

# Tax Aspects of Governmental Debt Issuance

## ARBITRAGE/REBATE

The following intends to be a brief summary of some of the more significant provisions of the Internal Revenue Code of 1986, as amended, as they relate to the requirement that certain profits from the investment of bond proceeds be rebated to the United States government, pursuant to Section 148(f) of the Code.

### Arbitrage Defined

True arbitrage is the selling of a security in one market and simultaneously buying a substantially equivalent security in another, for the purpose of making a profit on the price difference. This is most often done to take advantage of inefficiencies between two markets and, as such, may have a stigma because a profit results without added value being created.

As applied to municipal finance, however, arbitrage refers to selling securities (i.e., borrowing money) at tax-exempt rates and then investing unexpended proceeds at higher taxable rates. This generally results in a net profit for the amount invested which partially offsets the interest expense on the overall borrowing.

### Arbitrage Abused

A few municipal issuers took serious advantage of the arbitrage opportunity. Further, the U.S. Treasury argued that municipal issuers in general had shown a tendency to maximize arbitrage profits. Therefore, the Treasury felt compelled to restrict the earnings on a municipal issue which seemed to be beyond monies raised for actual municipal purposes. The Treasury set regulations in 1989, as amended, which required certain profits from the investment of bond proceeds to be rebated to the Treasury.

### Rebate Exceptions

- (1) **“Small Issuer” Exception.** To the extent that a municipal issuer who has general taxing powers reasonably expects to issue not more than \$5 million in principal amount of debt for governmental purposes in a calendar year, no rebate need be calculated or paid; or
- (2) **“Additional School Small Issuer” Exception.** The above \$5 million may be increased by the lesser of: \$15 million or so much as the aggregate face amount of bonds, attributable to financing the construction of public school facilities.
- (3) **“Six Month Expenditure” Exception.** Any municipal issuer who expends the entire proceeds of a debt issue within six months of the issuance date will not suffer a rebate calculation or payments; or
- (4) **“Eighteen Month Expenditure” Exception.** If the rebate requirement is met for all amounts not included in this exception, and all gross proceeds of this issue qualify for the initial temporary period under Section 1.148-2(e)(2) of the Treasury Regulations, no rebate will be owed if the proceeds are spent at least according to the following schedule:

	%	Time
(i)	10%	within six months
(ii)	60	within 12 months
(iii)	100	within 18 months

- (5) **“Construction Bonds” or “Twenty-four Month Construction” Exception.** If the proceeds of an issue are used to finance construction of property owned by a governmental unit no rebate will be owed if the proceeds are spent at least according to the following schedule:

	Time	%
(i)	10%	within six months
(ii)	45	within 12 months
(iii)	75	within 18 months
(iv)	100	within two years

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### **DECLARATION OF OFFICIAL INTENT**

The Internal Revenue Service promulgated its final reimbursement regulations, effective March 2, 1992, with respect to expenses previously advanced from sources other than tax-exempt securities (e.g., reserves) whereby the borrower may wish to ultimately use tax-exempt bond proceeds to reimburse itself. One of the requirements is that the borrower make a **"Declaration of Official Intent"**.

A Declaration of Official Intent is imperative for a governmental unit to the extent it intends to expend any monies prior to financing a project. Although certain "preliminary expenditures" are allowed under Treasury Regulation 1.103-18 without previously declaring official intent, any other monies expended prior to the date of the declaration are not eligible for tax-exempt financing.

The Declaration of Official Intent is an extremely straightforward process. Declaring official intent does not bind the government to go ahead with a financing, nor does it authorize the unit, or any of its officers, to proceed with the financing. It simply establishes the governmental entity's intent to reimburse itself for monies expended in pursuit of a project with proceeds of tax-exempt bonds.

### **DEEMED QUALIFIED AND DESIGNATED**

The Tax Reform Act of 1986, as amended, (i) eliminated the ability of bank portfolios to enjoy tax-exempt status from the purchase of certain municipal new issues (i.e., from "large issuers") and (ii) limited the ability of bank portfolios to enjoy only 80% of the tax-exemption of all other municipal issues (i.e., from "small issuers"). This is encompassed in the Internal Revenue Code of 1986, as amended (the "Code"), Section 265(B).

#### **Q&D**

In summary, the Code states that subject to an exception for the obligations of issuers of a limited amount of tax-exempt obligations for a calendar year (i.e., currently \$10 million), the Code denies a deduction for that portion of the interest expense of a financial institution that is allocable to interest received on bonds. To the extent that the municipal issuer issues an amount not greater than \$10 million in "new money" each calendar year, its bonds may be designated as **"qualified tax-exempt obligations"** within the meaning of Section 265(b)(3) of the Code and, in the case of certain financial institutions (within the meaning of Section 265(b)(5) of the Code), a deduction is allowed for 80% of that portion of such financial institutions' interest expense allocable to interest on bonds. The market may provide up to a 20 basis point (a basis point being .01%; the difference between 5.00% and 5.20% is 20 basis points) lower interest rate for an issue deemed qualified and designated ("Q&D").

#### **Pooled Financings**

While constituent issues that comprise a "pooled" financing, such as through a Bond Bank, may severally be small issuers the Code looks to the conduit, not the underlying municipal entities, as the issuer. Therefore, pooled issues do not typically enjoy Q&D status in that they historically borrow more than \$10 million in a calendar year. Thus, the potential for savings as a Q&D issue via a pooled financing is not typically available.

#### **Summary**

An issuer may structure and time their issues to allow Q&D status for projects, even though the actual project may exceed the \$10 million threshold. This is done with the issuance of Bond Anticipation Notes ("BANs") and/or separate bond issues which time the proposed issues appropriately to (i) comply with the Code, yet (ii) provide sufficient requisite proceeds through the project's phases.