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[4830-01-p]

## DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9777]

RIN 1545-BG41; RIN 1545-BH38

Arbitrage Guidance for Tax-Exempt Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the arbitrage restrictions under section 148 of the Internal Revenue Code (Code) applicable to tax-exempt bonds and other tax-advantaged bonds issued by State and local governments. These final regulations amend existing regulations to address certain market developments, simplify certain provisions, address certain technical issues, and make existing regulations more administrable. These final regulations affect State and local governments that issue tax-exempt and other tax-advantaged bonds.

DATES: Effective Date: These final regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §§1.141-15, 1.148-11, 1.150-1(a)(2)(iii), and 1.150-2(j).

FOR FURTHER INFORMATION CONTACT: Spence Hanemann, (202) 317-6980 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### **Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1347. The collection of information in these final regulations is in §1.148-4(h)(2)(viii), which contains a requirement that the issuer maintain in its records a certificate from the hedge provider. For a hedge to be a qualified hedge, existing regulations require, among other items, that the actual issuer identify the hedge on its books and records. The identification must specify the hedge provider, the terms of the contract, and the hedged bonds. These final regulations require that the identification also include a certificate from the hedge provider specifying certain information regarding the hedge.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

Books and records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### **Background**

This document contains amendments to the Income Tax Regulations (26 CFR part 1) on the arbitrage investment restrictions under section 148 of the Code and related provisions. On June 18, 1993, the Department of the Treasury

(the Treasury Department) and the IRS published comprehensive final regulations in the **Federal Register** (TD 8476, 58 FR 33510) on the arbitrage investment restrictions and related provisions for tax-exempt bonds under sections 103, 148, 149, and 150, and, since that time, those final regulations have been amended in certain limited respects (the regulations issued in 1993 and the amendments thereto collectively are referred to as the Existing Regulations).

A notice of proposed rulemaking was published in the **Federal Register** (72 FR 54606; REG-106143-07) on September 26, 2007 (the 2007 Proposed Regulations). The 2007 Proposed Regulations proposed amendments to the Existing Regulations. Comments on the 2007 Proposed Regulations were received and a public hearing was held on January 30, 2008.

Another notice of proposed rulemaking was published in the **Federal Register** (78 FR 56842; REG-148659-07) on September 16, 2013 (the 2013 Proposed Regulations). The 2013 Proposed Regulations proposed additional amendments to the Existing Regulations (the 2007 Proposed Regulations and the 2013 Proposed Regulations collectively are referred to as the Proposed Regulations). Comments on the 2013 Proposed Regulations were received and a public hearing was held on February 5, 2014. The 2013 Proposed Regulations addressed the definition of issue price, among other topics.

A partial withdrawal of notice of proposed rulemaking and notice of proposed rulemaking was published in the **Federal Register** (80 FR 36301; REG-138526-14) on June 24, 2015, re-proposing amendments to the definition

of issue price. After consideration of all the comments, the remaining portions of the Proposed Regulations are adopted as amended by this Treasury decision (the Final Regulations).

### **Summary of Comments and Explanation of Revisions**

This section discusses significant aspects of the comments received from the public regarding the Proposed Regulations. It also explains the revisions made in the Final Regulations.

#### 1. Section 1.148-1 Definitions and Elections

##### A. Working capital expenditures and replacement proceeds definition

###### i. Introduction

The Existing Regulations impose various restrictions on the use of tax-exempt bond financing for working capital expenditures. One way the Existing Regulations limit working capital financings is through the concept of replacement proceeds, a special category of funds included within the broad definition of gross proceeds to which the arbitrage investment restrictions under section 148 apply. Under the Existing Regulations, replacement proceeds arise if an issuer reasonably expects as of the issue date that: (1) The term of an issue will be longer than reasonably necessary for the governmental purposes of the issue; and (2) there will be available amounts (as defined in the Existing Regulations) for expenditures of the type being financed during the period the issue remains outstanding longer than necessary. The Existing Regulations provide certain safe harbors that prevent the creation of replacement proceeds.

## ii. Modified Safe Harbor for Short-Term Working Capital Financings

The 2013 Proposed Regulations proposed to shorten the bond maturity necessary to satisfy the safe harbor for most short-term working capital financings from two years to 13 months to conform with the permitted temporary investment period for working capital expenditures under §1.148-2(e)(3) and the administrative standard in Rev. Proc. 2002-31, 2002-1 CB 916. One commenter suggested extending this safe harbor to all working capital expenditure financings, rather than just those for restricted working capital expenditures (as defined in the Existing Regulations). This change, which would be implemented by deleting the word “restricted” from the safe harbor, would conform the safe harbor to the proposed extension of the temporary investment period for working capital expenditure financings in the 2013 Proposed Regulations (see section 2 of this preamble). The change also would benefit issuers by expanding the eligible purposes for short-term working capital financings to include extraordinary working capital expenditures. The Final Regulations adopt this comment.

## iii. New Safe Harbor for Longer-Term Working Capital Financings

The 2013 Proposed Regulations proposed to add a new safe harbor that would prevent the creation of replacement proceeds for longer-term working capital financings to enhance certainty for issuers experiencing financial distress. This new safe harbor would require an issuer to: (1) Determine the first year in which it expects to have available amounts for working capital expenditures; (2) monitor for actual available amounts in each year beginning with the year it first expects to have such amounts; and (3) 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). The safe harbor would require any amounts invested in eligible tax-exempt bonds to be invested (or reinvested) continuously, so long as the bonds using the safe harbor remain outstanding. In a narrow exception to this requirement, the safe harbor would permit such amounts not to be invested during a period of no more than 30 days per fiscal year in which such amounts are pending reinvestment. These requirements aimed to minimize the burden on the tax-exempt bond market.

The 2013 Proposed Regulations proposed to require an issuer to test for available amounts on the first day of its fiscal year and to apply such amounts to redeem or invest in eligible tax-exempt bonds within 90 days. Commenters sought greater flexibility with respect to the timing of testing the yearly available amounts and the use of such available amounts, based on considerations associated with potential unrepresentative cash positions on particular dates and potential expected short-term cash needs to finance governmental purposes.

To promote administrability and consistency, the Final Regulations retain the first day of the fiscal year as the required annual testing date for available amounts. The Treasury Department and the IRS have concluded that commenters' suggested solutions were complex in application and could produce a result that is unrepresentative of available amounts throughout the rest of the year. By requiring testing on the first day of the fiscal year, the Final Regulations provide an administrable testing date that mirrors the general rule for other replacement proceeds, under which an issuer also must determine its available

amounts on the first day of every fiscal year during the period when its bonds are outstanding longer than reasonably necessary. To address commenters' concerns about the need for greater flexibility to address short-term cash flow deficits, the Final Regulations include several other revisions to this safe harbor for longer-term working capital financings. The Final Regulations reduce the total amount the issuer must apply to redeem or invest in eligible tax-exempt bonds to take into account 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 amounts are included in available amounts. Further, the Final Regulations allow an issuer to sell eligible tax-exempt bonds acquired pursuant to the safe harbor, provided that the proceeds of that sale are used within 30 days for a governmental purpose (working capital or otherwise) and the issuer has no other available amounts that it could use for that purpose. Alternatively, an issuer may sell such investments and use those amounts to redeem eligible tax-exempt bonds. Together, these amendments to the Proposed Regulations aim to address issuers' concerns about cash flows in a manner consistent with the existing restrictions on financing working capital expenditures with bonds outstanding longer than reasonably necessary.

Commenters also urged a small, but significant, change to the definition of "available amount" to address situations in which an issuer has proceeds of more than one bond issue that finance working capital expenditures. The definition of available amount in the Existing Regulations specifically excludes proceeds of "the" issue, but not proceeds of other issues. The use of this existing definition

for the new safe harbor would have the effect of requiring an issuer to apply proceeds of other issues to redeem or invest in eligible tax-exempt bonds to meet the safe harbor rather than using such proceeds for the intended governmental purpose. The Final Regulations adopt this comment and revise the definition of available amount to exclude proceeds of “any” issue.

Commenters also recommended that the maximum amount required to be applied under the safe harbor to redeem or invest in eligible tax-exempt bonds be reduced from that proposed under the Proposed Regulations, which would set that maximum amount at an amount equal to the outstanding principal of the bonds subject to the safe harbor. The commenters’ suggestion would reduce the maximum amount in the Proposed Regulations by the amount of certain other eligible tax-exempt bonds redeemed by the issuer. The Final Regulations do not adopt this recommendation. The Final Regulations retain the measure of the maximum amount required to be applied to redeem or invest in eligible tax-exempt bonds under this safe harbor at the outstanding principal amount of the relevant bonds to ensure that issuers redeem the bonds that are the subject of the safe harbor whenever possible.

The 2013 Proposed Regulations proposed to define eligible tax-exempt bonds for purposes of the new safe harbor to mean those tax-exempt bonds that are not subject to the alternative minimum tax (non-AMT tax-exempt bonds). Commenters requested clarification that eligible tax-exempt bonds for these investments also include certain State and Local Government Series securities (SLGS or, individually, a SLGS security), specifically Demand Deposit SLGS,



and certain interests in regulated investment companies that invest in tax-exempt bonds and pass through to their owners income at least 95 percent of which is tax-exempt under section 103. The commenters noted that these two types of investments are included in the existing definition of tax-exempt bonds for purposes of the arbitrage investment restrictions. Commenters noted particularly that Demand Deposit SLGS are much easier to acquire than tax-exempt bonds and also have limited arbitrage potential. The purpose of the requirement to redeem or invest available amounts in certain tax-exempt bonds is to reduce the burden on the tax-exempt bond market of longer-term tax-exempt bonds issued for working capital expenditure financings. Although Demand Deposit SLGS are taxable obligations that do not reduce the burden on the tax-exempt bond market, the Treasury Department and the IRS recognize that including these as eligible tax-exempt bonds provides issuers a simple method of investing with little possibility of earning arbitrage. An interest in a regulated investment company that invests in non-AMT tax-exempt bonds is easier to buy and sell than a bond, and purchasing such an interest reduces the burden on the tax-exempt bond market. Thus, paralleling the existing definition of “tax-exempt bonds” applicable for purposes of the arbitrage investment restrictions, the Final Regulations clarify that eligible tax-exempt bonds include both Demand Deposit SLGS and an interest in a regulated investment company if at least 95% of the income to the holder is from non-AMT tax-exempt bonds.

Commenters also recommended that the Final Regulations expressly address the treatment of refunding bonds issued to refinance working capital

expenditures for purposes of the new safe harbor. The Final Regulations provide that this safe harbor applies to refunding bonds in the same way that it applies to other bonds.

#### iv. Other Technical Changes to Working Capital Rules

The 2013 Proposed Regulations proposed to remove a restriction against financing a working capital reserve, a complex restriction that penalized those State and local governments that previously have maintained the least amount of reserves. Commenters supported this change. The Final Regulations adopt this change as proposed.

The 2013 Proposed Regulations proposed to 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. The Treasury Department and the IRS received no unfavorable comments on this change. The Final Regulations adopt this change as proposed.

Commenters also raised several issues with respect to the working capital rules that the Treasury Department and the IRS have concluded are beyond the scope of this project and, therefore, did not address in the Final Regulations (see section 12 of this preamble).

## 2. Section 1.148-2 General Arbitrage Yield Restriction Rules-- Temporary Period Spending Exception to Yield Restriction

The Existing Regulations provide various temporary periods for investment of proceeds of tax-exempt bonds without yield restriction. No express temporary period covers proceeds used for working capital expenditures that are

not restricted working capital expenditures, such as extraordinary working capital items. The 2013 Proposed Regulations proposed to broaden the existing 13 month temporary period for restricted working capital expenditures to include all working capital expenditures. One commenter supported and none opposed this proposed change. The Final Regulations adopt this change as proposed.

### 3. Section 1.148-3 General Arbitrage Rebate Rules

#### A. Arbitrage rebate computation credit

The Existing Regulations allow an issuer to take a credit against payment of arbitrage rebate to help offset the cost of computing rebate. The 2007 Proposed Regulations proposed to increase the credit and proposed to add an inflation adjustment to this credit, based on changes in the Consumer Price Index. The Treasury Department and the IRS received no comments on this change. The Final Regulations adopt this change as proposed.

#### B. Recovery of overpayment of rebate

Generally, under the Existing Regulations, an issuer computes the amount of arbitrage rebate that it owes under a method that future values payments and receipts on investments using the yield on the bond issue. Under this method, an arbitrage payment made on one computation date is future valued to the next computation date to determine the amount of arbitrage rebate owed on that subsequent computation date. The Existing Regulations provide that an issuer may recover an overpayment of arbitrage rebate with respect to an issue of tax-exempt bonds if the issuer establishes to the satisfaction of the Commissioner that an overpayment occurred. The Existing Regulations further define an overpayment as the excess of “the amount paid” to the United States for an issue

under section 148 over the sum of the rebate amount for that 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. Thus, even if the future value of the issuer's arbitrage rebate payment on a computation date, computed under the method for determining arbitrage rebate, is greater than the issuer's rebate amount on that date, an issuer is only entitled to a refund to the extent that the amount actually paid exceeds that rebate amount. The Existing Regulations limit the amount of the refund in this manner because the Treasury Department and the IRS were concerned about whether the IRS had statutory authority to pay interest on arbitrage rebate payments. To permit a refund in an amount calculated in whole or in part based upon a future value of the amount actually paid would effectively result in an interest payment on that payment.

An example in the Existing Regulations has caused confusion because it could be interpreted to mean that an issuer can receive a refund of a rebate payment when the future value of such rebate payment exceeds the rebate amount on the next computation date, even though the actual amount of the previous rebate payment does not exceed the rebate amount on that next computation date. The Proposed Regulations proposed to make a technical amendment to this example to conform this example to the intended scope of recovery of an overpayment of arbitrage rebate.

Commenters recommended broadening the scope of recovery of overpayments of arbitrage rebate to permit future valuing of the amount actually paid in computing the amount of the overpayment. Because the Treasury

Department and the IRS have concluded that they lack the statutory authority to pay interest on overpayments of arbitrage rebate, the Final Regulations adopt this change as proposed.

#### 4. Section 1.148-4 Yield on an Issue of Bonds

##### A. Joint bond yield authority

The 2007 Proposed Regulations proposed to eliminate a provision in the Existing Regulations that permits computation of a single joint bond yield for two or more issues of qualified mortgage bonds or qualified student loan bonds. The 2007 Proposed Regulations solicited public comments on the feasibility of establishing generally applicable, objective standards for joint bond yield computations. Two commenters representing student loan lenders sought to retain this provision and described certain facts on which they believed that the joint computation of yield on student loan bonds might be based. However, in 2010, Congress terminated the Federal Family Education Loan Program (FFELP), effectively eliminating the program for which most student loan bonds were issued yet not affecting State supplemental student loan bond programs. Health Care and Education Reconciliation Act of 2010, Public Law No. 111-152, section 2201, 124 Stat 1029, 1074 (2010). Given the elimination of the FFELP and the highly factual nature of the requests for joint bond yield computations, the Final Regulations adopt the proposed elimination of the joint bond yield authority provision. In addition, however, in recognition of the administrative challenges for loan yield calculations in these portfolio loan programs, the Final Regulations extend the availability of yield reduction payments to include

qualified student loans and qualified mortgage loans generally (see section 5.A. of this preamble).

**B. Modification of yield computation for yield-to-call premium bonds**

The 2007 Proposed Regulations proposed to simplify the yield calculations for certain callable bonds issued with significant amounts of bond premium (sometimes called yield-to-call bonds) to focus on the redemption date that results in the lowest yield on the particular premium bond (rather than the more complex existing focus on the lowest yield on the issue). The Treasury Department and the IRS did not receive any adverse comments regarding this proposed change, received one question that raised issues beyond the scope of this project (see section 12 of this preamble), and received a favorable comment regarding this proposed change. The Final Regulations adopt this change as proposed.

**C. Integration of hedges**

The Existing Regulations permit issuers to compute the yield on an issue by taking into account payments under “qualified hedges.” Generally, under the Existing Regulations, to be a qualified hedge, the hedge must be interest based, the terms of the hedge must correspond closely with the terms of the hedged bonds, the issuer must duly identify the hedge, and the hedge must contain no significant investment element. The Existing Regulations provide two ways in which a qualified hedge may be taken into account in computing yield on the issue, known commonly as “simple integration” and “super integration.” In the case of simple integration all net payments and receipts on the qualified hedge and the hedged bonds are taken into account in determining the yield on the

bonds, such that generally these hedged bonds are treated as variable yield bonds for arbitrage purposes. In the case of super integration, certain hedged bonds are treated as fixed yield bonds, and the qualified hedge must meet additional eligibility requirements beyond those for simple integration. These additional eligibility requirements focus on assuring that the terms of the hedge and the hedged bonds sufficiently correspond so as to warrant treating the hedged bonds as fixed yield bonds for arbitrage purposes.

i. Cost-of-Funds Hedges

The 2007 Proposed Regulations proposed to clarify that for purposes of applying the definition of periodic payment to determine whether a hedge has a significant investment element, a “specified index” (upon which periodic payments are based) is deemed to include payments under a cost-of-funds swap, thereby eliminating any doubt that cost-of-funds swaps can be qualified hedges. One commenter supported this clarification and none opposed it. One commenter proposed an amendment that is beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt this clarification as proposed.

ii. Taxable Index Hedges

One of the eligibility requirements for a qualified hedge under the Existing Regulations is that the hedge be interest based. For simple integration, one of the factors used in determining whether a variable-to-fixed interest rate hedge is interest based focuses on whether the variable interest rate on the hedged bonds and the floating interest rate on the hedge are “substantially the same, but not identical to” one another. For super integration purposes, such rates must be

“reasonably expected to be substantially the same throughout the term of the hedge.” Issuers have raised interpretative questions about how to apply these rules to hedges based on taxable interest rate indices (taxable indices) because interest rates on taxable indices generally do not correspond as closely as interest rates on tax-exempt market indices to actual market interest rates on tax-exempt, variable-rate bonds. These interpretative questions are particularly important for hedges based on taxable indices (taxable index hedges) used with advance refunding bond issues because issuers generally need to use the qualified hedge rules or some other regime to determine with certainty the yield on the tax-exempt advance refunding bonds to comply with the applicable arbitrage yield restrictions on investments in defeasance escrows.

The 2007 Proposed Regulations proposed to clarify that taxable index hedges are eligible for simple integration but also included detailed provisions that prescribed the correlation of interest rates needed for taxable index hedges to qualify for simple integration. Commenters generally criticized the proposed interest rate correlation test for simple integration of taxable index hedges as excessively complex or unworkable in various respects. One commenter urged elimination of this rate correlation test as unnecessary on the grounds that other proposed changes in the 2007 Proposed Regulations, including particularly the provision limiting the size and scope of hedges (described in section 4.C.iii of this preamble), were sufficient to control the parameters of taxable index hedges for purposes of simple integration. The Final Regulations clarify that a taxable index hedge is an interest based contract and adopt the comment to eliminate the



interest rate correlation test for taxable index hedges. The Final Regulations also clarify that the difference between the interest rate used on the hedged bonds and that used to compute payments on the hedge will not prevent the hedge from being an interest based contract if the two interest rates are substantially similar.

The 2007 Proposed Regulations proposed to treat taxable index hedges as ineligible for super integration (except in the case of certain anticipatory hedges). Commenters requested an exception to this general prohibition on super integration for instances in which the variable rate on hedged bonds and the variable rate used to determine the hedge provider's payments to the issuer under the hedge are both based on a taxable index and are identical (or nearly so) to one another. The Final Regulations generally adopt the proposed rule that taxable index hedges are ineligible for super integration but, in response to the comments, add an exception for hedges in which the hedge provider's payments are based on an interest rate identical to that on the hedged bonds, because these hedges are perfect hedges that clearly result in a fixed yield. The Treasury Department and the IRS do not adopt commenters' request to permit super integration when the taxable-index-based interest rates for both the hedge and the hedged bonds are nearly identical but not perfectly so. The Treasury Department and the IRS have concluded that such a rule would add unnecessary complexity to the Final Regulations and that commenters' concerns are largely resolved by the extension in the Final Regulations of yield reduction payments to address basis differences between indexes used in hedges and underlying interest rates on hedged bonds in advance refundings (discussed elsewhere in

this section of the preamble). The Final Regulations remove references to the particular taxable index called “LIBOR,” without inference.

Commenters also sought other specific exceptions to the prohibition on super integration. One commenter noted that taxable index hedges cost less than hedges based on a tax-exempt index and recommended allowing super integration of taxable index hedges with mortgage revenue bonds to facilitate compliance with arbitrage restrictions on the yield of the financed mortgages. The Treasury Department and the IRS have concluded that the Final Regulations adequately address the commenter’s concerns by permitting simple integration of taxable index hedges and by allowing yield reduction payments for qualified mortgage loans to facilitate compliance with the arbitrage investment restrictions (see section 5.A. of this preamble).

Other commenters suggested that the proposed prohibition on super integration of taxable index hedges should be prospective. This provision in the Final Regulations applies to bonds sold on or after the date that is 90 days after publication of the Final Regulations in the **Federal Register**, and does not apply to bonds sold prior to that date or to hedges on those bonds, regardless of when the issuer enters into such a hedge, unless the issuer avails itself of permissive application under §1.148-11(l)(1) of these Final Regulations.

The 2007 Proposed Regulations also proposed to modify the yield reduction payment rules to permit issuers to make yield reduction payments on certain hedged advance refunding issues. This proposed provision effectively would allow yield reduction payments to cover the basis differences between the

hedge and the hedged bonds in certain circumstances in which super integration was unavailable to address those basis differences, such as when taxable index swaps hedge the interest rate on advance refunding bonds. Commenters requested clarification of which bonds in the issue must be hedged for the issuer to be eligible to make yield reduction payments under the proposed provision. The Final Regulations eliminate the term “hedged bond issue” to clarify that the yield reduction payment is narrowly targeted to the portion of the issue that funds the defeasance escrow and otherwise adopt this change as proposed.

### iii. Size and Scope of a Qualified Hedge

The 2007 Proposed Regulations proposed to add an express requirement that limits 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 hedged bonds. Generally, the purpose of this proposed limitation is to clarify that certain leveraged hedges are not qualified hedges.

The 2007 Proposed Regulations proposed an example of a hedge of the appropriate size and scope, based on the principal amount and the reasonably expected interest requirements of the hedged bonds. One commenter suggested clarifying this size and scope limitation to provide more flexibility for anticipatory hedges that are entered into before the issuance of the hedged bonds. The Final Regulations adopt the size and scope limitation as proposed and clarify that this limitation applies to anticipatory hedges based on the reasonably expected terms of the hedged bonds to be issued.

#### iv. Correspondence of Payments for Simple Integration

The Existing Regulations require that, for a hedge to be a qualified hedge, 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. The 2007 Proposed Regulations proposed to treat payments as corresponding closely in time for this purpose if the payments were made within 60 calendar days of each other.

One commenter recommended increasing the permitted period for corresponding payments from 60 days to 90 days to accommodate a range of conventions used in the swap market. The Final Regulations adopt this comment.

#### v. Identification of Qualified Hedges

The 2007 Proposed Regulations proposed to extend the time for an issuer to identify a qualified hedge from three days to 15 days and to clarify that these are calendar days. The 2013 Proposed Regulations proposed to add a requirement that the identification of a qualified hedge include a certificate from the hedge provider containing certain information. Under the 2013 Proposed Regulations, one element required to be certified by the hedge provider is that the rate being paid by the bonds' issuer on the hedge is comparable to the rate that would be paid by a similarly situated issuer of taxable debt.

Several commenters recommended clarifying the date on which the 15-day period for identification of a hedge commences. The Final Regulations clarify that the date on which the 15-day period begins is the date on which the parties enter into a binding agreement to enter into the hedge (as distinguished from the closing date of the hedge or start date for payments on the hedge, if different).

Several commenters suggested permitting a party other than the issuer to identify the hedge on its books and records, but such changes are beyond the scope of this project (see section 12 of this preamble).

One commenter supported the requirement of a hedge provider's certificate. Two other commenters recommended eliminating this requirement as both unnecessary and burdensome in that it exceeds the requirements for other financial contracts related to tax-exempt bond yield. These commenters recommended that, if the pricing of the hedge is a concern, the regulations should provide other methods for establishing fair pricing. These commenters, however, acknowledged that many issuers already use some form of hedge provider's certificate and that the provisions in the Proposed Regulations reflect to some degree the standard provisions of such certificates. In the alternative, these commenters recommended that the hedge provider's certificate should focus on factual aspects of establishing a qualified hedge, rather than on legal conclusions, and offered specific suggestions to that effect. For example, these commenters suggested that issuers also should be required to demonstrate their efforts to establish that the hedge pricing does not include compensation for

underwriting or other services, rather than to obtain a certification to that effect. These commenters further suggested that the representation in the Proposed Regulations that the terms of the hedge were agreed to between a willing buyer and a willing seller in a bona fide, arm's length transaction was unnecessary and required a legal conclusion outside the hedge provider's knowledge. Further, the commenters noted that comparable hedges on taxable debt with counterparties similar to State and local government issuers may be rare and recommended that issuers be required to establish that the rate on the hedge is comparable to the rate that the hedge provider would charge for a similar hedge with a counterparty similar to the issuer, but without a reference to debt obligations other than tax-exempt bonds.

The Final Regulations retain the requirement for a hedge provider's certificate because the hedge provider is uniquely positioned to validate pricing information needed to determine whether a hedge meets the requirements for being a qualified hedge. The Final Regulations retain the certification regarding an arm's length transaction between a willing buyer and a willing seller as one primarily based on fact and commonly obtained by issuers under current practices. In response to public comments, the Final Regulations amend the other required certifications to focus on factual aspects of the hedging transaction. In light of the evolving regulatory environment for swaps, however, the Final Regulations omit 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. The Final Regulations reserve the authority for the Commissioner to add

additional certifications in guidance published in the Internal Revenue Bulletin. In developing any future guidance, the Treasury Department and the IRS may look to the market for swaps on taxable debt and consider the availability of appropriate comparable rates.

vi. Accounting for Modifications and Terminations

a. Modifications and terminations of qualified hedges

The Existing Regulations provide that a termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer or the acquisition by the issuer of an offsetting hedge. The Existing Regulations further provide that a deemed termination of a qualified hedge occurs when the hedged bonds are redeemed, when the hedge ceases to be a qualified hedge, or when the modification or assignment of the hedge results in a deemed exchange under section 1001. The issuer takes termination payments resulting from a deemed or actual termination of an integrated hedge into account in computing yield on the bonds.

The 2013 Proposed Regulations proposed guidance on the treatment of modifications and terminations of qualified hedges. The 2013 Proposed Regulations also proposed to eliminate the ambiguous existing standard that triggered terminations for offsetting hedges. The 2013 Proposed Regulations proposed that a modification, including an actual modification, an acquisition of another hedge, or an assignment, results in a deemed termination of a hedge if the modification is material and results in a deemed disposition under section 1001.

The 2013 Proposed Regulations proposed to simplify the treatment of deemed terminations to provide that a material modification of a qualified hedge (that otherwise would result in a deemed termination) does not result in such a termination if the modified hedge is a qualified hedge. For this purpose, the 2013 Proposed Regulations proposed to require re-testing of the modified hedge for compliance with the requirements for a qualified hedge at the time of the modification, with adjustments. In doing this re-testing, the 2013 Proposed Regulations proposed to disregard any off-market value of the existing hedge at the time of modification. In addition, the 2013 Proposed Regulations proposed to measure the time period for identification of the modified hedge from the date of the modification. Finally, the 2013 Proposed Regulations proposed to omit the requirement for a hedge provider's certificate for the modified hedge.

Commenters supported these changes. The Final Regulations adopt these proposed changes with one modification: assignment of a hedge is no longer given as an example of a modification. The Final Regulations remove this example not because an assignment is not a modification, but because under the regulations under section 1001 an assignment generally does not result in a deemed exchange.

Commenters sought confirmation that the proposed rules for modifications of qualified hedges in the 2013 Proposed Regulations would replace an existing rule regarding such modifications that is set forth in the first sentence of section 5.1 of Notice 2008-41, 2008-1 CB 742. That sentence generally provides that a modification of a qualified hedge does not result in a deemed termination if the



issuer does not expect the modification to change the yield on the hedged bonds over their remaining term by more than 0.25% and the modified hedge is integrated with the bonds. The Final Regulations provide comprehensive rules for determining when a modification of a qualified hedge results in a termination and, therefore, supersede the first sentence of section 5.1 of Notice 2008-41. The Final Regulations have no effect on the remainder of Notice 2008-41. See the section in this preamble entitled “Effect on Other Documents.”

b. Continuations of qualified hedges in refundings

The 2013 Proposed Regulations similarly proposed to simplify the treatment of a qualified hedge upon a refunding of the hedged bonds when no actual termination of the associated hedge occurs. If the hedge meets the requirements for a qualified hedge of the refunding bonds as of the issue date of the refunding bonds, with certain exceptions, the 2013 Proposed Regulations proposed to treat the hedge as continuing as a qualified hedge of the refunding bonds instead of being terminated. The Treasury Department and the IRS received favorable comments regarding this proposed change and one comment beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt this change as proposed.

The Existing Regulations provide special rules for terminations of super-integrated qualified hedges. A termination is disregarded and these special rules do not apply if, based on the facts and circumstances, the yield will not change. The 2013 Proposed Regulations proposed to apply these special rules to a modified super-integrated qualified hedge that is eligible for continued simple integration. Commenters sought clarification of the effect of this rule on super

integration treatment. The purpose of this rule is to determine whether a modified super-integrated qualified hedge that continues to qualify for simple integration also would continue to qualify for super integration. The Final Regulations clarify that the applicable test is the test under the Existing Regulations for determining when to disregard terminations of super-integrated qualified hedges.

c. Terminations of hedges at fair market value

The Proposed Regulations proposed to modify the amounts taken into account for a deemed termination or actual termination of a qualified hedge. For an actual termination of a qualified hedge, the 2013 Proposed Regulations proposed to limit the amount of the hedge termination payment treated as made or received on the hedged bonds to an amount that is (i) no greater than the fair market value of the qualified hedge if paid by the issuer, and (ii) no less than the fair market value of the qualified hedge if received by the issuer. For a deemed termination of a qualified hedge, the 2013 Proposed Regulations proposed that the amount of the deemed termination payment is equal to the fair market value of the qualified hedge on the termination date.

Commenters recommended that, for an actual termination, the amount actually paid or received by the issuer in connection with the termination should be considered the fair market value of the qualified hedge. The commenters further recommended that, for a deemed termination, the issuer should be able to rely on bid-side quotations from the hedge provider and other providers for purposes of determining the fair market value of the qualified hedge on the termination date. The commenters indicated that, in all cases, the termination

amounts, whether actual or deemed, reflect the “bid side” of the hedge market. Because of concerns about the pricing of a hedge in determining the amount to be paid as a termination payment, 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. The Final Regulations simplify the Proposed Regulations by providing a uniform fair market value standard for both actual and deemed terminations. Although the Treasury Department and the IRS have concluded that bona fide market quotations may be used to support fair market value determinations, the Treasury Department and the IRS have concerns about further specification of particular types of market quotations for purposes of proper reflection of fair market value in various circumstances. Accordingly, the Final Regulations provide that the fair market value of a qualified hedge upon termination is based on all of the facts and circumstances.

## 5. Section 1.148-5 Yield and Valuation of Investments

### A. Yield reduction payment rules

For certain limited situations, the Existing Regulations permit payment of yield reduction payments to the United States to satisfy yield restriction requirements on certain investments. The 2007 Proposed Regulations proposed to expand these situations to permit issuers to make yield reduction payments to cover nonpurpose investments that an issuer purchases on a date when the issuer is unable to purchase SLGS because the Treasury Department has suspended sales of SLGS.

Three commenters favored the proposed expansion of the availability of yield reduction payments when SLGS are unavailable. One commenter expressed concern that the proposed provision may not address the circumstance in which a SLGS sale suspension is in effect when an issuer commits to purchase investments, but SLGS sales resume before settlement on that purchase. The Final Regulations 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.

The commenter also recommended extending the availability of yield reduction payments to cover the circumstance in which an issuer is uncertain whether the Treasury Department may suspend SLGS sales in the future after an issuer has subscribed to purchase SLGS and before the issuance of those SLGS. Although the Treasury Department reserves full discretion to manage its borrowings, including SLGS, it has been the Treasury Department's practice to honor all outstanding SLGS subscriptions received before it suspends SLGS sales. Accordingly, the Treasury Department and the IRS have concluded that yield reduction payments are not needed in this circumstance, and the Final Regulations do not adopt this comment.

In addition, in comments regarding the proposed elimination of the Commissioner's authority to compute a joint yield for two or more issues of qualified mortgage bonds or qualified student loan bonds, one commenter requested that issuers of qualified student loan bonds be permitted to make yield reduction payments for all qualified student loans, not just those under the

FFELP. The Treasury Department and the IRS recognize that the ability to make yield reduction payments for qualified student loans and qualified mortgage loans would provide issuers an administrable alternative to the rarely used authority to compute a joint bond yield on issues of such bonds. The Treasury Department and the IRS also recognize that these portfolio loan programs have particular administrative challenges with loan yield compliance due to the large number of loans. Accordingly, in connection with the elimination of that joint bond yield authority under the Final Regulations, the Treasury Department and the IRS adopt this comment and expand the availability of yield reduction payments to include qualified student loans and qualified mortgage loans generally.

Commenters requested permission to make yield reduction payments in several other situations not provided in the Proposed Regulations. The Treasury Department and the IRS have concluded these amendments are beyond the scope of this project and, therefore, did not address them in the Final Regulations (see section 12 of this preamble).

#### B. Valuation of investments

The Existing Regulations provide guidance on how to value investments allocated to an issue but leave some ambiguity about when the present value and the fair market value methods of valuation are permitted or required. The 2013 Proposed Regulations proposed to clarify 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 a deemed disposition.

The 2013 Proposed Regulations did not propose to distinguish between purpose investments and nonpurpose investments. One commenter urged clarification that purpose investments must be valued at present value at all times. This commenter further suggested that the rules clearly distinguish between purpose and nonpurpose investments. The Treasury Department and the IRS recognize that purpose investments are special investments that are intended to pass on the benefits of the lower borrowing costs of tax-exempt bond financings to eligible beneficiaries of the particular authorized tax-exempt bond program (for example, eligible first-time low and moderate income homebuyers who receive qualified mortgage loans financed with qualified mortgage bonds). Accordingly, the Final Regulations adopt these comments.

The Existing Regulations include an exception to the mandatory fair market value rule for reallocations of investments between tax-exempt bond issues as a result of the transferred proceeds rule under §1.148-9(b) or the universal cap rule under §1.148-6(b)(2). To remove a disincentive against retiring tax-exempt bonds with taxable bonds when the fair market value of the investments allocable to the tax-exempt bonds would cause investment yield to exceed the tax-exempt bond yield, the 2013 Proposed Regulations proposed to change this exception to the fair market value rule to require that only the issue from which the investment is allocated consist of tax-exempt bonds.

Commenters generally viewed this change favorably. One commenter suggested clarifying an ambiguity in the Existing Regulations regarding when a reallocation from one issue to another occurs “as a result of” the universal cap

rule. The Final Regulations clarify that 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 (for example, a pledge of investments to multiple bond issues secured by common security under a master indenture). In these circumstances, the issuer has not structured the transaction to benefit from the market valuation of the nonpurpose investments.

This commenter also suggested providing a safe harbor for when an issuer may liquidate escrow investments after a taxable refunding without concern that the Commissioner would exercise his anti-abuse authority to value the investment at fair market value. This comment is beyond the scope of this project (see section 12 of this preamble).

Commenters also recommended broad interpretations or expansions of the exception to fair market valuation for investments reallocated as a result of the universal cap rule to cover various types of transactions involving investments that secure a tax-exempt bond issue and that are liquidated at a profit so long as the investment proceeds of the liquidated investments are used to retire tax-exempt bonds early. In one representative scenario, an issuer using funds other than tax-exempt bond proceeds created a yield-restricted escrow fund to defease tax-exempt bonds for which it retained the call rights. If the fair market value of investments in the escrow appreciated, the issuer would issue

taxable bonds and use a portion of the proceeds of the taxable bonds to redeem the tax-exempt bonds. Applying universal cap principles, the investments would cease to be allocated to the tax-exempt bonds when the tax-exempt bonds were redeemed and the investments would be allocated to the taxable refunding bonds not as a result of a pre-existing pledge but as replacement proceeds. If the investments were valued at fair market value, the yield on the escrow would exceed the yield on the tax-exempt bonds resulting in arbitrage bonds. The bonds would not be arbitrage bonds if the regulations permitted these escrow investments to be valued at present value at the time of the refunding. Another scenario for which the commenters requested using the present value of investments rather than fair market value involves liquidating the appreciated investments in a defeasance escrow to redeem the tax-exempt issue rather than issuing taxable refunding bonds.

The Treasury Department and the IRS have concerns about potential unintended consequences and circumvention of arbitrage investment restrictions in these and other similar transactions. In the first scenario, the issuer has structured the transaction specifically to benefit from an appreciation of the escrow investments in a manner inconsistent with the arbitrage restrictions. In the second scenario, the use of present value would allow the issuer to realize the investment return in contravention of the statutory requirements to take into account any gain or loss on the disposition of a nonpurpose investment. Accordingly, except for the technical clarification of the limited application of universal cap deallocations under this rule, the Final Regulations adopt as



proposed the revised exception to fair market valuation for investments reallocated as a result of the transferred proceeds rule or the universal cap rule.

### C. Fair market value of Treasury obligations

The Existing Regulations provide a general rule that 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. For United States Treasury obligations that are traded on the open market, trading values at the time of trades are used to establish fair market values. The Existing Regulations further provide a special rule, aimed primarily at non-transferrable, non-tradable SLGS, that the fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury is its purchase price. This special rule properly indicates that the fair market value of a United States Treasury obligation that is purchased directly from the United States is its purchase price on the original purchase date, but this provision is ambiguous regarding how to determine the fair market value of such an obligation on dates after the original purchase date.

The 2013 Proposed Regulations proposed to clarify that, on the original purchase date only, the fair market value of such an obligation, including a SLGS security, is its purchase price. The 2013 Proposed Regulations further proposed that, on any date other than the original purchase date, the fair market value of a SLGS security is its redemption price. One commenter objected to the valuation of a SLGS security at other than its purchase price upon a deemed acquisition or deemed disposition. United States Treasury obligations other than SLGS may be purchased and sold on the open market. SLGS, however, are

nontransferable obligations that may be purchased or redeemed only from the United States Treasury. For this reason, the 2013 Proposed Regulations proposed that the fair market value of a SLGS security on any date other than its purchase date is the redemption price determined by the United States Treasury under applicable regulations for the SLGS program. The Final Regulations adopt this change as proposed.

D. Modified fair market value safe harbor for guaranteed investment contracts

The Existing Regulations provide a safe harbor for establishing the fair market value of a guaranteed investment contract. This safe harbor generally relies on a prescribed bidding procedure, including requirements that all bidders be given an equal opportunity to bid with no opportunity to review other bids before providing a bid (that is, the “no last look” rule) and that the bid specifications be provided to prospective bidders “in writing.” The 2007 Proposed Regulations proposed to amend this safe harbor to accommodate electronic bidding procedures by: (1) Permitting bid specifications to be sent electronically over the internet or by fax; and (2) providing that no impermissible last look occurs if in effect all bidders have an equal opportunity for a last look. One commenter noted an ambiguity in this proposed change. In response to this comment, the Final Regulations clarify that bids must be in writing and timely disseminated and that a writing may be in electronic form and may be disseminated by fax, email, an internet-based website, or other electronic medium that is similar to an internet-based website and regularly used to post bid specifications. The Final Regulations otherwise adopt this change as proposed.

#### E. External commingled investment funds

The Existing Regulations provide certain preferential rules for the treatment of administrative costs of certain widely held external commingled funds. Under the Existing Regulations, a fund is treated as widely held if the fund, on average, has more than 15 unrelated investors and each investor maintains a prescribed minimum average investment in the fund. The 2007 Proposed Regulations proposed to allow additional smaller investors to invest in an external commingled fund without disqualifying the fund so long as at least 16 unrelated investors each maintain the required minimum average investment in the fund.

One commenter suggested that the regulations should require that a specified percentage of the unrelated investors hold a specified percentage of the daily average value of the fund's assets. The Final Regulations do not adopt this comment, because it is inconsistent with the purpose of the proposed change to enable a fund to become even more widely held by accommodating an unlimited number of small investors without restriction so long as at least 16 unrelated investors each maintain the required minimum average investment in the fund. The commenter also suggested other amendments beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt this change as proposed.

#### 6. Section 1.148-8 Small Issuer Exception to Rebate Requirement-- Pooled Bonds

The 2007 Proposed Regulations proposed to amend the Existing Regulations to conform to changes made to section 148(f)(4)(D) by section 508

of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law No. 109-222, 120 Stat. 345, which eliminated a rule that permitted a pool bond issuer to ignore its pool bond issue in computing whether it had exceeded its \$5 million limit for purposes of the small issuer rebate exception. The Treasury Department and the IRS received no comments regarding this proposed change. The Final Regulations adopt this change as proposed.

7. Section 1.148-10 Anti-Abuse Rules and Authority of Commissioner

The 2013 Proposed Regulations proposed to amend 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 2013 Proposed Regulations proposed to remove the references to "economic substance" to prevent confusion of the Commissioner's authority under this arbitrage anti-abuse rule with the economic substance doctrine under general federal tax principles. No substantive change was intended.

Commenters suggested that this proposed change would give unduly broad discretion to the Commissioner and would reduce certainty of the applicability of published guidance. These commenters recommended limiting the Commissioner's authority to that necessary "to reflect the economics of the transaction to prevent such financial advantage." The Final Regulations adopt this comment.

## 8. Section 1.148-11 Transition Provision for Certain Guarantee Funds

The Existing Regulations include a transition rule that allows certain State perpetual trust funds (for example, certain State permanent school funds) to pledge funds to guarantee tax-exempt bonds without resulting in arbitrage-restricted replacement proceeds. The 2013 Proposed Regulations proposed to include changes proposed in Notice 2010-5, 2010-2 IRB 256, to increase the amount of tax-exempt bonds that such funds could guarantee under this special rule. Further, in response to comments received on Notice 2010-5, the 2013 Proposed Regulations proposed to extend this special rule to cover certain tax-exempt bonds issued to finance public charter schools, which may be 501(c)(3) organizations. The Treasury Department and the IRS received no comments on these proposed changes. The Final Regulations adopt these changes as proposed.

## 9. Section 1.150-1 Definitions

### A. Definition of tax-advantaged bonds

The 2013 Proposed Regulations proposed a new definition of tax-advantaged bonds. The Treasury Department and the IRS received no comments regarding this new definition. The Final Regulations substitute “tax benefit” for “subsidy” in describing tax-advantaged bonds but otherwise adopt the definition as proposed.

### B. Definition of issue

The Existing Regulations provide that tax-exempt bonds and taxable bonds are not part of the same issue. The 2013 Proposed Regulations proposed to clarify that taxable tax-advantaged bonds and other taxable bonds are part of

different issues and that different types of tax-advantaged bonds are parts of different issues. The Treasury Department and IRS received one comment supporting this proposed change and no opposing comments. The Final Regulations adopt this change as proposed.

### C. Definition and treatment of grants

The 2013 Proposed Regulations proposed that the existing definition of grant for arbitrage purposes applies for purposes of other tax-exempt bond provisions. The 2013 Proposed Regulations also proposed to clarify that 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.

Commenters requested confirmation that the proposed rule preserves the existing rule that an issuer spends proceeds used for grants for purposes of the arbitrage investment restrictions when the issuer makes the grant to an unrelated third-party. Thus, for example, if the grantee uses the grant to reimburse its expenditures, the reimbursement allocation rules do not apply. The 2013 Proposed Regulations expressly proposed the special grant expenditure rule for arbitrage purposes as an example of a specific exception to the proposed general rule. Commenters also suggested other amendments to the rules for grants that are beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt these changes as proposed.

### 10. Section 1.141-15 Effective Dates

The Final Regulations include certain technical amendments to final regulations (TD 9741) that were published in the **Federal Register** on Tuesday,

October 27, 2015 (80 FR 65637). Those final regulations provide guidance on allocation and accounting rules and certain remedial actions for purposes of the private activity bond restrictions under section 141 of the Internal Revenue Code that apply to tax-exempt bonds issued by State and local governments.

The 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. The technical amendments also clarify permissive application of certain provisions to outstanding bonds.

#### 11. Revenue Procedure 97-15

Revenue Procedure 97-15, 1997-1 CB 635, provides a program under which an issuer of tax-exempt bonds may request a closing agreement with respect to outstanding bonds to prevent the interest on those bonds from being includible in gross income of the bondholders or being treated as an item of tax preference for purposes of the alternative minimum tax as a result of an action subsequent to the issue date of the bonds that causes the bonds to fail to meet certain requirements relating to the use of proceeds. Notice 2008-31, 2008-1 CB 592, also provides a voluntary closing agreement program for tax-exempt bonds and tax credit bonds. The scope of the violations that can be remedied under Notice 2008-31 is broader than that under Rev. Proc. 97-15. As a result, this Treasury Decision obsoletes Rev. Proc. 97-15.

## 12. Comments Beyond the Scope of the Proposed and Final Regulations

Commenters submitted additional suggestions for revisions to the Existing Regulations. These suggestions include: (1) Adding a new safe harbor to prevent the creation of replacement proceeds specifically for grants and extraordinary working capital financings (and redefining “extraordinary working capital”); (2) adding new rules for using proceeds to fund working capital reserves; (3) providing how an issuer should allocate certain expenses related to yield-to-call premium bonds for computing yield on the issue; (4) revising the rules for determining if an interest rate cap contains a significant investment element; (5) permitting a conduit borrower to identify a qualified hedge on its books and records; (6) providing a safe harbor for when an issuer may liquidate escrow investments for purposes of valuation of investments; (7) revising the proceeds-spent-last expenditure rule to permit financing of certain payments on hedges; (8) permitting yield reduction payments on investments purchased to defease zero-coupon bonds; (9) providing yield reduction payments for a basis difference under circumstances other than those in the Proposed Regulations; (10) exempting external comingled funds that are operated by a government on a not-for-profit basis from the requirements for administrative costs of such funds to be included in qualified administrative costs of investments; (11) establishing an economic life for grants based on the benefit of the grant to the grantor; (12) providing rules for grant repayments; and (13) explaining how certain rules in the Proposed Regulations would apply to very specific facts. These comments identify issues that are beyond the scope of the Proposed Regulations and thus are not addressed in the Final Regulations.



## **Applicability Dates**

The Final Regulations generally apply to bonds that are sold on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Certain provisions related to hedges on bonds apply to hedges that are entered into or modified on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. The Final Regulations also permit issuers to apply certain of the amended provisions to bonds sold before **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For specific dates of applicability, see §§1.141-15, 1.148-11, 1.150-1, and 1.150-2.

## **Effect on Other Documents**

As of **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, Revenue Procedures 95-47 and 97-15 are obsolete and Notice 2008-41 is modified.

## **Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the collection of information in these regulations is required for hedging

transactions entered into primarily between larger State and local governments and large counterparties. It is also based on the fact that the estimated recordkeeping burden for all issuers and counterparties is relatively small and the reasonable costs of that burden do not constitute a significant economic impact. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. No comments were received.

### **Drafting Information**

The principal authors of these regulations are Johanna Som de Cerff, Spence Hanemann, and Lewis Bell of the Office of Associate Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

### **Availability of IRS Documents**

IRS revenue procedures and notices cited in these final regulations are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.148-6 to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.141-0 is amended by:

1. Revising the entry for §1.141-15(l)(2).
2. Adding an entry for §1.141-15(l)(3).
3. Adding an entry for §1.141-15(n).

The additions and revisions read as follows:

§1.141-0 Table of contents.

\* \* \* \* \*

§1.141-15 Effective/applicability dates.

\* \* \* \* \*

(l) \* \* \*

(2) Refunding bonds.

(3) Permissive application.

\* \* \* \* \*

(n) Effective/applicability dates for certain regulations relating to certain definitions.

\* \* \* \* \*

Par. 3. Section 1.141-1 is amended by revising paragraph (a) to read as follows:

§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.

\* \* \* \* \*

Par. 4. Section 1.141-15 is amended by:

1. Redesignating paragraph (l)(2) as (l)(3).
2. Adding new paragraph (l)(2).
3. Amending the first sentence of redesignated paragraph (l)(3) by adding “Except as otherwise provided in this section,” at the beginning of the sentence and removing the word “Issuers” and adding the word “issuers” in its place.
4. Adding paragraph (n).

The additions and revisions read as follows:

§1.141-15 Effective/applicability dates.

\* \* \* \* \*

(l) \* \* \*

(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.

\* \* \* \* \*

(n) Effective/applicability dates for certain regulations relating to certain definitions. §1.141-1(a) applies to bonds that are sold on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 5. Section 1.148-0(c) is amended by:

1. Revising the entry for §1.148-2(e)(3).
2. Adding an entry for §1.148-3(d)(4).
3. Revising the entry for §1.148-5(d)(2).
4. Revising the entry for §1.148-8(d).
5. Removing the entries for §1.148-8(d)(1) and (2).
6. Revising the entry for §1.148-10(e).
7. Adding entries for §1.148-11(k).
8. Revising the entries for §1.148-11(l).

The revisions and additions read as follows:

§1.148-0 Scope and table of contents.

\* \* \* \* \*

(c) \* \* \*

§1.148-2 General arbitrage yield restriction rules.

\* \* \* \* \*

(e) \* \* \*

(3) Temporary period for working capital expenditures.

\* \* \* \* \*

§1.148-3 General arbitrage rebate rules.

\* \* \* \* \*

(d) \* \* \*

(4) Cost-of-living adjustment.

\* \* \* \* \*

§1.148-5 Yield and valuation of investments.

\* \* \* \* \*

(d) \* \* \*

(2) Mandatory valuation of certain yield restricted investments at present value.

\* \* \* \* \*

§1.148-8 Small issuer exception to rebate requirement.

\* \* \* \* \*

(d) Pooled financings--treatment of conduit borrowers.

\* \* \* \* \*

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

\* \* \* \* \*

(e) Authority of the Commissioner to prevent transactions that are inconsistent with the purpose of the arbitrage investment restrictions.

\* \* \* \* \*

§1.148-11 Effective/applicability dates.

\* \* \* \* \*

(k) Certain arbitrage guidance updates.

(1) In general.

(2) Valuation of investments in refunding transactions.

(3) Rebate overpayment recovery.

(4) Hedge identification.

(5) Hedge modifications and termination.

(6) Small issuer exception to rebate requirement for conduit borrowers of pooled financings.

(l) Permissive application of certain arbitrage updates.

(1) In general.

(2) Computation credit.

(3) Yield reduction payments.

(4) External commingled funds.

Par. 6. Section 1.148-1 is amended by:

1. Revising paragraph (c)(4)(i)(B)(1).

2. Removing the “or” at the end of paragraph (c)(4)(i)(B)(2).

3. Removing the period at the end of paragraph (c)(4)(i)(B)(3) and adding

in its place a semicolon and the word “or”.

4. Adding paragraph (c)(4)(i)(B)(4).

5. Revising paragraph (c)(4)(ii).

The revisions and additions read as follows:

§1.148-1 Definitions and elections.

\* \* \* \* \*

(c) \* \* \*

(4) \* \* \*

(i) \* \* \*

(B) \* \* \*

(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;

\* \* \* \* \*

(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.

\* \* \* \* \*

Par. 7. Section 1.148-2 is amended by revising the heading of paragraph (e)(3) and revising paragraph (e)(3)(i) to read as follows:

§1.148-2 General arbitrage yield restriction rules.

\* \* \* \* \*

(e) \* \* \*

(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.

\* \* \* \* \*

Par. 8. Section 1.148-3 is amended by:

1. Revising paragraph (d)(1)(iv).
2. Adding paragraph (d)(4).
3. Revising Example 2(iii)(D) of paragraph (j).

The revisions and addition read as follows:

§1.148-3 General arbitrage rebate rules.

\* \* \* \* \*

(d) \* \* \*

(1) \* \* \*

(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

\* \* \* \* \*

(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.

\* \* \* \* \*

(j) \* \* \*

Example 2. \* \* \*

(iii) \* \* \*

(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.

\* \* \* \* \*

Par. 9. Section 1.148-4 is amended by:

1. Revising paragraph (a).
2. Revising paragraph (b)(3)(i).
3. Adding two sentences at the end of paragraph (h)(2)(ii)(A).
4. Revising the heading and introductory text of paragraph (h)(2)(v).
5. Revising the last sentence of paragraph (h)(2)(v)(B).
6. Adding a sentence at the end of paragraph (h)(2)(vi).
7. Revising paragraph (h)(2)(viii).
8. Revising paragraph (h)(3)(iv)(A).
9. Redesignating paragraphs (h)(3)(iv)(B) through (E) as paragraphs (h)(3)(iv)(E) through (H) respectively.
10. Adding new paragraphs (h)(3)(iv)(B), (C), and (D).
11. Revising newly redesignated paragraph (h)(3)(iv)(E).
12. Revising the first sentence in newly redesignated paragraph (h)(3)(iv)(F).
13. Revising newly redesignated paragraph (h)(3)(iv)(G).

14. Revising the first sentence in newly redesignated paragraph (h)(3)(iv)(H).

15. Adding a sentence at the end of paragraph (h)(4)(i)(C).

16. Adding paragraphs (h)(4)(i)(C)(1) and (2).

17. Adding paragraph (h)(4)(iv).

The revisions and additions read as follows:

§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) \* \* \*

(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.

\* \* \* \* \*

(h) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(A) \* \* \* 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.

\* \* \* \* \*

(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--

\* \* \* \* \*

(B) \* \* \* 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) \* \* \* 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.

\* \* \* \* \*

(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) \* \* \*

(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 re-tested 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.

\* \* \*

(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). \* \* \*

(4) \* \* \*

(i) \* \* \*

(C) \* \* \* 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.

\* \* \* \* \*

(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.

\* \* \* \* \*

Par. 10. Section 1.148-5 is amended by:

1. Revising paragraph (c)(3).
2. Revising paragraphs (d)(2) and (3).
3. Revising the last sentence in paragraph (d)(6)(i) and adding a sentence at the end of the paragraph.
4. Revising paragraphs (d)(6)(iii)(A)(1) and (6).
5. Revising the second sentence of paragraph (e)(2)(ii)(B).

The revisions and additions read as follows:

§1.148-5 Yield and valuation of investments.

\* \* \* \* \*

(c) \* \* \*

(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) \* \* \*

(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).

\* \* \* \* \*

(6) \* \* \*

(i) \* \* \* 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.

\* \* \* \* \*

(iii) \* \* \*

(A) \* \* \*

(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 website, or other electronic medium that is similar to an internet-based website and regularly used to post bid specifications.

\* \* \* \* \*

(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”).

\* \* \* \* \*

(e) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(B) \* \* \* 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). \* \* \*

\* \* \* \* \*

Par. 11. Section 1.148-6 is amended by:

1. Revising the second sentence of paragraph (d)(3)(iii)(A).
2. Removing paragraph (d)(4)(iii).

The revision reads as follows:

§1.148-6 General allocation and accounting rules.

\* \* \* \* \*

(d) \* \* \*

(3) \* \* \*

(iii) \* \* \*

(A) \* \* \* 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.

\* \* \* \* \*

Par. 12. Section 1.148-7 is revised by:

1. Revising paragraph (c)(3)(v).
2. Revising paragraph (i)(6)(ii).

The revisions read as follows:

§1.148-7 Spending exceptions to the rebate requirement.

\* \* \* \* \*

(c) \* \* \*

(3) \* \* \*

(v) Representing repayments of grants (as defined in §1.150-1(f)) financed by the issue.

\* \* \* \* \*

(i) \* \* \*

(6) \* \* \*

(ii) Repayments of grants (as defined in §1.150-1(f)) financed by the issue.

\* \* \* \* \*

Par. 13. Section 1.148-8(d) is revised to read as follows:

§1.148-8 Small issuer exception to rebate requirement.

\* \* \* \* \*

(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.

\* \* \* \* \*

Par. 14. Section 1.148-10 is amended by:

1. Revising the last sentence of paragraph (a)(4).

2. Revising the heading and first sentence of paragraph (e).

The revisions read as follows:

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

(a) \* \* \*

(4) \* \* \* 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.

\* \* \* \* \*

(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. \* \* \*

\* \* \* \* \*

Par. 15. Section 1.148-11 is amended by:

1. Redesignating paragraphs (d)(1)(i), (ii), (iii), (iv), (v), and (vi) as paragraphs (d)(1)(i)(A), (B), (C), (D), (E), and (F), respectively.
2. Revising the heading of paragraph (d)(1) and adding introductory text to paragraph (d)(1)(i).
3. Revising newly redesignated paragraphs (d)(1)(i)(B), (D), and (F).

4. Adding new paragraph (d)(1)(ii).

5. Adding paragraph (k).

6. Revising paragraph (l).

The revisions and additions read as follows:

§1.148-11 Effective/applicability dates.

\* \* \* \* \*

(d) \* \* \*

(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--

\* \* \* \* \*

(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;

\* \* \* \* \*

(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;

\* \* \* \* \*

(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.

\* \* \* \* \*

(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)(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 **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(2) Valuation of investments in refunding transactions. Section 1.148-5(d)(3) also applies to bonds refunded by bonds sold on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(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 **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(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 **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**;

(ii) Qualified hedges that are modified on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]** with respect to modifications on or after such date; and

(iii) Qualified hedges on bonds that are refunded on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]** 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 **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(2) Computation credit. Issuers may apply §1.148-3(d)(1)(iv) and (d)(4) for bond years ending on or after **[INSERT THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(3) Yield reduction payments. Issuers may apply §1.148-5(c)(3) for investments purchased on or after **[INSERT THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(4) External commingled funds. Issuers may apply §1.148-5(e)(2)(ii)(B) with respect to costs incurred on or after **[INSERT THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 16. Section 1.150-1 is amended by:

1. Adding paragraph (a)(2)(iii).
2. Adding a definition for “tax-advantaged bond” in alphabetical order to paragraph (b).
3. Revising paragraph (c)(2).
4. Adding paragraph (f).

The revisions and additions read as follows:

**§1.150-1 Definitions.**

(a) \* \* \*

(2) \* \* \*

(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 **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

\* \* \* \* \*

(b) \* \* \*

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.

\* \* \* \* \*

(c) \* \* \*

(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).

\* \* \* \* \*

(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.

Par. 17. Section 1.150-2(d)(3) is amended by:

1. Amending paragraph (a) by adding an entry for §1.150-2(j)(3).
2. Revising paragraphs (d)(3) and (j)(1).
3. Adding paragraph (j)(3).

The revisions and additions read as follows:

§1.150-2 Proceeds of bonds used for reimbursement.

(a) \* \* \*

(j) \* \* \*

(3) Nature of expenditure.

\* \* \* \* \*

(d) \* \* \*

(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.

\* \* \* \* \*

(j) \* \* \*

(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.

\* \* \* \* \*

(3) Nature of expenditure. Paragraph (d)(3) of this section applies to bonds that are sold on or after **[INSERT 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: June 28, 2016

Mark J. Mazur

Assistant Secretary of the Treasury.

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