Example 10. Preliminary Function—Final Disposal Process. Company J owns a waste transfer station and uses it to collect, sort, and process solid waste. Company J uses its trucks to haul the solid waste to the nearest landfill. At least 65 percent by weight and volume of the material brought to the transfer station is solid waste. The waste transfer station and the trucks perform functions that are preliminary and directly related to the solid waste disposal function of the landfill. Thus, the waste transfer station and the trucks qualify as solid waste disposal facilities.

Example 11. Mixed-Input Facility. Company K owns an incinerator financed by an issue and uses the incinerator exclusively to burn coal and other solid material to create steam. Each year while the issue is outstanding, 40 percent by volume and 45 percent by weight of the solid material that Company K processes in the conversion process is coal. The remainder of the solid material is either used material or residual material within the meaning of paragraph (c)(1)(i) of this section. Sixty percent of the costs of the property used to perform the energy conversion process are allocable to a solid waste disposal function.

(i) *Effective/Applicability Dates*—(1) *In general.* Except as otherwise provided in this paragraph (i), this section applies to bonds to which section 142 applies that are sold on or after October 18, 2011.

(2) *Elective retroactive application.* Issuers may apply this section, in whole, but not in part, to outstanding bonds to which section 142 applies and which were sold before October 18, 2011.

(3) *Certain refunding bonds.* An issuer need not apply this section to bonds that are issued in a current refunding to refund bonds to which this section does not apply if the weighted average maturity of the refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.

[T.D. 9546, 76 FR 51881, Aug. 19, 2011; 76 FR 55255, Sept. 7, 2011]

§ 1.142(f)(4)–1 Manner of making election to terminate tax-exempt bond financing.

(a) *Overview.* Section 142(f)(4) permits a person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and that expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and (f) to make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must meet the requirements of paragraphs (b) and (c) of this section.

(b) *Time for making election*—(1) *In general.* An election under section 142(f)(4)(B) must be filed with the Internal Revenue Service on or before 90 days after the date of the service area expansion that causes bonds to cease to meet the requirements of sections 142(a)(8) and (f).

(2) *Date of service area expansion.* For the purposes of this section, the date of the service area expansion is the first date on which the local furnisher is authorized to collect revenue for the provision of service in the expanded area.

(c) *Manner of making election.* An election under section 142(f)(4)(B) must be captioned ''ELECTION TO TERMINATE TAX-EXEMPT BOND FINANCING'', must be signed under penalties of perjury by a person who has authority to sign on behalf of the local furnisher, and must contain the following information—

(1) The name of the local furnisher;

(2) The tax identification number of the local furnisher;

(3) The complete address of the local furnisher;

(4) The date of the service area expansion;

(5) Identification of each bond issue subject to the election, including the complete name of each issue, the tax identification number of each issuer, the report number of the information return filed under section 149(e) for each issue, the issue date of each issue, the CUSIP number (if any) of the bond with the latest maturity of each issue, the issue price of each issue, the adjusted issue price of each issue as of the date of the election, the earliest date on which the bonds of each issue may be redeemed, and the principal amount of bonds of each issue to be redeemed on the earliest redemption date;

(6) A statement that the local furnisher making the election agrees to the conditions stated in section 142(f)(4)(B); and

(7) A statement that each issuer of the bonds subject to the election has received written notice of the election.

(d) *Effect on section 150(b).* Except as provided in paragraph (e) of this section, if a local furnisher files an election within the period specified in paragraph (b) of this section, section 150(b) does not apply to bonds identified in the election during and after that period.

(e) *Effect of failure to meet agreements.* If a local furnisher fails to meet any of the conditions stated in an election pursuant to paragraph (c)(6) of this section, the election is invalid.

(f) *Corresponding provisions of the Internal Revenue Code of 1954.* Section 103(b)(4)(E) of the Internal Revenue Code of 1954 set forth corresponding requirements for the exclusion from gross income of the interest on bonds issued for facilities for the local furnishing of electric energy or gas. For the purposes of this section any reference to sections 142(a)(8) and (f) of the Internal Revenue Code of 1986 includes a reference to the corresponding portion of section 103(b)(4)(E) of the Internal Revenue Code of 1954.

(g) *Effective dates.* This section applies to elections made on or after January 19, 2001.

[T.D. 8941, 66 FR 4671, Jan. 18, 2001]

§ 1.143(g)–1 Requirements related to arbitrage.

(a) *In general.* Under section 143, for an issue to be an issue of qualified mortgage bonds or qualified veterans' mortgage bonds (together, mortgage revenue bonds), the requirements of section 143(g) must be satisfied. An issue satisfies the requirements of section 143(g) only if such issue meets the requirements of paragraph (b) of this section and, in the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, such issue also meets the requirements of paragraph (c) of this section. The requirements of section 143(g) and this section are applicable in addition to the requirements of section 148 and §§ 1.148–0 through 1.148–11.

(b) *Effective rate of mortgage interest not to exceed bond yield by more than 1.125 percentage points*—(1) *Maximum yield.* An issue shall be treated as meeting the requirements of this paragraph (b) only if the excess of the effective rate of interest on the mortgages financed by the issue, over the yield on the issue, is not greater over the term of the issue than 1.125 percentage points.

(2) *Effective rate of interest.* (i) In determining the effective rate of interest on any mortgage for purposes of this paragraph (b), there shall be taken into account all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or to the bond issue. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

(ii) Items that shall be treated as borne by the mortgagor and shall be taken into account in calculating the effective rate of interest also include—

(A) All points, commitment fees, origination fees, or similar charges borne by the seller of the property; and

(B) The excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property when owner-financing is not provided through the use of mortgage revenue bonds.

(iii) The following items shall not be treated as borne by the mortgagor and shall not be taken into account in calculating the effective rate of interest—

(A) Any expected rebate of arbitrage profit under paragraph (c) of this section; and

(B) Any application fee, survey fee, credit report fee, insurance charge or similar settlement or financing cost to the extent such amount does not exceed amounts charged in the area in cases when owner-financing is not provided through the use of mortgage revenue bonds. For example, amounts paid for Federal Housing Administration, Veterans' Administration, or similar private mortgage insurance on an individual's mortgage, or amounts paid for pool mortgage insurance on a pool of mortgages, are not taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage, or pool of mortgages, that is not financed with mortgage revenue bonds. For this purpose, amounts paid for pool mortgage insurance include amounts paid to an entity (for example, the Government National Mortgage Association, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation, or other mortgage insurer) to directly guarantee the pool of mortgages financed with the bonds, or to guarantee a pass-through security backed by the pool of mortgages financed with the bonds.

(C) The following example illustrates the provisions of this paragraph (b)(2)(iii):

Example. Housing Authority X issues bonds intended to be qualified mortgage bonds under section 143(a). At the time the bonds are issued, X enters into an agreement with a group of mortgage lending institutions (lenders) under which the lenders agree to originate and service mortgages that meet certain specified requirements. After originating a specified amount of mortgages, each lender issues a ''pass-though security'' (each, a PTS) backed by the mortgages and sells the PTS to X. Under the terms of the PTS, the lender pays X an amount equal to the regular monthly payments on the mortgages (less certain fees), whether or not received by the lender (plus any prepayments and liquidation proceeds in the event of a foreclosure or other disposition of any mortgages). FNMA guarantees the timely payment of principal and interest on each PTS. From the payments received from each mortgagor, the lender pays a fee to FNMA for its guarantee of the PTS. The amounts paid to FNMA do not exceed the amounts charged in the area with respect to a similar pool of mortgages that is not financed with mortgage revenue bonds. Under this paragraph (b)(2)(iii), the fees for the guarantee provided by FNMA are an insurance charge because the guarantee is pool mortgage insurance. Because the amounts charged for the guarantee do not exceed the amounts charged in the area with respect to a similar pool of mortgages that is not financed with mortgage revenue bonds, the amounts charged for the guarantee are not taken into account in computing the effective rate of interest on the mortgages financed with X's bonds.

(3) *Additional rules.* To the extent not inconsistent with the Tax Reform Act of 1986, Public Law 99–514 (the 1986 Act), or subsequent law, §6a.103A–2(i)(2) (other than paragraphs (i)(2)(i) and (i)(2)(ii)(A) through (C)) of this chapter applies to provide additional rules relating to compliance with the requirement that the effective rate of mortgage interest not exceed the bond yield by more than 1.125 percentage points.

(c) *Arbitrage and investment gains to be used to reduce costs of owner-financing.* As provided in section 143(g)(3), certain earnings on nonpurpose investments must either be paid or credited to mortgagors, or paid to the United States, in certain circumstances. To the extent not inconsistent with the 1986 Act or subsequent law, §6a.103A–2(i)(4) of this chapter applies to provide guidance relating to compliance with this requirement.

(d) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, §1.143(g)–1 applies to bonds sold on or after May 23, 2005, that are subject to section 143.

(2) *Permissive retroactive application in whole.* Except as provided in paragraph (d)(4) of this section, issuers may apply §1.143(g)–1, in whole, but not in part, to bonds sold before May 23, 2005, that are subject to section 143.

(3) *Bonds subject to the Internal Revenue Code of 1954.* Except as provided in paragraph (d)(4) of this section and subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply §1.143(g)–1, in whole, but not in part, to bonds that are subject to section 103A(i) of the Internal Revenue Code of 1954.

(4) *Special rule for pre-July 1, 1993 bonds.* To the extent that an issuer applies this section to bonds issued before July 1, 1993, §6a.103A–2(i)(3) of this chapter also applies to the bonds.

[T.D. 9204, 70 FR 29449, May 23, 2005]

§ 1.144–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.144–1 and 1.144–2.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.144–1 Qualified small issue bonds, qualified student loan bonds, and qualified redevelopment bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(D), a qualified small issue bond issued under section 144(a) may be a qualified bond. Under section 144(a), any qualified small issue bond is any bond issued as a part of an issue 95 percent or more of the proceeds of which are to be used to provide certain manufacturing facilities or certain depreciable farm property and which meets other requirements. Under section 141(e)(1)(F) a qualified redevelopment bond issued under section 144(c) is a qualified bond. Under section 144(c), a qualified redevelopment bond is any bond issued as a part of an issue 95 percent or more of the net proceeds of which are to be used for one or more redevelopment purposes and which meets certain other requirements.

(b) *Scope.* Sections 1.144–0 through 1.144–2 apply for purposes of the rules for small issue bonds under section 144(a) and qualified redevelopment bonds under section 144(c), except that §1.144–2 does not apply to the requirements for qualified small issue bonds under section 144(a)(4) (relating to the limitation on capital expenditures) or under section 144(a)(10) (relating to the aggregate limit of tax-exempt bonds per taxpayer).

(c) *Effective dates.* For effective dates of §§1.144–0 through 1.144–2, see §1.141–16.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.144–2 Remedial actions.

The remedial action rules of §1.142–2 apply to qualified small issue bonds issued under section 144(a) and to qualified redevelopment bonds issued under section 144(c), for this purpose treating those bonds as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.145–0 Table of contents.

This section lists the captioned paragraphs contained in §§ 1.145–1 and 1.145–2.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997, as amended by T.D. 9234, 70 FR 75035, Dec. 19, 2005]

§ 1.145–1 Qualified 501(c)(3) bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(G), a qualified 501(c)(3) bond issued under section 145 is a qualified bond. Under section 145, a qualified 501(c)(3) bond is any bond issued as a part of an issue that satisfies the requirements of sections 145(a) through (d).

(b) *Scope.* Sections 1.145–0 through 1.145–2 apply for purposes of section 145(a).

(c) *Effective dates.* For effective dates of §§ 1.145–0 through 1.145–2, see § 1.141–15.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.145–2 Application of private activity bond regulations.

(a) *In general.* Except as provided in this section, §§ 1.141–0 through 1.141–15 apply to section 145(a). For example, under this section, § 1.141–1, and § 1.141–2, an issue ceases to be an issue of qualified 501(c)(3) bonds if the issuer or a conduit borrower 501(c)(3) organization takes a deliberate action, subsequent to the issue date, that causes the issue to fail to comply with the requirements of sections 141(e) and 145 (such as an action that results in revocation of exempt status of the 501(c)(3) organization).

(b) *Modification of private business tests.* In applying §§ 1.141–0 through 1.141–15 to section 145(a)—

(1) References to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under section 513(a);

(2) References to "10 percent" and "proceeds" in the context of the private business use test and the private security or payment test mean "5 percent" and "net proceeds"; and

(3) References to the private business use test in §§ 1.141–2 and 1.141–12 include the ownership test of section 145(a)(1).

(4) References to *governmental bonds* in § 1.141–6 mean qualified 501(c)(3) bonds.

(5) References to *ownership by governmental persons* in § 1.141–6 mean ownership by governmental persons or 501(c)(3) organizations.

(c) *Exceptions*—(1) *Certain provisions relating to governmental programs.* The following provisions do not apply to section 145: § 1.141–2(d)(4) (relating to the special rule for dispositions of personal property in the ordinary course of an established governmental program) and § 1.141–2(d)(5) (relating to the special rule for general obligation bond programs that finance a large number of separate purposes).

(2) *Costs of issuance.* Sections 1.141–3(g)(6) and 1.141–6(d) do not apply to the extent costs of issuance are allocated among the other purposes for which the proceeds are used or to portions of a project. For purposes of section 145(a)(2), costs of issuance are treated as private business use.

(d) *Issuance costs financed by prior issue.* Solely for purposes of applying the private business use test to a refunding issue under § 1.141–13, the use of proceeds of the prior issue (or any earlier issue in a series of refundings) to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997, as amended by T.D. 9234, 70 FR 75035, Dec. 19, 2005; T.D. 9741, 80 FR 65646, Oct. 27, 2015]

§ 1.147–0 Table of contents.

This section lists the captioned paragraphs contained in §§ 1.147–1 and 1.147–2.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147–1 Other requirements applicable to certain private activity bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 147, certain requirements must be met for a private activity bond to qualify as a qualified bond.

(b) *Scope.* Sections 1.147–0 through 1.147–2 apply for purposes of the rules in section 147 for qualified private activity bonds that permit use of proceeds to acquire land for environmental purposes (section 147(c)(3)), permit use of proceeds for certain rehabilitations (section 147(d) (2) and (3)), prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (section 147(e)), and require public approval (section 147(f)), but not for the rules limiting use of proceeds to acquire land or existing property under sections 147(c) (1) and (2), and (d)(1).

(c) *Effective dates.* For effective dates of §§ 1.147–0 through 1.147–2, see § 1.141–16.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147–2 Remedial actions.

The remedial action rules of § 1.142–2 apply to the rules in section 147 for qualified private activity bonds that permit use of proceeds to acquire land for environmental purposes (section 147(c)(3)), permit use of proceeds for certain rehabilitations (section 147(d) (2) and (3)), prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (section 147(e)), and require public approval (section 147(f)), for this purpose treating those private activity bonds subject to the rules under section 147 as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147(b)–1 Bond maturity limitation-treatment of working capital.

Section 147(b) does not apply to proceeds of a private activity bond issue used to finance working capital expenditures.

[T.D. 8476, 58 FR 33515, June 18, 1993]

§ 1.147(f)–1 Public approval of private activity bonds.

(a) *In general.* Interest on a private activity bond is excludable from gross income under section 103(a) only if the bond meets the requirements for a qualified bond as defined in section 141(e) and other applicable requirements provided in section 103. In order to be a qualified bond as defined in section 141(e), among other requirements, a private activity bond must meet the requirements of section 147(f). A private activity bond meets the requirements of section 147(f) only if the bond is publicly approved pursuant to paragraph (b) of this section or the bond qualifies for the exception for refunding bonds in section 147(f)(2)(D).

(b) *Public approval requirement*—(1) *In general.* Except as otherwise provided in this section, a bond meets the requirements of section 147(f) if, before the issue date, the issue of which the bond is a part receives issuer approval and host approval (each a *public approval*) as defined in paragraphs (b)(2) and (3) of this section in accordance with the method and process set forth in paragraphs (c) through (f) of this section.

(2) *Issuer approval.* Except as otherwise provided in this section, *issuer approval* means an approval that meets the requirements of this paragraph (b)(2). Either the governmental unit that issues the issue or the governmental unit on behalf of which the issue is issued must approve the issue. For this purpose, § 1.103–1 applies to the determination of whether an issuer issues bonds on behalf of another governmental unit. If an issuer issues

bonds on behalf of more than one governmental unit (for example, in the case of an authority that acts for two counties), any one of those governmental units may provide the issuer approval.

(3) *Host approval.* Except as otherwise provided in this section, *host approval* means an approval that meets the requirements of this paragraph (b)(3). Each governmental unit the geographic jurisdiction of which contains the site of a project to be financed by the issue must approve the issue. If, however, the entire site of a project to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of those governmental units may provide host approval for the issue for that project. For purposes of the host approval, if a project to be financed by the issue is located within the geographic jurisdiction of two or more governmental units but not entirely within any one of those governmental units, each portion of the project that is located entirely within the geographic jurisdiction of the respective governmental units may be treated as a separate project. The issuer approval provided pursuant to paragraph (b)(2) of this section may be treated as a host approval if the governmental unit providing the issuer approval is also a governmental unit eligible to provide the host approval pursuant to this section.

(4) *Special rule for host approval of airports or high-speed intercity rail facilities.* Pursuant to a special rule in section 147(f)(3), if the proceeds of an issue are to be used to finance a project that consists of either facilities located at an airport (within the meaning of section 142(a)(1)) or high-speed intercity rail facilities (within the meaning of section 142(a)(11)) and the issuer of that issue is the owner or operator of the airport or high-speed intercity rail facilities, the issuer is the only governmental unit that is required to provide the host approval for that project.

(5) *Special rule for issuer approval of scholarship funding bond issues and volunteer fire department bond issues.* In the case of a qualified scholarship funding bond as defined in section 150(d)(2), the governmental unit that made a request described in section 150(d)(2)(B) with respect to the issuer of the bond is the governmental unit on behalf of which the bond was issued for purposes of the issuer approval. If more than one governmental unit within a State made a request described in section 150(d)(2)(B), the State or any such requesting governmental unit may be treated as the governmental unit on behalf of which the bond was issued for purposes of the issuer approval. In the case of a bond of a volunteer fire department treated as a bond of a political subdivision of a State under section 150(e), the political subdivision described in section 150(e)(2)(B) with respect to that volunteer fire department is the governmental unit on behalf of which the bond is issued for purposes of the issuer approval.

(6) *Special rules for host approval of mortgage revenue bonds, student loan bonds, and certain qualified 501(c)(3) bonds.* In the case of a mortgage revenue bond (as defined in paragraph (g)(5) of this section), a qualified student loan bond as defined in section 144(b), and the portion of an issue of qualified 501(c)(3) bonds as defined in section 145 that finances working capital expenditures, the issue or portion of the issue must receive an issuer approval but no host approval is necessary. See also paragraph (f)(5) of this section, providing certain optional alternative special rules for certain qualified 501(c)(3) bonds for pooled loan financings described in section 147(b)(4)(B).

(c) *Method of public approval.* The method of public approval of an issue must satisfy either paragraph (c)(1) or (2) of this section. An approval may satisfy the requirements of this paragraph (c) without regard to the authority under State or local law for the acts constituting that approval.

(1) *Applicable elected representative.* An applicable elected representative of the approving governmental unit approves the issue following a public hearing for which there was reasonable public notice.

(2) *Voter referendum.* A voter referendum of the approving governmental unit approves the issue.

(d) *Public hearing and reasonable public notice*—(1) *Public hearing. Public hearing* means a forum providing a reasonable opportunity for interested individuals to express their views, orally or in writing, on the proposed issue of bonds and the location and nature of the proposed project to be financed.

(2) *Location of the public hearing.* The public hearing must be held in a location that, based on the facts and circumstances, is convenient for residents of the approving governmental unit. The location of the public hearing is presumed convenient for residents of the unit if the public hearing is located in the approving governmental unit's capital or seat of government. If more than one governmental unit is required to hold a public hearing, the hearings may be combined as long as the combined hearing affords the residents of all of the participating governmental units a reasonable opportunity to be heard. The location of any combined hearing is presumed convenient for residents of each participating governmental unit if it is no farther than 100 miles from the seat of government of each participating governmental unit beyond whose geographic jurisdiction the hearing is conducted.

(3) *Procedures for conducting the public hearing.* In general, a governmental unit may select its own procedure for a public hearing, provided that interested individuals have a reasonable opportunity to express their views. Thus, a governmental unit may impose reasonable requirements on persons who wish to participate in the hearing, such as a requirement that persons desiring to speak at the hearing make a written request to speak at least 24 hours before the hearing or that they limit their oral remarks to a prescribed time. For this purpose, it is unnecessary, for example, that the applicable elected representative of the approving governmental unit be present at the hearing, that a report on the hearing be submitted to that applicable elected representative, or that State administrative procedural requirements for public hearings be observed. Except to the extent State procedural requirements for public hearings are in conflict with a specific requirement of this section, a public hearing performed in compliance with State procedural requirements satisfies the requirements for a public hearing in this paragraph (d). A public hearing may be conducted by an individual appointed or employed to perform such function by the governmental unit or its agencies, or by the issuer. Thus, for example, for bonds to be issued by an authority that acts on behalf of a county, the hearing may be conducted by the authority, the county, or an appointee of either.

(4) *Reasonable public notice. Reasonable public notice* means notice that is reasonably designed to inform residents of an approving governmental unit, including the issuing governmental unit and the governmental unit in whose geographic jurisdiction a project is to be located, of the proposed issue. The notice must state the time and place for the public hearing and contain the information required by paragraph (f)(2) of this section. Notice is presumed to be reasonably designed to inform residents of an approving governmental unit if it satisfies the requirements of this paragraph (d)(4) and is given no fewer than seven (7) calendar days before the public hearing in one or more of the ways set forth in paragraphs (d)(4)(i) through (iv) of this section.

(i) *Newspaper publication.* Public notice may be given by publication in one or more newspapers of general circulation available to the residents of the governmental unit.

(ii) *Radio or television broadcast.* Public notice may be given by radio or television broadcast to the residents of the governmental unit.

(iii) *Governmental unit website posting.* Public notice may be given by electronic posting on the approving governmental unit's primary public website in an area of that website used to inform its residents about events affecting the residents (for example, notice of public meetings of the governmental unit). In the case of an issuer approval of an issue issued by an on-behalf-of issuer that acts on behalf of a governmental unit, such notice may be posted on the public website of the on-behalf-of issuer as an alternative to the public website of the approving governmental unit.

(iv) *Alternative State law public notice procedures.* Public notice may be given in a way that is permitted under a general State law for public notices for public hearings for the approving governmental unit, provided that the public notice is reasonably accessible.

(e) *Applicable elected representative*—(1) *In general*—(i) *Definition of applicable elected representative.* The *applicable elected representative* of a governmental unit means—

(A) The governmental unit's elected legislative body;

(B) The governmental unit's chief elected executive officer;

(C) In the case of a State, the chief elected legal officer of the State's executive branch of government; or

(D) Any official elected by the voters of the governmental unit and designated for purposes of this section by the governmental unit's chief elected executive officer or by State or local law to approve issues for the governmental unit.

(ii) *Elected officials.* For purposes of paragraphs (e)(1)(i)(B), (C), and (D) of this section, an official is considered elected only if that official is popularly elected at-large by the voters of the governmental unit. If an official popularly elected at-large by the voters of a governmental unit is appointed or selected pursuant to State or local law to be the chief executive officer of the unit, that official is deemed to be an elected chief executive officer for purposes of this section but for no longer than the official's tenure as an official popularly elected at-large.

(iii) *Legislative bodies.* In the case of a bicameral legislature that is popularly elected, both chambers together constitute an applicable elected representative. Absent designation under paragraph (e)(1)(i)(D) of this section, however, neither such chamber independently constitutes an applicable elected representative. If multiple elected legislative bodies of a governmental unit have independent legislative authority, the body with the more specific authority relating to the issue is the only legislative body that is treated as an elected legislative body under paragraph (e)(1)(i)(A) of this section.

(2) *Governmental unit with no applicable elected representative*—(i) *In general.* The applicable elected representatives of a governmental unit with no applicable elected representative (but for this paragraph (e)(2) and section 147(f)(2)(E)(ii)) are the applicable elected representatives of the next higher governmental unit (with an applicable elected representative) from which the governmental unit derives its authority. Except as otherwise provided in this section, any governmental unit from which the governmental unit with no applicable elected representative derives its authority may be treated as the next higher governmental unit without regard to the relative status of such higher governmental unit under State law. A governmental unit derives its authority from another governmental unit that—

(A) Enacts a specific law (for example, a provision in a State constitution, charter, or statute) by or under which the governmental unit is created;

(B) Otherwise empowers or approves the creation of the governmental unit; or

(C) Appoints members to the governing body of the governmental unit.

(ii) *Host approval.* For purposes of a host approval, a governmental unit may be treated as the next higher governmental unit only if the project is located within its geographic jurisdiction and eligible residents of the unit are entitled to vote for its applicable elected representatives.

(3) *On behalf of issuers.* In the case of an issuer that issues bonds on behalf of a governmental unit, the applicable elected representative is any applicable elected representative of the governmental unit on behalf of which the bonds are issued.

(f) *Public approval process*—(1) *In general.* The public approval process for an issue, including scope, content, and timing of the public approval, must meet the requirements of this paragraph (f). A governmental unit must timely approve either each project to be financed with proceeds of the issue or a plan of financing for each project to be financed with proceeds of the issue.

(2) *General rule on information required for a reasonable public notice and public approval.* Except as otherwise provided in this section, a project to be financed

with proceeds of an issue is within the scope of a public approval under section 147(f) if the reasonable public notice of the public hearing, if applicable, and the public approval (together the notice and approval) include the information set forth in paragraphs (f)(2)(i) through (iv) of this section.

(i) *The project.* The notice and approval must include a general functional description of the type and use of the project to be financed with the issue. For this purpose, a project description is sufficient if it identifies the project by reference to a particular category of exempt facility bond to be issued (for example, an exempt facility bond for an airport pursuant to section 142(a)(1)) or by reference to another general category of private activity bond together with information on the type and use of the project to be financed with the issue (for example, a qualified small issue bond as defined in section 144(a) for a manufacturing facility or a qualified 501(c)(3) bond as defined in section 145 for a hospital facility and working capital expenditures).

(ii) *The maximum stated principal amount of the issue.* The notice and approval must include the maximum stated principal amount of the issue of private activity bonds to be issued to finance the project or projects. If an issue finances multiple projects (for example, facilities at different locations on non-proximate sites that are not treated as part of the same project), the notice and approval must specify separately the maximum stated principal amount of bonds to be issued to finance each separate project to be financed as part of the issue. The maximum stated principal amount of bonds to be issued to finance a project may be determined on any reasonable basis and may take into account contingencies, without regard to whether the occurrence of any such contingency is reasonably expected at the time of the notice.

(iii) *The name of the initial legal owner or principal user of the project.* The notice and approval must include the name of either the expected initial legal owner or principal user (within the meaning of section 144(a)) of the project or, alternatively, the name of a significant true beneficial party of interest for such legal owner or user (for example, the name of a section 501(c)(3) organization that is the sole member of a limited liability company that is the legal owner or the name of a general partner of a partnership that owns the project).

(iv) *The location of the project.* The notice and approval must include a general description of the prospective location of the project by street address, reference to boundary streets or other geographic boundaries, or other description of the specific geographic location that is reasonably designed to inform readers of the location. For a project involving multiple capital projects or facilities located on the same site, or on adjacent or reasonably proximate sites with similar uses, a consolidated description of the location of those capital projects or facilities provides a sufficient description of the location of the project. For example, a project for a section 501(c)(3) educational entity involving multiple buildings on the entity's main urban college campus may describe the location of the project by reference to the outside street boundaries of that campus with a reference to any noncontiguous features of that campus.

(3) *Special rule for mortgage revenue bonds.* Mortgage loans financed by mortgage revenue bonds are within the scope of a public approval if the notice and approval state that the bonds are to be issued to finance residential mortgages, provide the maximum stated principal amount of mortgage revenue bonds expected to be issued, and provide a general description of the geographic jurisdiction in which the residences to be financed with the proceeds of the mortgage revenue bonds are expected to be located (for example, residences located throughout a State for an issuer with a statewide jurisdiction or residences within a particular local geographic jurisdiction, such as within a city or county, for a local issuer). For this purpose, in the case of mortgage revenue bonds, no information is required on specific names of mortgage loan borrowers or specific locations of individual residences to be financed.

(4) *Special rule for qualified student loan bonds.* Qualified student loans financed by qualified student loan bonds

as defined in section 144(b) are within the scope of a public approval if the notice and approval state that the bonds will be issued to finance student loans and state the maximum stated principal amount of qualified student loan bonds expected to be issued for qualified student loans. For this purpose, in the case of qualified student loan bonds, no information is required with respect to names of specific student loan borrowers.

(5) *Special rule for certain qualified 501(c)(3) bonds.* Qualified 501(c)(3) bonds issued pursuant to section 145 for pooled loan financings that are described in section 147(b)(4)(B) (without regard to any election under section 147(b)(4)(A)) are within the scope of a public approval if the public approval either meets the general requirements of paragraph (b) of this section or, alternatively, at the issuer's option, meets the special requirements of paragraphs (f)(5)(i) and (ii) of this section.

(i) *Pre-issuance issuer approval.* Within the time period required by paragraph (f)(7) of this section, an issuer approval is obtained after reasonable public notice of a public hearing is provided and a public hearing is held. For this purpose, a project is treated as described in the notice and approval if the notice and approval provide that the bonds will be qualified 501(c)(3) bonds to be used to finance loans described in section 147(b)(4)(B), state the maximum stated principal amount of bonds expected to be issued to finance loans to section 501(c)(3) organizations or governmental units as described in section 147(b)(4)(B), provide a general description of the type of project to be financed with such loans (for example, loans for hospital facilities or college facilities), and state that an additional public approval that includes specific project information will be obtained before any such loans are originated.

(ii) *Post-issuance public approval for specific loans.* Before a loan described in section 147(b)(4)(B) is originated, a supplemental public approval, including issuer approval and host approval, for the bonds to be used to finance that loan is obtained that meets all the requirements of section 147(f) and the requirements for a public approval in paragraph (b) of this section. This post-issuance supplemental public approval requirement applies by treating the bonds to be used to finance such loan as if they were reissued for purposes of section 147(f) (without regard to paragraph (f)(5) of this section). For this purpose, proceeds to be used to finance such loan do not include the portion of the issue used to finance a common reserve fund or common costs of issuance.

(6) *Deviations in public approval information*—(i) *In general.* Except as otherwise provided in this section, a substantial deviation between the stated use or amount of proceeds of an issue included in the information required to be provided in the notice and approval (*public approval information*) and the actual use or amount of proceeds of the issue causes that issue to fail to meet the public approval requirement. Conversely, insubstantial deviations between the stated use or amount of proceeds of an issue included in the public approval information and the actual use or amount of proceeds of the issue do not cause such a failure. In general, the determination of whether a deviation is substantial is based on all the facts and circumstances. In all events, however, a change in the fundamental nature or type of a project is a substantial deviation.

(ii) *Certain insubstantial deviations in public approval information.* The following deviations from the public approval information in the notice and approval are treated as insubstantial deviations:

(A) *Size of bond issue and use of proceeds.* A deviation between the maximum stated principal amount of a proposed issuance of bonds to finance a project that is specified in public approval information and the actual stated principal amount of bonds issued and used to finance that project is an insubstantial deviation if that actual stated principal amount is no more than ten percent (10%) greater than that maximum stated principal amount or is any amount less than that maximum stated principal amount. In addition, the use of proceeds to pay working capital expenditures directly associated with any project specified in the public approval information is an insubstantial deviation.

(B) *Initial legal owner or principal user*. A deviation between the initial legal owner or principal user of the project named in the notice and approval and the actual initial legal owner or principal user of the project is an insubstantial deviation if such parties are related parties on the issue date of the issue.

(iii) *Supplemental public approval to cure certain substantial deviations in public approval information*. A substantial deviation between the stated use or amount of proceeds of an issue included in the public approval information and the actual use or amount of the proceeds of the issue does not cause that issue to fail to meet the public approval requirement if all of the following requirements are met:

(A) *Original public approval and reasonable expectations*. The issue met the requirements for a public approval in paragraph (b) of this section. In addition, on the issue date of the issue, the issuer reasonably expected there would be no substantial deviations between the stated use or amount of proceeds of an issue included in the public approval information and the actual use or amount of the proceeds of the issue.

(B) *Unexpected events or unforeseen changes in circumstances*. As a result of unexpected events or unforeseen changes in circumstances that occur after the issue date of the issue, the issuer determines to use proceeds of the issue in a manner or amount not provided in a public approval.

(C) *Supplemental public approval*. Before using proceeds of the bonds in a manner or amount not provided in a public approval, the issuer obtains a supplemental public approval for those bonds that meets the public approval requirement in paragraph (b) of this section. This supplemental public approval requirement applies by treating those bonds as if they were reissued for purposes of section 147(f).

(7) *Certain timing requirements*. Public approval of an issue is timely only if the issuer obtains the public approval within one year before the issue date of the issue. Public approval of a plan of financing is timely only if the issuer obtains public approval for the plan of financing within one year before the issue date of the first issue issued under the plan of financing and the issuer issues all issues under the plan of financing within three years after the issue date of such first issue.

(g) *Definitions*. The definitions in this paragraph (g) apply for purposes of this section. In addition, the general definitions in §1.150–1 apply for purposes of this section.

(1) *Geographic jurisdiction* means the area encompassed by the boundaries prescribed by State or local law for a governmental unit or, if there are no such boundaries, the area in which a unit may exercise such sovereign powers that make that unit a governmental unit for purposes of §1.103–1 and this section.

(2) *Governmental unit* has the meaning of ‘‘State or local governmental unit’’ as defined in §1.103–1. Thus, a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

(3) *Host approval* is defined in paragraph (b)(3) of this section.

(4) *Issuer approval* is defined in paragraph (b)(2) of this section.

(5) *Mortgage revenue bonds* mean qualified mortgage bonds as defined in section 143(a), qualified veterans' mortgage bonds as defined in section 143(b), or refunding bonds issued to finance mortgages of owner-occupied residences pursuant to applicable law in effect prior to enactment of section 143(a) or section 143(b).

(6) *Proceeds* means ‘‘proceeds’’ as defined in §1.141–1(b), except that it does not include disposition proceeds.

(7) *Project* generally means one or more capital projects or facilities, including land, buildings, equipment, and other property, to be financed with an issue, that are located on the same site, or adjacent or proximate sites used for similar purposes, and that are subject to the public approval requirement of section 147(f). Capital projects or facilities that are not located on the same site or adjacent or proximate sites may be treated as one project if those capital projects or facilities are used in an integrated operation. For an issue of mortgage revenue bonds or an issue of qualified student loan bonds as

defined in section 144(b), the term project means the mortgage loans or qualified student loans to be financed with the proceeds of the issue. For an issue of qualified 501(c)(3) bonds as defined in section 145, the term project means a project as defined in the first sentence of this definition, and also is deemed to include working capital expenditures to be financed with proceeds of the issue.

(8) *Public approval information* is defined in paragraph (f)(6)(i) of this section.

(9) *Public hearing* is defined in paragraph (d)(1) of this section.

(10) *Reasonable public notice* is defined in paragraph (d)(4) of this section.

(11) *Voter referendum* means a vote by the voters of the affected governmental unit conducted in the same manner and time as voter referenda on matters relating to governmental spending or bond issuances by the governmental unit under applicable State and local law.

(h) *Applicability date.* This section applies to bonds issued pursuant to a public approval occurring on or after April 1, 2019. For bonds issued pursuant to a public approval occurring before April 1, 2019, see §5f.103–2 as contained in 26 CFR part 5f, revised as of April 1, 2018. In addition, an issuer may apply the provisions of paragraph (f)(6) of this section in whole, but not in part, to bonds issued pursuant to a public approval occurring before April 1, 2019.

[T.D. 9845, 83 FR 67690, Dec. 31, 2018]

§ 1.148–0 Scope and table of contents.

(a) *Overview.* Under section 103(a), interest on certain obligations issued by States and local governments is excludable from the gross income of the owners. Section 148 was enacted to minimize the arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. To accomplish these purposes, section 148 restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that certain earnings on higher yielding investments be rebated to the United States. Violation of these provisions causes the bonds in the issue to become *arbitrage bonds*, the interest on which is not excludable from the gross income of the owners under section 103(a). The regulations in §§1.148–1 through 1.148–11 apply in a manner consistent with these purposes.

(b) *Scope.* Sections 1.148–1 through 1.148–11 apply generally for purposes of the arbitrage restrictions on State and local bonds under section 148.

(c) *Table of contents.* This paragraph (c) lists the table of contents for §§1.148–1, 1.148–2, 1.148–3, 1.148–4, 1.148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10 and 1.148–11.

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§ 1.148–1 Definitions and elections.

(a) *In general.* The definitions in this section and the definitions under section 150 apply for purposes of section 148 and §§ 1.148–1 through 1.148–11.

(b) *Certain definitions*. The following definitions apply:

Accounting method means both the overall method used to account for gross proceeds of an issue (e.g., the cash method or a modified accrual method) and the method used to account for or allocate any particular item within that overall accounting method (e.g., accounting for investments, expenditures, allocations to and from different sources, and particular items of the foregoing).

Annuity contract means annuity contract as defined in section 72.

Available amount means available amount as defined in §1.148–6(d)(3)(iii).

Bona fide debt service fund means a fund, which may include proceeds of an issue, that—

(1) Is used primarily to achieve a proper matching of 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.

Bond year means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date.

Capital project or capital projects means all capital expenditures, plus related working capital expenditures to which the de minimis rule under §1.148–6(d)(3)(ii)(A) applies, that carry out the governmental purposes of an issue. For example, a capital project may include capital expenditures for one or more buildings, plus related start-up operating costs.

Commingled fund means any fund or account containing both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of that issue if the amounts in the fund or account are invested and accounted for collectively, without regard to the source of funds deposited in the fund or account. An open-end regulated investment company under section 851, however, is not a commingled fund.

Computation date means each date on which the rebate amount for an issue is computed under §1.148–3(e).

Computation period means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date.

Consistently applied means applied uniformly within a fiscal period and between fiscal periods to account for gross proceeds of an issue and any amounts that are in a commingled fund.

De minimis amount means—

(1) In reference to original issue discount (as defined in section 1273(a)(1)) or premium on an obligation—

(i) An amount that does not exceed 2 percent multiplied by the stated redemption price at maturity; plus

(ii) Any original issue premium that is attributable exclusively to reasonable underwriters' compensation; and

(2) In reference to market discount (as defined in section 1278(a)(2)(A)) or premium on an obligation, an amount that does not exceed 2 percent multiplied by the stated redemption price at maturity.

Economic accrual method (also known as the *constant interest method* or *actuarial method*) means the method of computing yield that is based on the compounding of interest at the end of each compounding period.

Fair market value means fair market value as defined in §1.148–5(d)(6).

Fixed rate investment means any investment whose yield is fixed and determinable on the issue date.

Fixed yield bond means any bond whose yield is fixed and determinable on the issue date using the assumptions and rules provided in §1.148–4(b).

Fixed yield issue means any issue if each bond that is part of the issue is a fixed yield bond.

Gross proceeds means any proceeds and replacement proceeds of an issue.

Guaranteed investment contract includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract).

Higher yielding investments means higher yielding investments as defined in section 148(b)(1).

Investment means any investment property as defined in sections 148(b)(2) and 148(b)(3), and any other tax-exempt bond.

Investment proceeds means any amounts actually or constructively received from investing proceeds of an issue.

Investment-type property is defined in paragraph (e) of this section.

Issue price means issue price as defined in paragraph (f) of this section.

Issuer generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.

Multipurpose issue means an issue the proceeds of which are used for two or more separate purposes determined in accordance with §1.148–9(h).

Net sale proceeds means sale proceeds, less the portion of those sale proceeds invested in a reasonably required reserve or replacement fund under section 148(d) and as part of a minor portion under section 148(e).

Nonpurpose investment means any investment property, as defined in section 148(b), that is not a purpose investment.

Payment means a payment as defined in §1.148–3(d) for purposes of computing the rebate amount, and a payment as defined in §1.148–5(b) for purposes of computing the yield on an investment.

Plain par bond means a qualified tender bond or a bond—

(1) Issued with not more than a de minimis amount of original issue discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Plain par investment means an investment that is an obligation—

(1) Issued with not more than a de minimis amount of original issue discount or premium, or, if acquired on a date other than the issue date, acquired with not more than a de minimis amount of market discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Pre-issuance accrued interest means amounts representing interest that accrued on an obligation for a period not greater than one year before its issue date but only if those amounts are paid within one year after the issue date.

Proceeds means any sale proceeds, investment proceeds, and transferred proceeds of an issue. Proceeds do not include, however, amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under §1.148–2(d) or section 143(g) or to qualified administrative costs recoverable under §1.148–5(e).

Program investment means a purpose investment that is part of a governmental program in which—

(1) The program involves the origination or acquisition of purpose investments;

(2) At least 95 percent (90 percent for qualified student loans under section 144(b)(1)(A)) of the cost of the purpose

investments acquired under the program represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, persons who provide housing and related facilities, or any combination of the foregoing;

(3) At least 95 percent of the receipts from the purpose investments are used to pay principal, interest, or redemption prices on issues that financed the program, to pay or reimburse administrative costs of those issues or of the program, to pay or reimburse anticipated future losses directly related to the program, to finance additional purpose investments for the same general purposes of the program, or to redeem and retire governmental obligations at the next earliest possible date of redemption;

(4) The program documents prohibit any obligor on a purpose investment financed by the program or any related party to that obligor from purchasing bonds of an issue that finance the program in an amount related to the amount of the purpose investment acquired from that obligor; and

(5) The issuer has not waived the right to treat the investment as a program investment.

Purpose investment means an investment that is acquired to carry out the governmental purpose of an issue.

Qualified administrative costs means qualified administrative costs as defined in §1.148–5(e).

Qualified guarantee means a qualified guarantee as defined in §1.148–4(f).

Qualified hedge means a qualified hedge as defined in §1.148–4(h)(2).

Reasonable expectations or reasonableness. An issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Factors relevant to a determination of reasonableness include the issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations, the level of inquiry by the issuer into factual matters, and the existence of covenants, enforceable by bondholders, that require implementation of specific expectations. For a conduit financing issue, factors relevant to a determination of reasonableness include the reasonable expectations of the conduit borrower, but only if, under the circumstances, it is reasonable and prudent for the issuer to rely on those expectations.

Rebate amount means 100 percent of the amount owed to the United States under section 148(f)(2), as further described in §1.148–3.

Receipt means a receipt as defined in §1.148–3(d) for purposes of computing the rebate amount, and a receipt as defined in §1.148–5(b) for purposes of computing yield on an investment.

Refunding escrow means one or more funds established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior issues. For this purpose, funds are generally not so established solely because of—

(1) The deposit of proceeds of an issue and replacement proceeds of the prior issue in an escrow more than 6 months apart, or

(2) The deposit of proceeds of completely separate issues in an escrow.

Replacement proceeds is defined in paragraph (c) of this section.

Restricted working capital expenditures means working capital expenditures that are subject to the proceeds-spent-last rule in §1.148–6(d)(3)(i) and are ineligible for any exception to that rule.

Sale proceeds means any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right that is associated with a bond, and that is described in §1.148–4(b)(4). See also §1.148–4(h)(5) treating amounts received upon the termination of certain hedges as sale proceeds.

Stated redemption price means the redemption price of an obligation under the terms of that obligation, including any call premium.

Transferred proceeds means transferred proceeds as defined in §1.148–9 (or the applicable corresponding provision of prior law).

Unconditionally payable means payable under terms in which—

(1) Late payment or nonpayment results in a significant penalty to the borrower or reasonable remedies to the lender, and

(2) It is reasonably certain on the issue date that the payment will actually be made.

Value means value determined under §1.148–4(e) for a bond, and value determined under §1.148–5(d) for an investment.

Variable yield bond means any bond that is not a fixed yield bond.

Variable yield issue means any issue that is not a fixed yield issue.

Yield means yield computed under §1.148–4 for an issue, and yield computed under §1.148–5 for an investment.

Yield restricted means required to be invested at a yield that is not materially higher than the yield on the issue under section 148(a) and §1.148–2.

(c) *Definition of replacement proceeds*—(1) *In general.* Amounts are replacement proceeds of an issue if the amounts 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. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in paragraph (c)(4) of this section, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

(2) *Sinking fund. Sinking fund* includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.

(3) *Pledged fund*—(i) *In general.* A *pledged fund* is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue. A pledge of more than 50 percent of the outstanding stock of a corporation that is a conduit borrower of the issue is not treated as a pledge for this purpose, unless the corporation is formed or availed of to avoid the creation of replacement proceeds.

(ii) *Negative pledges.* An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged under this paragraph (c)(3)(ii), however, if—

(A) The issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or

(B) The amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

(4) *Other replacement proceeds*—(i) *Bonds outstanding longer than necessary*—(A) *In general.* Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that—

(*1*) The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

(*2*) There will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under §1.148–10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

(B) *Safe harbor against creation of replacement proceeds.* As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section—

(*1*) For the portion of an issue that is to be used to finance working capital expenditures, if that portion is not outstanding longer than the temporary period under §1.148–2(e)(3) for which the proceeds qualify;

(*2*) For the portion of an issue (including a refunding issue) that is to be used to finance or refinance capital projects, if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined in the same manner as under section 147(b);

(*3*) For the portion of an issue that is a refunding issue, if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies paragraph (c)(4)(i)(B) (*1*) or (*2*) of this section; or

(*4*) For the portion of an issue (including a refunding issue) that is to be used to finance working capital expenditures, if that portion satisfies paragraph (c)(4)(ii) of this section.

(ii) *Safe harbor for longer-term working capital financings.* A portion of an issue used to finance working capital expenditures satisfies this paragraph (c)(4)(ii) if the issuer meets the requirements of paragraphs (c)(4)(ii)(A) through (E) of this section.

(A) *Determine first testing year.* On the issue date, the issuer must determine the first fiscal year following the applicable temporary period under §1.148–2(e) in which it reasonably expects to have available amounts (first testing year), but in no event can the first day of the first testing year be later than five years after the issue date.

(B) *Application of available amount to reduce burden on tax-exempt bond market.* Beginning with the first testing year and for each subsequent fiscal year for which the portion of the issue that is the subject of this safe harbor remains outstanding, the issuer must determine the available amount as of the first day of each fiscal year. Then, except as provided in paragraph (c)(4)(ii)(D) of this section, within the first 90 days of that fiscal year, the issuer must apply that amount (or if less, the available amount on the date of the required redemption or investment) to redeem or to invest in eligible tax-exempt bonds (as defined in paragraph (c)(4)(ii)(E) of this section). For this purpose, available amounts in a bona fide debt service fund are not treated as available amounts.

(C) *Continuous investment requirement.* Except as provided in this paragraph (c)(4)(ii)(C), any amounts invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section must be invested continuously in such tax-exempt bonds to the extent provided in paragraph (c)(4)(ii)(D) of this section.

(*1*) *Exception for reinvestment period.* Amounts previously invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section that are held for not more than 30 days in a fiscal year pending reinvestment in eligible tax-exempt bonds are treated as invested in eligible tax-exempt bonds.

(*2*) *Limited use of invested amounts.* An issuer may spend amounts previously invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section within 30 days of the date on which they cease to be so invested to make expenditures for a governmental purpose on any date on which the issuer has no other available amounts for such purpose, or to redeem eligible tax-exempt bonds.

(D) *Cap on applied or invested amounts.* The maximum amount that an issuer is required to apply under paragraph (c)(4)(ii)(B) of this section or to invest continuously under paragraph (c)(4)(ii)(C) of this section with respect to the portion of an issue that is the subject of this safe harbor is the outstanding principal amount of such portion. For purposes of this cap, an issuer receives credit towards its requirement to invest available amounts in eligible tax-exempt bonds for amounts previously invested under paragraph (c)(4)(ii)(B) of this section that remain continuously invested under paragraph (c)(4)(ii)(C) of this section.

(E) *Definition of eligible tax-exempt bonds.* For purposes of paragraph (c)(4)(ii) of this section, *eligible tax-exempt bonds* means any of the following:

(*1*) A bond the interest on which is excludable from gross income under section 103 and that is not a specified private activity bond (as defined in section 57(a)(5)(C)) subject to the alternative minimum tax;

(*2*) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest on a bond that is excludable from gross income under section 103 and that is not interest on a specified private activity bond (as defined in section 57(a)(5)(C)) subject to the alternative minimum tax; or

(*3*) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

(d) *Elections.* Except as otherwise provided, any required elections must be made in writing, and, once made, may not be revoked without the permission of the Commissioner.

(e) *Investment-type property*—(1) *In general.* Except as otherwise provided in this paragraph (e), investment-type property includes any property, other than property described in section 148(b)(2)(A), (B), (C), or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) *Prepayments*—(i) *In general*—(A) *Generally.* Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(*1*) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(*2*) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(*3*) The prepayment meets the requirements of paragraph (e)(2)(iii)(A) or (B) of this section.

(B) *Example.* The following example illustrates an application of this paragraph (e)(2)(i):

Example. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

(ii) *Customary prepayments.* The determination of whether a prepayment satisfies paragraph (e)(2)(i)(A)(*1*) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (e)(2)(i)(A)(*1*) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iii) *Certain prepayments to acquire a supply of natural gas or electricity*—(A) *Natural gas prepayments.* A prepayment meets the requirements of this paragraph (e)(2)(iii)(A) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person, as defined in §1.141–1(b) (each of which is referred to in this paragraph (e)(2)(iii)(A) as the issuing municipal utility), to purchase a supply of natural gas; and

(*2*) At least 90 percent of the prepaid natural gas financed by the issue is used for a qualifying use. Natural gas is used for a qualifying use if it is to be—

(*i*) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, provided, however, that gas used to produce electricity for sale shall not be included under this paragraph (e)(2)(iii)(A)(*2*)(*i*);

(*ii*) Used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility;

(*iii*) Used by the issuing municipal utility to produce electricity that will be sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser;

(*iv*) Sold to a utility that is owned by a governmental person if the requirements of paragraph (e)(2)(iii)(A)(*2*)(*i*), (*ii*) or (*iii*) of this section are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or

(*v*) Used to fuel the pipeline transportation of the prepaid gas supply acquired in accordance with this paragraph (e)(2)(iii)(A).

(B) *Electricity prepayments.* A prepayment meets the requirements of this paragraph (e)(2)(iii)(B) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(*2*) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be—

(*i*) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or

(*ii*) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

(C) *Service area.* For purposes of this paragraph (e)(2)(iii), the service area of a utility owned by a governmental person consists of—

(*1*) Any area throughout which the utility provided, at all times during the 5-year period ending on the issue date—

(*i*) In the case of a natural gas utility, natural gas transmission or distribution service; and

(*ii*) In the case of an electric utility, electricity distribution service; and

(*2*) Any area recognized as the service area of the utility under state or Federal law.

(D) *Retail customer.* For purposes of this paragraph (e)(2)(iii), a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale.

(E) *Commodity swaps.* A prepayment does not fail to meet the requirements of this paragraph (e)(2)(iii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas or electricity supplier), or between the gas or electricity supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas or electricity supply contract or another swap contract); provided, however, that a commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas or electricity supplier to deliver gas or electricity for which the swap contract is a hedge.

(F) *Remedial action*. Issuers may apply principles similar to the rules of §1.141–12, including §1.141–12(d) (relating to redemption or defeasance of nonqualified bonds) and §1.141–12(e) (relating to alternative use of disposition proceeds), to cure a violation of paragraph (e)(2)(iii)(A)(*2*) or (e)(2)(iii)(B)(*2*) of this section. For this purpose, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141–7(d), treating nonqualified sales of gas or electricity under this paragraph (e)(2)(iii) as satisfying the benefits and burdens test under §1.141–7(c)(1).

(iv) *Additional prepayments as permitted by the Commissioner*. The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

(3) *Certain hedges*. Investment-type property also includes the investment element of a contract that is a hedge (within the meaning of §1.148–4(h)(2)(i)(A)) and that contains a significant investment element because a payment by the issuer relates to a conditional or unconditional obligation by the hedge provider to make a payment on a later date. See §1.148–4(h)(2)(ii) relating to hedges with a significant investment element.

(4) *Exception for certain capital projects*. Investment-type property does not include real property or tangible personal property (for example, land, buildings, and equipment) that is used in furtherance of the public purposes for which the tax-exempt bonds are issued. For example, investment-type property does not include a courthouse financed with governmental bonds or an eligible exempt facility under section 142, such as a public road, financed with private activity bonds.

(f) *Definition of issue price*—(1) *In general*. Except as otherwise provided in this paragraph (f), ''issue price'' is defined in sections 1273 and 1274 and the regulations under those sections.

(2) *Bonds issued for money*—(i) *General rule*. Except as otherwise provided in this paragraph (f)(2), the issue price of bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. If a bond is issued for money in a private placement to a single buyer that is not an underwriter or a related party (as defined in §1.150–1(b)) to an underwriter, the issue price of the bond is the price paid by that buyer. Issue price is not reduced by any issuance costs (as defined in §1.150–1(b)).

(ii) *Special rule for use of initial offering price to the public*. The issuer may treat the initial offering price to the public as of the sale date as the issue price of the bonds if the requirements of paragraphs (f)(2)(ii)(A) and (B) of this section are met.

(A) The underwriters offered the bonds to the public for purchase at a specified initial offering price on or before the sale date, and the lead underwriter in the underwriting syndicate or selling group (or, if applicable, the sole underwriter) provides, on or before the issue date, a certification to that effect to the issuer, together with reasonable supporting documentation for that certification, such as a copy of the pricing wire or equivalent communication.

(B) Each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price that is higher than the initial offering price to the public during the period starting on the sale date and ending on the earlier of the following:

(*1*) The close of the fifth (5th) business day after the sale date; or

(*2*) The date on which the underwriters have sold a substantial amount of the bonds to the public at a price that is no higher than the initial offering price to the public.

(iii) *Special rule for competitive sales*. For bonds issued for money in a competitive sale, an issuer may treat the reasonably expected initial offering price to the public as of the sale date as the issue price of the bonds if the issuer obtains from the winning bidder a certification of the bonds' reasonably expected initial offering price to the public as of the sale date upon which the price in the winning bid is based.

(iv) *Choice of rule for determining issue price.* If more than one rule for determining the issue price of the bonds is available under this paragraph (f)(2), at any time on or before the issue date, the issuer may select the rule it will use to determine the issue price of the bonds. On or before the issue date of the bonds, the issuer must identify the rule selected in its books and records maintained for the bonds.

(3) *Definitions.* For purposes of this paragraph (f), the following definitions apply:

(i) *Competitive sale* means a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process in which the issuer offers the bonds for sale to underwriters at specified written terms, if that process meets the following requirements:

(A) The issuer disseminates the notice of sale to potential underwriters in a manner that is reasonably designed to reach potential underwriters (for example, through electronic communication that is widely circulated to potential underwriters by a recognized publisher of municipal bond offering documents or by posting on an Internet-based Web site or other electronic medium that is regularly used for such purpose and is widely available to potential underwriters);

(B) All bidders have an equal opportunity to bid (within the meaning of §1.148–5(d)(6)(iii)(A)(*6*));

(C) The issuer receives bids from at least three underwriters of municipal bonds who have established industry reputations for underwriting new issuances of municipal bonds; and

(D) The issuer awards the sale to the bidder who submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).

(ii) *Public* means any person (as defined in section 7701(a)(1)) other than an underwriter or a related party (as defined in §1.150–1(b)) to an underwriter.

(iii) *Underwriter* means:

(A) Any person (as defined in section 7701(a)(1)) that agrees pursuant to a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to participate in the initial sale of the bonds to the public; and

(B) Any person that agrees pursuant to a written contract directly or indirectly with a person described in paragraph (f)(3)(iii)(A) of this section to participate in the initial sale of the bonds to the public (for example, a retail distribution agreement between a national lead underwriter and a regional firm under which the regional firm participates in the initial sale of the bonds to the public).

(4) *Other special rules.* For purposes of this paragraph (f), the following special rules apply:

(i) *Separate determinations.* The issue price of bonds in an issue that do not have the same credit and payment terms is determined separately. The issuer need not apply the same rule to determine issue price for all of the bonds in the issue.

(ii) *Substantial amount.* Ten percent is a substantial amount.

(iii) *Bonds issued for property.* If a bond is issued for property, the adjusted applicable Federal rate, as determined under section 1288 and §1.1288–1, is used in lieu of the applicable Federal rate to determine the bond's issue price under section 1274.

[T.D. 8476, 58 FR 33517, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24041, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 9085, 68 FR 45775, Aug. 4, 2003; T.D. 9777, 81 FR 46592, July 18, 2016; T.D. 9801, 81 FR 89003, Dec. 9, 2016; T.D. 9854, 84 FR 14007, Apr. 9, 2019]

§ 1.148–2 General arbitrage yield restriction rules.

(a) *In general.* Under section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. The investment of proceeds in higher yielding investments, however, during a temporary period described in paragraph (e) of this section, as part of a reasonably required reserve or replacement fund described in paragraph (f) of this section, or as part of a minor portion described in paragraph (g) of this section does not cause the bonds of the issue to be arbitrage bonds. Bonds are not arbitrage bonds under this section as a result of an inadvertent, insubstantial error.

(b) *Reasonable expectations*—(1) *In general.* Except as provided in paragraph (c) of this section, the determination of whether an issue consists of arbitrage bonds under section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue.

(2) *Certification of expectations*—(i) *In general.* An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's expectations as of the issue date. The certification must state the facts and estimates that form the basis for the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.

(ii) *Exceptions to certification requirement.* An issuer is not required to make a certification for an issue under paragraph (b)(2)(i) of this section if—

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., equipment lease financings in which the issuer purchases equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed $1,000,000.

(c) *Intentional acts.* The taking of any deliberate, intentional action by the issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional.

(d) *Materially higher yielding investments*—(1) *In general.* The yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of *materially higher* set forth in paragraph (d)(2) of this section. If yield restricted investments in the same class are subject to different definitions of *materially higher*, the applicable definition of *materially higher* that produces the lowest permitted yield applies to all the investments in the class. The yield on the issue is determined under §1.148–4. The yield on investments is determined under §1.148–5.

(2) *Definitions of materially higher yield*—(i) *General rule for purpose and nonpurpose investments.* For investments that are not otherwise described in this paragraph (d)(2), materially higher means one-eighth of 1 percentage point.

(ii) *Refunding escrows and replacement proceeds.* For investments in a refunding escrow or for investments allocable to replacement proceeds, materially higher means one-thousandth of 1 percentage point.

(iii) *Program investments.* For program investments that are not described in paragraph (d)(2)(iv) of this section, materially higher means 1 and one-half percentage points.

(iv) *Student loans.* For qualified student loans that are program investments, materially higher means 2 percentage points.

(v) *Tax-exempt investments.* For investments that are tax-exempt bonds and are not investment property under section 148(b)(3), no yield limitation applies.

(3) *Mortgage loans.* Qualified mortgage loans that satisfy the requirements of section 143(g) are treated as meeting the requirements of this paragraph (d).

(e) *Temporary periods*—(1) *In general.* During the temporary periods set forth in this paragraph (e), the proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds. This paragraph (e) does not apply to refunding issues (see §1.148–9).

(2) *General 3-year temporary period for capital projects and qualified mortgage loans*—(i) *In general.* The net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of 3 years beginning on the issue date

(the *3-year temporary period).* The 3-year temporary period also applies to the proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting *qualified mortgage loans* in each place that *capital projects* appears in this paragraph (e)(2). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. These rules apply separately to each conduit loan financed by an issue (other than qualified mortgage loans), with the expenditure and time tests measured from the issue date of the issue.

(A) *Expenditure test.* The expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period.

(B) *Time test.* The time test is met if the issuer incurs within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds of the issue on the capital projects. An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control.

(C) *Due diligence test.* The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceed with due diligence.

(ii) *5-year temporary period.* In the case of proceeds expected to be allocated to a capital project involving a substantial amount of construction expenditures (as defined in §1.148–7), a 5-year temporary period applies in lieu of the 3-year temporary period if the issuer satisfies the requirements of paragraph (e)(2)(i) of this section applied by substituting ''5 years'' in each place that ''3 years'' appears, and both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project.

(3) *Temporary period for working capital expenditures*—(i) *General rule.* The proceeds of an issue that are reasonably expected to be allocated to working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Paragraph (e)(2) of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

(ii) *Longer temporary period for certain tax anticipation issues.* If an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the temporary period under paragraph (e)(3)(i) of this section is extended until the maturity date of the issue.

(4) *Temporary period for pooled financings*—(i) *In general.* Proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of 6 months while held by the issuer before being loaned to a conduit borrower. Any otherwise available temporary period for proceeds held by a conduit borrower, however, is reduced by the period of time during which those proceeds were held by the issuer before being loaned. For example, if the proceeds of a pooled financing issue loaned to a conduit borrower would qualify for a 3-year temporary period, and the proceeds are held by the issuer for 5 months before being loaned to the conduit borrower, the proceeds qualify for only an additional 31-month temporary period after being loaned to the conduit borrower. Except as provided in paragraph (e)(4)(iv) of this section, this paragraph (e)(4) does not apply to any qualified mortgage bond or qualified veterans' mortgage bond under section 143.

(ii) *Loan repayments*—(A) *Amount held by the issuer.* The temporary period under this paragraph (e)(4) for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans is 3 months.

(B) *Amounts re-loaned to conduit borrowers.* Any temporary period for proceeds held by a conduit borrower under a new loan from amounts described in paragraph (e)(4)(ii)(A) of this section is determined by treating the date the new loan is made as the issue date and by reducing the temporary period by the period the amounts were held by the issuer following the last repayment.

(iii) *Construction issues.* If all or a portion of a pooled financing issue qualifies as a construction issue under §1.148–7(b)(6), paragraph (e)(4)(i) of this section is applied by substituting ''2 years'' for ''6 months.''

(iv) *Amounts re-loaned for qualified mortgage loans.* The temporary period under this paragraph (e)(4) for proceeds from the sale, prepayment, or repayment of any qualified mortgage loan that are reasonably expected to be used to make or finance new qualified mortgage loans is 3 years.

(5) *Temporary period for replacement proceeds*—(i) *In general.* Except as otherwise provided, replacement proceeds qualify for a temporary period of 30 days beginning on the date that the amounts are first treated as replacement proceeds.

(ii) *Temporary period for bona fide debt service funds.* Amounts in a bona fide debt service fund for an issue qualify for a temporary period of 13 months. If only a portion of a fund qualifies as a bona fide debt service fund, only that portion qualifies for this temporary period.

(6) *Temporary period for investment proceeds.* Except as otherwise provided in this paragraph (e), investment proceeds qualify for a temporary period of 1 year beginning on the date of receipt.

(7) *Other amounts.* Gross proceeds not otherwise eligible for a temporary period described in this paragraph (e) qualify for a temporary period of 30 days beginning on the date of receipt.

(f) *Reserve or replacement funds*—(1) *General 10 percent limitation on funding with sale proceeds.* An issue consists of arbitrage bonds if sale proceeds of the issue in excess of 10 percent of the stated principal amount of the issue are used to finance any reserve or replacement fund, without regard to whether those sale proceeds are invested in higher yielding investments. If an issue has more than a de minimis amount of original issue discount or premium, the issue price (net of pre-issuance accrued interest) is used to measure the 10-percent limitation in lieu of stated principal amount. This rule does not limit the use of amounts other than sale proceeds of an issue to fund a reserve or replacement fund.

(2) *Exception from yield restriction for reasonably required reserve or replacement funds*—(i) *In general.* The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds. A reasonably required reserve or replacement fund may consist of all or a portion of one or more funds, however labelled, derived from one or more sources. Amounts in a reserve or replacement fund in excess of the amount that is reasonably required are not part of a reasonably required reserve or replacement fund.

(ii) *Size limitation.* The amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue. If an issue has more than a de minimis amount of original issue discount or premium, the issue price of the issue (net of pre-issuance accrued interest) is used to measure the 10 percent limitation in lieu of its stated principal amount. For a reserve or replacement fund that secures more than one issue (e.g. a parity reserve fund), the size limitation may be measured on an aggregate basis.

(iii) *Valuation of investments.* Investments in a reasonably required reserve or replacement fund may be valued in any reasonable, consistently applied manner that is permitted under §1.148–5.

(iv) *150 percent debt service limitation on investment in nonpurpose investments for certain private activity bonds.* Section 148(d)(3) contains additional limits on the amount of gross proceeds of an issue of private activity bonds, other than qualified 501(c)(3) bonds, that may be invested in higher yielding nonpurpose investments without causing the bonds to be arbitrage bonds. For purposes of these rules, *initial temporary period* means the temporary periods under paragraphs (e)(2), (e)(3), and (e)(4) of this section and under §1.148–9(d)(2)(i), (ii), and (iii).

(3) *Certain parity reserve funds.* The limitation contained in paragraph (f)(1) of this section does not apply to an issue if the master legal document authorizing the issuance of the bonds (e.g., a master indenture) was adopted before August 16, 1986, and that document—

(i) Requires a reserve or replacement fund in excess of 10 percent of the sale proceeds, but not more than maximum annual principal and interest requirements;

(ii) Is not amended after August 31, 1986 (other than to permit the issuance of additional bonds as contemplated in the master legal document); and

(iii) Provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under the document without satisfying the reserve fund requirements of the indenture.

(g) *Minor portion.* Under section 148(e), a bond of an issue is not an arbitrage bond solely because of the investment in higher yielding investments of gross proceeds of the issue in an amount not exceeding the lesser of—

(1) 5 percent of the sale proceeds of the issue; or

(2) $100,000.

(h) *Certain waivers permitted.* On or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period under paragraph (e) of this section or as part of a reasonably required reserve or replacement fund under paragraph (f) of this section. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion under paragraph (g) of this section.

[T.D. 8476, 58 FR 33520, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 9777, 81 FR 46593, July 18, 2016]

§ 1.148–3 General arbitrage rebate rules.

(a) *In general.* Section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds. The arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

(b) *Definition of rebate amount.* As of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

(c) *Computation of future value of a payment or receipt.* The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received (or treated as paid or received), plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and financial conventions used to compute that yield.

(d) *Payments and receipts*—(1) *Definition of payments.* For purposes of this section, payments are—

(i) Amounts actually or constructively paid to acquire a nonpurpose investment (or treated as paid to a commingled fund);

(ii) For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired (e.g., an investment that becomes allocable to transferred proceeds or to replacement proceeds) or that becomes subject to the rebate requirement on a date after it is actually acquired (e.g., an investment allocated to a reasonably required reserve or replacement fund for a construction issue at the end of the 2-year spending period), the value of that investment on that date;

(iii) For a nonpurpose investment that was allocated to an issue at the end of the preceding computation period, the value of that investment at the beginning of the computation period;

(iv) On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of $1,400 for any bond year ending in 2007 and, for bond years ending after 2007, a computation credit in the amount determined under paragraph (d)(4) of this section; and

(v) Yield reduction payments on nonpurpose investments made pursuant to §1.148–5(c).

(2) *Definition of receipts.* For purposes of this section, receipts are—

(i) Amounts actually or constructively received from a nonpurpose investment (including amounts treated as received from a commingled fund), such as earnings and return of principal;

(ii) For a nonpurpose investment that ceases to be allocated to an issue before its disposition or redemption date (e.g., an investment that becomes allocable to transferred proceeds of another issue or that ceases to be allocable to the issue pursuant to the universal cap under §1.148–6) or that ceases to be subject to the rebate requirement on a date earlier than its disposition or redemption date (e.g., an investment allocated to a fund initially subject to the rebate requirement but that subsequently qualifies as a bona fide debt service fund), the value of that nonpurpose investment on that date; and

(iii) For a nonpurpose investment that is held at the end of a computation period, the value of that investment at the end of that period.

(3) *Special rules for commingled funds.* Section 1.148–6(e) provides special rules to limit certain of the required determinations of payments and receipts for investments of a commingled fund.

(4) *Cost-of-living adjustment.* For any calendar year after 2007, the $1,400 computation credit set forth in paragraph (d)(1)(iv) of this section shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such year, as modified by this paragraph (d)(4). In applying section 1(f)(3) to determine this cost-of-living adjustment, the reference to "calendar year 1992" in section 1(f)(3)(B) shall be changed to "calendar year 2006." If any such increase determined under this paragraph (d)(4) is not a multiple of $10, such increase shall be rounded to the nearest multiple thereof.

(e) *Computation dates*—(1) *In general.* For a fixed yield issue, an issuer may treat any date as a computation date. For a variable yield issue, an issuer:

(i) May treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid under paragraph (f) of this section (the *first required payment date*) as a computation date but may not change that treatment after the first payment date; and

(ii) After the first required payment date, must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date.

(2) *Final computation date.* The date that an issue is discharged is the final computation date. For an issue retired within 3 years of the issue date, however, the final computation date need not occur before the end of 8 months after the issue date or during the period in which the issuer reasonably expects that any of the spending exceptions under §1.148–7 will apply to the issue.

(f) *Amount of required rebate installment payment*—(1) *Amount of interim rebate payments.* The first rebate installment payment must be made for a computation date that is not later than 5 years after the issue date. Subsequent rebate installment payments must be made for a computation date that is not later than 5 years after the previous computation date for which an installment payment was made. A rebate installment payment must be in an amount that, when added to the future value, as of the computation date, of previous rebate payments made for the issue, equals at least 90 percent of the rebate amount as of that date.

(2) *Amount of final rebate payment.* For the final computation date, a final rebate payment must be paid in an amount that, when added to the future value of previous rebate payments made for the issue, equals 100 percent of the rebate amount as of that date.

(3) *Future value of rebate payments.* The future value of a rebate payment is determined under paragraph (c) of this

section. This value is computed by taking into account recoveries of overpayments.

(g) *Time and manner of payment.* Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. Any rebate payment paid within this 60-day period may be treated as paid on the computation date to which it relates. A rebate payment is paid when it is filed with the Internal Revenue Service at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.

(h) *Penalty in lieu of loss of tax exemption*—(1) *In general.* The failure to pay the correct rebate amount when required will cause the bonds of the issue to be arbitrage bonds, unless the Commissioner determines that the failure was not caused by willful neglect and the issuer promptly pays a penalty to the United States. If no bond of the issue is a private activity bond (other than a qualified 501(c)(3) bond), the penalty equals 50 percent of the rebate amount not paid when required to be paid, plus interest on that amount. Otherwise, the penalty equals 100 percent of the rebate amount not paid when required to be paid, plus interest on that amount.

(2) *Interest on underpayments.* Interest accrues at the underpayment rate under section 6621, beginning on the date the correct rebate amount is due and ending on the date 10 days before it is paid.

(3) *Waivers of the penalty.* The penalty is automatically waived if the rebate amount that the issuer failed to pay plus interest is paid within 180 days after discovery of the failure, unless, the Commissioner determines that the failure was due to willful neglect, or the issue is under examination by the Commissioner at any time during the period beginning on the date the failure first occurred and ending on the date 90 days after the receipt of the rebate amount. Generally, extensions of this 180-day period and waivers of the penalty in other cases will be granted by the Commissioner only in unusual circumstances. For purposes of this paragraph (h)(3), willful neglect does not include a failure that is attributable solely to the permissible retroactive selection of a short first bond year if the rebate amount that the issuer failed to pay is paid within 60 days of the selection of that bond year.

(4) *Application to alternative penalty under §1.148–7.* Paragraphs (h) (1), (2), and (3) of this section apply to failures to pay penalty payments under §1.148–7 (*alternative penalty amounts*) by substituting *alternative penalty amounts* for *rebate amount* and *the last day of each spending period* for *computation date.*

(i) *Recovery of overpayment of rebate*—(1) *In general.* An issuer may recover an overpayment for an issue of tax-exempt bonds by establishing to the satisfaction of the Commissioner that the overpayment occurred. An overpayment is the excess of the amount paid to the United States for an issue under section 148 over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested.

(2) *Limitations on recovery.* (i) An overpayment may be recovered only to the extent that a recovery on the date that it is first requested would not result in an additional rebate amount if that date were treated as a computation date.

(ii) Except for overpayments of penalty in lieu of rebate under section 148(f)(4)(C)(vii) and §1.148–7(k), an overpayment of less than $5,000 may not be recovered before the final computation date.

(3) *Time and manner for requesting refund.* (i) An issuer must request a refund of an overpayment (claim) no later than the date that is two years after the final computation date for the issue to which the overpayment relates (the filing deadline). The claim must be made using the form provided by the Commissioner for this purpose.

(ii) The Commissioner may request additional information to support a claim. The issuer must file the additional information by the date specified in the Commissioner's request, which date may be extended by the Commissioner if unusual circumstances warrant. An issuer will be given at least 21 calendar days to respond to a request for additional information.

(iii) A claim described in either paragraph (i)(3)(iii)(A) or (B) of this section that has been denied by the Commissioner may be appealed to the Office of Appeals under this paragraph (i)(3)(iii). Upon a determination in favor of the issuer, the Office of Appeals must return the undeveloped case to the Commissioner for further consideration of the substance of the claim.

(A) A claim is described in this paragraph (i)(3)(iii)(A) if the Commissioner asserts that the claim was filed after the filing deadline.

(B) A claim is described in this paragraph (i)(3)(iii)(B) if the Commissioner asserts that additional information to support the claim was not submitted within the time specified in the request for information or in any extension of such specified time period.

(j) *Examples*. The provisions of this section may be illustrated by the following examples.

Example 1. Calculation and payment of rebate for a fixed yield issue. (i) *Facts*. On January 1, 1994, City *A* issues a fixed yield issue and invests all the sale proceeds of the issue ($49 million). There are no other gross proceeds. The issue has a yield of 7.0000 percent per year compounded semiannually (computed on a 30 day month/360 day year basis). City *A* receives amounts from the investment and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
2/1/94	$3,000,000
5/1/94	5,000,000
1/1/95	5,000,000
9/1/95	20,000,000
3/1/96	22,000,000

(ii) *First computation date*. (A) City *A* chooses January 1, 1999, as its first computation date. This date is the latest date that may be used to compute the first required rebate installment payment. The rebate amount as of this date is computed by determining the future value of the receipts and the payments for the investment. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts, plus the computation credit, as of January 1, 1999, is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/94	($49,000,000)	($69,119,339)
2/1/94	3,000,000	4,207,602
5/1/94	5,000,000	6,893,079
1/1/95	5,000,000	6,584,045
1/1/95	(1,000)	(1,317)
9/1/95	20,000,000	25,155,464
1/1/96	(1,000)	1,229)
3/1/96	22,000,000	26,735,275
1/1/97	(1,000)	(1,148)
Rebate amount (1/01/99)	....	452,432

(B) City *A* pays 90 percent of the rebate amount ($407,189) to the United States within 60 days of January 1, 1999.

(iii) *Second computation date*. (A) On the next required computation date, January 1, 2004, the future value of the payments and receipts is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/99	$452,432	$638,200
Rebate amount (1/01/04)	....	638,200

(B) As of this computation date, the future value of the payment treated as made on January 1, 1999, is $574,380, which equals at least 90 percent of the rebate amount as of this computation date ($638,200 × 0.9), and thus no additional rebate payment is due as of this date.

(iv) *Final computation date*. (A) On January 1, 2009, City *A* redeems all the bonds, and thus this date is the final computation date. The future value of the receipts and payments as of this date is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/04	$638,200	$900,244
1/1/09	(1,000)	(1,000)
Rebate amount (1/01/09)	....	899,244

(B) As of this computation date, the future value of the payment made on January 1, 1999, is $810,220 and thus an additional rebate payment of $89,024 is due. This payment reflects the future value of the 10 percent unpaid portion, and thus would not be owed had the issuer paid the full rebate amount as of any prior computation date.

Example 2. Calculation and payment of rebate for a variable yield issue. (i) *Facts*. On July 1, 1994, City *B* issues a variable yield issue and invests all of the sale proceeds of the issue ($30 million). There are no other gross proceeds. As of July 1, 1999, there are nonpurpose investments allocated to the issue. Prior to July 1, 1999, City *B* receives amounts from nonpurpose investments and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
8/1/1994	$5,000,000
7/1/1995	8,000,000
12/1/1995	17,000,000
7/1/1999	650,000

(ii) *First computation date.* (A) City *B* treats the last day of the fifth bond year (July 1, 1999) as a computation date. The yield on the variable yield issue during the first computation period (the period beginning on the issue date and ending on the first computation date) is 6.0000 percent per year compounded semiannually. The value of the nonpurpose investments allocated to the issue as of July 1, 1999, is $3 million. The rebate amount as of July 1, 1999, is computed by determining the future value of the receipts and the payments for the nonpurpose investments. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts and of the computation date credits as of July 1, 1999, is:

Date	Receipts (payments)	FV (6.0000 percent)
7/1/1994	($30,000,000)	($40,317,491)
8/1/1994	5,000,000	6,686,560
7/1/1995	(1,000)	(1,267)
7/1/1995	8,000,000	10,134,161
12/1/1995	17,000,000	21,011,112
7/1/1996	(1,000)	(1,194)
7/1/1997	(1,000)	(1,126)
7/1/1998	(1,000)	(1,061)
7/1/1999	3,000,000	3,000,000
7/1/1999	650,000	650,000
7/1/1999	(1,000)	(1,000)
Rebate amount (7/01/1999)		1,158,694

(B) City *B* pays 90 percent of the rebate amount ($1,042,824.60) to the United States within 60 days of July 1, 1999.

(iii) *Next computation date.* (A) On July 1, 2004, City *B* redeems all of the bonds. Thus, the next computation date is July 1, 2004. On July 30, 1999, City *B* chose to compute rebate for periods following the first computation period by treating the end of each fifth bond year as a computation date. The yield during the second computation period is 5.0000 percent per year compounded semiannually. The computation of the rebate amount as of this date reflects the value of the nonpurpose investments allocated to the issue at the end of the prior computation period. On July 1, 2004, City *B* sells those nonpurpose investments for $3,925,000 and expends that amount for the governmental purpose of the issue.

(B) As of July 1, 2004, the future value of the rebate amount computed as of July 1, 1999, and of all other payments and receipts is:

Date	Receipts (payments)	FV (5.0000 percent)
7/1/1999	$1,158,694	$1,483,226
7/1/1999	(3,000,000)	(3,840,254)
7/1/2000	(1,000)	(1,218)
7/1/2001	(1,000)	(1,160)
7/1/2002	(1,000)	(1,104)
7/1/2003	(1,000)	(1,051)
7/1/2004	(2,000)	(2,000)
7/1/2004	3,925,000	3,925,000
		1,561,439

(C) As of this computation date, the future value of the payment made on July 1, 1999, is $1,334,904 and thus an additional rebate payment of $226,535 is due.

(D) If the yield during the second computation period were, instead, 7.0000 percent, the rebate amount computed as of July 1, 2004, would be $1,320,891. The future value of the payment made on July 1, 1999, would be $1,471,007. Although the future value of the payment made on July 1, 1999 ($1,471,007), exceeds the rebate amount computed as of July 1, 2004 ($1,320,891), §1.148–3(i) limits the amount recoverable as a defined overpayment of rebate under section 148 to the excess of the total ''amount paid'' over the sum of the amount determined under the future value method to be the ''rebate amount'' as of the most recent computation date and all other amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested. Because the total amount that the issuer paid on July 1, 1999 ($1,042,824.60), does not exceed the rebate amount as of July 1, 2004 ($1,320,891), the issuer would not be entitled to recover any overpayment of rebate in this case.

(k) *Bona fide debt service fund exception.* Under section 148(f)(4)(A), the rebate requirement does not apply to amounts in certain bona fide debt service funds. An issue with an average annual debt service that is not in excess of $2,500,000 may be treated as satisfying the $100,000 limitation in section 148(f)(4)(A)(ii).

[T.D. 8476, 58 FR 33522, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8476, 59 FR 24350, May 11, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 9701, 79 FR 67351, Nov. 13, 2014; T.D. 9777, 81 FR 46593, July 18, 2016]

§ 1.148–4 Yield on an issue of bonds.

(a) *In general.* The yield on an issue of bonds is used to apply investment yield restrictions under section 148(a) and to compute rebate liability under section 148(f). Yield is computed under the economic accrual method using any consistently applied compounding interval of not more than one year. A short first compounding interval and a short last compounding interval may be used. Yield is expressed as an annual percentage rate that is calculated to at least four decimal places (for example, 5.2525 percent). Other reasonable, standard financial conventions, such as the 30 days per month/360 days per year convention, may be used in computing yield but must be consistently applied. The yield on an issue that would be a purpose investment (absent section 148(b)(3)(A)) is equal to the yield on the conduit financing issue that financed that purpose investment.

(b) *Computing yield on a fixed yield issue*—(1) *In general*—(i) *Yield on an issue.* The yield on a fixed yield issue is the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue and amounts reasonably expected to be paid as fees for qualified guarantees on the issue, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price of bonds of the issue as of the issue date. Further, payments include certain amounts properly allocable to a qualified hedge. Yield on a fixed yield issue is computed as of the issue date and is not affected by subsequent unexpected events, except to the extent provided in paragraphs (b)(4) and (h)(3) of this section.

(ii) *Yield on a bond.* Yield on a fixed yield bond is computed in the same manner as yield on a fixed yield issue.

(2) *Yield on certain fixed yield bonds subject to mandatory or contingent early redemption*—(i) *In general.* The yield on a fixed yield issue that includes a bond subject to mandatory early redemption or expected contingent redemption is computed by treating that bond as redeemed on its reasonably expected early redemption date for an amount equal to its value on that date. Reasonable expectations are determined on the issue date. A bond is subject to mandatory early redemption if it is unconditionally payable in full before its final maturity date. A bond is subject to a contingent redemption if it must be, or is reasonably expected to be, redeemed prior to final maturity upon the occurrence of a contingency. A contingent redemption is taken into account only if the contingency is reasonably expected to occur, in which case the date of occurrence of the contingency must be reasonably estimated. For example, if bonds are reasonably expected to be redeemed early using excess revenues from general or special property taxes or benefit assessments or similar amounts, the reasonably expected redemption schedule is used to determine yield. For purposes of this paragraph (b)(2)(i), excess proceeds calls for issues for which the requirements of §1.148–2(e) (2) or (3) are satisfied, calamity calls, and refundings do not cause a bond to be subject to early redemption. The value of a bond is determined under paragraph (e) of this section.

(ii) *Substantially identical bonds subject to mandatory early redemption.* If substantially identical bonds of an issue are subject to specified mandatory redemptions prior to final maturity (e.g., a mandatory sinking fund redemption requirement), yield on that issue is computed by treating those bonds as redeemed in accordance with the redemption schedule for an amount equal to their value. Generally, bonds are substantially identical if the stated interest rate, maturity, and payment dates are the same. In computing the yield on an issue containing bonds described in this paragraph (b)(2)(ii), each of those bonds must be treated as redeemed at its present value, unless the stated redemption price at maturity of the bond does not exceed the issue price of the bond by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of years to the weighted average maturity date of the substantially identical bonds, in which case each of those bonds must be treated as redeemed at its outstanding stated principal amount, plus accrued, unpaid interest. Weighted average maturity is determined by taking into account the mandatory redemption schedule.

(3) *Yield on certain fixed yield bonds subject to optional early redemption*—(i) *In general.* If a fixed yield bond is subject to optional early redemption and is described in paragraph (b)(3)(ii) of

this section, the yield on the issue containing the bond is computed by treating the bond as redeemed at its stated redemption price on the optional redemption date that would produce the lowest yield on that bond.

(ii) *Fixed yield bonds subject to special yield calculation rule.* A fixed yield bond is described in this paragraph (b)(3)(ii) only if it—

(A) Is subject to optional redemption within five years of the issue date, but only if the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on that issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption;

(B) Is issued at an issue price that exceeds the stated redemption price at maturity by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of complete years to the first optional redemption date for the bond; or

(C) Bears interest at increasing interest rates (*i.e.*, a *stepped coupon bond*).

(4) *Yield recomputed upon transfer of certain rights associated with the bond.* For purposes of §1.148–3, as of the date of any transfer, waiver, modification, or similar transaction (collectively, a *transfer*) of any right that is part of the terms of a bond or is otherwise associated with a bond (e.g., a redemption right), in a transaction that is separate and apart from the original sale of the bond, the issue is treated as if it were retired and a new issue issued on the date of the transfer (*reissued*). The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the date of the transfer. In computing yield on the new issue, any amounts received by the issuer as consideration for the transfer are taken into account.

(5) *Special aggregation rule treating certain bonds as a single fixed yield bond.* Two variable yield bonds of an issue are treated in the aggregate as a single fixed yield bond if—

(i) Aggregate treatment would result in the single bond being a fixed yield bond; and

(ii) The terms of the bonds do not contain any features that could distort the aggregate fixed yield from what the yield would be if a single fixed yield bond were issued. For example, if an issue contains a bond bearing interest at a floating rate and a related bond bearing interest at a rate equal to a fixed rate minus that floating rate, those two bonds are treated as a single fixed yield bond only if neither bond may be redeemed unless the other bond is also redeemed at the same time.

(6) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples.

Example 1. No early call—(i) *Facts.* On January 1, 1994, City *A* issues an issue consisting of four identical fixed yield bonds. The stated final maturity date of each bond is January 1, 2004, and no bond is subject to redemption before this date. Interest is payable on January 1 of each year at a rate of 6.0000 percent per year on the outstanding principal amount. The total stated principal amount of the bonds is $20 million. The issue price of the bonds $20,060,000.

(ii) *Computation.* The yield on the issue is computed by treating the bonds as retired at the stated maturity under the general rule of §1.148–4(b)(1). The bonds are treated as redeemed for their stated redemption prices. The yield on the issue is 5.8731 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.8731 percent)
1/1/1995	$1,200,000	$1,132,510
1/1/1996	1,200,000	1,068,816
1/1/1997	1,200,000	1,008,704
1/1/1998	1,200,000	951,973
1/1/1999	1,200,000	898,433
1/1/2000	1,200,000	847,903
1/1/2001	1,200,000	800,216
1/1/2002	1,200,000	755,210
1/1/2003	1,200,000	712,736
1/1/2004	21,200,000	11,883,498
		20,060,000

Example 2. Mandatory calls. (i) *Facts.* The facts are the same as in *Example 1*. In this case, however, the bonds are subject to mandatory sinking fund redemption on January 1 of each year, beginning January 1, 2001. On each sinking fund redemption date, one of the bonds is chosen by lottery and is required to be redeemed at par plus accrued interest.

(ii) *Computation.* Because the bonds are subject to specified redemptions, yield on the issue is computed by treating the bonds as redeemed in accordance with the redemption schedule under § 1.148–4(b)(2)(ii). Because the bonds are not sold at a discount, the bonds are treated as retired at their stated redemption prices. The yield on the issue is 5.8678 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.8678 percent)
1/1/1995	$1,200,000	$1,132,569
1/1/1996	1,200,000	1,068,926
1/1/1997	1,200,000	1,008,860
1/1/1998	1,200,000	952,169
1/1/1999	1,200,000	898,664
1/1/2000	1,200,000	848,166
1/1/2001	6,200,000	4,135,942
1/1/2002	5,900,000	3,714,650
1/1/2003	5,600,000	3,327,647
1/1/2004	5,300,000	2,972,407
		$20,060,000

Example 3. Optional early call. (i) *Facts.* On January 1, 1994, City *C* issues an issue consisting of three bonds. Each bond has a stated principal amount of $10 million dollars and is issued for par. Bond *X* bears interest at 5 percent per year and matures on January 1, 1999. Bond *Y* bears interest at 6 percent per year and matures on January 1, 2002. Bond *Z* bears interest at 7 percent per year and matures on January 1, 2004. Bonds *Y* and *Z* are callable by the issuer at par plus accrued interest after December 31, 1998.

(ii) *Computation.* (A) The yield on the issue computed as if each bond is outstanding to its maturity is 6.0834 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (6.0834 percent)
1/1/1995	$1,800,000	$1,695,299
1/1/1996	1,800,000	1,596,689
1/1/1997	1,800,000	1,503,814
1/1/1998	1,800,000	1,416,342
1/1/1999	11,800,000	8,744,830
1/1/2000	1,300,000	907,374
1/1/2001	1,300,000	854,595
1/1/2002	11,300,000	6,996,316
1/1/2003	700,000	408,190
1/1/2004	10,700,000	5,876,551
		30,000,000

(B) The yield on the issue computed as if all bonds are called at the earliest date for redemption is 5.9126 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.9126 percent)
1/1/1995	$1,800,000	$1,698,113
1/1/1996	1,800,000	1,601,994
1/1/1997	1,800,000	1,511,315
1/1/1998	1,800,000	1,425,769
1/1/1999	31,800,000	23,762,809
		30,000,000

(C) Because the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on the issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption, each bond is treated as redeemed on the date that would produce the lowest yield for the issue. The lowest yield on the issue would result from a redemption of all the bonds on January 1, 1999. Thus, the yield on the issue is 5.9126 percent per year compounded semiannually.

(c) *Computing yield on a variable yield issue*—(1) *In general.* The yield on a variable yield issue is computed separately for each computation period. The yield for each computation period is the discount rate that, when used in computing the present value as of the first day of the computation period of all the payments of principal and interest and fees for qualified guarantees that are attributable to the computation period, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price (or deemed issue price, as determined in paragraph (c)(2)(iv) of this section) of the bonds of the issue as of the first day of the computation period. The yield on a variable yield bond is computed in the same manner as the yield on a variable yield issue. Except as provided in paragraph (c)(2) of this section, yield on any fixed yield bond in a variable yield issue is computed in the same manner as the yield on a fixed yield issue as provided in paragraph (b) of this section.

(2) *Payments on bonds included in yield for a computation period*—(i) *Payments in general.* The payments on a bond that are attributable to a computation period include any amounts actually paid during the period for principal on the bond. Payments also include any amounts paid during the current period both for interest accruing on the bond during the current period and for interest accruing during the prior period that was included in the deemed issue

price of the bond as accrued unpaid interest at the start of the current period under this paragraph (c)(2). Further, payments include any amounts properly allocable to fees for a qualified guarantee of the bond for the period and to any amounts properly allocable to a qualified hedge for the period.

(ii) *Payments at actual redemption.* If a bond is actually redeemed during a computation period, an amount equal to the greater of its value on the redemption date or the actual redemption price is a payment on the actual redemption date.

(iii) *Payments for bonds outstanding at end of computation period.* If a bond is outstanding at the end of a computation period, a payment equal to the bond's value is taken into account on the last day of that period.

(iv) *Issue price for bonds outstanding at beginning of next computation period.* A bond outstanding at the end of a computation period is treated as if it were immediately reissued on the next day for a deemed issue price equal to the value from the day before as determined under paragraph (c)(2)(iii) of this section.

(3) *Example.* The provisions of this paragraph (c) may be illustrated by the following example.

Example. On January 1, 1994, City *A* issues an issue of identical plain par bonds in an aggregate principal amount of $1,000,000. The bonds pay interest at a variable rate on each June 1 throughout the term of the issue. The entire principal amount of the bonds plus accrued, unpaid interest is payable on the final maturity date of January 1, 2000. No bond year is selected. On June 1, 1994, 1995, 1996, 1997, and 1998, interest in the amounts of $30,000, $55,000, $57,000, $56,000, and $45,000 is paid on the bonds. From June 1, 1998, to January 1, 1999, $30,000 of interest accrues on the bonds. From January 1, 1999, to June 1, 1999, another $35,000 of interest accrues. On June 1, 1999, the issuer actually pays $65,000 of interest. On January 1, 2000, $1,000,000 of principal and $38,000 of accrued interest are paid. The payments for the computation period starting on the issue date and ending on January 1, 1999, include all annual interest payments paid from the issue date to June 1, 1998. Because the issue is outstanding on January 1, 1999, it is treated as redeemed on that date for amount equal to its value ($1,000,000 plus accrued, unpaid interest of $30,000 under paragraph (e)(1) of this section). Thus, $1,030,000 is treated as paid on January 1, 1999. The issue is then treated as reissued on January 1, 1999, for $1,030,000. The payments for the next computation period starting on January 1, 1999, and ending on January 1, 2000, include the interest actually paid on the bonds during that period ($65,000 on June 1, 1999, plus $38,000 paid on January 1, 2000). Because the issue was actually redeemed on January 1, 2000, an amount equal to its stated redemption price is also treated as paid on January 1, 2000.

(d) *Conversion from variable yield issue to fixed yield issue.* For purposes of determining yield under this section, as of the first day on which a variable yield issue would qualify as a fixed yield issue if it were newly issued on that date (a *conversion date*), that issue is treated as if it were reissued as a fixed yield issue on the conversion date. The redemption price of the variable yield issue and the issue price of the fixed yield issue equal the aggregate values of all the bonds on the conversion date. Thus, for example, for plain par bonds (e.g., tender bonds), the deemed issue price would be the outstanding principal amount, plus accrued unpaid interest. If the conversion date occurs on a date other than a computation date, the issuer may continue to treat the issue as a variable yield issue until the next computation date, at which time it must be treated as converted to a fixed yield issue.

(e) *Value of bonds*—(1) *Plain par bonds.* Except as otherwise provided, the value of a plain par bond is its outstanding stated principal amount, plus accrued unpaid interest. The value of a plain par bond that is actually redeemed or treated as redeemed is its stated redemption price on the redemption date, plus accrued, unpaid interest.

(2) *Other bonds.* The value of a bond other than a plain par bond on a date is its present value on that date. The present value of a bond is computed under the economic accrual method taking into account all the unconditionally payable payments of principal, interest, and fees for a qualified guarantee to be paid on or after that date and using the yield on the bond as the discount rate, except that for purposes of §1.148–6(b)(2) (relating to the universal cap), these values may be determined by consistently using the yield on the issue of which the bonds are a part. To determine yield on fixed yield

bonds, see paragraph (b)(1) of this section. The rules contained in paragraphs (b)(2) and (b)(3) of this section apply for this purpose. In the case of bonds described in paragraph (b)(2)(ii) of this section, the present value of those bonds on any date is computed using the yield to the final maturity date of those bonds as the discount rate. In determining the present value of a variable yield bond under this paragraph (e)(2), the initial interest rate on the bond established by the interest index or other interest rate setting mechanism is used to determine the interest payments on that bond.

(f) *Qualified guarantees*—(1) *In general.* Fees properly allocable to payments for a qualified guarantee for an issue (as determined under paragraph (f)(6) of this section) are treated as additional interest on that issue under section 148. A guarantee is a qualified guarantee if it satisfies each of the requirements of paragraphs (f)(2) through (f)(4) of this section.

(2) *Interest savings.* As of the date the guarantee is obtained, the issuer must reasonably expect that the present value of the fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee. For this purpose, present value is computed using the yield on the issue, determined with regard to guarantee payments, as the discount rate.

(3) *Guarantee in substance.* The arrangement must create a guarantee in substance. The arrangement must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments, such as payments for principal and interest, redemption prices, or tender prices, on the guaranteed bonds. Reasonable procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional. In the case of a guarantee against failure to remarket a qualified tender bond, commercially reasonable limitations based on credit risk, such as limitations on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor, do not cause the guarantee to be conditional. The guarantee may be in any form. The guarantor may not be a co-obligor. Thus, the guarantor must not expect to make any payments other than under a direct-pay letter of credit or similar arrangement for which the guarantor will be reimbursed immediately. The guarantor and any related parties together must not use more than 10 percent of the proceeds of the portion of the issue allocable to the guaranteed bonds.

(4) *Reasonable charge*—(i) *In general.* Fees for a guarantee must not exceed a reasonable, arm's-length charge for the transfer of credit risk. In complying with this requirement, the issuer may not rely on the representations of the guarantor.

(ii) *Fees for services other than transfer of credit risk must be separately stated.* A fee for a guarantee must not include any payment for any direct or indirect services other than the transfer of credit risk, unless the compensation for those other services is separately stated, reasonable, and excluded from the guarantee fee. Fees for the transfer of credit risk include fees for the guarantor's overhead and other costs relating to the transfer of credit risk. For example, a fee includes payment for services other than transfer of credit risk if—

(A) It includes payment for the cost of underwriting or remarketing bonds or for the cost of insurance for casualty to bond-financed property;

(B) It is refundable upon redemption of the guaranteed bond before the final maturity date and the amount of the refund would exceed the portion of the fee that had not been earned; or

(C) The requirements of §1.148–2(e)(2) (relating to temporary periods for capital projects) are not satisfied, and the guarantor is not reasonably assured that the bonds will be repaid if the project to be financed is not completed.

(5) *Guarantee of purpose investments.* Except for guarantees of qualified mortgage loans and qualified student loans, a guarantee of payments on a purpose investment is a qualified guarantee of the issue if all payments on the purpose investment reasonably coincide with payments on the related bonds and the payments on the purpose investment are unconditionally payable no more than 6 months before the corresponding interest payment and 12

months before the corresponding principal payments on the bonds. This paragraph (f)(5) only applies if, in addition to satisfying the other requirements of this paragraph (f), the guarantee is, in substance, a guarantee of the bonds allocable to that purpose investment and to no other bonds except for bonds that are equally and ratably secured by purpose investments of the same conduit borrower.

(6) *Allocation of qualified guarantee payments*—(i) *In general.* Payments for a qualified guarantee must be allocated to bonds and to computation periods in a manner that properly reflects the proportionate credit risk for which the guarantor is compensated. Proportionate credit risk for bonds that are not substantially identical may be determined using any reasonable, consistently applied method. For example, this risk may be based on the ratio of the total principal and interest paid and to be paid on a guaranteed bond to the total principal and interest paid and to be paid on all bonds of the guaranteed issue. An allocation method generally is not reasonable, for example, if a substantial portion of the fee is allocated to the construction portion of the issue and a correspondingly insubstantial portion is allocated to the later years covered by the guarantee. Reasonable letter of credit *set up* fees may be allocated ratably during the initial term of the letter of credit. Upon an early redemption of a variable yield bond, fees otherwise allocable to the period after the redemption are allocated to remaining outstanding bonds of the issue or, if none remain outstanding, to the period before the redemption.

(ii) *Safe harbor for allocation of qualified guarantee fees for variable yield issues.* An allocation of non-level payments for a qualified guarantee for variable yield bonds is treated as meeting the requirements of paragraph (f)(6)(i) of this section if, for each bond year for which the guarantee is in effect, an equal amount (or for any short bond year, a proportionate amount of the equal amount) is treated as paid as of the beginning of that bond year. The present value of the annual amounts must equal the fee for the guarantee allocated to that bond, with present value computed as of the first day the guarantee is in effect by using as the discount rate the yield on the variable yield bonds covered by the guarantee, determined without regard to any fee allocated under this paragraph (f)(6)(ii).

(7) *Refund or reduction of guarantee payments.* If as a result of an investment of proceeds of a refunding issue in a refunding escrow, there will be a reduction in, or refund of, payments for a guarantee (*savings*), the savings must be treated as a reduction in the payments on the refunding issue.

(g) *Yield on certain mortgage revenue and student loan bonds.* For purposes of section 148 and this section, section 143(g)(2)(C)(ii) applies to the computation of yield on an issue of qualified mortgage bonds or qualified veterans' mortgage bonds. For purposes of applying section 148 and section 143(g) with respect to purpose investments allocable to a variable yield issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds that is reasonably expected as of the issue date to convert to a fixed yield issue, the yield may be computed over the term of the issue, and, if the yield is so computed, paragraph (d) of this section does not apply to the issue. As of any date, the yield over the term of the issue is based on—

(1) With respect to any bond of the issue that has not converted to a fixed and determinable yield on or before that date, the actual amounts paid or received to that date and the amounts that are reasonably expected (as of that date) to be paid or received with respect to that bond over the remaining term of the issue (taking into account prepayment assumptions under section 143(g)(2)(B)(iv), if applicable); and

(2) With respect to any bond of the issue that has converted to a fixed and determinable yield on or before that date, the actual amounts paid or received before that bond converted, if any, and the amount that was reasonably expected (on the date that bond converted) to be paid or received with respect to that bond over the remaining term of the issue (taking into account prepayment assumptions under section 143(g)(2)(B)(iv), if applicable).

(h) *Qualified hedging transactions*—(1) *In general.* Payments made or received by an issuer under a qualified hedge (as defined in paragraph (h)(2) of this section) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue. Except as provided in paragraphs (h)(4) and (h)(5)(ii)(E) of this section, the bonds to which a qualified hedge relates are treated as variable yield bonds from the issue date of the bonds. This paragraph (h) applies solely for purposes of sections 143(g), 148, and 149(d).

(2) *Qualified hedge defined.* Except as provided in paragraph (h)(5) of this section, the term *qualified hedge* means a contract that satisfies each of the following requirements:

(i) *Hedge*—(A) *In general.* The contract is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond (a hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.

(B) *Special rule for fixed rate issues.* If the contract modifies the issuer's risk of interest rate changes with respect to a bond that is part of an issue that, absent the contract, would be a fixed rate issue, the contract must be entered into—

(*1*) No later than 15 days after the issue date (or the deemed issue date under paragraph (d) of this section) of the issue; or

(*2*) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies paragraph (h)(2)(i)(B)(*1*) of this section; or

(*3*) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies either paragraph (h)(2)(i)(B)(*2*) of this section or this paragraph (h)(2)(i)(B)(*3*).

(C) *Contracts with certain acquisition payments.* If a hedge provider makes a single payment to the issuer (e.g., a payment for an off-market swap) in connection with the acquisition of a contract, the issuer may treat a portion of that contract as a hedge provided—

(*1*) The hedge provider's payment to the issuer and the issuer's payments under the contract in excess of those that it would make if the contract bore rates equal to the on-market rates for the contract (determined as of the date the parties enter into the contract) are separately identified in a certification of the hedge provider; and

(*2*) The payments described in paragraph (h)(2)(i)(C)(*1*) of this section are not treated as payments on the hedge.

(ii) *No significant investment element*—(A) *In general.* The contract does not contain a significant investment element. Except as provided in paragraph (h)(2)(ii)(B) of this section, a contract contains a significant investment element if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date. Examples of contracts that contain a significant investment element are a debt instrument held by the issuer; an interest rate swap requiring any payments other than periodic payments, within the meaning of §1.446–3 (periodic payments) (e.g., a payment for an off-market swap or prepayment of part or all of one leg of a swap); and an interest rate cap requiring the issuer's premium for the cap to be paid in a single, up-front payment. Solely for purposes of determining if a hedge is a qualified hedge under this section, payments that an issuer receives pursuant to the terms of a hedge that are equal to the issuer's cost of funds are treated as periodic payments under §1.446–3 without regard to whether the payments are calculated by reference to a ''specified index'' described in §1.446–3(c)(2). Accordingly, a hedge does not have a significant investment element under this paragraph (h)(2)(ii)(A) solely because an issuer receives payments pursuant to the terms of a hedge that are computed to be equal to the issuer's cost of funds, such as the issuer's actual market-based tax-exempt variable interest rate on its bonds.

(B) *Special level payment rule for interest rate caps.* An interest rate cap does not contain a significant investment element if—

(*1*) All payments to the issuer by the hedge provider are periodic payments;

(*2*) The issuer makes payments for the cap at the same time as periodic payments by the hedge provider must be made if the specified index (within the meaning of §1.446–3) of the cap is above the strike price of the cap; and

(*3*) Each payment by the issuer bears the same ratio to the notional principal amount (within the meaning of §1.446–3) that is used to compute the hedge provider's payment, if any, on that date.

(iii) *Parties.* The contract is entered into between the issuer or the political subdivision on behalf of which the issuer issues the bonds (collectively referred to in this paragraph (h) as the *issuer*) and a provider that is not a related party (the *hedge provider*).

(iv) *Hedged bonds.* The contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity, and terms). Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first 5 years following their issuance. For purposes of this paragraph (h), unless the context clearly requires otherwise, *hedged bonds* means the specific bonds or portions thereof covered by a hedge.

(v) *Interest-based contract and size and scope of hedge.* The contract is primarily interest-based (for example, a hedge based on a debt index, including a tax-exempt debt index or a taxable debt index, rather than an equity index). In addition, the size and scope of the hedge under the contract is limited to that which is reasonably necessary to hedge the issuer's risk with respect to interest rate changes on the hedged bonds. For example, a contract is limited to hedging an issuer's risk with respect to interest rate changes on the hedged bonds if the hedge is based on the principal amount and the reasonably expected interest payments of the hedged bonds. For anticipatory hedges under paragraph (h)(5) of this section, the size and scope limitation applies based on the reasonably expected terms of the hedged bonds to be issued. A contract is not primarily interest based unless—

(A) The hedged bond, without regard to the contract, is either a fixed rate bond, a variable rate debt instrument within the meaning of §1.1275–5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in §1.1275–4(d)(2), or an inflation-indexed debt instrument within the meaning of §1.1275–7; and

(B) As a result of treating all payments on (and receipts from) the contract as additional payments on (and receipts from) the hedged bond, the resulting bond would be substantially similar to either a fixed rate bond, a variable rate debt instrument within the meaning of §1.1275–5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in §1.1275–4(d)(2), or an inflation-indexed debt instrument within the meaning of §1.1275–7. For this purpose, differences that would not prevent the resulting bond from being substantially similar to another type of bond include: a difference between the interest rate used to compute payments on the hedged bond and the interest rate used to compute payments on the hedge where one interest rate is substantially similar to the other; the difference resulting from the payment of a fixed premium for a cap (for example, payments for a cap that are made in other than level installments); and the difference resulting from the allocation of a termination payment where the termination was not expected as of the date the contract was entered into.

(vi) *Payments closely correspond.* The payments received by the issuer from the hedge provider under the contract correspond closely in time to either the specific payments being hedged on the hedged bonds or specific payments required to be made pursuant to the bond documents, regardless of the hedge, to a sinking fund, debt service fund, or similar fund maintained for the issue of which the hedged bond is a part. For this purpose, such payments will be treated as corresponding closely in time under this paragraph (h)(2)(vi) if they are made within 90 calendar days of each other.

(vii) *Source of payments.* Payments to the hedge provider are reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal and interest on the hedged bonds.

(viii) *Identification*—(A) *In general.* The actual issuer must identify the contract on its books and records maintained for the hedged bonds not later than 15 calendar days after the date on which there is a binding agreement to enter into a hedge contract (for example, the date of a hedge pricing confirmation, as distinguished from the closing date for the hedge or start date for payments on the hedge, if different). The identification must specify the name of the hedge provider, the terms of the contract, the hedged bonds, and include a hedge provider's certification as described in paragraph (h)(2)(viii)(B) of this section. The identification must contain sufficient detail to establish that the requirements of this paragraph (h)(2) and, if applicable, paragraph (h)(4) of this section are satisfied. In addition, the existence of the hedge must be noted on the first form relating to the issue of which the hedged bonds are a part that is filed with the Internal Revenue Service on or after the date on which the contract is identified pursuant to this paragraph (h)(2)(viii).

(B) *Hedge provider's certification.* The hedge provider's certification must—

(*1*) Provide that the terms of the hedge were agreed to between a willing buyer and willing seller in a bona fide, arm's-length transaction;

(*2*) Provide that the hedge provider has not made, and does not expect to make, any payment to any third party for the benefit of the issuer in connection with the hedge, except for any such third-party payment that the hedge provider expressly identifies in the documents for the hedge;

(*3*) Provide that the amounts payable to the hedge provider pursuant to the hedge do not include any payments for underwriting or other services unrelated to the hedge provider's obligations under the hedge, except for any such payment that the hedge provider expressly identifies in the documents for the hedge; and

(*4*) Contain any other statements that the Commissioner may provide in guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii) of this chapter.

(3) *Accounting for qualified hedges*—(i) *In general.* Except as otherwise provided in paragraph (h)(4) of this section, payments made or received by the issuer under a qualified hedge are treated as payments made or received, as appropriate, on the hedged bonds that are taken into account in determining the yield on those bonds. These payments are reasonably allocated to the hedged bonds in the period to which the payments relate, as determined under paragraph (h)(3)(iii) of this section. Payments made or received by the issuer include payments deemed made or received when a contract is terminated or deemed terminated under this paragraph (h)(3). Payments reasonably allocable to the modification of risk of interest rate changes and to the hedge provider's overhead under this paragraph (h) are included as payments made or received under a qualified hedge.

(ii) *Exclusions from hedge.* If any payment for services or other items under the contract is not expressly treated by paragraph (h)(3)(i) of this section as a payment under the qualified hedge, the payment is not a payment with respect to a qualified hedge.

(iii) *Timing and allocation of payments.* Except as provided in paragraphs (h)(3)(iv) and (h)(5) of this section, payments made or received by the issuer under a qualified hedge are taken into account in the same period in which those amounts would be treated as income or deductions under §1.446–4 (without regard to §1.446–4(a)(2)(iv)) and are adjusted as necessary to reflect the end of a computation period and the start of a new computation period.

(iv) *Accounting for modifications and terminations*—(A) *Modification defined.* A modification of a qualified hedge includes, without limitation, a change in the terms of the hedge or an issuer's acquisition of another hedge with terms that have the effect of modifying an issuer's risk of interest rate changes or other terms of an existing qualified hedge. For example, if the issuer enters into a qualified hedge that is an interest rate swap under which it receives payments based on the Securities Industry and Financial Market Association (SIFMA) Municipal Swap Index and subsequently enters a second hedge (with the same or different provider) that limits the issuer's exposure under the existing qualified hedge to variations in the SIFMA Municipal Swap Index, the new hedge modifies the qualified hedge.

(B) *Termination defined.* A termination means either an actual termination or a deemed termination of a qualified hedge. Except as otherwise provided, an actual termination of a qualified hedge occurs to the extent that the issuer sells, disposes of, or otherwise actually terminates all or a portion of the hedge. A deemed termination of a qualified hedge occurs if the hedge ceases to meet the requirements for a qualified hedge; the issuer makes a modification (as defined in paragraph (h)(3)(iv)(A) of this section) that is material either in kind or in extent and, therefore, results in a deemed exchange of the hedge and a realization event to the issuer under section 1001; or the issuer redeems all or a portion of the hedged bonds.

(C) *Special rules for certain modifications when the hedge remains qualified.* A modification of a qualified hedge that otherwise would result in a deemed termination under paragraph (h)(3)(iv)(B) of this section does not result in such a termination if the modified hedge is retested for qualification as a qualified hedge as of the date of the modification, the modified hedge meets the requirements for a qualified hedge as of such date, and the modified hedge is treated as a qualified hedge prospectively in determining the yield on the hedged bonds. For purposes of this paragraph (h)(3)(iv)(C), when determining whether the modified hedge is qualified, the fact that the existing qualified hedge is off-market as of the date of the modification is disregarded and the identification requirement in paragraph (h)(2)(viii) of this section applies by measuring the time period for identification from the date of the modification and without regard to the requirement for a hedge provider's certification.

(D) *Continuations of certain qualified hedges in refundings.* If hedged bonds are redeemed using proceeds of a refunding issue, the qualified hedge for the refunded bonds is not actually terminated, and the hedge meets the requirements for a qualified hedge for the refunding bonds as of the issue date of the refunding bonds, then no termination of the hedge occurs and the hedge instead is treated as a qualified hedge for the refunding bonds. For purposes of this paragraph (h)(3)(iv)(D), when determining whether the hedge is a qualified hedge for the refunding bonds, the fact that the hedge is off-market with respect to the refunding bonds as of the issue date of the refunding bonds is disregarded and the identification requirement in paragraph (h)(2)(viii) of this section applies by measuring the time period for identification from the issue date of the refunding bonds and without regard to the requirement for a hedge provider's certification.

(E) *General allocation rules for hedge termination payments.* Except as otherwise provided in paragraphs (h)(3)(iv)(F), (G), and (H) of this section, a payment made or received by an issuer to terminate a qualified hedge, or a payment deemed made or received for a deemed termination, is treated as a payment made or received, as appropriate, on the hedged bonds. Upon an actual termination or a deemed termination of a qualified hedge, the amount that an issuer may treat as a termination payment made or received on the hedged bonds is the fair market value of the qualified hedge on its termination date, based on all of the facts and circumstances. Except as otherwise provided, a termination payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge.

(F) *Special rule for terminations when bonds are redeemed.* Except as otherwise provided in this paragraph (h)(3)(iv)(F) and in paragraph (h)(3)(iv)(G) of this section, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the termination payment as determined under paragraph (h)(3)(iv)(E) of this section is treated as made or received on that date. When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but not below zero, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The remainder of the payment, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess.

(G) *Special rules for refundings.* When there is a termination of a qualified hedge because there is a refunding of the hedged bonds, to the extent that the hedged bonds are redeemed using the proceeds of a refunding issue, the termination payment is accounted for under paragraph (h)(3)(iv)(E) of this section by treating it as a payment on the refunding issue, rather than the hedged bonds. In addition, to the extent that the refunding issue is redeemed during the period to which the termination payment has been allocated to that issue, paragraph (h)(3)(iv)(F) of this section applies to the termination payment by treating it as a payment on the redeemed refunding issue.

(H) *Safe harbor for allocation of certain termination payments.* A payment to terminate a qualified hedge does not result in that hedge failing to satisfy the applicable provisions of paragraph (h)(3)(iv)(E) of this section if that payment is allocated in accordance with this paragraph (h)(3)(iv)(H). For an issue that is a variable yield issue after termination of a qualified hedge, an amount must be allocated to each date on which the hedge provider's payment, if any, would have been made had the hedge not been terminated. The amounts allocated to each date must bear the same ratio to the notional principal amount (within the meaning of §1.446–3) that would have been used to compute the hedge provider's payment, if any, on that date, and the sum of the present values of those amounts must equal the present value of the termination payment. Present value is computed as of the day the qualified hedge is terminated, using the yield on the hedged bonds, determined without regard to the termination payment. The yield used for this purpose is computed for the period beginning on the first date the qualified hedge is in effect and ending on the date the qualified hedge is terminated. On the other hand, for an issue that is a fixed yield issue after termination of a qualified hedge, the termination payment is taken into account as a single payment on the date it is paid.

(4) *Certain variable yield bonds treated as fixed yield bonds*—(i) *In general.* Except as otherwise provided in this paragraph (h)(4), if the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if:

(A) *Maturity.* The term of the hedge is equal to the entire period during which the hedged bonds bear interest at variable interest rates, and the issuer does not reasonably expect that the hedge will be terminated before the end of that period.

(B) *Payments closely correspond.* Payments to be received under the hedge correspond closely in time to the hedged portion of payments on the hedged bonds. Hedge payments received within 15 days of the related payments on the hedged bonds generally so correspond.

(C) *Aggregate payments fixed.* Taking into account all payments made and received under the hedge and all payments on the hedged bonds (*i.e.*, after netting all payments), the issuer's aggregate payments are fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. Payments on bonds are treated as fixed for purposes of this paragraph (h)(4)(i)(C) if payments on the bonds are based, in whole or in part, on one interest rate, payments on the hedge are based, in whole or in part, on a second interest rate that is substantially the same as, but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index may be substantially the same as an issuer's individual 30-day interest rate. A hedge based on a taxable interest rate or taxable interest index cannot meet the requirements of this paragraph (h)(4)(i)(C) unless either—

(*1*) The hedge is an anticipatory hedge that is terminated or otherwise closed substantially contemporaneously with the issuance of the hedged bond in accordance with paragraph (h)(5)(ii) or (iii) of this section; or

(*2*) The issuer's payments on the hedged bonds and the hedge provider's payments on the hedge are based on identical interest rates.

(ii) *Accounting.* Except as otherwise provided in this paragraph (h)(4)(ii), in determining yield on the hedged bonds, all the issuer's payments on the hedged bonds and all payments made and received on a hedge described in paragraph (h)(4)(i) of this section are taken into account. If payments on the bonds and payments on the hedge are based, in whole or in part, on variable interest rates that are substantially the same within the meaning of paragraph (h)(4)(i)(C) of this section (but not identical), yield on the issue is determined by treating the variable interest rates as identical. For example, if variable rate bonds bearing interest at a weekly rate equal to the rate necessary to remarket the bonds at par are hedged with an interest rate swap under which the issuer receives payments based on a short-term floating rate index that is substantially the same as, but not identical to, the weekly rate on the bonds, the interest payments on the bonds are treated as equal to the payments received by the issuer under the swap for purposes of computing the yield on the bonds.

(iii) *Effect of termination*—(A) *In general.* Except as otherwise provided in this paragraph (h)(4)(iii) and paragraph (h)(5) of this section, the issue of which the hedged bonds are a part is treated as if it were reissued as of the termination date of the qualified hedge covered by paragraph (h)(4)(i) of this section in determining yield on the hedged bonds for purposes of §1.148–3. The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the termination date. In computing the yield on the new issue for this purpose, any termination payment is accounted for under paragraph (h)(3)(iv) of this section, applied by treating the termination payment as made or received on the new issue under this paragraph (h)(4)(iii).

(B) *Effect of early termination.* Except as otherwise provided in this paragraph (h)(4)(iii), the general rules of paragraph (h)(4)(i) of this section do not apply in determining the yield on the hedged bonds for purposes of §1.148–3 if the hedge is terminated or deemed terminated within 5 years after the issue date of the issue of which the hedged bonds are a part. Thus, the hedged bonds are treated as variable yield bonds for purposes of §1.148–3 from the issue date.

(C) *Certain terminations disregarded.* This paragraph (h)(4)(iii) does not apply to a termination if, based on the facts and circumstances (e.g., taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in the yield.

(iv) *Consequences of certain modifications.* The special rules under paragraph (h)(4)(iii) of this section regarding the effects of termination of a qualified hedge of fixed yield hedged bonds apply to a modification described in paragraph (h)(3)(iv)(C) of this section. Thus, such a modification is treated as a termination for purposes of paragraph (h)(4)(iii) of this section unless the rule in paragraph (h)(4)(iii)(C) applies.

(5) *Contracts entered into before issue date of hedged bond*—(i) *In general.* A contract does not fail to be a hedge under paragraph (h)(2)(i) of this section solely because it is entered into before the issue date of the hedged bond. However, that contract must be one to which either paragraph (h)(5)(ii) or (h)(5)(iii) of this section applies.

(ii) *Contracts expected to be closed substantially contemporaneously with the issue date of hedged bond*—(A) *Application.* This paragraph (h)(5)(ii) applies to a contract if, on the date the contract is identified, the issuer reasonably expects to terminate or otherwise close (terminate) the contract substantially contemporaneously with the issue date of the hedged bond.

(B) *Contract terminated.* If a contract to which this paragraph (h)(5)(ii) applies is terminated substantially contemporaneously with the issue date of the hedged bond, the amount paid or received, or deemed to be paid or received, by the issuer in connection with the issuance of the hedged bond to terminate the contract is treated as an adjustment to the issue price of the hedged bond and as an adjustment to the sale proceeds of the hedged bond for purposes of section 148. Amounts paid or received, or deemed to be paid or received, before the issue date of the hedged bond are treated as paid or received on the issue date in an amount equal to the future value of the payment or receipt on that date. For this purpose, future value is computed using yield on the hedged bond without taking into account amounts paid or received (or deemed paid or received) on the contract.

(C) *Contract not terminated.* If a contract to which this paragraph (h)(5)(ii) applies is not terminated substantially contemporaneously with the issue date of the hedged bond, the contract is deemed terminated for its fair market value as of the issue date of the hedged bond. Once a contract has been deemed terminated pursuant to this paragraph (h)(5)(ii)(C), payments on and receipts from the contract are no longer taken into account under this paragraph (h) for purposes of determining yield on the hedged bond.

(D) *Relation to other requirements of a qualified hedge.* Payments made in connection with the issuance of a bond to terminate a contract to which this paragraph (h)(5)(ii) applies do not prevent the contract from satisfying the requirements of paragraph (h)(2)(vi) of this section.

(E) *Fixed yield treatment.* A bond that is hedged with a contract to which this paragraph (h)(5)(ii) applies does not fail to be a fixed yield bond if, taking into account payments on the contract and the payments to be made on the bond, the bond satisfies the definition of fixed yield bond. See also paragraph (h)(4) of this section.

(iii) *Contracts expected not to be closed substantially contemporaneously with the issue date of hedged bond*—(A) *Application.* This paragraph (h)(5)(iii) applies to a contract if, on the date the contract is identified, the issuer does not reasonably expect to terminate the contract substantially contemporaneously with the issue date of the hedge bond.

(B) *Contract terminated.* If a contract to which this paragraph (h)(5)(iii) applies is terminated in connection with the issuance of the hedged bond, the amount paid or received, or deemed to be paid or received, by the issuer to terminate the contract is treated as an adjustment to the issue price of the hedged bond and as an adjustment to the sale proceeds of the hedged bond for purposes of section 148.

(C) *Contract not terminated.* If a contract to which this paragraph (h)(5)(iii) applies is not terminated substantially contemporaneously with the issue date of the hedged bond, no payments with respect to the hedge made by the issuer before the issue date of the hedged bond are taken into account under this section.

(iv) *Identification.* The identification required under paragraph (h)(2)(viii) of this section must specify the reasonably expected governmental purpose, issue price, maturity, and issue date of the hedged bond, the manner in which interest is reasonably expected to be computed, and whether paragraph (h)(5)(ii) or (h)(5)(iii) of this section applies to the contract. If an issuer identifies a contract under this paragraph (h)(5)(iv) that would be a qualified hedge with respect to the anticipated bond, but does not issue the anticipated bond on the identified issue date, the contract is taken into account as a qualified hedge of any bond of the issuer that is issued for the identified governmental purpose within a reasonable interval around the identified issue date of the anticipated bond.

(6) *Authority of the Commissioner.* The Commissioner, by publication of a revenue ruling or revenue procedure (see §601.601(d)(2) of this chapter), may specify contracts that, although they do not meet the requirements of paragraph (h)(2) of this section, are qualified hedges or, although they do not meet the requirements of paragraph (h)(4) of this section, cause the hedged

bonds to be treated as fixed yield bonds.

[T.D. 8476, 58 FR 33524, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 8838, 64 FR 48547, Sept. 7, 1999; T.D. 9777, 81 FR 46593, July 18, 2016; 83 FR 14175, Apr. 3, 2018]

§ 1.148–5 Yield and valuation of investments.

(a) *In general.* This section provides rules for computing the yield and value of investments allocated to an issue for various purposes under section 148.

(b) *Yield on an investment*—(1) *In general.* Except as otherwise provided, the yield on an investment allocated to an issue is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. For this purpose, *payments* means amounts to be actually or constructively paid to acquire the investment, and *receipts* means amounts to be actually or constructively received from the investment, such as earnings and return of principal. The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue. For an issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds on which interest is paid semiannually, all regular monthly loan payments to be received during a semiannual debt service period may be treated as received at the end of that period. In addition, for any conduit financing issue, payments made by the conduit borrower are not treated as paid until the conduit borrower ceases to receive the benefit of earnings on those amounts.

(2) *Yield on a separate class of investments*—(i) *In general.* For purposes of the yield restriction rules of section 148(a) and § 1.148–2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended.

(ii) *Separate classes of investments.* Each of the following is a separate class of investments—

(A) Each category of yield restricted purpose investment and program investment that is subject to a different definition of *materially higher* under § 1.148–2(d)(2);

(B) Yield-restricted nonpurpose investments; and

(C) All other nonpurpose investments;

(iii) *Permissive application of single investment rules to certain yield restricted investments for all purposes of section 148.* For all purposes of section 148, if an issuer reasonably expects as of the issue date to establish and maintain a sinking fund solely to reduce the yield on the investments in a refunding escrow, then the issuer may treat all of the yield restricted nonpurpose investments in the refunding escrow and that sinking fund as a single investment having a single yield, determined under this paragraph (b)(2). Thus, an issuer may not treat the nonpurpose investments in a reasonably required reserve fund and a refunding escrow as a single investment having a single yield under this paragraph (b)(2)(iii).

(iv) *Mandatory application of single investment rules for refunding escrows for all purposes of section 148.* For all purposes of section 148, in computing the yield on yield restricted investments allocable to proceeds (*i.e.*, sale proceeds, investment proceeds, and transferred proceeds) of a refunding issue that are held in one or more refunding escrows, the individual investments are treated as a single investment having a single yield, whether or not held concurrently. For example, this single investment includes both the individual investments allocable to sale and investment proceeds of a refunding issue that are held in one refunding escrow for a prior issue and the investments allocable to transferred proceeds of that refunding issue that are held in another refunding escrow.

(3) *Investments to be held beyond issue's maturity or beyond temporary period.* In computing the yield on investments allocable to an issue that are to be held beyond the reasonably expected redemption date of the issue, those investments are treated as sold for an amount equal to their value on that date. In computing the yield on investments that are held beyond an applicable temporary period under §1.148–2, for purposes of §1.148–2 those investments may be treated as purchased for an amount equal to their fair market value as of the end of the temporary period.

(4) *Consistent redemption assumptions on purpose investments.* The yield on purpose investments allocable to an issue is computed using the same redemption assumptions used to compute the yield on the issue. Yield on purpose investments allocable to an issue of qualified mortgage bonds and qualified veterans' mortgage bonds must be determined in a manner that is consistent with, and using the assumptions required by, section 143(g)(2)(B).

(5) *Student loan special allowance payments included in yield.* Except as provided in §1.148–11(e), the yield on qualified student loans is computed by including as receipts any special allowance payments made by the Secretary of Education pursuant to section 438 of the Higher Education Act of 1965.

(c) *Yield reduction payments to the United States*—(1) *In general.* In determining the yield on an investment to which this paragraph (c) applies, any amount paid to the United States in accordance with this paragraph (c), including a rebate amount, is treated as a payment for that investment that reduces the yield on that investment.

(2) *Manner of payment*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, an amount is paid under this paragraph (c) if it is paid to the United States at the same time and in the same manner as rebate amounts are required to be paid or at such other time or in such manner as the Commissioner may prescribe. For example, yield reduction payments must be made on or before the date of required rebate installment payments as described in §§1.148–3(f), (g), and (h). The provisions of §1.148–3(i) apply to payments made under this paragraph (c).

(ii) *Special rule for purpose investments.* For purpose investments allocable to an issue—

(A) No amounts are required to be paid to satisfy this paragraph (c) until the earlier of the end of the tenth bond year after the issue date of the issue or 60 days after the date on which the issue is no longer outstanding; and

(B) For payments made prior to the date on which the issue is retired, the issuer need not pay more than 75 percent of the amount otherwise required to be paid as of the date to which the payment relates.

(3) *Applicability of special yield reduction rule.* Paragraph (c) applies only to investments that are described in at least one of paragraphs (c)(3)(i) through (ix) of this section and, except as otherwise expressly provided in paragraphs (c)(3)(i) through (ix) of this section, that are allocated to proceeds of an issue other than gross proceeds of an advance refunding issue.

(i) *Nonpurpose investments allocated to proceeds of an issue that qualified for certain temporary periods.* Nonpurpose investments allocable to proceeds of an issue that qualified for one of the temporary periods available for capital projects, working capital expenditures, pooled financings, or investment proceeds under §1.148–2(e)(2), (3), (4), or (6), respectively.

(ii) *Investments allocable to certain variable yield issues.* Investments allocable to a variable yield issue during any computation period in which at least 5 percent of the value of the issue is represented by variable yield bonds, unless the issue is an issue of hedge bonds (as defined in section 149(g)(3)(A)).

(iii) *Nonpurpose investments allocable to certain transferred proceeds.* Nonpurpose investments allocable to transferred proceeds of—

(A) A current refunding issue to the extent necessary to reduce the yield on those investments to satisfy yield restrictions under section 148(a); or

(B) An advance refunding issue to the extent that investment of the refunding escrows allocable to the proceeds, other than transferred proceeds, of the refunding issue in zero-yielding nonpurpose investments is insufficient to satisfy yield restrictions under section 148(a).

(iv) *Purpose investments allocable to qualified student loans and qualified mortgage loans*. Purpose investments allocable to qualified student loans and qualified mortgage loans.

(v) *Nonpurpose investments allocable to gross proceeds in certain reserve funds*. Nonpurpose investments allocable to gross proceeds of an issue in a reasonably required reserve or replacement fund or a fund that, except for its failure to satisfy the size limitation in §1.148–2(f)(2)(ii), would qualify as a reasonably required reserve or replacement fund, but only to the extent the requirements in paragraphs (c)(3)(v)(A) or (B) of this section are met. This paragraph (c)(3)(v) includes nonpurpose investments described in this paragraph that are allocable to transferred proceeds of an advance refunding issue, but only to the extent necessary to satisfy yield restriction under section 148(a) on those proceeds treating all investments allocable to those proceeds as a separate class.

(A) The value of the nonpurpose investments in the fund is not greater than 15 percent of the stated principal amount of the issue, as computed under §1.148–2(f)(2)(ii).

(B) The amounts in the fund (other than investment earnings) are not reasonably expected to be used to pay debt service on the issue other than in connection with reductions in the amount required to be in that fund (for example, a reserve fund for a revolving fund loan program).

(vi) *Nonpurpose investments allocable to certain replacement proceeds of refunded issues*. Nonpurpose investments allocated to replacement proceeds of a refunded issue, including a refunded issue that is an advance refunding issue, as a result of the application of the universal cap to amounts in a refunding escrow.

(vii) *Investments allocable to replacement proceeds under a certain transition rule*. Investments described in §1.148–11(f).

(viii) *Nonpurpose investments allocable to proceeds when State and Local Government Series Securities are unavailable*. Nonpurpose investments allocable to proceeds of an issue, including an advance refunding issue, that an issuer purchases if, on the date the issuer enters into the agreement to purchase such investments, the issuer is unable to subscribe for State and Local Government Series Securities because the U.S. Department of the Treasury, Bureau of the Fiscal Service, has suspended sales of those securities.

(ix) *Nonpurpose investments allocable to proceeds of certain variable yield advance refunding issues*. Nonpurpose investments allocable to proceeds of the portion of a variable yield issue used for advance refunding purposes that are deposited in a yield restricted defeasance escrow if—

(A) The issuer has entered into a qualified hedge under §1.148–4(h)(2) with respect to all of the variable yield bonds of the issue allocable to the yield restricted defeasance escrow and that hedge is in the form of a variable-to-fixed interest rate swap under which the issuer pays the hedge provider a fixed interest rate and receives from the hedge provider a floating interest rate;

(B) Such qualified hedge covers a period beginning on the issue date of the hedged bonds and ending on or after the date on which the final payment is to be made from the yield restricted defeasance escrow; and

(C) The issuer restricts the yield on the yield restricted defeasance escrow to a yield that is not greater than the yield on the issue, determined by taking into account the issuer's fixed payments to be made under the hedge and by assuming that the issuer's variable yield payments to be paid on the hedged bonds are equal to the floating payments to be received by the issuer under the qualified hedge and are paid on the same dates (that is, such yield reduction payments can only be made to address basis risk differences between the variable yield payments on the hedged bonds and the floating payments received on the hedge).

(d) *Value of investments*—(1) *In general*. Except as otherwise provided, the value of an investment (including a payment or receipt on the investment) on a date must be determined using one of the following valuation methods consistently for all purposes of section 148 to that investment on that date:

(i) *Plain par investment—outstanding principal amount*. A plain par investment may be valued at its outstanding stated principal amount, plus any accrued unpaid interest on that date.

(ii) *Fixed rate investment—present value*. A fixed rate investment may be valued at its present value on that date.

(iii) *Any investment—fair market value*. An investment may be valued at its fair market value on that date.

(2) *Mandatory valuation of certain yield restricted investments at present value*. A purpose investment must be valued at present value, and except as otherwise provided in paragraphs (b)(3) and (d)(3) of this section, a yield restricted nonpurpose investment must be valued at present value.

(3) *Mandatory valuation of certain investments at fair market value*—(i) *In general*. Except as otherwise provided in paragraphs (d)(3)(ii) and (d)(4) of this section, a nonpurpose investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition. For example, if an issuer deposits existing nonpurpose investments into a sinking fund for an issue, those investments must be valued at fair market value as of the date first deposited into the fund.

(ii) *Exception to fair market value requirement for transferred proceeds allocations, certain universal cap allocations, and commingled funds*. Paragraph (d)(3)(i) of this section does not apply if the investment is allocated from one issue to another as a result of the transferred proceeds allocation rule under §1.148–9(b) or is deallocated from one issue as a result of the universal cap rule under §1.148–6(b)(2) and reallocated to another issue as a result of a preexisting pledge of the investment to secure that other issue, provided that, in either circumstance (that is, transferred proceeds allocations or universal cap deallocations), the issue from which the investment is allocated (that is, the first issue in an allocation from one issue to another issue) consists of tax-exempt bonds. In addition, paragraph (d)(3)(i) of this section does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is an investment being initially deposited in or withdrawn from a commingled fund described in §1.148–6(e)(5)(iii).

(4) *Special transition rule for transferred proceeds*. The value of a nonpurpose investment that is allocated to transferred proceeds of a refunding issue on a transfer date may not exceed the value of that investment on the transfer date used for purposes of applying the arbitrage restrictions to the refunded issue.

(5) *Definition of present value of an investment*. Except as otherwise provided, present value of an investment is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The present value of an investment on a date is equal to the present value of all unconditionally payable receipts to be received from and payments to be paid for the investment after that date, using the yield on the investment as the discount rate.

(6) *Definition of fair market value*—(i) *In general*. The fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction. Fair market value generally is determined on the date on which a contract to purchase or sell the nonpurpose investment becomes binding (*i.e.*, the trade date rather than the settlement date). Except as otherwise provided in this paragraph (d)(6), an investment that is not of a type traded on an established securities market, within the meaning of section 1273, is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value. On the purchase date, the fair

market value of a United States Treasury obligation that is purchased directly from the United States Treasury, including a State and Local Government Series Security, is its purchase price. The fair market value of a State and Local Government Series Security on any date other than the purchase date is the redemption price for redemption on that date.

(ii) *Safe harbor for establishing fair market value for certificates of deposit.* This paragraph (d)(6)(ii) applies to a certificate of deposit that has a fixed interest rate, a fixed payment schedule, and a substantial penalty for early withdrawal. The purchase price of such a certificate of deposit is treated as its fair market value on the purchase date if the yield on the certificate of deposit is not less than—

(A) The yield on reasonably comparable direct obligations of the United States; and

(B) The highest yield that is published or posted by the provider to be currently available from the provider on reasonably comparable certificates of deposit offered to the public.

(iii) *Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.* The purchase price of a guaranteed investment contract and the purchase price of an investment purchased for a yield restricted defeasance escrow will be treated as the fair market value of the investment on the purchase date if all of the following requirements are satisfied:

(A) The issuer makes a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation that satisfies all of the following requirements:

(*1*) The bid specifications are in writing and are timely disseminated to potential providers. For purposes of this paragraph (d)(6)(iii)(A)(*1*), a writing may be in electronic form and may be disseminated by fax, email, an internet-based Web site, or other electronic medium that is similar to an internet-based Web site and regularly used to post bid specifications.

(*2*) The bid specifications include all material terms of the bid. A term is material if it may directly or indirectly affect the yield or the cost of the investment.

(*3*) The bid specifications include a statement notifying potential providers that submission of a bid is a representation that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any other formal or informal agreement that the potential provider has with the issuer or any other person (whether or not in connection with the bond issue), and that the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the requirements of paragraph (d)(6)(iii)(B)(*1*) or (*2*) of this section.

(*4*) The terms of the bid specifications are commercially reasonable. A term is commercially reasonable if there is a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of the investment. For example, for solicitations of investments for a yield restricted defeasance escrow, the hold firm period must be no longer than the issuer reasonably requires.

(*5*) For purchases of guaranteed investment contracts only, the terms of the solicitation take into account the issuer's reasonably expected deposit and drawdown schedule for the amounts to be invested.

(*6*) All potential providers have an equal opportunity to bid. If the bidding process affords any opportunity for a potential provider to review other bids before providing a bid, then providers have an equal opportunity to bid only if all potential providers have an equal opportunity to review other bids. Thus, no potential provider may be given an opportunity to review other bids that is not equally given to all potential providers (that is, no exclusive ''last look'').

(*7*) At least three reasonably competitive providers are solicited for bids. A reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

(B) The bids received by the issuer meet all of the following requirements:

(*1*) The issuer receives at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of paragraph (d)(6)(iii)(A) of this section and that do not have a material financial interest in the issue. A lead underwriter in a negotiated underwriting transaction is deemed to have a material financial interest in the issue until 15 days after the issue date of the issue. In addition, any entity acting as a financial advisor with respect to the purchase of the investment at the time the bid specifications are forwarded to potential providers has a material financial interest in the issue. A provider that is a related party to a provider that has a material financial interest in the issue is deemed to have a material financial interest in the issue.

(*2*) At least one of the three bids described in paragraph (d)(6)(iii)(B)(*1*) of this section is from a reasonably competitive provider, within the meaning of paragraph (d)(6)(iii)(A)(*7*) of this section.

(*3*) If the issuer uses an agent to conduct the bidding process, the agent did not bid to provide the investment.

(C) The winning bid meets the following requirements:

(*1*) *Guaranteed investment contracts.* If the investment is a guaranteed investment contract, the winning bid is the highest yielding bona fide bid (determined net of any broker's fees).

(*2*) *Other investments.* If the investment is not a guaranteed investment contract, the following requirements are met:

(*i*) The winning bid is the lowest cost bona fide bid (including any broker's fees). The lowest cost bid is either the lowest cost bid for the portfolio or, if the issuer compares the bids on an investment-by-investment basis, the aggregate cost of a portfolio comprised of the lowest cost bid for each investment. Any payment received by the issuer from a provider at the time a guaranteed investment contract is purchased (e.g., an escrow float contract) for a yield restricted defeasance escrow under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii) is taken into account in determining the lowest cost bid.

(*ii*) The lowest cost bona fide bid (including any broker's fees) is not greater than the cost of the most efficient portfolio comprised exclusively of State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt. The cost of the most efficient portfolio of State and Local Government Series Securities is to be determined at the time that bids are required to be submitted pursuant to the terms of the bid specifications.

(*iii*) If State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt are not available for purchase on the day that bids are required to be submitted pursuant to terms of the bid specifications because sales of those securities have been suspended, the cost comparison of paragraph (d)(6)(iii) (C)(*2*)(*ii*) of this section is not required.

(D) The provider of the investments or the obligor on the guaranteed investment contract certifies the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment.

(E) The issuer retains the following records with the bond documents until three years after the last outstanding bond is redeemed:

(*1*) For purchases of guaranteed investment contracts, a copy of the contract, and for purchases of investments other than guaranteed investment contracts, the purchase agreement or confirmation.

(*2*) The receipt or other record of the amount actually paid by the issuer for the investments, including a record of any administrative costs paid by the issuer, and the certification under paragraph (d)(6)(iii)(D) of this section.

(*3*) For each bid that is submitted, the name of the person and entity submitting the bid, the time and date of the bid, and the bid results.

(*4*) The bid solicitation form and, if the terms of the purchase agreement or the guaranteed investment contract deviated from the bid solicitation form or a submitted bid is modified, a brief statement explaining the deviation and stating the purpose for the deviation. For example, if the issuer purchases a portfolio of investments for a yield restricted defeasance escrow and, in order to satisfy the yield restriction requirements of section 148, an investment in the winning bid is replaced with an investment with a lower yield, the issuer must retain a record of the substitution and how the price of the substitute investment was determined. If the issuer replaces an investment in the winning bid portfolio with another investment, the purchase price of the new investment is not covered by the safe harbor unless the investment is bid under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii).

(*5*) For purchases of investments other than guaranteed investment contracts, the cost of the most efficient portfolio of State and Local Government Series Securities, determined at the time that the bids were required to be submitted pursuant to the terms of the bid specifications.

(e) *Administrative costs of investments*—(1) *In general.* Except as otherwise provided in this paragraph (e), an allocation of gross proceeds of an issue to a payment or a receipt on an investment is not adjusted to take into account any costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment (administrative costs). Thus, these administrative costs generally do not increase the payments for, or reduce the receipts from, investments.

(2) *Qualified administrative costs on nonpurpose investments*—(i) *In general.* In determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. General overhead costs and similar indirect costs of the issuer such as employee salaries and office expenses and costs associated with computing the rebate amount under section 148(f) are not qualified administrative costs. In general, administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

(ii) *Special rule for administrative costs of nonpurpose investments in certain regulated investment companies and commingled funds.* Qualified administrative costs include all reasonable administrative costs, without regard to the limitation on indirect costs under paragraph (e)(2)(i) of this section, incurred by:

(A) *Regulated investment companies.* A publicly offered regulated investment company (as defined in section 67(c)(2)(B)); and

(B) *External commingled funds.* A widely held commingled fund in which no investor in the fund owns more than 10 percent of the beneficial interest in the fund. For purposes of this paragraph (e)(2)(ii)(B), a fund is treated as widely held only if, during the immediately preceding fixed, semiannual period chosen by the fund (for example, semiannual periods ending June 30 and December 31), the fund had a daily average of more than 15 investors that were not related parties, and at least 16 of the unrelated investors each maintained a daily average amount invested in the fund that was not less than the lesser of $500,000 and one percent (1%) of the daily average of the total amount invested in the fund (with it being understood that additional smaller investors will not disqualify the fund). For purposes of this paragraph (e)(2)(ii)(B), an investor will be treated as owning not more than 10 percent of the beneficial interest in the fund if, on the date of each deposit by the investor into the fund, the total amount the investor and any related parties have on deposit in the fund is not more than 10 percent of the total amount that all investors have on deposit in the fund. For purposes of the preceding sentence, the total amount that all investors have on deposit in the fund is equal to the sum of all deposits made by the investor and any related parties on the date of those deposits and the closing balance in the fund on the day before those deposits.

If any investor in the fund owns more than 10 percent of the beneficial interest in the fund, the fund does not qualify under this paragraph (e)(2)(ii)(B) until that investor makes sufficient withdrawals from the fund to reduce its beneficial interest in the fund to 10 percent or less.

(iii) *Special rule for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow*—(A) *In general.* An amount paid for a broker's commission or similar fee with respect to a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is a qualified administrative cost if the fee is reasonable within the meaning of paragraph (e)(2)(i) of this section.

(B) *Safe harbor*—(*1*) *In general.* A broker's commission or similar fee with respect to the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is reasonable within the meaning of paragraph (e)(2)(i) of this section to the extent that—

(*i*) The amount of the fee that the issuer treats as a qualified administrative cost does not exceed the lesser of:

(*A*) $30,000 and

(*B*) 0.2% of the computational base or, if more, $3,000; and

(*ii*) For any issue, the issuer does not treat as qualified administrative costs more than $85,000 in brokers' commissions or similar fees with respect to all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue.

(*2*) *Computational base.* For purposes of paragraph (e)(2)(iii)(B)(*1*) of this section, computational base shall mean—

(*i*) For a guaranteed investment contract, the amount of gross proceeds the issuer reasonably expects, as of the date the contract is acquired, to be deposited in the guaranteed investment contract over the term of the contract, and

(*ii*) For investments (other than guaranteed investment contracts) to be deposited in a yield restricted defeasance escrow, the amount of gross proceeds initially invested in those investments.

(*3*) *Cost-of-living adjustment.* In the case of a calendar year after 2004, each of the dollar amounts in paragraph (e)(2)(iii)(B)(*1*) of this section shall be increased by an amount equal to—

(*i*) Such dollar amount; multiplied by

(*ii*) The cost-of-living adjustment determined under section 1(f)(3) for such calendar year by using the language ''calendar year 2003'' instead of ''calendar year 1992'' in section 1(f)(3)(B).

(*4*) *Rounding.* If any increase determined under paragraph (e)(2)(iii)(B)(*3*) of this section is not a multiple of $1,000, such increase shall be rounded to the nearest multiple thereof.

(*5*) *Applicable year for cost-of-living adjustment.* The cost-of-living adjustments under paragraph (e)(2)(iii)(B)(*3*) of this section shall apply to the safe harbor amounts under paragraph (e)(2)(iii)(B)(*1*) of this section based on the year the guaranteed investment contract or the investments for the yield restricted defeasance escrow, as applicable, are acquired.

(*6*) *Cost-of-living adjustment to determine remaining amount of per-issue safe harbor*—(i) *In general.* This paragraph (e)(2)(iii)(B)(*6*) applies to determine the portion of the safe harbor amount under paragraph (e)(2)(iii)(B)(1)(*ii*) of this section, as modified by paragraph (e)(2)(iii)(B)(*3*) of this section (the per-issue safe harbor), that is available (the remaining amount) for any year (the determination year) if the per-issue safe harbor was partially used in one or more prior years.

(*ii*) *Remaining amount of per-issue safe harbor.* The remaining amount of the per-issue safe harbor for any determination year is equal to the per-issue safe harbor for that year, reduced by the portion of the per-issue safe harbor used in one or more prior years.

(*iii*) *Portion of per-issue safe harbor used in prior years.* The portion of the per-issue safe harbor used in any prior year (the prior year) is equal to the total amount of broker's commissions or similar fees paid in connection with guaranteed investment contracts or investments for a yield restricted defeasance escrow acquired in the prior year that the issuer treated as qualified administrative costs for the issue, multiplied by a fraction the numerator of which is the per-issue safe harbor for the determination year and the denominator of which is the per-issue safe harbor for the prior year. See paragraph (e)(2)(iii)(C) *Example 2* of this section.

(C) *Examples.* The following examples illustrate the application of the safe harbor in paragraph (e)(2)(iii)(B) of this section:

Example 1. Multipurpose issue. In 2003, the issuer of a multipurpose issue uses brokers to acquire the following investments with gross proceeds of the issue: a guaranteed investment contract for amounts to be deposited in a construction fund (construction GIC), Treasury securities to be deposited in a yield restricted defeasance escrow (Treasury investments) and a guaranteed investment contract that will be used to earn a return on what otherwise would be idle cash balances from maturing investments in the yield restricted defeasance escrow (the float GIC). The issuer deposits $22,000,000 into the construction GIC and reasonably expects that no further deposits will be made over its term. The issuer uses $8,040,000 of the proceeds to purchase the Treasury investments. The issuer reasonably expects that it will make aggregate deposits of $600,000 to the float GIC over its term. The brokers' fees are $30,000 for the construction GIC, $16,080 for the Treasury investments and $3,000 for the float GIC. The issuer has not previously treated any brokers' commissions or similar fees as qualified administrative costs. The issuer may claim all $49,080 in brokers' fees for these investments as qualified administrative costs because the fees do not exceed the safe harbors in paragraph (e)(2)(iii)(B) of this section. Specifically, each of the brokers' fees equals the lesser of $30,000 and 0.2% of the computational base (or, if more, $3,000) (*i.e.*, lesser of $30,000 and 0.2% × $22,000,000 for the construction GIC; lesser of $30,000 and 0.2% × $8,040,000 for the Treasury investments; and lesser of $30,000 and $3,000 for the float GIC). In addition, the total amount of brokers' fees claimed by the issuer as qualified administrative costs ($49,080) does not exceed the per-issue safe harbor of $85,000.

Example 2. Cost-of-living adjustment. In 2003, an issuer issues bonds and uses gross proceeds of the issue to acquire two guaranteed investment contracts. The issuer pays a total of $50,000 in brokers' fees for the two guaranteed investment contracts and treats these fees as qualified administrative costs. In a year subsequent to 2003 (Year Y), the issuer uses gross proceeds of the issue to acquire two additional guaranteed investment contracts, paying a total of $20,000 in broker's fees for the two guaranteed investment contracts, and treats those fees as qualified administrative costs. For Year Y, applying the cost-of-living adjustment under paragraph (e)(2)(iii)(B)(*3*) of this section, the safe harbor dollar limits under paragraph (e)(2)(iii)(B)(*1*) of this section are $3,000, $32,000 and $90,000. The remaining amount of the per-issue safe harbor for Year Y is $37,059 ($90,000–[$50,000 × $90,000/$85,000]). The broker's fees in Year Y do not exceed the per-issue safe harbor under paragraph (e)(2)(iii)(B)(*1*)(*ii*) (as modified by paragraph (e)(2)(iii)(B)(*3*)) of this section because the broker's fees do not exceed the remaining amount of the per-issue safe harbor determined under paragraph (e)(2)(iii)(B)(*6*) of this section for Year Y. In a year subsequent to Year Y (Year Z), the issuer uses gross proceeds of the issue to acquire an additional guaranteed investment contract, pays a broker's fee of $15,000 for the guaranteed investment contract, and treats the broker's fee as a qualified administrative cost. For Year Z, applying the cost-of-living adjustment under paragraph (e)(2)(iii)(B)(*3*) of this section, the safe harbor dollar limits under paragraph (e)(2)(iii)(B)(*1*) of this section are $3,000, $33,000 and $93,000. The remaining amount of the per-issue safe harbor for Year Z is $17,627 ($93,000—[($50,000 × $93,000/$85,000) + ($20,000 × $93,000/$90,000)]). The broker's fee incurred in Year Z does not exceed the per-issue safe harbor under paragraph (e)(2)(iii)(B)(*1*)(*ii*) (as modified by paragraph (e)(2)(iii)(B)(*3*)) of this section because the broker's fee does not exceed the remaining amount of the per-issue safe harbor determined under paragraph (e)(2)(iii)(B)(*6*) of this section for Year Z. See paragraph (e)(2)(iii)(B)(*6*) of this section.

(3) *Qualified administrative costs on purpose investments*—(i) *In general.* In determining payments and receipts on purpose investments, qualified administrative costs described in this paragraph (e)(3) paid by the conduit borrower are taken into account. Thus, these costs increase the payments for, or decrease the receipts from, the purpose investments. This rule applies even if those payments merely reimburse the issuer. Although the actual payments by the conduit borrower may be made at any time, for this purpose, a pro rata portion of each payment made by a conduit borrower is treated as a reimbursement of reasonable administrative costs, if the present value of those payments does not exceed the present value of the reasonable administrative costs paid by the issuer, using the yield on the issue as the discount rate.

(ii) *Definition of qualified administrative costs of purpose investments*—(A) *In general.* Except as otherwise provided in this paragraph (e)(3)(ii), qualified administrative costs of a purpose investment means—

(*1*) Costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment; and

(*2*) Costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

(B) *Limitation on program investments.* For a program investment, qualified administrative costs include only those costs described in paragraph (e)(3)(ii)(A)(*2*) of this section.

[T.D. 8476, 58 FR 33529, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24044, May 10, 1994; T.D. 8718, 62 FR 25511, May 9, 1997; T.D. 8801, 63 FR 71751, Dec. 30, 1998; T.D. 9097, 68 FR 69022, Dec. 11, 2003; T.D. 9777, 81 FR 46595, July 17, 2016]

§ 1.148–6 General allocation and accounting rules.

(a) *In general*—(1) *Reasonable accounting methods required.* An issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.

(2) *Bona fide deviations from accounting method.* An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special State law restrictions imposed on specific funds or actions to avoid grant forfeitures.

(3) *Absence of allocation and accounting methods.* If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue and the allocation of the proceeds of that issue, the rules of this section are applied using the specific tracing method. This paragraph (a)(3) applies to bonds issued on or after May 16, 1997.

(b) *Allocation of gross proceeds to an issue*—(1) *One-issue rule and general ordering rules.* Except as otherwise provided, amounts are allocable to only one issue at a time as gross proceeds, and if amounts simultaneously are proceeds of one issue and replacement proceeds of another issue, those amounts are allocable to the issue of which they are proceeds. Amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are allocated to transferred proceeds of another issue, or cease to be allocated to that issue at retirement of the issue or under the universal cap of paragraph (b)(2) of this section. Amounts cease to be allocated to an issue as replacement proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are no longer used in a manner that causes those amounts to be replacement proceeds of that issue, or cease to be allocated to that issue because of the retirement of the issue or the application of the universal cap under paragraph (b)(2) of this section. Amounts that cease to be allocated to an issue as gross proceeds are eligible for allocation to another issue. Under § 1.148–10(a), however, the rules in this paragraph (b)(1) do not apply in certain cases involving abusive arbitrage devices.

(2) *Universal cap on value of nonpurpose investments allocated to an issue*—(i) *Application.* The rules in this paragraph (b)(2) provide an overall limitation on the amount of gross proceeds allocable to an issue. Although the universal cap generally may be applied at any time in the manner described in this paragraph (b)(2), it need not be applied on any otherwise required date of application if its application on that date would not result in a reduction or reallocation of gross proceeds of an issue. For this purpose, if an issuer reasonably expects as of the issue date that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not be applied on any date on which an issue actually has all of the following characteristics—

(A) No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve or replacement fund;

(B) The net sale proceeds of the issue—

(*1*) Qualified for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings under § 1.148–2 (e)(2), (e)(3), or (e)(4), and those net sales proceeds were in fact allocated to expenditures prior to the expiration of the longest applicable temporary period; or

(*2*) were deposited in a refunding escrow and expended as originally expected;

(C) The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;

(D) None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; and

(E) No proceeds of the issue are invested in qualified student loans or qualified mortgage loans.

(ii) *General rule.* Except as otherwise provided below, amounts that would otherwise be gross proceeds allocable to an issue are allocated (and remain allocated) to the issue only to the extent that the value of the nonpurpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue. For this purpose, gross proceeds allocable to cash, tax-exempt bonds that would be nonpurpose investments (absent section 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as nonpurpose investments. The values of bonds and investments are determined under §1.148–4(e) and §1.148–5(d), respectively. The value of all outstanding bonds of the issue is referred to as the *universal cap.* Thus, for example, the universal cap for an issue of plain par bonds is equal to the outstanding stated principal amount of those bonds plus accrued interest.

(iii) *Determination and application of the universal cap.* Except as otherwise provided, beginning with the first bond year that commences after the second anniversary of the issue date, the amount of the universal cap and the value of the nonpurpose investments must be determined as of the first day of each bond year. For refunding and refunded issues, the cap and values must be determined as of each date that, but for this paragraph (b)(2), proceeds of the refunded issue would become transferred proceeds of the refunding issue, and need not otherwise be determined in the bond year in which that date occurs. All values are determined as of the close of business on each determination date, after giving effect to all payments on bonds and payments for and receipts on investments on that date.

(iv) *General ordering rule for allocations of amounts in excess of the universal cap*—(A) *In general.* If the value of all nonpurpose investments allocated to the gross proceeds of an issue exceeds the universal cap for that issue on a date as of which the cap is determined under paragraph (b)(2)(iii) of this section, nonpurpose investments allocable to gross proceeds necessary to eliminate that excess cease to be allocated to the issue, in the following order of priority—

(*1*) First, nonpurpose investments allocable to replacement proceeds;

(*2*) Second, nonpurpose investments allocable to transferred proceeds; and

(*3*) Third, nonpurpose investments allocable to sale proceeds and investment proceeds.

(B) *Re-allocation of certain amounts.* Except as provided in §1.148–9(b)(3), amounts that cease to be allocated to an issue as a result of the application of the universal cap may only be allocated to another issue as replacement proceeds.

(C) *Allocations of portions of investments.* Portions of investments to which this paragraph (b)(2)(iv) applies are allocated under either the ratable method or the representative method in the same manner as allocations of portions of investments to transferred proceeds under §1.148–9(c).

(v) *Nonpurpose investments in a bona fide debt service fund not counted.* For purposes of this paragraph (b)(2), nonpurpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the nonpurpose investments, and those nonpurpose investments remain allocated to the issue.

(c) *Fair market value limit on allocations to nonpurpose investments.* Upon a purchase or sale of a nonpurpose investment, gross proceeds of an issue are not allocated to a payment for that nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of the nonpurpose investment as of the purchase or sale date. For purposes of this paragraph (c) only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to the investment.

(d) *Allocation of gross proceeds to expenditures*—(1) *Expenditures in general*—(i) *General rule.* Reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

(ii) *General limitation.* An allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue. A *current outlay of cash* means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made.

(iii) *Timing.* An issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier. This paragraph (d)(1)(iii) applies to bonds issued on or after May 16, 1997.

(2) *Treatment of gross proceeds invested in purpose investments*—(i) *In general.* Gross proceeds of an issue invested in a purpose investment are allocated to an expenditure on the date on which the conduit borrower under the purpose investment allocates the gross proceeds to an expenditure in accordance with this paragraph (d).

(ii) *Exception for qualified mortgage loans and qualified student loans.* If gross proceeds of an issue are allocated to a purpose investment that is a qualified mortgage loan or a qualified student loan, those gross proceeds are allocated to an expenditure for the governmental purpose of the issue on the date on which the issuer allocates gross proceeds to that purpose investment.

(iii) *Continuing allocation of gross proceeds to purpose investments.* Regardless of whether gross proceeds of a conduit financing issue invested in a purpose investment have been allocated to an expenditure under paragraph (d)(2) (i) or (ii) of this section, with respect to the actual issuer those gross proceeds continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment.

(3) *Expenditures for working capital purposes*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3) or paragraph (d)(4) of this section, proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in paragraph (d)(3)(iii) of this section) as of that date (*i.e.*, a ''proceeds-spent-last'' method). For this purpose, proceeds include replacement proceeds described in § 1.148–1(c)(4).

(ii) *Exceptions*—(A) *General de minimis exception.* Paragraph (d)(3)(i) of this section does not apply to expenditures to pay—

(*1*) Any issuance costs of the issue or any qualified administrative costs within the meaning of §§ 1.148–5(e)(2) (i) or (ii), or § 1.148–5(e)(3)(ii)(A);

(*2*) Fees for qualified guarantees of the issue or payments for a qualified hedge for the issue;

(*3*) Interest on the issue for a period commencing on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service;

(*4*) Amounts paid to the United States under §§ 1.148–3, 1.148–5(c), or 1.148–7 for the issue;

(*5*) Costs, other than those described in paragraphs (d)(3)(ii)(A) (*1*) through (*4*) of this section, that do not exceed 5 percent of the sale proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project);

(*6*) Principal or interest on an issue paid from unexpected excess sale or investment proceeds; and

(*7*) Principal or interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

(B) *Exception for extraordinary items.* Paragraph (d)(3)(i) of this section does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (e.g., a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

(C) *Exception for payment of principal and interest on prior issues.* Paragraph (d)(3)(i) of this section does not apply to expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue.

(D) *No exceptions if replacement proceeds created.* The exceptions provided in this paragraph (d)(3)(ii) do not apply if the allocation merely substitutes gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds. For example, if a purported reimbursement allocation of proceeds of a reimbursement bond does not result in an expenditure under §1.150–2, those proceeds may not be allocated to pay interest on an issue that, absent this allocation, would have been paid from the issuer's current revenues.

(iii) *Definition of available amount*—(A) *In general.* For purposes of this paragraph (d)(3), *available amount* means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of any issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

(B) *Reasonable working capital reserve treated as unavailable.* A reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

(C) *Qualified endowment funds treated as unavailable.* For a 501(c)(3) organization, a qualified endowment fund is treated as unavailable. A fund is a qualified endowment fund if—

(*1*) The fund is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures;

(*2*) Pursuant to reasonable, established practices of the organization, the governing body of the 501(c)(3) organization designates and consistently operates the fund as a permanent endowment fund or quasi-endowment fund restricted as to use; and

(*3*) There is an independent verification that the fund is reasonably necessary as part of the organization's permanent capital.

(D) *Application to statutory safe harbor for tax and revenue anticipation bonds.* For purposes of section 148(f)(4)(B)(iii)(II), *available amount* has the same meaning as in paragraph (d)(3)(iii) of this section, except that the otherwise-permitted reasonable working capital reserve is treated as part of the available amount.

(4) *Expenditures for grants*—(i) *In general.* Gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made.

(ii) *Characterization of repayments of grants.* If any amount of a grant financed by gross proceeds of an issue is repaid to the grantor, the repaid amount is treated as unspent proceeds of the issue as of the repayment date unless expended within 60 days of repayment.

(5) *Expenditures for reimbursement purposes.* In allocating gross proceeds of issues of reimbursement bonds (as defined in §1.150–2)) to certain expenditures, §1.150–2 applies. In allocating gross proceeds to an expenditure to reimburse a previously paid working capital expenditure, paragraph (d)(3) of this section applies. Thus, if the expenditure is described in paragraph (d)(3)(ii) of this section or there are no available amounts on the date a working capital expenditure is made and there are no other available amounts on the date of the reimbursement of that expenditure, gross proceeds are allocated to the working capital expenditure as of the date of the reimbursement.

(6) *Expenditures of certain commingled investment proceeds of governmental issues.* This paragraph (d)(6) applies to any issue of governmental bonds, any issue of private activity bonds issued to finance a facility that is required by section 142 to be owned by a governmental unit, and any portion of an issue that is not treated as consisting of private activity bonds under section 141(b)(9). Investment proceeds of the issue (other than investment proceeds held in a refunding escrow) are treated as allocated to expenditures for a governmental purpose when the amounts are deposited in a commingled fund with substantial tax or other revenues from governmental operations of the issuer and the amounts are reasonably expected to be spent for governmental purposes within 6 months from the date of the commingling. In establishing these reasonable expectations, an issuer may use any reasonable accounting assumption and is not bound by the *proceeds-spent-last* assumption generally required for working capital expenditures under paragraph (d)(3) of this section.

(7) *Payments to related parties.* Any payment of gross proceeds of the issue to a related party of the payor is not an expenditure of those gross proceeds.

(e) *Special rules for commingled funds*—(1) *In general.* An accounting method for gross proceeds of an issue in a commingled fund, other than a bona fide debt service fund, is reasonable only if it satisfies the requirements of paragraphs (e)(2) through (6) of this section in addition to the other requirements of this section.

(2) *Investments held by a commingled fund*—(i) *Required ratable allocations.* Not less frequently than as of the close of each fiscal period, all payments and receipts (including deemed payments and receipts) on investments held by a commingled fund must be allocated (but not necessarily distributed) among the different investors in the fund. This allocation must be based on a consistently applied, reasonable ratable allocation method.

(ii) *Safe harbors for ratable allocation methods.* Reasonable ratable allocation methods include, without limitation, methods that allocate these items in proportion to either—

(A) The average daily balances of the amounts in the commingled fund from different investors during a fiscal period (as described in paragraph (e)(4) of this section); or

(B) The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.

(iii) *Definition of investor.* For purposes of this paragraph (e), the term *investor* means each different source of funds invested in a commingled fund. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, it is treated as two different investors.

(3) *Certain expenditures involving a commingled fund.* If a ratable allocation method is used under paragraph (d) of this section to allocate expenditures from the commingled fund, the same ratable allocation method must be used to allocate payments and receipts on investments in the commingled fund under paragraph (e)(2) of this section.

(4) *Fiscal periods.* The fiscal year of a commingled fund is the calendar year unless the fund adopts another fiscal year. A commingled fund may use any consistent fiscal period that does not exceed three months (e.g., a daily, weekly, monthly, or quarterly fiscal period).

(5) *Unrealized gains and losses on investments of a commingled fund*—(i) *Mark-to-market requirement for internal commingled funds with longer-term investment portfolios*. Except as otherwise provided in this paragraph (e), in the case of a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund (an *internal commingled fund*), the fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.

(ii) *Exception for internal commingled funds with shorter-term investment portfolios*. If the remaining weighted average maturity of all investments held by a commingled fund during a particular fiscal year does not exceed 18 months, and the investments held by the commingled fund during that fiscal year consist exclusively of obligations, the mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply.

(iii) *Exception for commingled reserve funds and sinking funds*. The mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply to a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer.

(6) *Allocations of commingled funds serving as common reserve funds or sinking funds*—(i) *Permitted ratable allocation methods*. If a commingled fund serves as a common reserve fund, replacement fund, or sinking fund for two or more issues (a *commingled reserve*), after making reasonable adjustments to account for proceeds allocated under paragraph (b)(1) or (b)(2) of this section, investments held by that commingled fund must be allocated ratably among the issues served by the commingled fund in accordance with one of the following methods—

(A) The relative values of the bonds of those issues under §1.148–4(e);

(B) The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or

(C) The relative original stated principal amounts of the outstanding issues.

(ii) *Frequency of allocations*. An issuer must make any allocations required by this paragraph (e)(6) as of a date at least every 3 years and as of each date that an issue first becomes secured by the commingled reserve. If relative original principal amounts are used to allocate, allocations must also be made on the retirement of any issue secured by the commingled reserve.

[T.D. 8476, 58 FR 33532, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24045, May 10, 1994; T.D. 8712, 62 FR 2304, Jan. 16, 1997; T.D. 8718, 62 FR 25512, May 9, 1997; T.D. 9777, 81 FR 46597, July 18, 2016]

§ 1.148–7 Spending exceptions to the rebate requirement.

(a) *Scope of section*—(1) *In general*. This section provides guidance on the spending exceptions to the arbitrage rebate requirement of section 148(f)(2). These exceptions are the 6-month exception in section 148(f)(4)(B) (the *6-month exception*), the 18-month exception under paragraph (d) of this section (the *18-month exception*), and the 2-year construction exception under section 148(f)(4)(C) (the *2-year exception*) (collectively, the *spending exceptions*).

(2) *Relationship of spending exceptions*. Each of the spending exceptions is an independent exception to arbitrage rebate. For example, a construction issue may qualify for the 6-month exception or the 18-month exception even though the issuer makes one or more elections under the 2-year exception with respect to the issue.

(3) *Spending exceptions not mandatory*. Use of the spending exceptions is not mandatory. An issuer may apply the arbitrage rebate requirement to an issue that otherwise satisfies a spending exception. If an issuer elects to pay penalty in lieu of rebate under the 2-year exception, however, the issuer must apply those penalty provisions.

(b) *Rules applicable for all spending exceptions*. The provisions of this paragraph (b) apply for purposes of applying each of the spending exceptions.

(1) *Special transferred proceeds rules*—(i) *Application to prior issues.* For purposes of applying the spending exceptions to a prior issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue continue to be treated as unspent proceeds of the prior issue. If the prior issue satisfies one of the spending exceptions, the proceeds of the prior issue that are excepted from rebate under that spending exception are not subject to rebate either as proceeds of the prior issue or as transferred proceeds of the refunding issue.

(ii) *Application to refunding issues*—(A) *In general.* The only spending exception applicable to refunding issues is the 6-month exception. For purposes of applying the 6-month exception to a refunding issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue generally are not treated as proceeds of the refunding issue and need not be spent for the refunding issue to satisfy that spending exception. Even if the refunding issue qualifies for that spending exception, those transferred proceeds are subject to rebate as proceeds of the refunding issue unless an exception to rebate applied to those proceeds as proceeds of the prior issue.

(B) *Exception.* For purposes of applying the 6-month exception to refunding issues, those transferred proceeds of the refunding issue excluded from the gross proceeds of the prior issue under the special definition of gross proceeds in paragraph (c)(3) of this section, and those that transferred from a prior taxable issue, are generally treated as gross proceeds of the refunding issue. Thus, for the refunding issue to qualify for the 6-month exception, those proceeds must be spent within 6 months of the issue date of the refunding issue, unless those amounts continue to be used in a manner that does not cause those amounts to be gross proceeds under paragraph (c)(3) of this section.

(2) *Application of multipurpose issue rules.* Except as otherwise provided, if any portion of an issue is treated as a separate issue allocable to refunding purposes under §1.148–9(h) (relating to multipurpose issues), for purposes of this section, that portion is treated as a separate issue.

(3) *Expenditures for governmental purposes of the issue.* For purposes of this section, expenditures for the governmental purpose of an issue include payments for interest, but not principal, on the issue, and for principal or interest on another issue of obligations. The preceding sentence does not apply for purposes of the 18-month and 2-year exceptions if those payments cause the issue to be a refunding issue.

(4) *De minimis rule.* Any failure to satisfy the final spending requirement of the 18-month exception or the 2-year exception is disregarded if the issuer exercises due diligence to complete the project financed and the amount of the failure does not exceed the lesser of 3 percent of the issue price of the issue or $250,000.

(5) *Special definition of reasonably required reserve or replacement fund.* For purposes of this section only, a reasonably required reserve or replacement fund also includes any fund to the extent described in §1.148–5(c)(3)(i)(E) or (G).

(6) *Pooled financing issue*—(i) *In general.* Except as otherwise provided in this paragraph (b)(6), the spending exceptions apply to a pooled financing issue as a whole, rather than to each loan separately.

(ii) *Election to apply spending exceptions separately to each loan*—(A) *In general.* At the election (made on or before the issue date) of the issuer of a pooled financing issue, the spending exceptions are applied separately to each conduit loan, and the applicable spending requirements for a loan begin on the earlier of the date the loan is made, or the first day following the 1-year period beginning on the issue date of the pooled financing issue. If this election is made, the rebate requirement applies to, and none of the spending exceptions are available for, gross proceeds of the pooled financing bonds before the date on which the spending requirements for those proceeds begin.

(B) *Application of spending exceptions.* If the issuer makes the election under this paragraph (b)(6)(ii), the rebate requirement is satisfied for proceeds used to finance a particular conduit loan to the extent that the loan satisfies a spending exception or the small issuer exception under §1.148–8, regardless of whether any other conduit loans allocable to the issue satisfy such an exception. A pooled financing issue is an issue of arbitrage bonds, however, unless the entire issue satisfies the requirements of section 148. An issuer may pay rebate for some conduit loans and 1½ percent penalty for other conduit loans from the same pooled financing issue. The 1½ percent penalty is computed separately for each conduit loan.

(C) *Elections under 2-year exception.* If the issuer makes the election under this paragraph (b)(6)(ii), the issuer may make all elections under the 2-year exception separately for each loan. Elections regarding a loan that otherwise must be made by the issuer on or before the issue date instead may be made on or before the date the loan is made (but not later than 1 year after the issue date).

(D) *Example.* The operation of this paragraph (b)(6) is illustrated by the following example:

Example. Pooled financing issue. On January 1, 1994, Authority *J* issues bonds. As of the issue date, *J* reasonably expects to use the proceeds of the issue to make loans to City *K*, County *L*, and City *M*. *J* does not reasonably expect to use more than 75 percent of the available construction proceeds of the issue for construction expenditures. On or before the issue date, *J* elects to apply the spending exceptions separately for each loan, with spending requirements beginning on the earlier of the date the loan is made or the first day following the 1-year period beginning on the issue date. On February 1, 1994, *J* loans a portion of the proceeds to *K*, and *K* reasonably expects that 45 percent of those amounts will be used for construction expenditures. On the date this loan is made, *J* elects under paragraph (j) of this section to treat 60 percent of the amount loaned to *K* as a separate construction issue, and also elects the 1½ percent penalty under paragraph (k) of this section for the separate construction issue. On March 1, 1994, *J* loans a portion of the proceeds to *L*, and *L* reasonably expects that more than 75 percent of those amounts will be used for construction expenditures. On March 1, 1995, *J* loans the remainder of the proceeds to *M*, and none of those amounts will be used for construction expenditures. *J* must satisfy the rebate requirement for all gross proceeds before those amounts are loaned. For the loan to *K*, the spending periods begin on February 1, 1994, and the 1½ percent penalty must be paid for any failure to meet a spending requirement for the portion of the loan to *K* that is treated as a separate construction issue. Rebate must be paid on the remaining portion of the loan to *K*, unless that portion qualifies for the 6-month exception. For the loan to *L*, the spending periods begin on March 1, 1994, and the rebate requirement must be satisfied unless the 6-month, 18-month, or the 2-year exception is satisfied with respect to those amounts. For the loan to *M*, the spending periods begin on January 2, 1995, and the rebate requirement must be satisfied for those amounts unless the 6-month or 18-month exception is satisfied.

(c) *6-month exception*—(1)*General rule.* An issue is treated as meeting the rebate requirement if—

(i) The gross proceeds (as modified by paragraph (c)(3) of this section) of the issue are allocated to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date (the *6-month spending period*); and

(ii) The rebate requirement is met for amounts not required to be spent within the 6-month spending period (excluding earnings on a bona fide debt service fund).

(2) *Additional period for certain bonds.* The 6-month spending period is extended for an additional 6 months in certain circumstances specified under section 148(f)(4)(B)(ii).

(3) *Amounts not included in gross proceeds.* For purposes of paragraph (c)(1)(i) of this section only, gross proceeds has the meaning used in §1.148–1, except it does not include amounts—

(i) In a bona fide debt service fund;

(ii) In a reasonably required reserve or replacement fund (see §1.148–7(b)(5));

(iii) That, as of the issue date, are not reasonably expected to be gross proceeds but that become gross proceeds after the end of the 6-month spending period;

(iv) Representing sale or investment proceeds derived from payments under any purpose investment of the issue; and

(v) Representing repayments of grants (as defined in §1.150–1(f)) financed by the issue.

(4) *Series of refundings.* If a principal purpose of a series of refunding issues is to exploit the difference between taxable and tax-exempt interest rates by investing proceeds during the temporary periods provided in §1.148–9(d), the 6-month spending period for all

issues in the series begins on the issue date of the first issue in the series.

(d) *18-month exception*—(1) *General rule.* An issue is treated as meeting the rebate requirement if all of the following requirements are satisfied—

(i) *18-month expenditure schedule met.* The gross proceeds (as defined in paragraph (d)(3) of this section) are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule (the *18-month expenditure schedule*) measured from the issue date—

(A) At least 15 percent within 6 months (the *first spending period*);

(B) At least 60 percent within 12 months (the *second spending period*); and

(C) 100 percent within 18 months (the *third spending period*).

(ii) *Rebate requirement met for amounts not required to be spent.* The rebate requirement is met for all amounts not required to be spent in accordance with the 18-month expenditure schedule (other than earnings on a bona fide debt service fund).

(iii) *Issue qualifies for initial temporary period.* All of the gross proceeds (as defined in paragraph (d)(3)(i) of this section) of the issue qualify for the initial temporary period under §1.148–2(e)(2).

(2) *Extension for reasonable retainage.* An issue does not fail to satisfy the spending requirement for the third spending period as a result of a reasonable retainage if the reasonable retainage is allocated to expenditures within 30 months of the issue date. Reasonable retainage has the meaning under paragraph (h) of this section, as modified to refer to net sale proceeds on the date 18 months after the issue date.

(3) *Gross proceeds*—(i) *Definition of gross proceeds.* For purposes of paragraph (d)(1) of this section only, *gross proceeds* means gross proceeds as defined in paragraph (c)(3) of this section, as modified to refer to ''18 months'' in paragraph (c)(3)(iii) of this section in lieu of ''6 months.''

(ii) *Estimated earnings.* For purposes of determining compliance with the first two spending periods under paragraph (d)(1)(i) of this section, the amount of investment proceeds included in gross proceeds of the issue is determined based on the issuer's reasonable expectations on the issue date.

(4) *Application to multipurpose issues.* This paragraph (d) does not apply to an issue any portion of which is treated as meeting the rebate requirement under paragraph (e) of this section (relating to the 2-year exception).

(e) *2-year exception*—(1) *General rule.* A construction issue is treated as meeting the rebate requirement for available construction proceeds if those proceeds are allocated to expenditures for governmental purposes of the issue in accordance with the following schedule (the *2-year expenditure schedule*), measured from the issue date—

(i) At least 10 percent within 6 months (the *first spending period*);

(ii) At least 45 percent within 1 year (the *second spending period*);

(iii) At least 75 percent within 18 months (the *third spending period*); and

(iv) 100 percent within 2 years (the *fourth spending period*).

(2) *Extension for reasonable retainage.* An issue does not fail to satisfy the spending requirement for the fourth spending period as a result of unspent amounts for reasonable retainage (as defined in paragraph (h) of this section) if those amounts are allocated to expenditures within 3 years of the issue date.

(3) *Definitions.* For purposes of the 2-year exception, the following definitions apply:

(i) *Real property* means land and improvements to land, such as buildings or other inherently permanent structures, including interests in real property. For example, real property includes wiring in a building, plumbing systems, central heating or air-conditioning systems, pipes or ducts, elevators, escalators installed in a building, paved parking areas, roads, wharves and docks, bridges, and sewage lines.

(ii) *Tangible personal property* means any tangible property other than real property, including interests in tangible personal property. For example, tangible personal property includes machinery that is not a structural component of a building, subway cars, fire trucks, automobiles, office equipment, testing equipment, and furnishings.

(iii) *Substantially completed.* Construction may be treated as substantially completed when the issuer abandons construction or when at least 90 percent of the total costs of the construction reasonably expected, as of that date, to be financed with the available construction proceeds have been allocated to expenditures.

(f) *Construction issue*—(1) *Definition. Construction issue* means any issue that is not a refunding issue if—

(i) The issuer reasonably expects, as of the issue date, that at least 75 percent of the available construction proceeds of the issue will be allocated to construction expenditures (as defined in paragraph (g) of this section) for property owned by a governmental unit or a 501(c)(3) organization; and

(ii) Any private activity bonds that are part of the issue are qualified 501(c)(3) bonds or private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization.

(2) *Use of actual facts.* For the provisions of paragraphs (e) through (m) of this section that apply based on the issuer's reasonable expectations, an issuer may elect on or before the issue date to apply all of those provisions based on actual facts, except that this election does not apply for purposes of determining whether an issue is a construction issue under paragraph (f)(1) of this section if the 1½ percent penalty election is made under paragraph (k) of this section.

(3) *Ownership requirement*—(i) *In general.* A governmental unit or 501(c)(3) organization is treated as the owner of property if it would be treated as the owner for Federal income tax purposes. For obligations issued on behalf of a State or local governmental unit, the entity that actually issues the bonds is treated as a governmental unit.

(ii) *Safe harbor for leases and management contracts.* Property leased by a governmental unit or a 501(c)(3) organization is treated as owned by the governmental unit or 501(c)(3) organization if the lessee complies with the requirements of section 142(b)(1)(B). For a bond described in section 142(a)(6), the requirements of section 142(b)(1)(B) apply as modified by section 146(h)(2).

(g) *Construction expenditures*—(1) *Definition.* Except as otherwise provided, *construction expenditures* means capital expenditures (as defined in §1.150–1) that are allocable to the cost of real property or constructed personal property (as defined in paragraph (g)(3) of this section). Except as provided in paragraph (g)(2) of this section, construction expenditures do not include expenditures for acquisitions of interests in land or other existing real property.

(2) *Certain acquisitions under turnkey contracts treated as construction expenditures.* Expenditures are not for the acquisition of an interest in existing real property other than land if the contract between the seller and the issuer requires the seller to build or install the property (e.g., a *turnkey contract*), but only to the extent that the property has not been built or installed at the time the parties enter into the contract.

(3) *Constructed personal property. Constructed personal property* means tangible personal property (or, if acquired pursuant to a single acquisition contract, properties) or specially developed computer software if—

(i) A substantial portion of the property or properties is completed more than 6 months after the earlier of the date construction or rehabilitation commenced and the date the issuer entered into an acquisition contract;

(ii) Based on the reasonable expectations of the issuer, if any, or representations of the person constructing the property, with the exercise of due diligence, completion of construction or rehabilitation (and delivery to the issuer) could not have occurred within that 6-month period; and

(iii) If the issuer itself builds or rehabilitates the property, not more than 75 percent of the capitalizable cost is attributable to property acquired by the issuer (e.g., components, raw materials, and other supplies).

(4) *Specially developed computer software. Specially developed computer software* means any programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs, provided that the software is specially developed

and is functionally related and subordinate to real property or other constructed personal property.

(5) *Examples.* The operation of this paragraph (g) is illustrated by the following examples:

Example 1. Purchase of construction materials. City A issues bonds to finance a new office building. *A* uses proceeds of the bonds to purchase materials to be used in constructing the building, such as bricks, pipes, wires, lighting, carpeting, heating equipment, and similar materials. Expenditures by *A* for the construction materials are construction expenditures because those expenditures will be capitalizable to the cost of the building upon completion, even though they are not initially capitalizable to the cost of existing real property. This result would be the same if *A* hires a third-party to perform the construction, unless the office building is partially constructed at the time that *A* contracts to purchase the building.

Example 2. Turnkey contract. City *B* issues bonds to finance a new office building. *B* enters into a turnkey contract with developer *D* under which *D* agrees to provide *B* with a completed building on a specified completion date on land currently owned by *D*. Under the agreement, *D* holds title to the land and building and assumes any risk of loss until the completion date, at which time title to the land and the building will be transferred to *B*. No construction has been performed by the date that *B* and *D* enter into the agreement. All payments by *B* to *D* for construction of the building are construction expenditures because all the payments are properly capitalized to the cost of the building, but payments by *B* to *D* allocable to the acquisition of the land are not construction expenditures.

Example 3. Right-of-way. P, a public agency, issues bonds to finance the acquisition of a right-of-way and the construction of sewage lines through numerous parcels of land. The right-of-way is acquired primarily through *P'* s exercise of its powers of eminent domain. As of the issue date, *P* reasonably expects that it will take approximately 2 years to acquire the entire right-of-way because of the time normally required for condemnation proceedings. No expenditures for the acquisition of the right-of-way are construction expenditures because they are costs incurred to acquire an interest in existing real property.

Example 4. Subway cars. City *C* issues bonds to finance new subway cars. *C* reasonably expects that it will take more than 6 months for the subway cars to be constructed to *C*'s specifications. The subway cars are constructed personal property. Alternatively, if the builder of the subway cars informs *C* that it will only take 3 months to build the subway cars to *C*'s specifications, no payments for the subway cars are construction expenditures.

Example 5. Fractional interest in property. U, a public agency, issues bonds to finance an undivided fractional interest in a newly constructed power-generating facility. *U* contributes its ratable share of the cost of building the new facility to the project manager for the facility. *U*'s contributions are construction expenditures in the same proportion that the total expenditures for the facility qualify as construction expenditures.

Example 6. Park land. City *D* issues bonds to finance the purchase of unimproved land and the cost of subsequent improvements to the land, such as grading and landscaping, necessary to transform it into a park. The costs of the improvements are properly capitalizable to the cost of the land, and therefore, are construction expenditures, but expenditures for the acquisition of the land are not.

(h) *Reasonable retainage definition. Reasonable retainage* means an amount, not to exceed 5 percent of available construction proceeds as of the end of the fourth spending period, that is retained for reasonable business purposes relating to the property financed with the proceeds of the issue. 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.

(i) *Available construction proceeds*—(1) *Definition in general. Available construction proceeds* has the meaning used in section 148(f)(4)(C)(vi). For purposes of this definition, earnings include earnings on any tax-exempt bond. Pre-issuance accrued interest and earnings thereon may be disregarded. Amounts that are not gross proceeds as a result of the application of the universal cap under §1.148–6(b)(2) are not available construction proceeds.

(2) *Earnings on a reasonably required reserve or replacement fund.* Earnings on any reasonably required reserve or replacement fund are available construction proceeds only to the extent that those earnings accrue before the earlier of the date construction is substantially completed or the date that is 2 years after the issue date. An issuer may elect on or before the issue date to

exclude from available construction proceeds the earnings on such a fund. If the election is made, the rebate requirement applies to the excluded amounts from the issue date.

(3) *Reasonable expectations test for future earnings.* For purposes of determining compliance with the spending requirements as of the end of each of the first three spending periods, available construction proceeds include the amount of future earnings that the issuer reasonably expected as of the issue date.

(4) *Issuance costs.* Available construction proceeds do not include gross proceeds used to pay issuance costs financed by an issue, but do include earnings on such proceeds. Thus, an expenditure of gross proceeds of an issue for issuance costs does not count toward meeting the spending requirements. The expenditure of earnings on gross proceeds used to pay issuance costs does count toward meeting those requirements. If the spending requirements are met and the proceeds used to pay issuance costs are expended by the end of the fourth spending period, those proceeds and the earnings thereon are treated as having satisfied the rebate requirement.

(5) *One and one-half percent penalty in lieu of arbitrage rebate.* For purposes of the spending requirements of paragraph (e) of this section, available construction proceeds as of the end of any spending period are reduced by the amount of penalty in lieu of arbitrage rebate (under paragraph (k) of this section) that the issuer has paid from available construction proceeds before the last day of the spending period.

(6) *Payments on purpose investments and repayments of grants.* Available construction proceeds do not include—

(i) Sale or investment proceeds derived from payments under any purpose investment of the issue; or

(ii) Repayments of grants (as defined in §1.150–1(f)) financed by the issue.

(7) *Examples.* The operation of this paragraph (i) is illustrated by the following examples:

Example 1. Treatment of investment earnings. City *F* issues bonds having an issue price of $10,000,000. *F* deposits all of the proceeds of the issue into a construction fund to be used for expenditures other than costs of issuance. *F* estimates on the issue date that, based on reasonably expected expenditures and rates of investment, earnings on the construction fund will be $800,000. As of the issue date and the end of each of the first three spending periods, the amount of available construction proceeds is $10,800,000. To qualify as a construction issue, *F* must reasonably expect on the issue date that at least $8,100,000 (75 percent of $10,800,000) will be used for construction expenditures. In order to meet the 10 percent spending requirement at the end of the first spending period, *F* must spend at least $1,080,000. As of the end of the fourth spending period, *F* has received $1,100,000 in earnings. In order to meet the spending requirement at the end of the fourth spending period, however, *F* must spend all of the $11,100,000 of actual available construction proceeds (except for reasonable retainage not exceeding $555,000).

Example 2. Treatment of investment earnings without a reserve fund. City *G* issues bonds having an issue price of $11,200,000. *G* does not elect to exclude earnings on the reserve fund from available construction proceeds. *G* uses $200,000 of proceeds to pay issuance costs and deposits $1,000,000 of proceeds into a reasonably required reserve fund. *G* deposits the remaining $10,000,000 of proceeds into a construction fund to be used for construction expenditures. On the issue date, *G* reasonably expects that, based on the reasonably expected date of substantial completion and rates of investment, total earnings on the construction fund will be $800,000, and total earnings on the reserve fund to the date of substantial completion will be $150,000. *G* reasonably expects that substantial completion will occur during the fourth spending period. As of the issue date, the amount of available construction proceeds is $10,950,000 ($10,000,000 originally deposited into the construction fund plus $800,000 expected earnings on the construction fund and $150,000 expected earnings on the reserve fund). To qualify as a construction issue, *G* must reasonably expect on the issue date that at least $8,212,500 will be used for construction expenditures.

Example 3. Election to exclude earnings on a reserve fund. The facts are the same as *Example 2*, except that *G* elects on the issue date to exclude earnings on the reserve fund from available construction proceeds. The amount of available construction proceeds as of the issue date is $10,800,000.

(j) *Election to treat portion of issue used for construction as separate issue*—(1) *In general.* For purposes of paragraph (e) of this section, if any proceeds of an issue are to be used for construction expenditures, the issuer may elect on or before the issue date to treat the portion of the issue that is not a refunding issue as two, and only two, separate issues, if—

(i) One of the separate issues is a construction issue as defined in paragraph (f) of this section;

(ii) The issuer reasonably expects, as of the issue date, that this construction issue will finance all of the construction expenditures to be financed by the issue; and

(iii) The issuer makes an election to apportion the issue under this paragraph (j)(1) in which it identifies the amount of the issue price of the issue allocable to the construction issue.

(2) *Example.* The operation of this paragraph (j) is illustrated by the following example.

Example. City *D* issues bonds having an issue price of $19,000,000. On the issue date, *D* reasonably expects to use $10,800,000 of bond proceeds (including investment earnings) for construction expenditures for the project being financed. *D* deposits $10,000,000 in a construction fund to be used for construction expenditures and $9,000,000 in an acquisition fund to be used for acquisition of equipment not qualifying as construction expenditures. *D* estimates on the issue date, based on reasonably expected expenditures and rates of investment, that total earnings on the construction fund will be $800,000 and total earnings on the acquisition fund will be $200,000. Because the total construction expenditures to be financed by the issue are expected to be $10,800,000, the maximum available construction proceeds for a construction issue is $14,400,000 ($10,800,000 divided by 0.75). To determine the maximum amount of the issue price allocable to a construction issue, the estimated investment earnings allocable to the construction issue are subtracted. The entire $800,000 of earnings on the construction fund are allocable to the construction issue. Only a portion of the $200,000 of earnings on the acquisition fund, however, are allocable to the construction issue. The total amount of the available construction proceeds that is expected to be used for acquisition is $3,600,000 ($14,400,000 − $10,800,000). The portion of earnings on the acquisition fund that is allocable to the construction issue is $78,261 ($200,000 × $3,600,000/$9,200,000). Accordingly, *D* may elect on or before the issue date to treat up to $13,521,739 of the issue price as a construction issue ($14,400,000 − $800,000 − $78,261). *D*'s election must specify the amount of the issue price treated as a construction issue. The balance of the issue price is treated as a separate nonconstruction issue that is subject to the rebate requirement unless it meets another exception to arbitrage rebate. Because the financing of a construction issue is a separate governmental purpose under §1.148–9(h), the election causes the issue to be a multipurpose issue under that section.

(k) *One and one-half percent penalty in lieu of arbitrage rebate*—(1) *In general.* Under section 148(f)(4)(C)(vii), an issuer of a construction issue may elect on or before the issue date to pay a penalty (the *1½ percent penalty*) to the United States in lieu of the obligation to pay the rebate amount on available construction proceeds upon failure to satisfy the spending requirements of paragraph (e) of this section. The 1½ percent penalty is calculated separately for each spending period, including each semiannual period after the end of the fourth spending period, and is equal to 1.5 percent times the underexpended proceeds as of the end of the spending period. For each spending period, underexpended proceeds equal the amount of available construction proceeds required to be spent by the end of the spending period, less the amount actually allocated to expenditures for the governmental purposes of the issue by that date. The 1½ percent penalty must be paid to the United States no later than 90 days after the end of the spending period to which it relates. The 1½ percent penalty continues to apply at the end of each spending period and each semiannual period thereafter until the earliest of the following—

(i) The termination of the penalty under paragraph (l) of this section;

(ii) The expenditure of all of the available construction proceeds; or

(iii) The last stated final maturity date of bonds that are part of the issue and any bonds that refund those bonds.

(2) *Application to reasonable retainage.* If an issue meets the exception for reasonable retainage except that all retainage is not spent within 3 years of the issue date, the issuer must pay the 1½ percent penalty to the United States for any reasonable retainage that was not so spent as of the close of the 3-year period and each later spending period.

(3) *Coordination with rebate requirement.* The rebate requirement is treated as met with respect to available construction proceeds for a period if

the 1½ percent penalty is paid in accordance with this section.

(l) *Termination of 1½ percent penalty*—(1)*Termination after initial temporary period.* The issuer may terminate the 1½ percent penalty after the initial temporary period (a *section 148(f)(4)(C)(viii) penalty termination*) if—

(i) Not later than 90 days after the earlier of the end of the initial temporary period or the date construction is substantially completed, the issuer elects to terminate the 1½ percent penalty; provided that solely for this purpose, the initial temporary period may be extended by the issuer to a date ending 5 years after the issue date;

(ii) Within 90 days after the end of the initial temporary period, the issuer pays a penalty equal to 3 percent of the unexpended available construction proceeds determined as of the end of the initial temporary period, multiplied by the number of years (including fractions of years computed to 2 decimal places) in the initial temporary period;

(iii) For the period beginning as of the close of the initial temporary period, the unexpended available construction proceeds are not invested in higher yielding investments; and

(iv) On the earliest date on which the bonds may be called or otherwise redeemed, with or without a call premium, the unexpended available construction proceeds as of that date (not including any amount earned after the date on which notice of the redemption was required to be given) must be used to redeem the bonds. Amounts used to pay any call premium are treated as used to redeem bonds. This redemption requirement may be met by purchases of bonds by the issuer on the open market at prices not exceeding fair market value. A portion of the annual principal payment due on serial bonds of a construction issue may be paid from the unexpended amount, but only in an amount no greater than the amount that bears the same ratio to the annual principal due that the total unexpended amount bears to the issue price of the construction issue.

(2) *Termination before end of initial temporary period.* If the construction to be financed by the construction issue is substantially completed before the end of the initial temporary period, the issuer may elect to terminate the 1½ percent penalty before the end of the initial temporary period (a *section 148(f)(4)(C)(ix) penalty termination*) if—

(i) Before the close of the initial temporary period and not later than 90 days after the date the construction is substantially completed, the issuer elects to terminate the 1½ percent penalty;

(ii) The election identifies the amount of available construction proceeds that will not be spent for the governmental purposes of the issue; and

(iii) The issuer has met all of the conditions for a section 148(f)(4)(C)(viii) penalty termination, applied as if the initial temporary period ended as of the date the required election for a section 148(f)(4)(C)(ix) penalty termination is made. That penalty termination election satisfies the required election for a section 148(f)(4)(C)(viii) termination.

(3) *Application to reasonable retainage.* Solely for purposes of determining whether the conditions for terminating the 1½ percent penalty are met, reasonable retainage may be treated as spent for a governmental purpose of the construction issue. Reasonable retainage that is so treated continues to be subject to the 1½ percent penalty.

(4) *Example.* The operation of this paragraph (l) is illustrated by the following example.

Example. City *I* issues a construction issue having a 20-year maturity and qualifying for a 3-year initial temporary period. The bonds are first subject to optional redemption 10 years after the issue date at a premium of 3 percent. *I* elects, on or before the issue date, to pay the 1½ percent penalty in lieu of arbitrage rebate. At the end of the 3-year temporary period, the project is not substantially completed, and $1,500,000 of available construction proceeds of the issue are unspent. At that time, *I* reasonably expects to need $500,000 to complete the project. *I* may terminate the 1½ percent penalty in lieu of arbitrage rebate with respect to the excess $1,500,000 by electing to terminate within 90 days of the end of the initial temporary period; paying a penalty to the United States of $135,000 (3 percent of $1,500,000 multiplied by 3 years); restricting the yield on the investment of unspent available construction proceeds for 7 years until the first call date, although any portion of these proceeds may still be spent on the project prior to that call date; and using the available construction proceeds that, as of the first call date, have not been allocated to expenditures for the governmental purposes of the issue to redeem bonds on that call date. If *I* fails to make the termination election, *I* is required to pay the 1½ percent penalty on unspent available construction proceeds every 6 months until the latest maturity date of bonds of the issue (or any bonds of another issue that refund such bonds).

(m) *Payment of penalties.* Each penalty payment under this section must be paid in the manner provided in §1.148–3(g). See §1.148–3(h) for rules on failures to pay penalties under this section.

[T.D. 8476, 58 FR 33535, June 18, 1993; 58 FR 44452, Aug. 23, 1993; T.D. 9777, 81 FR 46597, July 18, 2016]

§ 1.148–8 Small issuer exception to rebate requirement.

(a) *Scope.* Under section 148(f)(4)(D), bonds issued to finance governmental activities of certain small issuers are treated as meeting the arbitrage rebate requirement of section 148(f)(2) (the ''small issuer exception''). This section provides guidance on the small issuer exception.

(b) *General taxing powers.* The small issuer exception generally applies only to bonds issued by governmental units with general taxing powers. A governmental unit has general taxing powers if it has the power to impose taxes (or to cause another entity to impose taxes) of general applicability which, when collected, may be used for the general purposes of the issuer. The taxing power may be limited to a specific type of tax, provided that the applicability of the tax is not limited to a small number of persons. The governmental unit's exercise of its taxing power may be subject to procedural limitations, such as voter approval requirements, but may not be contingent on approval by another governmental unit. See, also, section 148(f)(4)(D)(iv).

(c) *Size limitation*—(1) *In general.* An issue (other than a refunding issue) qualifies for the small issuer exception only if 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 during that calendar year will not exceed $5,000,000; or the aggregate face amount of all tax-exempt bonds of the issuer (other than private activity bonds) actually issued during that calendar year does not exceed $5,000,000. For this purpose, if an issue has more than a de minimis amount of original issue discount or premium, *aggregate face amount* means the aggregate issue price of that issue (determined without regard to pre-issuance accrued interest).

(2) *Aggregation rules.* The following aggregation rules apply for purposes of applying the $5,000,000 size limitation under paragraph (c)(1) of this section.

(i) *On-behalf-of issuers.* An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

(ii) *Subordinate entities*—(A) *In general.* Except as otherwise provided in paragraph (d) of this section and section 148(f)(4)(D)(iv), all bonds issued by a subordinate entity are also treated as issued by each entity to which it is subordinate. An issuer is subordinate to another governmental entity if it is directly or indirectly controlled by the other entity within the meaning of §1.150–1(e).

(B) *Exception for allocations of size limitation.* If an entity properly makes an allocation of a portion of its $5,000,000 size limitation to a subordinate entity (including an on behalf of issuer) under section 148(f)(4)(D)(iv), the portion of bonds issued by the subordinate entity under the allocation is treated as issued only by the allocating entity and not by any other entity to which the issuing entity is subordinate. These allocations are irrevocable and must bear a reasonable relationship to the benefits received by the allocating unit from issues issued by the subordinate entity. The benefits to be considered include the manner in which—

(*1*) Proceeds are to be distributed;

(*2*) The debt service is to be paid;

(*3*) The facility financed is to be owned;

(*4*) The use or output of the facility is to be shared; and

(*5*) Costs of operation and maintenance are to be shared.

(iii) *Avoidance of size limitation.* An entity formed or availed of to avoid the purposes of the $5,000,000 size limitation and all entities that would benefit from the avoidance are treated as one issuer. Situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer—

(A) Issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity; and

(B) Does not receive a substantial benefit from the project financed by the bonds.

(3) *Certain refunding bonds not taken into account.* In applying the $5,000,000 size limitation, there is not taken into account the portion of an issue that is a current refunding issue to the extent that the stated principal amount of the refunding bond does not exceed the portion of the outstanding stated principal amount of the refunded bond paid with proceeds of the refunding bond. For this purpose, *principal amount* means, in reference to a plain par bond, its stated principal amount plus accrued unpaid interest, and in reference to any other bond, its present value.

(d) *Pooled financings—treatment of conduit borrowers.* A loan to a conduit borrower in a pooled financing qualifies for the small issuer exception, regardless of the size of either the pooled financing or of any loan to other conduit borrowers, only if—

(1) The bonds of the pooled financing are not private activity bonds;

(2) None of the loans to conduit borrowers are private activity bonds; and

(3) The loan to the conduit borrower meets all the requirements of the small issuer exception.

(e) *Refunding issues*—(1) *In general.* Sections 148(f)(4)(D) (v) and (vi) provide restrictions on application of the small issuer exception to refunding issues.

(2) *Multipurpose issues.* The multipurpose issue allocation rules of §1.148–9(h) apply for purposes of determining whether refunding bonds meet the requirements of section 148(f)(4)(D)(v).

[T.D. 8476, 58 FR 33540, June 18, 1993, as amended by T.D. 9777, 81 FR 46597, July 18, 2016]

§1.148–9 Arbitrage rules for refunding issues.

(a) *Scope of application.* This section contains special arbitrage rules for refunding issues. These rules apply for all purposes of section 148 and govern allocations of proceeds, bonds, and investments to determine transferred proceeds, temporary periods, reasonably required reserve or replacement funds, minor portions, and separate issue treatment of certain multipurpose issues.

(b) *Transferred proceeds allocation rule*—(1) *In general.* When proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is an amount equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction—

(i) The numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge; and

(ii) The denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge.

(2) *Special definition of principal amount.* For purposes of this section, *principal amount* means, in reference to a plain par bond, its stated principal amount, and in reference to any other bond, its present value.

(3) *Relation of transferred proceeds rule to universal cap rule*—(i) *In general.* Paragraphs (b)(1) and (c) of this section apply to allocate transferred proceeds and corresponding investments to a refunding issue on any date required by those paragraphs before the application of the universal cap rule of §1.148–6(b)(2) to reallocate any of those amounts. To the extent nonpurpose investments allocable to proceeds of a refunding issue exceed the universal cap for the issue on the date that amounts become transferred proceeds of the refunding issue, those transferred proceeds and corresponding investments are reallocated back to the issue from which they transferred on that same date to the extent of the unused universal cap on that prior issue.

(ii) *Example*. The following example illustrates the application of this paragraph of (b)(3):

Example. On January 1, 1995, $100,000 of nonpurpose investments allocable to proceeds of issue *A* become transferred proceeds of issue *B* under §1.148–9, but the unused portion of issue *B'* s universal cap is $75,000 as of that date. On January 1, 1995, issue *A* has unused universal cap in excess of $25,000. Thus, $25,000 of nonpurpose investments representing the transferred proceeds are immediately reallocated back to issue *A* on January 1, 1995, and are proceeds of issue *A*. On the next transfer date under §1.148–9, the $25,000 receives no priority in determining transferred proceeds as of that date but is treated the same as all other proceeds of issue *A* subject to transfer.

(4) *Limitation on multi-generational transfers*. This paragraph (b)(4) contains limitations on the manner in which proceeds of a first generation issue that is refunded by a refunding issue (a *second generation issue*) become transferred proceeds of a refunding issue (a *third generation issue*) that refunds the second generation issue. Proceeds of the first generation issue that become transferred proceeds of the third generation issue are treated as having a yield equal to the yield on the refunding escrow allocated to the second generation issue (*i.e.*, as determined under §1.148–5(b)(2)(iv)). The determination of the transferred proceeds of the third generation issue does not affect compliance with the requirements of section 148, including the determination of the amount of arbitrage rebate with respect to or the yield on the refunding escrow, of the second generation issue.

(c) *Special allocation rules for refunding issues*—(1) *Allocations of investments*—(i) *In general*. Except as otherwise provided in this paragraph (c), investments purchased with sale proceeds or investment proceeds of a refunding issue must be allocated to those proceeds, and investments not purchased with those proceeds may not be allocated to those proceeds (*i.e.*, a *specific tracing method*).

(ii) *Allocations to transferred proceeds*. When proceeds of a prior issue become transferred proceeds of a refunding issue, investments (and the related payments and receipts) of proceeds of the prior issue that are held in a refunding escrow for another issue are allocated to the transferred proceeds under the ratable allocation method described in paragraph (c)(1)(iii) of this section. Investments of proceeds of the prior issue that are not held in a refunding escrow for another issue are allocated to the transferred proceeds by application of the allocation methods described in paragraph (c)(1) (iii) or (iv) of this section, consistently applied to all investments on a transfer date.

(iii) *Ratable allocation method*. Under the ratable allocation method, a ratable portion of each nonpurpose and purpose investment of proceeds of the prior issue is allocated to transferred proceeds of the refunding issue.

(iv) *Representative allocation method*—(A) *In general*. Under the representative allocation method, representative portions of the portfolio of nonpurpose investments and the portfolio of purpose investments of proceeds of the prior issue are allocated to transferred proceeds of the refunding issue. Unlike the ratable allocation method, this representative allocation method permits an allocation of particular whole investments. Whether a portion is representative is based on all the facts and circumstances, including, without limitation, whether the current yields, maturities, and current unrealized gains or losses on the particular allocated investments are reasonably comparable to those of the unallocated investments in the aggregate. In addition, if a portion of nonpurpose investments is otherwise representative, it is within the issuer's discretion to allocate the portion from whichever source of funds it deems appropriate, such as a reserve fund or a construction fund for a prior issue.

(B) *Mark-to-market safe harbor for representative allocation method*. In addition to other representative allocations, a specific allocation of a particular nonpurpose investment to transferred proceeds (e.g., of lower yielding investments) is treated as satisfying the representative allocation method if that investment is valued at fair market value on the transfer date in determining the payments and receipts on that date, but only if the portion of the nonpurpose investments that transfers is based on the relative fair market value of all nonpurpose investments.

(2) *Allocations of mixed escrows to expenditures for principal, interest, and redemption prices on a prior issue*—(i) *In general.* Except for amounts required or permitted to be accounted for under paragraph (c)(2)(ii) of this section, proceeds of a refunding issue and other amounts that are not proceeds of a refunding issue that are deposited in a refunding escrow (a *mixed escrow*) must be accounted for under this paragraph (c)(2)(i). Those proceeds and other amounts must be allocated to expenditures for principal, interest, or stated redemption prices on the prior issue so that the expenditures of those proceeds do not occur faster than ratably with expenditures of the other amounts in the mixed escrow. During the period that the prior issue has unspent proceeds, however, these allocations must be ratable (with reasonable adjustments for rounding) both between sources for expenditures (*i.e.*, proceeds and other amounts) and between uses (*i.e.*, principal, interest, and stated redemption prices on the prior issue).

(ii) *Exceptions*—(A) *Mandatory allocation of certain non-proceeds to earliest expenditures.* If amounts other than proceeds of the refunding issue are deposited in a mixed escrow, but before the issue date of the refunding issue those amounts had been held in a bona fide debt service fund or a fund to carry out the governmental purpose of the prior issue (e.g., a construction fund), those amounts must be allocated to the earliest maturing investments in the mixed escrow.

(B) *Permissive allocation of non-proceeds to earliest expenditures.* Excluding amounts covered by paragraph (c)(2)(ii)(A) of this section and subject to any required earlier expenditure of those amounts, any amounts in a mixed escrow that are not proceeds of a refunding issue may be allocated to the earliest maturing investments in the mixed escrow, provided that those investments mature and the proceeds thereof are expended before the date of any expenditure from the mixed escrow to pay any principal of the prior issue.

(d) *Temporary periods in refundings*—(1) *In general.* Proceeds of a refunding issue may be invested in higher yielding investments under section 148(c) only during the temporary periods described in paragraph (d)(2) of this section.

(2) *Types of temporary periods in refundings.* The available temporary periods for proceeds of a refunding issue are as follows:

(i) *General temporary period for refunding issues.* Except as otherwise provided in this paragraph (d)(2), the temporary period for proceeds (other than transferred proceeds) of a refunding issue is the period ending 30 days after the issue date of the refunding issue.

(ii) *Temporary periods for current refunding issues*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days.

(B) *Temporary period for short-term current refunding issues.* The temporary period for proceeds (other than transferred proceeds) of a current refunding issue that has an original term to maturity of 270 days or less may not exceed 30 days. The aggregate temporary periods for proceeds (other than transferred proceeds) of all current refunding issues described in the preceding sentence that are part of the same series of refundings is 90 days. An issue is part of a series of refundings if it finances or refinances the same expenditures for a particular governmental purpose as another issue.

(iii) *Temporary periods for transferred proceeds*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(iii)(B) of this section, each available temporary period for transferred proceeds of a refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue.

(B) *Termination of initial temporary period for prior issue in an advance refunding.* The initial temporary period under §1.148–2(e) (2) and (3) for the proceeds of a prior issue that is refunded by an advance refunding issue (including transferred proceeds) terminates on the issue date of the advance refunding issue.

(iv) *Certain short-term gross proceeds.* Except for proceeds of a refunding issue held in a refunding escrow, proceeds otherwise reasonably expected to be used to pay principal or interest on the prior issue, replacement proceeds not held in a bona fide debt service fund, and transferred proceeds, the temporary period for gross proceeds of a refunding issue is the 13-month period beginning on the date of receipt.

(e) *Reasonably required reserve or replacement funds in refundings.* In addition to the requirements of §1.148–2(f), beginning on the issue date of a refunding issue, a reserve or replacement fund for a refunding issue or a prior issue is a reasonably required reserve or replacement fund under section 148(d) that may be invested in higher yielding investments only if the aggregate amount invested in higher yielding investments under this paragraph (e) for both the refunding issue and the prior issue does not exceed the size limitations under §1.148–2 (f)(2) and (f)(3), measured by reference to the refunding issue only (regardless of whether proceeds of the prior issue have become transferred proceeds of the refunding issue).

(f) *Minor portions in refundings.* Beginning on the issue date of the refunding issue, gross proceeds not in excess of a minor portion of the refunding issue qualify for investment in higher yielding investments under section 148(e), and gross proceeds not in excess of a minor portion of the prior issue qualify for investment in higher yielding investments under either section 148(e) or section 149(d)(3)(A)(v), whichever is applicable. *Minor portion* is defined in §1.148–2(g).

(g) *Certain waivers permitted.* On or before the issue date, an issuer may waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve or replacement fund. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion.

(h) *Multipurpose issue allocations*—(1) *Application of multipurpose issue allocation rules.* The portion of the bonds of a multipurpose issue reasonably allocated to any separate purpose under this paragraph (h) is treated as a separate issue for all purposes of section 148 except the following—

(i) *Arbitrage yield.* Except to the extent that the proceeds of an issue are allocable to two or more conduit loans that are tax-exempt bonds, determining the yield on a multipurpose issue and the yield on investments for purposes of the arbitrage yield restrictions of section 148 and the arbitrage rebate requirement of section 148(f);

(ii) *Rebate amount.* Except as provided in paragraph (h)(1)(i) of this section, determining the rebate amount for a multipurpose issue, including subsidiary matters with respect to that determination, such as the computation date credit under §1.148–3(d)(1), the due date for payments, and the $100,000 bona fide debt service fund exception under section 148(f)(4)(A)(ii);

(iii) *Minor portion.* Determining the *minor portion* of an issue under section 148(e);

(iv) *Reasonably required reserve or replacement fund.* Determining the portion of an issue eligible for investment in higher yielding investments as part of a reasonably required reserve or replacement fund under section 148(d); and

(v) *Effective date.* Applying the provisions of §1.148–11(b) (relating to elective retroactive application of §§1.148–1 through 1.148–10 to certain issues).

(2) *Rules on allocations of multipurpose issues*—(i) *In general.* This paragraph (h) applies to allocations of multipurpose issues, including allocations involving the refunding purposes of the issue. Except as otherwise provided in this paragraph (h), proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method. An allocation is not reasonable if it achieves more favorable results under section 148 or 149(d) than could be achieved with actual separate issues. An allocation under this paragraph (h) may be made at any time, but once made may not be changed.

(ii) *Allocations involving certain common costs.* A ratable allocation of common costs (as described in paragraph (h)(3)(ii) of this section) among the separate purposes of the multipurpose issue is generally reasonable. If another allocation method more accurately reflects the extent to which any separate purpose of a multipurpose issue enjoys the economic benefit or bears the economic burden of certain common costs, that allocation method may be used.

(3) *Separate purposes of a multipurpose issue*—(i) *In general.* Separate purposes of a multipurpose issue include refunding a separate prior issue, financing a separate purpose investment, financing a construction issue (as defined in §1.148–7(f)), and any clearly discrete governmental purpose reasonably expected to be financed by that issue. In general, all integrated or functionally related capital projects that qualify for the same initial temporary period under §1.148–2(e)(2) are treated as having a single governmental purpose. The separate purposes of a refunding issue include the separate purposes of the prior issue, if any. Separate purposes may be treated as a single purpose if the proceeds used to finance those purposes are eligible for the same initial temporary period under section 148(c). For example, the use of proceeds of a multipurpose issue to finance separate qualified mortgage loans may be treated as a single purpose.

(ii) *Financing common costs.* Common costs of a multipurpose issue are not separate purposes. Common costs include issuance costs, accrued interest, capitalized interest on the issue, a reserve or replacement fund, qualified guarantee fees, and similar costs properly allocable to the separate purposes of the issue.

(iii) *Example.* The following example illustrates the application of this paragraph (h)(3).

Example. On January 1, 1994, Housing Authority of State *A* issues a $10 million issue (the *1994 issue*) at an interest rate of 10 percent to finance qualified mortgage loans for owner-occupied residences under section 143. During 1994, *A* originates $5 million in qualified mortgage loans at an interest rate of 10 percent. In 1995, the market interest rates for housing loans falls to 8 percent and *A* is unable to originate further loans from the 1994 issue. On January 1, 1996, *A* issues a $5 million issue (the *1996 issue*) at an interest rate of 8 percent to refund partially the 1994 issue. Under paragraph (h) of this section, *A* treats the portion of the 1994 issue used to originate $5 million in loans as a separate issue comprised of that group of purpose investments. *A* allocates those purpose investments representing those loans to that separate unrefunded portion of the issue. In addition, *A* treats the unoriginated portion of the 1994 issue as a separate issue and allocates the nonpurpose investments representing the unoriginated proceeds of the 1994 issue to the refunded portion of the issue. Thus, when proceeds of the 1996 issue are used to pay principal on the refunded portion of the 1994 issue that is treated as a separate issue under paragraph (h) of this section, only the portion of the 1994 issue representing unoriginated loan funds invested in nonpurpose investments transfer to become transferred proceeds of the 1996 issue.

(4) *Allocations of bonds of a multipurpose issue*—(i) *Reasonable allocation of bonds to portions of issue.* After reasonable adjustment of the issue price of a multipurpose issue to account for common costs, the portion of the bonds of a multipurpose issue allocated to a separate purpose must have an issue price that bears the same ratio to the aggregate issue price of the multipurpose issue as the portion of the sale proceeds of the multipurpose issue used for that separate purpose bears to the aggregate sale proceeds of the multipurpose issue. For a refunding issue used to refund two or more prior issues, the portion of the sales proceeds allocated to the refunding of a separate prior issue is based on the present value of the refunded debt service on that prior issue, using the yield on investments in the refunding escrow allocable to the entire refunding issue as the discount rate.

(ii) *Safe harbor for pro rata allocation method for bonds.* The use of the relative amount of sales proceeds used for each separate purpose to ratably allocate each bond or a ratable number of substantially identical whole bonds is a reasonable method for allocating bonds of a multipurpose issue.

(iii) *Safe harbor for allocations of bonds used to finance separate purpose investments.* An allocation of a portion of the bonds of a multipurpose issue to a particular purpose investment is generally reasonable if that purpose investment has principal and interest payments that reasonably coincide in time and amount to principal and interest payments on the bonds allocated to that purpose investment.

(iv) *Rounding of bond allocations to next whole bond denomination permitted.* An allocation that rounds each resulting fractional bond up or down to the next integral multiple of a permitted denomination of bonds of that issue not in excess of $100,000 does not prevent the allocation from satisfying this paragraph (h)(4).

(v) *Restrictions on allocations of bonds to refunding purposes.* For each portion of a multipurpose issue that is used to refund a separate prior issue, a method of allocating bonds of that issue is reasonable under this paragraph (h) only if, in addition to the requirements of paragraphs (h)(1) and (h)(2) of this section, the portion of the bonds allocated to the refunding of that prior issue—

(A) Results from a pro rata allocation under paragraph (h)(4)(ii) of this section;

(B) Reflects aggregate principal and interest payable in each bond year that is less than, equal to, or proportionate to, the aggregate principal and interest payable on the prior issue in each bond year;

(C) Results from an allocation of all the bonds of the entire multipurpose issue in proportion to the remaining weighted average economic life of the capital projects financed or refinanced by the issue, determined in the same manner as under section 147(b); or

(D) Results from another reasonable allocation method, but only to the extent that the application of the allocation methods provided in this paragraph (h)(4)(v) is not permitted under state law restrictions applicable to the bonds, reasonable terms of bonds issued before, or subject to a master indenture that became effective prior to, July 1, 1993, or other similar restrictions or circumstances. This paragraph (h)(4)(v)(D) shall be strictly construed and is available only if it does not result in a greater burden on the market for tax-exempt bonds than would occur using one of the other allocation methods provided in this paragraph (h)(4)(v). (See also §1.148–11(c)(2).)

(vi) *Exception for refundings of interim notes.* Paragraph (h)(4)(v) of this section need not be applied to refunding bonds issued to provide permanent financing for one or more projects if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(5) *Limitation on multi-generation allocations.* This paragraph (h) does not apply to allocations of a multipurpose refunded issue unless that refunded issue is refunded directly by an issue to which this paragraph (h) applies. For example, if a 1994 issue refunds a 1984 multipurpose issue, which in turn refunded a 1980 multipurpose issue, this paragraph (h) applies to allocations of the 1984 issue for purposes of allocating the refunding purposes of the 1994 issue, but does not permit allocations of the 1980 issue.

(i) *Operating rules for separation of prior issue into refunded and unrefunded portions*—(1) *In general.* For purposes of paragraph (h)(3)(i) of this section, the separate purposes of a prior issue include the refunded and unrefunded portions of the prior issue. Thus, the refunded and unrefunded portions are treated as separate issues under paragraph (h)(1) of this section. Those separate issues must satisfy the requirements of paragraphs (h) and (i) of this section. The refunded portion of the bonds of a prior issue is based on a fraction the numerator of which is the principal amount of the prior issue to be paid with proceeds of the refunding issue and the denominator of which is the outstanding principal amount of the bonds of the prior issue, each determined as of the issue date of the refunding issue. (See also paragraph (b)(2) of this section.)

(2) *Allocations of proceeds and investments in a partial refunding.* As of the issue date of a partial refunding issue under this paragraph (i), unspent proceeds of the prior issue are allocated ratably between the refunded and unrefunded portions of the prior issue and the investments allocable to those unspent proceeds are allocated in the 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.

[T.D. 8476, 58 FR 33541, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24045, May 10, 1994; T.D. 8718, 62 FR 25512, May 9, 1997]

§ 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, such as bona fide cost underruns, an issuer's bona fide need to finance extraordinary working capital items, or an issuer's 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 letter 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 prevent transactions that are inconsistent with the purpose of the arbitrage investment restrictions.* 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 reflect the economics of the transaction to prevent such financial advantage. 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, 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.

[T.D. 8476, 58 FR 33544, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8476, 59 FR 24351, May 11, 1994; T.D. 8718, 62 FR 25512, May 9, 1997; T.D. 9777, 81 FR 46597, July 18, 2016]

§ 1.148–11 Effective/applicability 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 contracts 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.* (i) 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—

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

(B) The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers or public elementary and public secondary schools;

(C) Substantially all of the available income of the fund is required to be applied annually to support designated functions;

(D) The issue guaranteed consists of obligations that are not private activity bonds (other than qualified 501(c)(3) bonds) substantially all of the proceeds of which are to be used for designated functions;

(E) The fund satisfied each of the requirements of paragraphs (d)(1)(i) through (d)(1)(iii) of this section on August 16, 1986; and

(F) As of the sale date of the bonds to be guaranteed, the amount of the bonds to be guaranteed by the fund plus the then-outstanding amount of bonds previously guaranteed by the fund does not exceed a total amount equal to 500 percent of the total costs of the assets held by the fund as of December 16, 2009.

(ii) The Commissioner may, by published guidance, set forth additional circumstances under which guarantees by certain perpetual trust funds will not cause amounts in the fund to be treated as replacement proceeds.

(2) *Permanent University Fund.* Replacement proceeds do not include amounts allocable to investments of the fund described in section 648 of Public Law 98–369.

(e) *Transition rule regarding special allowance payments.* Section 1.148–5(b)(5) applies to any bond issued after January 5, 1990, except a bond issued exclusively to refund a bond issued before January 6, 1990, if the amount of the refunding bond does not exceed 101 percent of the amount of the refunded bond, and the maturity date of the refunding bond is not later than the date that is 17 years after the date on which the refunded bond was issued (or, in the case of a series of refundings, the date on which the original bond was issued), but only if §1.148–2(d)(2)(iv) is applied by substituting *1 and one-half percentage points* for *2 percentage points.*

(f) *Transition rule regarding applicability of yield reduction rule.* Section 1.148–5(c) applies to nonpurpose investments allocable to replacement proceeds of an issue that are held in a reserve or replacement fund to the extent that—

(1) Amounts must be paid into the fund under a constitutional provision, statute, or ordinance adopted before May 3, 1978;

(2) Under that provision, amounts paid into the fund (and investment earnings thereon) can be used only to pay debt service on the issues; and

(3) The size of the payments made into the fund is independent of the size of the outstanding issues or the debt service thereon.

(g) *Provisions applicable to certain bonds sold before effective date.* Except for bonds to which paragraph (b)(1) of this section applies—

(1) Section 1.148–11A provides rules applicable to bonds sold after June 6, 1994, and before July 8, 1997; and

(2) Sections 1.148–1 through 1.148–11 as in effect on July 1, 1993 (see 26 CFR part 1 as revised April 1, 1994), and §1.148–11A(i) (relating to elective retroactive application of certain provisions) provide rules applicable to certain issues issued before June 7, 1994.

(h) *Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.* The provisions of §1.148–5(d)(6)(iii) are applicable to bonds sold on or after March 1, 1999. Issuers may apply these provisions to bonds sold on or after December 30, 1998, and before March 1, 1999.

(i) *Special rule for certain broker's commissions and similar fees.* Section 1.148–5(e)(2)(iii) applies to bonds sold on or after February 9, 2004. In the case of bonds sold before February 9, 2004, that are subject to §1.148–5 (pre-effective date bonds), issuers may apply §1.148–5(e)(2)(iii), in whole but not in part, with respect to transactions entered into on or after December 11, 2003. If an issuer applies §1.148–5(e)(2)(iii) to pre-effective date bonds, the per-issue safe harbor in §1.148–5(e)(2)(iii)(B)(*1*)(*ii*) is applied by taking into account all brokers' commissions or similar fees with respect to guaranteed investment contracts and investments for yield restricted defeasance escrows that the issuer treats as qualified administrative costs for the issue, including all such commissions or fees paid before February 9, 2004. For purposes of §§1.148–5(e)(2)(iii)(B)(*3*) and 1.148–5(e)(2)(iii)(B)(*6*) (relating to cost-of-living adjustments), transactions entered into before 2003 are treated as entered into in 2003.

(j) *Certain prepayments.* Section 1.148–1(e)(1) and (2) apply to bonds sold on or after October 3, 2003. Issuers may apply §1.148–1(e)(1) and (2), in whole but not in part, to bonds sold before October 3, 2003, that are subject to §1.148–1.

(k) *Certain arbitrage guidance updates*—(1) *In general.* Sections 1.148–1(c)(4)(i)(B)(1); 1.148–1(c)(4)(i)(B)(4); 1.148–1(c)(4)(ii); 1.148–2(e)(3)(i); 1.148–3(d)(1)(iv); 1.148–3(d)(4); 1.148–4(a); 1.148–4(b)(3)(i); 1.148–4(h)(2)(ii)(A); 1.148–4(h)(2)(v); 1.148–4(h)(2)(vi); 1.148(h)(4)(i)(C); 1.148–5(c)(3); 1.148–5(d)(2); 1.148–5(d)(3); 1.148–5(d)(6)(i); 1.148–5(d)(6)(iii)(A); 1.148–5(e)(2)(ii)(B); 1.148–6(d)(3)(iii)(A); 1.148–6(d)(4); 1.148–7(c)(3)(v); 1.148–7(i)(6)(ii); 1.148–10(a)(4); 1.148–10(e); 1.148–11(d)(1)(i)(B); 1.148–11(d)(1)(i)(D); 1.148–11(d)(1)(i)(F); and 1.148–11(d)(1)(ii) apply to bonds sold on or after October 17, 2016.

(2) *Valuation of investments in refunding transactions.* Section 1.148–5(d)(3) also applies to bonds refunded by bonds sold on or after October 17, 2016.

(3) *Rebate overpayment recovery.* (i) Section 1.148–3(i)(3)(i) applies to claims arising from an issue of bonds to which §1.148–3(i) applies and for which the final computation date is after June 24, 2008. For purposes of this paragraph (k)(3)(i), issues for which the actual final computation date is on or before June 24, 2008, are deemed to have a final computation date of July 1, 2008, for purposes of applying §1.148–3(i)(3)(i).

(ii) Section 1.148–3(i)(3)(ii) and (iii) apply to claims arising from an issue of bonds to which §1.148–3(i) applies and for which the final computation date is after September 16, 2013.

(iii) Section 1.148–3(j) applies to bonds subject to §1.148–3(i).

(4) *Hedge identification.* Section 1.148–4(h)(2)(viii) applies to hedges that are entered into on or after October 17, 2016.

(5) *Hedge modifications and termination.* Section 1.148–4(h)(3)(iv)(A) through (H) and (h)(4)(iv) apply to—

(i) Hedges that are entered into on or after *October 17, 2016;*

(ii) Qualified hedges that are modified on or after October 17, 2016 with respect to modifications on or after such date; and

(iii) Qualified hedges on bonds that are refunded on or after October 17, 2016 with respect to the refunding on or after such date.

(6) *Small issuer exception to rebate requirement for conduit borrowers of pooled financings.* Section 1.148–8(d) applies to bonds issued after May 17, 2006.

(l) *Permissive application of certain arbitrage updates*—(1) *In general.* Except as otherwise provided in this paragraph (l), issuers may apply the provisions described in paragraph (k)(1), (2), and (5) in whole, but not in part, to bonds sold before October 17, 2016.

(2) *Computation credit.* Issuers may apply §1.148–3(d)(1)(iv) and (d)(4) for bond years ending on or after July 18, 2016.

(3) *Yield reduction payments.* Issuers may apply §1.148–5(c)(3) for investments purchased on or after July 18, 2016.

(4) *External commingled funds.* Issuers may apply §1.148–5(e)(2)(ii)(B) with respect to costs incurred on or after July 18, 2016.

(m) *Definition of issue price.* The definition of issue price in §1.148–1(b) and (f) applies to bonds that are sold on or after June 7, 2017.

(n) *Investment-type property.* Section 1.148–1(e)(1) and (4) apply to bonds sold on or after July 8, 2019. An issuer may apply the provisions of §1.148–1(e)(1) and (4) to bonds sold before July 8, 2019.

[T.D. 8476, 58 FR 33547, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8718, 62 FR 25512, May 9, 1997; T.D. 8476, 64 FR 37037, July 9, 1999; T.D. 9085, 68 FR 45777, Aug. 4, 2003; T.D. 9097, 68 FR 69023, Dec. 11, 2003; T.D. 9701, 79 FR 67351, Nov. 13, 2014; T.D. 9777, 81 FR 46597, July 18, 2016; 81 FR 57459, Aug. 23, 2016; T.D. 9801, 81 FR 89004, Dec. 9, 2016; 82 FR 37817, Aug. 14, 2017; T.D. 9854, 84 FR 14007, Apr. 9, 2019]

§ 1.149(b)–1 Federally guaranteed bonds.

(a) *General rule.* Under section 149(b) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue that is federally guaranteed.

(b) *Exceptions.* Pursuant to section 149(b)(3)(B), section 149(b)(1) and paragraph (a) of this section do not apply to—

(1) Investments in obligations issued pursuant to §21B(d)(3) of the Federal Home Loan Bank Act, as amended by §511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision; or

(2) Any investments that are held in a refunding escrow (as defined in §1.148–1).

(c) *Effective date.* This section applies to investments made after June 30, 1993.

[T.D. 8476, 58 FR 33548, June 18, 1993]

§ 1.149(d)–1 Limitations on advance refundings.

(a) *General rule.* Under section 149(d) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in paragraphs (2), (3), or (4) of section 149(d).

(b) *Advance refunding issues that employ abusive devices*—(1) *In general.* An advance refunding issue employs an abusive device and is described in section 149(d)(4) if the issue violates any of the anti-abuse rules under §1.148–10.

(2) *Failure to pay required rebate.* An advance refunding issue is described in section 149(d)(4) if the issue fails to meet the requirements of §1.148–3. This paragraph (b)(2) applies to any advance refunding issue issued after August 31, 1986.

(3) *Mixed escrows invested in tax-exempt bonds.* An advance refunding issue is described in section 149(d)(4) if—

(i) Any of the proceeds of the issue are invested in a refunding escrow in which a portion of the proceeds are invested in tax-exempt bonds and a portion of the proceeds are invested in nonpurpose investments;

(ii) The yield on the tax-exempt bonds in the refunding escrow exceeds the yield on the issue;

(iii) The yield on all the investments (including investment property and tax-exempt bonds) in the refunding escrow exceeds the yield on the issue; and

(iv) The weighted average maturity of the tax-exempt bonds in the refunding escrow is more than 25 percent greater or less than the weighted average maturity of the nonpurpose investments in the refunding escrow, and the weighted average maturity of nonpurpose investments in the refunding escrow is greater than 60 days.

(4) *Tax-exempt conduit loans.* For purposes of applying section 149(d) to a conduit financing issue that finances any conduit loan that is a tax-exempt bond, the actual issuer of a conduit financing issue and the conduit borrower of that conduit financing issue are treated as related parties. Thus, the issue date of the conduit loan does not occur prior to the date on which the actual issuer of the conduit financing issue sells, exchanges, or otherwise disposes of that conduit loan, and the use of the proceeds of the disposition to pay debt service on the conduit financing issue causes the conduit loan to be a refunding issue. See §1.148–10(d), *Example 4.*

(c) *Unrefunded debt service remains eligible for future advance refunding.* For purposes of section 149(d)(3)(A)(i), any principal or interest on a prior issue that has not been paid or provided for by any advance refunding issue is treated as not having been advance refunded.

(d) *Application of arbitrage regulations*—(1) *Application of multipurpose issue rules.* For purposes of sections 149(d)(2) and (3)(A)(i), (ii), and (iii), the provisions of the multipurpose issue rule in §1.148–9(h) apply, except that the limitation in §1.148–9(h)(5) is disregarded.

(2) *General mixed escrow rules.* For purposes of section 149(d), the provisions of §1.148–9(c) (relating to mixed escrows) apply, except that those provisions do not apply for purposes of section 149(d)(2) and (d)(3)(A) (i) and (ii)

to amounts that were not gross proceeds of the prior issue before the issue date of the refunding issue.

(3) *Temporary periods and minor portions.* Section 1.148–9(d) and (f) contains rules applicable to temporary periods and minor portions for advance refunding issues.

(4) *Definitions.* Section 1.148–1 applies for purposes of section 149(d).

(e) *Taxable refundings*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, for purposes of section 149(d)(3)(A)(i), an advance refunding issue the interest on which is not excludable from gross income under section 103(a) (*i.e.*, a taxable advance refunding issue) is not taken into account. In addition, for this purpose, an advance refunding of a taxable issue is not taken into account unless the taxable issue is a conduit loan of a tax-exempt conduit financing issue.

(2) *Use to avoid section 149(d)(3)(A)(i).* A taxable issue is taken into account under section 149(d)(3)(A)(i) if it is issued to avoid the limitations of that section. For example, in the case of a refunding of a tax-exempt issue with a taxable advance refunding issue that is, in turn, currently refunded with a tax-exempt issue, the taxable advance refunding issue is taken into account under section 149(d)(3)(A)(i) if the two tax-exempt issues are outstanding concurrently for more than 90 days.

(f) *Redemption at first call date*—(1) *General rule.* Under sections 149(d)(3)(A)(ii) and (iii) (the *first call requirement*), bonds refunded by an advance refunding must be redeemed on their first call date if the savings test under section 149(d)(3)(B)(i) (the *savings test*) is satisfied. The savings test is satisfied if the issuer may realize present value debt service savings (determined without regard to administrative expenses) in connection with the issue of which the refunding bond is a part.

(2) *First call date. First call date* means the earliest date on which a bond may be redeemed (or, if issued before 1986, on the earliest date on which that bond may be redeemed at a redemption price not in excess of 103 percent of par). If, however, the savings test is not met with respect to the date described in the preceding sentence (*i.e.*, there are no present value savings if the refunded bonds are retired on that date), the first call date is the first date thereafter on which the bonds can be redeemed and on which the savings test is met.

(3) *Application of savings test to multipurpose issues.* Except as otherwise provided in this paragraph (f)(3), the multipurpose issue rules in §1.148–9(h) apply for purposes of the savings test. If any separate issue in a multipurpose issue increases the aggregate present value debt service savings on the entire multipurpose issue or reduces the present value debt service losses on that entire multipurpose issue, that separate issue satisfies the savings test.

(g) *Limitation on advance refundings of private activity bonds.* Under section 149(d)(2) and this section, interest on a bond is not excluded from gross income if any portion of the issue of which the bond is a part is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond). For this purpose, the term private activity bond—

(1) Includes a qualified bond described in section 141(e) (other than a qualified 501(c)(3) bond), regardless of whether the refunding issue consists of private activity bonds under §1.141–13; and

(2) Does not include a taxable bond.

(h) *Effective dates*—(1) *In general.* Except as provided in this paragraph (h), this section applies to bonds issued after June 30, 1993, to which §§1.148–1 through 1.148–11 apply, including conduit loans that are treated as issued after June 30, 1993, under paragraph (b)(4) of this section. In addition, this section applies to any issue to which the election described in §1.148–11(b)(1) is made.

(2) *Special effective date for paragraph (b)(3).* Paragraph (b)(3) of this section applies to any advance refunding issue issued after May 28, 1991.

(3) *Special effective date for paragraph (f)(3).* Paragraph (f)(3) of this section applies to bonds sold on or after July 8, 1997 and to any issue to which the election described in §1.148–11(b)(1) is made. See §1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

(4) *Special effective date for paragraph (g).* See §1.141–15 for the applicability date of paragraph (g) of this section.

[T.D. 8476, 58 FR 33548, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8718, 62 FR 25513, May 9, 1997; T.D. 9234, 70 FR 75035, Dec. 19, 2005]

§ 1.149(e)–1 Information reporting requirements for tax-exempt bonds.

(a) *General rule.* Interest on a bond is included in gross income unless certain information with respect to the issue of which the bond is a part is reported to the Internal Revenue Service in accordance with the requirements of this section. This section applies to any bond if the issue of which the bond is a part is issued after December 31, 1986 (including any bond issued to refund a bond issued on or before December 31, 1986).

(b) *Requirements for private activity bonds*—(1) *In general.* If the issue of which the bond is a part is an issue of private activity bonds, the issuer must comply with the following requirements—

(i) Not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, the issuer must file with the Internal Revenue Service a completed information reporting form prescribed for this purpose;

(ii) If any bond that is part of the issue is taken into account under section 146 (relating to volume cap on private activity bonds), the state certification requirement of paragraph (b)(2) of this section must be satisfied; and

(iii) If any bond that is part of the issue is a qualified mortgage bond or qualified veterans' mortgage bond (within the meaning of section 143 (a) or (b) or section 103A(c) (1) or (3) as in effect on the day before enactment of the Tax Reform Act of 1986), the issuer must submit the annual report containing information on the borrowers of the original proceeds of the issue as required under §1.103A–2 (k)(2)(ii) and (k)(3) through (k)(6).

(2) *State certification with respect to volume cap*—(i) *In general.* If an issue is subject to the volume cap under section 146, a state official designated by state law (if there is no such official, then the governor or the governor's delegate) must certify that the issue meets the requirements of section 146, and a copy of this certification must be attached to the information reporting form filed with respect to the issue. In the case of any constitutional home rule city (as defined in section 146(d)(3)(C)), the preceding sentence is applied by substituting ''city'' for ''state'' and ''chief executive officer'' for ''governor.''

(ii) *Certification.* The certifying official need not perform an independent investigation in order to certify that the issue meets the requirements of section 146. For example, if the certifying official receives an affidavit that was executed by an officer of the issuer who is responsible for issuing the bonds and that sets forth, in brief and summary terms, the facts necessary to determine that the issue meets the requirements of section 146 and if the certifying official has compared the information in that affidavit to other readily available information with respect to that issuer (e.g., previous affidavits and certifications for other private activity bonds issued by that issuer), the certifying official may rely on the affidavit.

(c) *Requirements for governmental bonds*—(1) *Issue price of $100,000 or more.* If the issue of which the bond is a part has an issue price of $100,000 or more and is not an issue of private activity bonds, then, not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, the issuer must file with the Internal Revenue Service a completed information reporting form prescribed for this purpose.

(2) *Issue price of less than $100,000*—(i) *In general.* If the issue of which the bond is a part has an issue price of less than $100,000 and is not an issue of private activity bonds, the issuer must file with the Internal Revenue Service one of the following information reporting forms within the prescribed period—

(A) *Separate return.* Not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, a completed information reporting form prescribed for this purpose with respect to that issue; or

(B) *Consolidated return.* Not later than February 15 of the calendar year following the calendar year in which the issue is issued, a completed information form prescribed for this purpose with respect to all issues to which this paragraph (c)(2) applies that were issued by the issuer during the calendar year and for which information was not reported on a separate information return pursuant to paragraph (c)(2)(i)(A) of this section.

(ii) *Bond issues issued before January 1, 1992.* Paragraph (c)(2)(i)(A) of this section does not apply if the issue of which the bond is a part is issued before January 1, 1992.

(iii) *Extended filing date for first and second calendar quarters of 1992.* If the issue of which the bond is a part is issued during the first or second calendar quarter of 1992, the prescribed period for filing an information reporting form with respect to that issue pursuant to paragraph (c)(2)(i)(A) of this section is extended until November 16, 1992.

(d) *Filing of forms and special rules*—(1) *Completed form.* For purposes of this section—

(i) *Good faith effort.* An information reporting form is treated as completed if the issuer (or a person acting on behalf of the issuer) has made a good faith effort to complete the form (taking into account the instructions to the form).

(ii) *Information.* In general, information reporting forms filed pursuant to this section must be completed on the basis of available information and reasonable expectations as of the date the issue is issued. Forms that are filed on a consolidated basis pursuant to paragraph (c)(2)(i)(B) of this section, however, may be completed on the basis of information readily available to the issuer at the close of the calendar year to which the form relates, supplemented by estimates made in good faith.

(iii) *Certain information not required.* An issuer need not report to the Internal Revenue Service any information specified in the first sentence of section 149(e)(2) that is not required to be reported to the Internal Revenue Service pursuant to the information reporting forms prescribed under that section and the instructions to those forms.

(2) *Manner of filing*—(i) *Place for filing.* The information reporting form must be filed with the Internal Revenue Service at the address specified on the form or in the instructions to the form.

(ii) *Extension of time.* The Commissioner may grant an extension of time to file any form or attachment required under this section if the Commissioner determines that the failure to file in a timely manner was not due to willful neglect. The Commissioner may make this determination with respect to an issue or to a class of issues.

(e) *Definitions.* For purposes of this section only—(1) *Private activity bond.* The term ''private activity bond'' has the meaning given that term in section 141(a) of the Internal Revenue Code, except that the term does not include any bond described in section 1312(c) of the Tax Reform Act of 1986 to which section 1312 or 1313 of the Tax Reform Act of 1986 applies.

(2) *Issue*—(i) *In general.* Except as otherwise provided in this paragraph (e)(2), bonds are treated as part of the same issue only if the bonds are issued—

(A) By the same issuer;

(B) On the same date; and

(C) Pursuant to a single transaction or to a series of related transactions.

(ii) *Draw-down loans, commercial paper, etc.* (A) Bonds issued during the same calendar year may be treated as part of the same tissue if the bonds are issued—

(*1*) Pursuant to a loan agreement under which amounts are to be advanced periodically (''draw-down loan''); or

(*2*) With a term not exceeding 270 days.

(B) In addition, the bonds must be equally and ratably secured under a single indenture or loan agreement and issued pursuant to a common financing arrangement (e.g., pursuant to the same official statement that is periodically updated to reflect changing factual circumstances). In the case of bonds issued pursuant to a draw-down loan that meets the requirements of the preceding sentence, bonds issued during different calendar years may be treated as part of the same issue if all the amounts to be advanced pursuant to the draw-down loan are reasonably expected to be advanced within three years of the date of issue of the first bond.

(iii) *Leases and installment sales.* Bonds other than private activity bonds may be treated as part of the same issue if—

(A) The bonds are issued pursuant to a single agreement that is in the form of a lease or installment sales agreement; and

(B) All of the property covered by that agreement is reasonably expected to be delivered within three years of the date of issue of the first bond.

(iv) *Qualified 501(c)(3) bonds.* If an issuer elects under section 141(b)(9) to treat a portion of an issue as a qualified 501(c)(3) bond, that portion is treated as a separate issue.

(3) *Date of issue*—(i) *Bond.* The date of issue of a bond is determined under §1.150–1.

(ii) *Issue.* The date of issue of an issue of bonds is the date of issue of the first bond that is part of the issue. See paragraphs (e)(2) (ii) and (iii) of this section for rules relating to draw-down loans, commercial paper, etc., and leases and installment sales.

(iii) *Bonds to which prior law applied.* Notwithstanding the provisions of this paragraph (e)(3), an issue for which an information report was required to be filed under section 103(l) or section 103A(j)(3) is treated as issued prior to January 1, 1987.

(4) *Issue price.* The term ''issue price'' has the same meaning given the term under §1.148–1(b).

[T.D. 8425, 57 FR 36002, Aug. 12, 1992, as amended at 59 FR 24351, May 11, 1994]

§ 1.149(g)–1 Hedge bonds.

(a) *Certain definitions.* Except as otherwise provided, the definitions set forth in §1.148–1 apply for purposes of section 149(g) and this section. In addition, the following terms have the following meanings:

Reasonable expectations means reasonable expectations (as defined in §1.148–1), as modified to take into account the provisions of section 149(f)(2)(B).

Spendable proceeds means net sale proceeds (as defined in §1.148–1).

(b) *Applicability of arbitrage allocation and accounting rules.* Section 1.148–6 applies for purposes of section 149(g), except that an expenditure that results in the creation of replacement proceeds (other than amounts in a bona fide debt service fund or a reasonably required reserve or replacement fund) is not an expenditure for purposes of section 149(g).

(c) *Refundings*—(1) *Investment in tax-exempt bonds.* A bond issued to refund a bond that is a tax-exempt bond by virtue of the rule in section 149(g)(3)(B) is not a tax-exempt bond unless the gross proceeds of that refunding bond (other than proceeds in a refunding escrow for the refunded bond) satisfy the requirements of section 149(g)(3)(B).

(2) *Anti-abuse rule.* A refunding bond is treated as a hedge bond unless there is a significant governmental purpose for the issuance of that bond (e.g., an advance refunding bond issued to realize debt service savings or to relieve the issuer of significantly burdensome document provisions, but not to otherwise hedge against future increases in interest rates).

(d) *Effective date.* This section applies to bonds issued after June 30, 1993 to which §§1.148–1 through 1.148–11 apply. In addition, this section applies to any issue to which the election described in §1.148–11(b)(1) is made.

[T.D. 8476, 58 FR 33549, June 18, 1993]

§ 1.150–1 Definitions.

(a) *Scope and effective date*—(1) *In general.* Except as otherwise provided, the definitions in this section apply for all purposes of sections 103 and 141 through 150.

(2) *Effective/applicability date*—(i) *In general.* Except as otherwise provided in this paragraph (a)(2), this section applies to issues issued after June 30, 1993 to which §§1.148–1 through 1.148–11 apply. In addition, this section (other than paragraph (c)(3) of this section) applies to any issue to which the election described in §1.148–11(b)(1) is made.

(ii) *Special effective date for paragraphs (c)(1), (c)(4)(iii), and (c)(6).* Paragraphs (c)(1), (c)(4)(iii), and (c)(6) of this section apply to bonds sold on or after July 8, 1997 and to any issue to which the election described in §1.148–11(b)(1) is made. See §1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

(iii) *Special effective date for definitions of tax-advantaged bond, issue, and grant.* The definition of tax-advantaged bond in paragraph (b) of this section, the revisions to the definition of issue in paragraph (c)(2) of this section, and the definition and rules regarding the treatment of grants in paragraph (f) of this section apply to bonds that are sold on or after October 17, 2016.

(3) *Exceptions to general effective date.* See §1.141–15 for the applicability date of the definition of bond documents contained in paragraph (b) of this section and the effective date of paragraph (c)(3)(ii) of this section.

(4) *Additional exception to the general applicability date.* Section 1.150–1(b), *Issuance costs*, applies on and after July 6, 2011.

(b) *Certain general definitions.* The following definitions apply:

Bond means any obligation of a State or political subdivision thereof under section 103(c)(1).

Bond documents means the bond indenture or resolution, transcript of proceedings, and any related documents.

Capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under §1.150–2(c)) under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property. Future changes in law do not affect whether an expenditure is a capital expenditure.

Conduit borrower means the obligor on a purpose investment (as defined in §1.148–1). For example, if an issuer invests proceeds in a purpose investment in the form of a loan, lease, installment sale obligation, or similar obligation to another entity and the obligor uses the proceeds to carry out the governmental purpose of the issue, the obligor is a conduit borrower.

Conduit financing issue means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Conduit loan means a purpose investment (as defined in §1.148–1).

Governmental bond means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

Issuance costs means costs to the extent incurred in connection with, and allocable to, the issuance of an issue within the meaning of section 147(g). For example, issuance costs include the following costs but only to the extent incurred in connection with, and allocable to, the borrowing: underwriters' spread; counsel fees; financial advisory fees; fees paid to an organization to evaluate the credit quality of an issue; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than for qualified guarantees (as defined in §1.148–4(f)); and similar costs.

Issue date means, in reference to an issue, the first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. Issue date means, in reference to a bond, the date on which the issuer receives the purchase price in exchange for that bond. In no event is the issue date earlier than the first day on which interest begins to accrue on the bond or bonds for Federal income tax purposes.

Obligation means any valid evidence of indebtedness under general Federal income tax principles.

Pooled financing issue means an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to finance a single capital project.

Private activity bond means a private activity bond (as defined in section 141).

Qualified mortgage loan means a mortgage loan with respect to an owner-occupied residence acquired with the proceeds of an obligation described in section 143(a)(1) or 143(b) (or applicable prior law).

Qualified student loan means a student loan acquired with the proceeds of an obligation described in section 144(b)(1).

Related party means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group, and, in reference to any person that is not a governmental unit or 501(c)(3) organization, a related person (as defined in section 144(a)(3)).

Taxable bond means any obligation the interest on which is not excludable from gross income under section 103.

Tax-advantaged bond means a tax-exempt bond, a taxable bond that provides a federal tax credit to the investor with respect to the issuer's borrowing costs, a taxable bond that provides a refundable federal tax credit payable directly to the issuer of the bond for its borrowing costs under section 6431, or any future similar bond that provides a federal tax benefit that reduces an issuer's borrowing costs. Examples of tax-advantaged bonds include qualified tax credit bonds under section 54A(d)(1) and build America bonds under section 54AA.

Tax-exempt bond means any bond the interest on which is excludable from gross income under section 103(a). For purposes of section 148, tax-exempt bond includes:

(1) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103; and

(2) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Working capital expenditure means any cost that is not a capital expenditure. Generally, current operating expenses are working capital expenditures.

(c) *Definition of issue*—(1) *In general.* Except as otherwise provided in this paragraph (c), the term *issue* means two or more bonds that meet all of the following requirements:

(i) *Sold at substantially the same time.* The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart.

(ii) *Sold pursuant to the same plan of financing.* The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally—

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) *Payable from same source of funds.* The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

(2) *Exceptions for different types of tax-advantaged bonds and taxable bonds.* Each type of tax-advantaged bond that has a different structure for delivery of the tax benefit that reduces the issuer's borrowing costs or different program eligibility requirements is treated as part of a different issue under this paragraph (c). Further, tax-advantaged bonds and bonds that are not tax-advantaged bonds are treated as part of different issues under this paragraph (c). The issuance of tax-advantaged bonds in a transaction with other bonds that are not tax-advantaged bonds must be tested under the arbitrage anti-abuse rules under §1.148–10(a) and other applicable anti-abuse rules (for example, limitations against window maturity structures or unreasonable allocations of bonds).

(3) *Exception for certain bonds financing separate purposes*—(i) *In general.* Bonds may be treated as part of separate issues if the requirements of this paragraph (c)(3) are satisfied. Each of these separate issues must finance a

separate purpose (e.g., refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose). Each of these separate issues independently must be a tax-exempt bond (e.g., a governmental bond or a qualified mortgage bond). The aggregate proceeds, investments, and bonds in such a transaction must be allocated between each of the separate issues using a reasonable, consistently applied allocation method. If any separate issue consists of refunding bonds, the allocation rules in §1.148–9(h) must be satisfied. An allocation is not reasonable if it achieves more favorable results under sections 103 and 141 to 150 than could be achieved with actual separate issues. All allocations under this paragraph (c)(3) must be made in writing on or before the issue date.

(ii) *Exceptions.* This paragraph (c)(3) does not apply for purposes of sections 141, 144(a), 148, 149(d) and 149(g).

(4) *Special rules for certain financings*—(i) *Draw-down loans.* Bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of $50,000 or 5 percent of the issue price.

(ii) *Commercial paper*—(A) *In general.* Short-term bonds having a maturity of 270 days or less (*commercial paper*) issued pursuant to the same commercial paper program may be treated as part of a single issue, the issue date of which is the first date the aggregate amount of commercial paper issued under the program exceeds the lesser of $50,000 or 5 percent of the aggregate issue price of the commercial paper in the program. A commercial paper program is a program to issue commercial paper to finance or refinance the same governmental purpose pursuant to a single master legal document. Commercial paper is not part of the same commercial paper program unless issued during an 18-month period, beginning on the deemed issue date. In addition, commercial paper issued after the end of this 18-month period may be treated as part of the program to the extent issued to refund commercial paper that is part of the program, but only to the extent that—

(*1*) There is no increase in the principal amount outstanding; and

(*2*) The program does not have a term in excess of—

(*i*) 30 years; or

(*ii*) The period reasonably necessary for the governmental purposes of the program.

(B) *Safe harbor.* The requirement of paragraph (c)(4)(ii)(A)(*2*) of this section is treated as satisfied if the weighted average maturity of the issue does not exceed 120 percent of the weighted average expected economic life of the property financed by the issue.

(iii) *Certain general obligation bonds.* Except as otherwise provided in paragraph (c)(2) of this section, bonds that are secured by a pledge of the issuer's full faith and credit (or a substantially similar pledge) and sold and issued on the same dates pursuant to a single offering document may be treated as part of the same issue if the issuer so elects on or before the issue date.

(5) *Anti-abuse rule.* In order to prevent the avoidance of sections 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

(6) *Sale date.* The sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(d) *Definition of refunding issue and related definitions*—(1) *General definition of refunding issue. Refunding issue* means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a *prior issue,* as more particularly defined in paragraph (d)(5) of this section), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue.

(2) *Exceptions and special rules.* For purposes of paragraph (d)(1) of this section, the following exceptions and special rules apply—

(i) *Payment of certain interest.* An issue is not a refunding issue if the only principal and interest that is paid with proceeds of the issue (determined without regard to the multipurpose issue rules of §1.148–9(h)) is interest on another issue that—

(A) Accrues on the other issue during a one-year period including the issue date of the issue that finances the interest;

(B) Is a capital expenditure; or

(C) Is a working capital expenditure to which the de minimis rule of §1.148–6(d)(3)(ii)(A) applies.

(ii) *Certain issues with different obligors*—(A) *In general.* An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue.

(B) *Definition of obligor.* The *obligor* of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in §1.148–1) does not include the ultimate recipient of the loan (e.g., the homeowner, the student).

(iii) *Certain special rules for purpose investments.* For purposes of this paragraph (d), the following special rules apply:

(A) *Refunding of a conduit financing issue by a conduit loan refunding issue.* Except as provided in paragraph (d)(2)(iii)(B) of this section, the use of the proceeds of an issue that is used to refund an obligation that is a purpose investment (a *conduit refunding issue*) by the actual issuer of the conduit financing issue determines whether the conduit refunding issue is a refunding of the conduit financing issue (in addition to a refunding of the obligation that is the purpose investment).

(B) *Recycling of certain payments under purpose investments.* A conduit refunding issue is not a refunding of a conduit financing issue to the extent that the actual issuer of the conduit financing issue reasonably expects as of the date of receipt of the proceeds of the conduit refunding issue to use those amounts within 6 months (or, if greater, during the applicable temporary period for those amounts under section 148(c) or under applicable prior law) to acquire a new purpose investment. Any new purpose investment is treated as made from the proceeds of the conduit financing issue.

(C) *Application to tax-exempt loans.* For purposes of this paragraph (d), obligations that would be purpose investments (absent section 148(b)(3)(A)) are treated as purpose investments.

(iv) *Substance of transaction controls.* In the absence of other applicable controlling rules under this paragraph (d), the determination of whether an issue is a refunding issue is based on the substance of the transaction in light of all the facts and circumstances.

(v) *Certain integrated transactions in connection with asset acquisition not treated as refunding issues.* If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

(3) *Current refunding issue. Current refunding issue* means:

(i) Except as provided in paragraph (d)(3)(ii) of this section, a refunding issue that is issued not more than 90 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; and

(ii) In the case of a refunding issue issued before 1986—

(A) A refunding issue that is issued not more than 180 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; or

(B) A refunding issue if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(4) *Advance refunding issue. Advance refunding issue* means a refunding issue that is not a current refunding issue.

(5) *Prior issue. Prior issue* means an issue of obligations all or a portion of the principal, interest, or call premium on which is paid or provided for with proceeds of a refunding issue. A prior issue may be issued before, at the same time as, or after a refunding issue. If the refunded and unrefunded portions of a prior issue are treated as separate issues under §1.148–9(i), for the purposes for which that section applies, except to the extent that the context clearly requires otherwise, references to a prior issue refer only to the refunded portion of that prior issue.

(e) *Controlled group* means a group of entities controlled directly or indirectly by the same entity or group of entities within the meaning of this paragraph (e).

(1) *Direct control.* The determination of direct control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the *controlling entity*) generally controls another entity or group of entities (the *controlled entity*) for purposes of this paragraph if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial—

(i) The right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or

(ii) The right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

(2) *Indirect control.* If a controlling entity controls a controlled entity under the test in paragraph (e)(1) of this section, then the controlling entity also controls all entities controlled, directly or indirectly, by the controlled entity or entities.

(3) *Exception for general purpose governmental entities.* An entity is not a controlled entity under this paragraph (e) if the entity possesses substantial taxing, eminent domain, and police powers. For example, a city possessing substantial amounts of each of these sovereign powers is not a controlled entity of the state.

(f) *Definition and treatment of grants*—(1) *Definition.* Grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor or a related party. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

(2) *Treatment.* Except as otherwise provided (for example, §1.148–6(d)(4), which treats proceeds used for grants as spent for arbitrage purposes when the grant is made), the character and nature of a grantee's use of proceeds are taken into account in determining which rules are applicable to the bond issue and whether the applicable requirements for the bond issue are met. For example, a grantee's use of proceeds generally determines whether the proceeds are used for capital projects or working capital expenditures under section 148 and whether the qualified purposes for the specific type of bond issue are met.

[T.D. 8476, 58 FR 33549, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8712, 62 FR 2304, Jan. 16, 1997; T.D. 8718, 62 FR 25513, May 9, 1997; T.D. 9234, 70 FR 75036, Dec. 19, 2005; T.D. 9533, 76 FR 39280, July 6, 2011; T.D. 9637, 78 FR 54759, Sept. 6, 2013; T.D. 9777, 81 FR 46598, July 18, 2016]

§ 1.150–2 Proceeds of bonds used for reimbursement.

(a) *Table of contents.* This table of contents contains a listing of the headings contained in §1.150–2.

(g) Special rules on refundings.
(1) In general—once financed, not reimbursed.
(2) Certain proceeds of prior issue used for reimbursement treated as unspent.
(h) Anti-abuse rules.
(1) General rule.
(2) One-year step transaction rule.
(i) Authority of the Commissioner to prescribe rules.
(j) Effective date.
(1) In general.
(2) Transitional rules.
(3) Nature of expenditure.

(b) *Scope.* This section applies to reimbursement bonds (as defined in paragraph (c) of this section) for all purposes of sections 103 and 141 to 150.

(c) *Definitions.* The following definitions apply:

Issuer means—

(1) For any private activity bond (excluding a qualified 501(c)(3) bond, qualified student loan bond, qualified mortgage bond, or qualified veterans' mortgage bond), the entity that actually issues the reimbursement bond; and

(2) For any bond not described in paragraph (1) of this definition, either the entity that actually issues the reimbursement bond or, to the extent that the reimbursement bond proceeds are to be loaned to a conduit borrower, that conduit borrower.

Official intent means an issuer's declaration of intent to reimburse an original expenditure with proceeds of an obligation.

Original expenditure means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond.

Placed in service means, with respect to a facility, the date on which, based on all the facts and circumstances—

(1) The facility has reached a degree of completion which would permit its operation at substantially its design level; and

(2) The facility is, in fact, in operation at such level.

Reimbursement allocation means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.

Reimbursement bond means the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date.

(d) *General operating rules for reimbursement expenditures.* Except as otherwise provided, a reimbursement allocation is treated as an expenditure of proceeds of a reimbursement bond for the governmental purpose of the original expenditure on the date of the reimbursement allocation only if:

(1) *Official intent.* Not later than 60 days after payment of the original expenditure, the issuer adopts an official intent for the original expenditure that satisfies paragraph (e) of this section.

(2) *Reimbursement period*—(i) *In general.* The reimbursement allocation is made not later than 18 months after the later of—

(A) The date the original expenditure is paid; or

(B) The date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid.

(ii) *Special rule for small issuers.* In applying paragraph (d)(2)(i) of this section to an issue that satisfies section 148(f)(4)(D)(i) (I) through (IV), the "18 month" limitation is changed to "3 years" and the "3-year" maximum reimbursement period is disregarded.

(iii) *Special rule for long-term construction projects.* In applying paragraph (d)(2)(i) to a construction project for which both the issuer and a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project, the maximum reimbursement period is changed from "3 years" to "5 years."

(3) *Nature of expenditure.* The original expenditure is a capital expenditure, a cost of issuance for a bond, an expenditure described in §1.148–6(d)(3)(ii)(B) (relating to certain extraordinary working capital items), a grant (as defined in §1.150–1(f)), a qualified student loan, a qualified mortgage loan, or a qualified veterans' mortgage loan.

(e) *Official intent rules.* An official intent satisfies this paragraph (e) if:

(1) *Form of official intent.* The official intent is made in any reasonable form, including issuer resolution, action by an appropriate representative of the

issuer (e.g., a person authorized or designated to declare official intent on behalf of the issuer), or specific legislative authorization for the issuance of obligations for a particular project.

(2) *Project description in official intent*—(i) *In general.* The official intent generally describes the project for which the original expenditure is paid and states the maximum principal amount of obligations expected to be issued for the project. A project includes any property, project, or program (e.g., *highway capital improvement program, hospital equipment acquisition,* or *school building renovation*).

(ii) *Fund accounting.* A project description is sufficient if it identifies, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., *parks and recreation fund—recreational facility capital improvement program*).

(iii) *Reasonable deviations in project description.* Deviations between a project described in an official intent and the actual project financed with reimbursement bonds do not invalidate the official intent to the extent that the actual project is reasonably related in function to the described project. For example, *hospital equipment* is a reasonable deviation from *hospital building improvements.* In contrast, a *city office building rehabilitation* is not a reasonable deviation from *highway improvements.*

(3) *Reasonableness of official intent.* On the date of the declaration, the issuer must have a reasonable expectation (as defined in §1.148–1(b)) that it will reimburse the original expenditure with proceeds of an obligation. Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project (e.g., *blanket declarations*) are not reasonable. Similarly, a pattern of failure to reimburse actual original expenditures covered by official intents (other than in extraordinary circumstances) is evidence of unreasonableness. An official intent declared pursuant to a specific legislative authorization is rebuttably presumed to satisfy this paragraph (e)(3).

(f) *Exceptions to general operating rules*—(1) *De minimis exception.* Paragraphs (d)(1) and (d)(2) of this section do not apply to costs of issuance of any bond or to an amount not in excess of the lesser of $100,000 or 5 percent of the proceeds of the issue.

(2) *Preliminary expenditures exception.* Paragraphs (d)(1) and (d)(2) of this section do not apply to any preliminary expenditures, up to an amount not in excess of 20 percent of the aggregate issue price of the issue or issues that finance or are reasonably expected by the issuer to finance the project for which the preliminary expenditures were incurred. Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

(g) *Special rules on refundings*—(1) *In general—once financed, not reimbursed.* Except as provided in paragraph (g)(2) of this section, paragraph (d) of this section does not apply to an allocation to pay principal or interest on an obligation or to reimburse an original expenditure paid by another obligation. Instead, such an allocation is analyzed under rules on refunding issues. See §1.148–9.

(2) *Certain proceeds of prior issue used for reimbursement treated as unspent.* In the case of a refunding issue (or series of refunding issues), proceeds of a prior issue purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was a valid expenditure under applicable law on reimbursement expenditures on the issue date of the prior issue.

(h) *Anti-abuse rules*—(1) *General rule.* A reimbursement allocation is not an expenditure of proceeds of an issue under this section if the allocation employs an abusive arbitrage device under §1.148–10 to avoid the arbitrage restrictions or to avoid the restrictions under sections 142 through 147.

(2) *One-year step transaction rule*—(i) *Creation of replacement proceeds.* A purported reimbursement allocation is invalid and thus is not an expenditure of proceeds of an issue if, within 1 year

after the allocation, funds corresponding to the proceeds of a reimbursement bond for which a reimbursement allocation was made are used in a manner that results in the creation of replacement proceeds (as defined in §1.148–1) of that issue or another issue. The preceding sentence does not apply to amounts deposited in a bona fide debt service fund (as defined in §1.148–1).

(ii) *Example.* The provisions of paragraph (h)(2)(i) of this section are illustrated by the following example.

Example. On January 1, 1994, County *A* issues an issue of 7 percent tax-exempt bonds (the *1994 issue*) and makes a purported reimbursement allocation to reimburse an original expenditure for specified capital improvements. *A* immediately deposits funds corresponding to the proceeds subject to the reimbursement allocation in an escrow fund to provide for payment of principal and interest on its outstanding 1991 issue of 9 percent tax-exempt bonds (the *prior issue*). The use of amounts corresponding to the proceeds of the reimbursement bonds to create a sinking fund for another issue within 1 year after the purported reimbursement allocation invalidates the reimbursement allocation. The proceeds retain their character as unspent proceeds of the 7 percent issue upon deposit in the escrow fund. Accordingly, the proceeds are subject to the 7 percent yield restriction of the 1994 issue instead of the 9 percent yield restriction of the prior issue.

(i) *Authority of the Commissioner to prescribe rules.* The Commissioner may by revenue ruling or revenue procedure (see §601.601(d)(2)(ii)(*b*) of this chapter) prescribe rules for the expenditure of proceeds of reimbursement bonds in circumstances that do not otherwise satisfy this section.

(j) *Effective date*—(1) *In general.* Except as otherwise provided, the provisions of this section apply to all allocations of proceeds of reimbursement bonds issued after June 30, 1993.

(2) *Transitional rules*—(i) *Official intent.* An official intent is treated as satisfying the official intent requirement of paragraph (d)(1) of this section if it—

(A) Satisfied the applicable provisions of §1.103–8(a)(5) as in effect prior to July 1, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made prior to that date, or

(B) Satisfied the applicable provisions of §1.103–18 as in effect between January 27, 1992, and June 30, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made during that period.

(ii) *Certain expenditures of private activity bonds.* For any expenditure that was originally paid prior to August 15, 1993, and that would have qualified for expenditure by reimbursement from the proceeds of a private activity bond under T.D. 7199, section 1.103–8(a)(5), 1972–2 C.B. 45 (see §601.601(d)(2)(ii)(*b*)) of this chapter, the requirements of that section may be applied in lieu of this section.

(3) *Nature of expenditure.* Paragraph (d)(3) of this section applies to bonds that are sold on or after October 17, 2016.

[T.D. 8476, 58 FR 33551, June 18, 1993; 58 FR 44453, Aug. 23, 1993; T.D. 9777, 81 FR 46598, July 18, 2016]

§ 1.150–4 Change in use of facilities financed with tax-exempt private activity bonds.

(a) *Scope.* This section applies for purposes of the rules for change of use of facilities financed with private activity bonds under sections 150(b)(3) (relating to qualified 501(c)(3) bonds), 150(b)(4) (relating to certain exempt facility bonds and small issue bonds), 150(b)(5) (relating to facilities required to be owned by governmental units or 501(c)(3) organizations), and 150(c).

(b) *Effect of remedial actions*—(1) *In general.* Except as provided in this section, the change of use provisions of sections 150(b) (3) through (5), and 150(c) apply even if the issuer takes a remedial action described in §§1.142–2, 1.144–2, or 1.145–2.

(2) *Exceptions*—(i) *Redemption.* If nonqualified bonds are redeemed within 90 days of a deliberate action under §1.145–2(a) or within 90 days of the date on which a failure to properly use proceeds occurs under §1.142–2 or §1.144–2, sections 150(b) (3) through (5) do not apply during the period between that date and the date on which the nonqualified bonds are redeemed.

(ii) *Alternative qualifying use of facility.* If a bond-financed facility is used for an alternative qualifying use under §§1.145–2 and 1.141–12(f), sections 150(b) (3) and (5) do not apply because of the alternative use.

(iii) *Alternative use of disposition proceeds.* If disposition proceeds are used for a qualifying purpose under §§1.145–2 and 1.141–12(e), 1.142–2(c)(4), or 1.144–2, sections 150(b) (3) through (5) do not apply because of the deliberate action that gave rise to the disposition proceeds after the date on which all of the disposition proceeds have been expended on the qualifying purpose. If all of the disposition proceeds are so expended within 90 days of the date of the deliberate action, however, sections 150(b) (3) through (5) do not apply because of the deliberate action.

(c) *Allocation rules*—(1) *In general.* If a change in use of a portion of the property financed with an issue of qualified private activity bonds causes section 150 (b)(3), (b)(4), or (b)(5) to apply to an issue, the bonds of the issue allocable to that portion under section 150(c)(3) are the same as the nonqualified bonds determined for purposes of §§1.142–1, 1.144–1, and 1.145–1, except that bonds allocable to all common areas are also allocated to that portion.

(2) *Special rule when remedial action is taken.* If an issuer takes a remedial action with respect to an issue of private activity bonds under §§1.142–2, 1.144–2, or 1.145–2, the bonds of the issue allocable to a portion of property are the same as the nonqualified bonds determined for purposes of those sections.

(d) *Effective dates.* For effective dates of this section, see §1.141–16.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.150–5 Filing notices and elections.

(a) *In general.* Notices and elections under the following sections must be filed with the Internal Revenue Service, 1111 Constitution Avenue, NW, Attention: T:GE:TEB:O, Washington, DC 20224 or such other place designated by publication of a notice in the Internal Revenue Bulletin—

(1) Section 1.141–12(d)(4);

(2) Section 1.142(f)(4)-1; and

(3) Section 1.142–2(c)(2).

(b) *Effective dates.* This section applies to notices and elections filed on or after January 19, 2001.

[T.D. 8941, 66 FR 4671, Jan. 18, 2001, as amended by T.D. 9741, 80 FR 65646, Oct. 27, 2015]

REGULATIONS APPLICABLE TO CERTAIN BONDS SOLD PRIOR TO JULY 8, 1997

EDITORIAL NOTE: IRS redesignated the following sections to appear below the undesignated center heading "Regulations Applicable to Certain Bonds Sold Prior to July 8, 1997" and preceding the undesignated center heading "Deductions for Personal Exemptions." See 62 FR 25507 and 25513, May 9, 1997 for the specific sections involved in the redesignation.

§§ 1.148–1A—1.148–6A [Reserved]

§§ 1.148–9A—1.148–10A [Reserved]

§ 1.148–11A Effective dates.

(a) through (c)(3) [Reserved]. For guidance see §1.148–11.

(c)(4) *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.

(d) through (h) [Reserved]. For guidance see §1.148–11.

(i) *Transition rules for certain amendments*—(1) *In general.* Section 1.103–8(a)(5), §§1.148–1, 1.148–2, 1.148–3, 1.148–4, .148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10, 1.148–11, 1.149(d)–1, and 1.150–1 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), and §§1.148–1A through 1.148–11A, 1.149(d)–1A, and 1.150–1A apply, in whole, but not in part—

(i) To bonds sold after June 6, 1994, and before July 8, 1997;

(ii) To bonds issued before July 1, 1993, that are outstanding on June 7, 1994, if the first time the issuer applies §§1.148–1 through 1.148–11 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), to the bonds under §1.148–11 (b) or (c) is after June 6, 1994, and before July 8, 1997;

(iii) At the option of the issuer, to bonds to which §§1.148–1 through 1.148–11, as in effect on July 1, 1993 (see 26 CFR part 1 as revised April 1, 1994), apply, if the bonds are outstanding on June 7, 1994, and the issuer applies §1.103–8(a)(5), §§1.148–1, 1.148–2, 1.148–3, 1.148–4, 1.148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10, 1.148–11, 1.149(d)–1, and 1.150–1 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), and §§1.148–1A through 1.148–11A,