



August 2016

U.S. Treasury Releases Long-Awaited Final Arbitrage Regulations

On July 18, 2016, the U.S. Department of the Treasury (Treasury) promulgated long-awaited final regulations (the Final Regulations) under Section 148 of the Internal Revenue Code of 1986, as amended (the Code), relating to arbitrage restrictions that finalize numerous provisions of prior proposed regulations from 2007 (2007 Proposed Regulations) and 2013 (2013 Proposed Regulations), other than with respect to the definition of “issue price,” and with amendments in certain instances. As more fully described below, among other areas, the Final Regulations address working capital financings, qualified hedging transactions, valuation of investments, and the treatment of bond-financed grants.

Working Capital Financings

The current Treasury regulations (Current Regulations) provide restrictions on the financing of working capital expenditures by providing that replacement proceeds (which must be invested at a yield no higher than the yield on the related bond issue) arise unless the term of the bond issue will not be longer than is reasonably necessary for the governmental purposes of the issue, and the issuer will have amounts available to pay for expenditures of the type financed by the issue during the period that the issue remains outstanding longer than necessary. The Current Regulations provide safe harbors that prevent replacement proceeds from arising, one of which is a two-year limitation on the duration that the bonds may be outstanding. The 2013 Proposed Regulations proposed shortening this safe-harbor period to 13 months to conform to the 13-month temporary period rules for working capital financings. The Final Regulations adopt this change, extend the safe harbor to all—not just restricted—working capital financings, and retain the requirement that available amounts be tested at the beginning of each fiscal year.

New Safe Harbor

The Final Regulations add a new safe harbor against creation of replacement proceeds for long-term working capital financings that requires an issuer to:

- > determine the first year in which it expects to have “available amounts” for working capital expenditures;
- > monitor for actual available amounts in each year beginning with the year it first expects to have such amounts;
- > apply such available amounts in each year either to redeem or to invest in (or some combination of redeeming and investing in) certain tax-exempt bonds (eligible tax-exempt bonds);
- > continuously invest (or reinvest) any amounts invested in eligible tax-exempt bonds so long as the bonds using the safe harbor remain outstanding (while permitting such amounts not to be invested during a maximum of 30 days per fiscal year in which such amounts are pending reinvestment);
- > reduce the total amount the issuer must apply to redeem or invest in eligible tax-exempt bonds to account for the expenditure of available amounts during the first 90 days of the fiscal year and amounts held in *bona fide* debt service funds to the extent that those amount are included in available amounts; and
- > permit an issuer to sell eligible tax-exempt bonds acquired under the safe harbor as long as the proceeds of that sale are used within 30 days for any governmental purpose for which the issuer has no other available amounts.

With regard to working capital financings, the Final Regulations also:

- > amend the definition of “available amount” to exclude the proceeds of *any* bond issue of the issuer, rather than just the proceeds of *the* bond issue;
- > clarify that eligible tax-exempt bonds for purposes of the safe harbor include both Demand Deposit SLGS and an interest in a regulated investment company (if at least 95 percent of the income to the holder is from non-AMT tax-exempt bonds);
- > provide that the safe harbor applies to refunding bonds for working capital expenditures in the same way as it applies to other bonds;
- > remove the restriction against financing a working capital reserve;
- > expand the factors listed in an anti-abuse rule that may justify a bond maturity in excess of those in the safe harbors that prevent the creation of replacement proceeds to include extraordinary working capital items; and
- > broaden the existing 13-month temporary period for restricted working capital expenditures to include all working capital expenditures.

Rebate and Yield Reduction Payments

The Final Regulations adopt the 2007 Proposed Regulations proposal to increase the rebate computation credit and to add an inflation adjustment to that credit based on the Consumer Price Index. In addition, the Final Regulations adopt a technical amendment to an example in the Current Regulations proposed in the 2013 Proposed Regulations designed to clarify that no rebate overpayment may be obtained when the future value of a rebate payment exceeds the rebate amount on the next rebate computation date, even though the actual amount of the previous rebate payment does not exceed the rebate amount on that next computation date. With regard to the small issuer exception to the rebate requirement as applied to pooled bonds, the Final Regulations adopted the 2007 Proposed Regulations proposal to eliminate a rule that permitted a pool bond issuer to ignore its pool bond issue in computing whether it had exceeded its \$5 million limit. In addition, the Final Regulations adopt the 2007 Proposed Regulations proposal and clarify that an issuer is permitted to make yield reduction payments if it enters into an agreement to purchase investments on a date when SLGS sales are suspended.

Bond Yield: Joint Yields and Yield on Yield-to-Call Bonds

The Final Regulations adopt the elimination of joint bond-yield computations for two or more mortgage bonds or qualified student loan bonds proposed in the 2007 Proposed Regulations (the latter because of the termination of the Federal Family Education Loan Program, which effectively eliminated the program for which most student loan bonds were issued (although not affecting State supplemental student loan bond programs)). The Final Regulations do, however, extend the availability of yield reduction payments to both qualified student loans and qualified mortgage

loans in recognition of the administrative challenges for loan calculations in these programs. The Final Regulations also adopt the 2007 Proposed Regulations proposal to simplify the yield calculations for yield-to-call bonds to focus on the redemption date that results in the lowest yield on the *particular premium bond* rather than on the redemption date that produces the lowest yield on the *bond issue* as a whole.

Hedges

The Final Regulations adopt numerous proposals from the 2007 Proposed Regulations to:

- > provide that a specified index upon which periodic payments are based is deemed to include payments under a cost-of-funds swap, thus clarifying that **cost-of-funds swaps can be qualified hedges**;
- > clarify that a **taxable index hedge is an interest-based contract**, while eliminating the interest-rate correlation test for taxable index hedges proposed in the 2007 Proposed Regulations (which was found to be excessively complex or unworkable);
- > provide that taxable index hedges are ineligible for “super integration,” but (in recognizing that these hedges are perfect hedges that clearly result in a fixed yield) allow an exception for hedges in which the hedge provider’s payments are based on an interest rate identical to that on the hedged bonds;
- > **permit issuers to make yield reduction payments on certain hedged advance refunding issues** with regard to only the portion of the issue that funds the defeasance escrow;
- > limit the size and scope of a qualified hedge to a level that is reasonably necessary to hedge the issuer’s risk with respect to interest rate changes on the bonds (based on the reasonably expected terms of the hedged bonds to be issued with respect to anticipatory hedges);
- > expand to 90 calendar days from 60 calendar days the period that payments made within each other may qualify with respect to the requirement that, for simple integration, the payments received by the issuer from the hedge provider correspond “closely in time” to the payments being hedged; and
- > **extend the time for an issuer to identify a qualified hedge from three calendar days to 15 calendar days.**

Hedge Identification: Hedge Provider Certificate

The Final Regulations also adopt the 2013 Proposed Regulations proposal to add a requirement that the identification of a qualified hedge include a **certificate from the hedge provider** containing certain information, including:

- > a statement that the hedge was negotiated in an arm’s-length transaction between a willing buyer and a willing seller;
- > amending other required certifications to focus on factual aspects of the hedging transaction; and
- > omitting the certification that the issuer’s rate on the hedge is comparable to the rate that would be paid by a similarly situated issuer of taxable debt (although reserving the authority of the Commissioner to add additional certifications in guidance published in the Internal Revenue Bulletin that may look to the swap market for taxable debt and consider the availability of appropriate comparable rates).

Modifications and Terminations of Qualified Hedges

The Final Regulations adopt the following 2013 Proposed Regulations proposals:

- > that a modification, including an actual modification or an acquisition of another hedge, results in a deemed termination of a hedge if the modification is material and results in a deemed disposition under section 1001;
- > **indicating that no deemed termination occurs if the modified hedge is a qualified hedge as retested at the time of the modification when disregarding any off-market value of the existing hedge at the time of modification**;
- > **measuring the time period for identification of the modified hedge from the date of modification**;
- > omitting the requirement for a hedge provider’s certificate for the modified hedge;
- > noting, in the preamble to the Final Regulations, that the Final Regulations supersede statements in Notice 2008-41 regarding whether the modification results in a change in yield over the remaining term of the hedged bonds by more than 0.25 percent and the modified hedge is integrated with the hedged bonds;

- > treating a qualified hedge on refunded bonds that meets the requirements for a qualified hedge of refunding bonds as of their issue date as continuing as a qualified hedge of those refunding bonds instead of being terminated; and
- > clarifying that a termination of a super-integrated qualified hedge is disregarded and special rules do not apply if, based on facts and circumstances, the yield will not change.

The Final Regulations retain the rule that the amount of a termination payment that may be taken into account for arbitrage purposes is the fair market value of the qualified hedge on the termination date for both actual and deemed terminations, and that the fair market value of a qualified hedge upon termination is based on all facts and circumstances.

Valuation of Investments

Regarding valuation of investments, the Final Regulations adopt the following 2013 Proposed Regulations proposals that:

- > the fair market value method of valuation generally is required for any investment on the date the investment 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, with the clarification that purpose investments must be valued at present value at all times;
- > the exception to fair market valuation for investments reallocated as a result of the universal cap rule applies narrowly to circumstances in which investments are deallocated from an issue as a result of the universal cap rule and are reallocated to another issue without further action as a result of an existing pledge of the investment to the other issue;
- > **allows an exception with regard to fair market valuation for investments reallocated as a result of the transferred proceeds rule;** and
- > the fair market value of a SLGS security on any date other than its purchase date (on which its fair market value is its purchase price) is the redemption price determined by the U.S. Treasury under applicable SLGS regulations.

Guaranteed Investment Contracts

With regard to valuation of guaranteed investment contracts, the Final Regulations adopt the 2007 Proposed Regulations proposal to amend the Current Regulations' safe harbor by:

- > **permitting bid specifications to be sent electronically over the internet or by fax;**
- > **providing that no impermissible last look occurs if in effect all bidders have an equal opportunity for a last look;**
- > clarifying that bids must be in writing and timely disseminated; and
- > clarifying that a writing may be in electronic form and may be disseminated by fax, email, an internet-based website, or other electronic medium similar to an internet-based website and regularly used to post bid specifications.

External Commingled Funds

With regard to external commingled funds, the Final Regulations adopt the 2007 Proposed Regulations proposal to allow additional smaller investors to invest in an external commingled fund without disqualifying the fund from being treated as widely held (and thus receiving preferential treatment of administrative costs) if the fund, on average, has more than 15 unrelated investors and each investor maintains a prescribed minimum average investment in the fund, so long as at least 16 unrelated investors each maintain the required minimum average investment in the fund.

Anti-Abuse Rules and Commissioner Authority

In response to industry comments to a 2013 Proposed Regulations proposal regarding the Commissioner's authority to depart from the arbitrage regulations when 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 inconsistent with the purposes of section 148, from that "necessary to clearly reflect the economic substance of the

transaction” to that “necessary to prevent such financial advantage,” the Final Regulations limit the Commissioner’s authority to depart from the arbitrage regulations to that necessary “to reflect the economics of the transaction to prevent such finance advantage.”

Grants

The Final Regulations adopt the 2013 Proposed Regulations proposals that:

- > the existing definition of “grant” for arbitrage purposes applies for purposes of other tax-exempt bond provisions;
- > the character and nature of a grantee’s use of proceeds generally is taken into account in determining whether arbitrage and other applicable requirements of the issue are met; and
- > clarify that the special grant expenditure rule, that the issuer is treated as spending proceeds used for grants for arbitrage investment restriction purposes when the issuer makes the grant to an unrelated third party, is an example of a specific exception to the general rule.

Miscellaneous: State Perpetual Trust Fund Guarantees; Definitions; Separation of Issues

The Final Regulations adopt the 2013 Proposed Regulations proposals to:

- > increase the amount of tax-exempt bonds that certain State perpetual trust funds are allowed to pledge to guarantee bonds without resulting in arbitrage-restricted replacement proceeds, as well as to extend this rule to cover certain tax-exempt bonds issued to finance public charter schools, which may be 501(c)(3) organizations;
- > adopt changes to the definition of tax-advantaged bonds; and
- > clarify that taxable tax-advantaged bonds and other taxable bonds are parts of different issues and that different types of tax-advantaged bonds are parts of different issues.

Effective Dates and Effect on Other IRS Pronouncements.

The Final Regulations generally apply to bonds sold on or after, and to hedges that are entered into or modified on or after, Oct. 17, 2016. Issuers may apply certain of the amended provisions to bonds sold before Oct. 17, 2016, as set forth in Regulations section 1.141-15; 1.148-11, 1.150-1, and 1.150.2.

In addition, the Treasury Decision that includes the Final Regulations includes certain technical amendments to final regulations published in the Federal Register on Oct. 27, 2015, that provided guidance on allocation and accounting rules and certain remedial actions for purposes of Code section 141. These technical amendments amend the applicability dates to include a transition rule for refunding bonds (provided that the weighted average maturity of the refunding bonds is no longer than that of the refunded bonds or, in the case of certain short-term obligations, no longer than 120 percent of the weighted average reasonably expected economic life of the facilities financed). These technical amendments also clarify permissive application of certain provisions to outstanding bonds.

Last, because of the release of Notice 2008-31, which establishes a voluntary closing agreement program for tax-exempt and tax-credit bonds to preserve their status, the Treasury Decision also obsoletes Rev. Proc. 97-15 and Rev. Proc. 95-47 regarding requests for a closing agreement to preserve the tax-exempt status of interest on outstanding bonds because of failures to meet certain requirements relating to use of bond proceeds.

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