Part III - Administrative, Procedural, and Miscellaneous

# Arbitrage Treatment of Certain Guarantee Funds

Notice 2010-5

This Notice describes proposed rules that the Internal Revenue Service (IRS) and the Department of the Treasury expect to issue regarding whether certain perpetual trust funds created and controlled by States that are pledged as credit enhancement to guarantee tax-exempt bonds will be treated as replacement proceeds of the guaranteed bonds for purposes of the arbitrage investment restrictions on tax-exempt bonds under § 148 of the Internal Revenue Code (Code). (Unless noted, section references in this Notice are to the Code and the Income Tax Regulations.) Such rules are intended to provide further flexibility to State and local governments to obtain credit enhancement for tax-exempt bonds in recognition of credit constraints in the municipal bond market. This Notice affects certain state guarantee programs that support local public schools and other governmental purposes.

In addition, this Notice solicits public comments regarding provisions of the regulations under § 148 that may impede an issuer's ability to obtain credit enhancement for tax-exempt bonds.

**SECTION 2. BACKGROUND**

In general, the interest on bonds issued by State and local governments is excludable from gross income under § 103(a) if certain requirements are met. Section 148 imposes arbitrage investment restrictions on tax-exempt bonds that limit the investment of proceeds of tax-exempt bonds in higher-yielding investments and that require issuers to rebate certain excess earnings above the yield on tax-exempt bonds to the Federal Government. The arbitrage restrictions apply to ordinary proceeds derived from the sale of tax-exempt bonds and investment earnings thereon. In addition, the arbitrage restrictions apply to a special type of tax-exempt bond proceeds, known as "replacement proceeds," as a result of their use as security for tax-exempt bonds or other nexus to tax-exempt bonds. These special replacement proceeds include, among other things, certain "pledged funds" that are pledged to secure repayment of tax-exempt bonds with a reasonable assurance of availability for such purpose. One special exception to the treatment of pledged funds as replacement proceeds covers certain perpetual trust funds under certain parameters and under a specified size limitation, as described further herein.

In particular, § 148(a) defines an arbitrage bond as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that a bond is an arbitrage bond if an issuer intentionally uses any portion of the proceeds of the issue of which

such bond is a part to acquire higher yielding investments or to replace funds which were used directly or indirectly to acquire higher yielding investments. In addition, § 148(f) requires that issuers rebate certain excess earnings on proceeds of tax-exempt bonds to the Federal Government. Under §§ 1.148-2(a) and 1.148-3(a) of the Income Tax Regulations, “proceeds” for these purposes means “gross proceeds”. Section 1.148-1(b) defines “gross proceeds” to include proceeds and replacement proceeds of an issue.

Section 1.148-1(c)(1) defines “replacement proceeds” as amounts that have a sufficiently direct nexus to a tax-exempt bond issue or to the governmental purpose of a tax-exempt bond issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the bond issue were not used or to be used for that governmental purpose. Section 1.148-1(c)(1) further provides that replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in § 1.148-1(c)(4) to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. Section 1.148-1(c)(1) defines a substantial beneficiary of an issue to include the issuer of such issue, any related party to the issuer and, if the issuer is not a State, the State in which the issuer is located. Section 1.148-1(c) further provides, however, that a person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

Section 1.148-1(c)(3)(i) defines a “pledged fund” as any amount that is directly or indirectly pledged to pay principal or interest on the issue. Although a pledge need not

be cast in any particular form, it must, in substance provide reasonable assurance that the amount will be available to pay principal or interest on the issue even if the issuer encounter financial difficulties.

Section §1.148-11(d)(1) provides a special exception to the treatment of funds as pledged funds for arbitrage purposes for certain perpetual trust funds if the requirements and limitations enumerated in §§ 1.148-11(d)(1)(i) through (vi) are satisfied. Specifically, § 1.148-11(d)(1) provides that a guarantee by a fund created and controlled by a State and established pursuant to such State's constitution does not cause the amounts in such fund to be pledged funds treated as replacement proceeds for purposes of § 148 if: (i) substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests, (ii) the fund corpus may be invaded only to support specifically designated essential governmental functions (the "designated functions") carried on by a political subdivision with general taxing powers; (iii) substantially all of the available income of the fund is required to be applied annually to support the designated functions; (iv) the issue of bonds guaranteed consists of general obligation bonds that are not private activity bonds substantially all of the proceeds of which are to be used for the designated functions; (v) the fund satisfied all of requirements in §§ 1.148-11(d)(1)(i) through (iii) on August 16, 1986; and (vi) the guarantee is not attributable to a deposit to the fund after May 14, 1989, unless the deposit is attributable to the sale or other disposition of fund assets or unless prior to the deposit, the outstanding amount of the bonds guaranteed by the fund did not exceed 250 percent of the lower of the cost or fair market value of

the fund.

The recent financial crisis has resulted in significant volatility in the fair market value of assets in these perpetual trust funds and has constrained the availability of credit enhancement in the municipal bond market. As a result, certain perpetual trust funds that otherwise could provide credit enhancement under the special exception to the arbitrage restrictions for eligible pledged funds under § 1.148-11(d)(1) have been limited in their capacity to provide guarantees for tax-exempt bonds at a time when there is a significant need for such guarantees.

**SECTION 3. SCOPE AND APPLICATION**

The IRS and the Department of the Treasury intend to issue proposed regulations to amend § 1.148-11(d)(1)(vi) in its entirety to provide that, as of the sale date of the tax-exempt 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 may 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.

**SECTION 4. RELIANCE ON THIS NOTICE**

This Notice may be relied upon for bonds sold on or after December 16, 2009 and before the effective date of future regulations or other public administrative guidance under § 148 addressing or otherwise affecting funds described in § 1.148-11(d)(1) and this Notice.

**SECTION 5. REQUEST FOR COMMENTS**

Before any notice of proposed rulemaking is issued with respect to the guidance

provided in this Notice, consideration will be given to any written public comments on this Notice that are submitted. In addition, the Treasury Department and the IRS specifically request comments regarding provisions of the regulations under § 148 that may impede an issuer's ability to obtain credit enhancement and how those provisions should be amended. Comments should be submitted in writing and can be emailed to *notice.comments@irscounsel.treas.gov* (include "Notice 2009-5" in the subject line) or mailed to Office of Associate Chief Counsel (Financial Institutions and Products), Re: Notice 2009-5, CC:FIP:B5, Room 3547, 1111 Constitution Avenue, NW, Washington, DC 20224. Comments that are submitted will be made available to the public.

**SECTION 6. DRAFTING INFORMATION**

The principal authors of this Notice are Aviva M. Roth and Johanna Som de Cerff, Office of the Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this Notice, contact Johanna Som de Cerff at (202) 622-3980 (not a toll-free call).