HAWKINS ADVISORY

2016 Final Arbitrage Regulations

On July 18, 2016, the Internal Revenue Service published final regulations (the "**Updated Regulations**") amending certain provisions of the existing arbitrage regulations (the "**Existing Regulations**") to "address certain market developments, simplify certain provisions, address certain technical issues, and make existing regulations more administrable." The Updated Regulations, which affect issuers and borrowers of tax-exempt and other tax-advantaged bonds, finalize certain changes to the Existing Regulations that were the subject of proposed regulations published in 2007 and 2013. Notably, the Updated Regulations do not address the issue price regulations that were re-proposed in 2015.

In summary, the Updated Regulations provide detailed amendments to provisions relating to:

- working capital financings, including additional guidance on long-term working capital financings,
- hedging transactions, including more flexibility in maintaining a hedge's status as a qualified hedge in connection with a modification or a refunding, and
- the definition and treatment of grants.

The Updated Regulations also amend various other provisions of the Existing Regulations including, but not limited to:

- certain arbitrage rebate rules,
- calculating yield on an issue,
- yield and valuation of investments,
- anti-abuse rules,
- transition provision for certain guarantee funds, and
- the definition of "tax-advantaged bond" and "issue."

The discussion below summarizes the various amendments made by the Updated Regulations.

Working Capital Financings/Replacement Proceeds

Background. The Existing Regulations impose various restrictions on the use of tax-exempt bonds to finance short-term working capital expenditures (*e.g.,* operating deficits and seasonal cash flow deficits) and long-term working capital expenditures (*e.g.*, extraordinary non-recurring working capital expenditures and issuers experiencing long-term financial distress). The Existing Regulations limit working capital financings through the concept of "replacement proceeds." Replacement proceeds arise if an issuer reasonably expects as of the issue date that: (i) the term of an issue will be longer than reasonably necessary to accomplish the governmental purpose of the issue; and (ii) there will be "available amounts" for expenditures of the type being financed during the period the issue remains outstanding. Under both the Existing Regulations and the Updated Regulations, an "available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue." Replacement proceeds can be difficult for an issuer to track, especially with respect to bonds issued to provide long-term working capital financings.

***Safe Harbor Provisions for Working Capital Financings*.** The Existing Regulations provide a safe-harbor from the creation of replacement proceeds for restricted working capital financings that are outstanding for no longer than two years. This safe-harbor was called into question in Revenue Procedure 2002-31, which reduced this safe-harbor from two years to 13 months. In addition, the Existing Regulations do not provide a safe-harbor for extraordinary working capital financings.

The Updated Regulations shorten the bond maturity limitation in the safe-harbor against the creation of replacement proceeds from two years to 13 months and extend the application of the safe-harbor to include extraordinary working capital financings. The Updated Regulations also extend the application of the 13 month temporary period during which the proceeds of the issue may be invested at an unrestricted yield to all working capital financings.

The Updated Regulations also provide a new safe-harbor from the creation of replacement proceeds applicable to working capital financings with a term in excess of 13 months. The safe-harbor requires the issuer:

- on the issue date, to determine the first fiscal year following the 13 month safe-harbor period in which it reasonably expects to have available amounts (the "**first testing year**");
- beginning in the first testing year and each fiscal year thereafter, to determine the available amount as of the first day of each fiscal year; and
- within 90 days of the start of each fiscal year, to apply that amount (or if less, the available amount on the date of the required redemption or investment) to redeem and/or invest in "eligible tax-exempt bonds," as described below.

In applying this safe-harbor:

- the first testing year cannot be later than five years after the issue date of the bonds;
- the available amount may be reduced by taking into account the expenditure of the available amount during the first 90 days of the fiscal year;
- amounts in a bona fide debt service fund are not treated as available amounts;
- proceeds of *any* issue of working capital bonds are not treated as available amounts; this differs from the Existing Regulations which exclude only proceeds of the actual working capital issue from the calculation of available amounts;
- eligible tax-exempt bonds include non-AMT tax-exempt bonds, 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 in non-AMT tax-exempt bonds, and Demand Deposit State and Local Government Series securities ("**Demand Deposit SLGS**");
- the safe-harbor applies to refunding bonds issued to refinance working capital expenditures in the same manner it applies to new money bonds;
- an issuer may sell eligible tax-exempt bonds previously acquired by it to comply with the safe-harbor requirements, provided that the proceeds of such sale are used within 30 days for a governmental purpose (working capital or otherwise) and the issuer has no other amounts that it could use for such purpose; and
- an issuer may sell eligible tax-exempt bonds previously acquired by it to comply with the safe-harbor requirements and use the proceeds of such sale to redeem its own eligible tax-exempt bonds.

Sizing of Working Capital Reserve. The Existing Regulations provide that available amounts do not include a "reasonable working capital reserve." Generally, a working capital reserve is reasonable if it does not exceed five percent of the actual working capital expenditures of the issuer in the prior fiscal year. For purposes of this determination, "working capital expenditures" include any expenditure whether capital or working capital paid out of current revenues. In addition, a reasonable working capital reserve for a large issuer is limited to the lesser of the preceding five percent amount or the average amount maintained by the issuer as a working capital reserve during annual periods of at least one year, the last of which ends within one year before the issue date. This provision penalized those large issuers that maintained a reserve amount less than the permitted five percent amount. The Updated Regulations remove the requirement that an issuer must have actually maintained a working capital reserve and apply to all issuers the general test that provides financing a working capital reserve is reasonable if it does not exceed five percent of the prior year's actual working capital expenditures.

Hedging Transactions/Replacement Proceeds

Background. The Existing Regulations permit issuers to compute the yield of an issue by taking into account payments and receipts under a "qualified hedge." 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 identify the hedge; and
- the hedge must not contain a significant investment element.

A qualified hedge may be taken into account in computing yield through "simple integration," which takes into account all payments and receipts on the qualified hedge and the hedged bonds and treats the bonds as variable rate bonds, or "super integration," which treats the bonds as fixed rate bonds. In order to achieve super integration, the bonds must meet additional eligibility requirements which focus on assuring that the terms of the hedge and hedged bonds sufficiently correspond so as to warrant treating the hedged bonds as fixed rate bonds.

Cost of Funds Hedges. The Existing Regulations require that a qualified hedge not have a "significant investment element." One factor in determining that a hedge does not have a significant investment element is if the hedge requires "periodic payments." The definition of periodic payments includes payments based on a "specified index." The Existing Regulations are ambiguous on whether payments made under a cost-of-funds hedge qualify as a "specified index." The Updated Regulations clarify that for purposes of applying the definition of periodic payments to determine whether a hedge has a significant investment element, payments under a cost-of-funds swap are treated as periodic payments.

Taxable Index Hedges. A hedge must be interest-based to qualify for treatment as a qualified hedge. The Existing Regulations are ambiguous as to whether a hedge based on a taxable index can be treated as "interest-based." In addition, one factor to determine if a hedge is interest-based is whether the variable interest rate on the hedged bonds and the floating interest rate on the hedge are "substantially similar." This factor is difficult to apply to hedges that use a taxable index. The Updated Regulations clarify that hedges based on a taxable index are interest-based contracts. Moreover, the Updated Regulations provide that such hedges are only eligible for simple integration, unless the hedge provider's payments are perfectly hedged based on an interest rate identical to that on the hedged bonds, in which case super integration of the hedge is possible.

Size and Scope of a Qualified Hedge. The Existing Regulations do not contain an express provision limiting 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. The Updated Regulations provide that the size and scope of a qualified hedging contract must be reasonable based on the principal amount and the reasonably expected interest payments on the hedged bonds, including any such amounts reasonably expected to be paid in respect of an anticipatory hedge.

Correspondence of Payments for Simple Integration. The Existing Regulations require that payments received by an issuer from a hedge provider correspond closely in time to either the specific payments being hedged on the hedged bonds or the specific payment required to be made under the bond documents to a sinking fund, debt service fund, or similar fund. The Updated Regulations provide that these payments will be treated as corresponding closely in time if they are paid within 90 calendar days of each other.

Identification of Qualified Hedges. The Existing Regulations provide that the actual issuer of the Bonds must identify a qualified hedge not later than three days after the date on which the issuer and hedge provider enter into the contract.

The Updated Regulations provide that the actual issuer must identify a qualified hedge within 15 calendar days rather than three days and that the 15 days begin on the date that the parties enter into a binding agreement for the hedge (rather than the closing date of the hedge or start date for payments on the hedge, if different). In addition, the Updated Regulations require a certificate to be delivered by the hedge provider (already a common practice in the industry), and require that such certificate include the following:

- the terms of the hedge were agreed to between a willing buyer and willing seller in a bona fide, arm's -length transaction;
- no payments have been made or are expected to be made to any third party for the benefit of the issuer in connection with the hedge, except as expressly stated in the certificate;
- payments made under the hedge do not include any payments for underwriting or other services unrelated to the hedge provider's obligations under the hedge, except as expressly stated in the certificate (it should be noted that such payments may not be taken into account in determining the yield on the hedged bonds); and
- any statements that the IRS Commissioner may provide in future guidance published in the Internal Revenue Bulletin.

Accounting for Modifications and Terminations. The Existing Regulations do not provide for a definition of "modification" but do include modification in the definition of "termination." The Existing Regulations provide that the 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 IRC Section 1001. The termination payments resulting from a deemed or an actual termination of an integrated hedge are taken into account in computing the yield on the hedged bond issue. The Existing Regulations do not provide sufficient flexibility in maintaining the integrated status of a qualified hedge in the event of a modification or refunding.

The Updated Regulations provide separate definitions for a "modification" and "termination" of a hedge. A modification of a qualified hedge occurs at the time of, but not limited to, a change in the terms of the hedge or an issuer's acquisition of another hedge with terms that have the effect of modifying the issuer's risk of interest rate changes or other terms of the existing qualified hedge. A termination means either an actual or deemed termination of a qualified hedge. An actual termination occurs, generally, when the issuer sells, disposes of or otherwise actually terminates all or a portion of the qualified hedge. A deemed termination occurs if the hedge ceases to meet the requirements of a qualified hedge.

The Updated Regulations allow an issuer to maintain the status of an existing hedge as a qualified hedge in the event that the hedge is modified or the issuer issues refunding bonds if on the date the hedge is modified or refunding bonds are issued, the hedge meets the requirements for a qualified hedge. In determining whether the hedge meets such requirements, any off-market values are disregarded. The identification requirements in respect of the modified hedge must be complied with not later than 15 calendar days after the date the hedge is modified, or the date the refunding bonds are issued, as the case may be, and the issuer need not obtain a certification from the hedge provider. The Updated Regulations supersede the first sentence of Section 5.1 in IRS Notice 2008-41, which 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 percent and the modified hedge is integrated with the bonds.

Termination Amount. The Existing Regulations do not expressly specify the amount taken into account in connection with a deemed termination or actual termination of a qualified hedge.

The Updated Regulations provide for a uniform fair market value standard for both actual and deemed terminations. While the IRS and Treasury Department concluded that bona fide market quotations can be used to support fair market value, fair market value is based on all facts and circumstances.

Definition and Treatment of Grants

The Existing Regulations include certain rules for determining when bond proceeds that are used to make a "grant" are considered allocated to expenditures for arbitrage purposes but are silent on the treatment of grants for other purposes. The Updated Regulations provide additional guidance on the treatment of grants including:

- extending the definition of "grant" contained in the arbitrage regulations to other sections of the regulations applicable to tax-advantaged bonds;
- providing that a grantee's uses of the proceeds generally determines whether the proceeds are treated as used for capital expenditures or working capital expenditures and whether other applicable non-arbitrage purposes of the bond issue are met; and
- clarifying that proceeds of a bond issue may be used to reimburse amounts used by an issuer prior to the issue date to make a grant to the same extent and under the same conditions and limitations imposed on the use of proceeds to reimburse other expenditures, but such reimbursement limitations do not apply to the grantee's use of the grant monies when received.

Certain Arbitrage Rebate Rules

Arbitrage Rebate Computation Credit. The Existing Regulations allow an issuer to take a $1,000 credit against payment of arbitrage rebate to help offset the cost of computing rebate. The Updated Regulations finalize formerly proposed changes which increased the credit amount to $1,400 for any bond year ending during or after 2007, as adjusted for inflation for bond years ending after 2007 based on the changes in the Consumer Price Index, rounded to the nearest multiple of $10. The arbitrage rebate computation credit for calendar year 2016 is $1,650.

Recovery of Overpayment of Rebate. Under the Existing Regulations, an issuer may recover an overpayment of arbitrage rebate if it establishes that an overpayment has occurred. An example in the Existing Regulations led issuers to request refunds of rebate payments based on the future value of the rebate overpayments. Such refund requests were denied by the IRS. The Updated Regulations state that the Treasury Department and the IRS have concluded that the IRS lacks statutory authority to pay interest on arbitrage rebate overpayments. The Updated Regulations revise this example to clarify that the recovery of an overpayment is limited to the extent that the amount actually paid exceeds the rebate amount without any future valuing.

Small Issuer Exception to Rebate – Pooled Bonds. The Updated Regulations amend the Existing Regulations to conform to current statutory law providing that an issuer's pooled financing issue is taken into account in determining whether such issuer meets the $5 million small issuer exception to rebate.

Calculating Yield on an Issue

Joint Bond Yield Authority. The Existing Regulations permit the calculation of a single bond yield for two or more issues of qualified mortgage bonds or qualified student loan bonds at the discretion of the Commissioner. This provision has resulted in the IRS receiving numerous requests for private letter rulings that have been very factual in nature. The Updated Regulations eliminate the joint bond yield authority provision. However, as described below, yield reduction payments are now available for qualified mortgage loans and qualified student loans to facilitate yield compliance.

Modification of Yield Computation for Yield-to-Call Premium Bonds. For yield calculation purposes, the Existing Regulations treat a callable bond issued with significant amounts of bond premium as called on the optional redemption date that would produce the lowest yield on the bond issue. The Updated Regulations simplify the yield calculation by treating a callable bond issued with significant amounts of bond premium as called on the optional redemption date that would produce the lowest yield on that bond (rather than the lowest yield on the issue).

Yield and Valuation of Investments

Yield Reduction Payments When United States Treasury Securities – State and Local Government Series ("SLGS") Not Available. Yield reduction payments are a helpful tool for issuers when proceeds of a bond issue are invested at yields in excess of the bond yield. However, the Existing Regulations do not permit an issuer to make yield reduction payments to satisfy yield restriction requirements with respect to nonpurpose investments acquired with certain proceeds of a tax-exempt issue, including nonpurpose investments in an advance refunding escrow. The Updated Regulations expand the ability to make yield reduction payments in certain limited situations by permitting an issuer to make yield reduction payments for nonpurpose investments, including those in an advance refunding escrow if, on the date that the issuer enters into the agreement to purchase such investments, the issuer is unable to subscribe for SLGS because the U.S. Department of the Treasury, Bureau of the Fiscal Service, has suspended sales of SLGSs.

Yield Reduction Payments for Qualified Mortgage and Student Loans. The Existing Regulations do not permit an issuer to make yield reduction payments for loans made with the proceeds of qualified mortgage bonds and qualified student loan bonds, with the exception of certain qualified student loans made under the now terminated Federal Family Education Loan Program. The Updated Regulations remove this prohibition and permit an issuer to make yield reduction payments on all qualified mortgage loans and qualified student loans to facilitate yield compliance.

Yield Reduction Payments on Hedged Advance Refunding Bonds. The Existing Regulations do not permit an issuer to make yield reduction payments in connection with hedged advance refunding issues. The Updated Regulations modify this provision to permit yield reduction payments with respect to investments in the refunding escrow of a hedged advance refunding issue in situations in which super integration is not available, such as when a taxable index swap hedges the interest rate on the advance refunding issue.

Valuation of Investments. The Existing Regulations provide guidance on valuing investments allocated to an issue. Absent a special rule, the Existing Regulations give issuers the option to choose a valuation method, provided that the chosen method is consistently applied for arbitrage purposes on a valuation date. The special rules in the Existing Regulations leave some ambiguity regarding when the present value and the fair market value methods of valuation are permitted or required. The Updated Regulations clarify that the present value method of valuation is required for purpose investments and, except in limited circumstances, yield restricted nonpurpose investments.

The Existing Regulations provide an exception to the fair market value requirement for transferred proceeds allocations, universal cap allocations and commingled funds. The Updated Regulations clarify that the exception applies when an investment is allocated from one issue to another as a result of the transferred proceeds rules or is deallocated from one issue as a result of the universal cap rule 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.

Fair Market Value of Treasury Obligations. The Existing Regulations provide that the fair market value of a United States Treasury obligation purchased directly from the United States is its purchase price but is silent as to its value on any other date. The Updated Regulations clarify that, (i) on the purchase date, the fair market value of a United States Treasury obligation purchased directly from the United States, including a SLGS, is its purchase price and (ii) on any date other than its purchase date, the fair market value of a SLGS is its redemption price determined by the United States Treasury under applicable SLGS regulations.

Safe Harbor For FMV for GICs and Investments Purchased for Yield Restricted Defeasance Escrows. The Existing Regulations provide a safe-harbor in establishing the fair market value of guaranteed investment contracts ("**GICs**") and yield restricted defeasance escrows if certain requirements are met. Two of these requirements are (i) the bid specifications are in writing and timely forwarded to potential bidders, and (ii) all bidders have an equal opportunity to bid and no bidder has an opportunity to review other bids (*i.e.*, a "**last look**") before providing a bid. The Updated Regulations provide more flexibility (i) by allowing bid specifications to be disseminated in electronic form, including 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, and (ii) by permitting all potential providers an equal opportunity to review other bids and submit another bid without violating the "last look" prohibition.

External Commingled Investment Funds. The Existing Regulations provide 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 Updated Regulations 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. The minimum average investment in the fund is an amount not less than the lesser of $500,000 and one percent of the daily average of the total amount invested in the fund.

ANTI-ABUSE RULES AND AUTHORITY OF IRS COMMISSIONER

The Existing Regulations provide that 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 IRC Section 148, the "Commissioner may exercise the Commissioner's discretion to depart from the arbitrage rules as necessary to clearly reflect the economic substance of the transaction." The Updated Regulations revise the above sentence to state that the "Commissioner may exercise the Commissioner's discretion to depart from the arbitrage rules as necessary to reflect the economics of the transaction to prevent such financial advantage."

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 Updated Regulations increase the amount of tax-exempt bonds that such funds could guarantee under this rule, which is consistent with changes proposed in IRS Notice 2010-5. The Updated Regulations also extend this special rule to cover certain tax-exempt bonds issued to finance public charter schools, which may be 501(c)(3) organizations.

Now, under the Updated Regulations, 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 cannot exceed a total amount equal to 500 percent of the total costs of the assets held by the fund as of December 16, 2009.

DEFINITION OF "TAX-ADVANTAGED BOND" AND "ISSUE"

The Updated Regulations define "tax-advantaged bond" as a tax-exempt bond, a taxable bond that provides a federal tax credit to the investor, a taxable bond that provides a refundable tax credit payable directly to the issuer of the bond, or any future similar bond that provides a federal tax benefit that reduces an issuer's borrowing costs. The Updated Regulations also provide that 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 a different "issue."

VCAP PROCEDURE

The Updated Regulations provide that IRS Notice 2008-31 subsumes and makes obsolete Revenue Procedure 97-15 (dealing with closing agreement requests). Notice 2008-31 announced the Voluntary Closing Agreement Program ("**VCAP**") for tax-exempt bonds and tax credit bonds, which allows a broader scope of violations to be remedied.

TECHNICAL AMENDMENT TO ALLOCATION AND ACCOUNTING REGULATIONS

The Updated Regulations provide technical amendments to the final regulations published on October 27, 2015 relating to the allocation and accounting rules and certain remedial actions. The Updated Regulations provide a transition rule for refunding 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 the remaining weighted average maturity of the refunded bonds or, in the case of short-term obligations that the issuer reasonably expects to refund with a long-term financing, 120 percent of the weighted average reasonably expected economic life of the facilities financed.

EFFECTIVE DATES

The Updated Regulations generally apply to bonds sold or hedges entered into or modified on or after October 16, 2016. The Updated Regulations permit issuers to apply certain of the provisions in the Updated Regulations to bonds sold or hedges entered into or modified prior to July 18, 2016.

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