Module C

IRC Section 149 - Rules Applicable to All Tax-Exempt Bonds

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IRC Section 149 - Rules Applicable to All Tax-Exempt Bonds

Overview

Introduction

This module will discuss all of the provisions of IRC section 149. Remember that both governmental and qualified private activity bonds are subject to these rules.

Objectives

At the end of this lesson, the student will be able to:

1. Identify "registration-required" bonds.
2. Determine if registration-required bonds have been properly registered.
3. Determine if a bond is federally guaranteed.
4. Determine if the interest on a federally guaranteed bond is tax exempt.
5. Identify bonds whose interest is tax exempt by virtue of provisions other than IRC section 103(a) of the Code.
6. Identify a refunding issue.
7. Apply the rules of IRC section 149(d) to advance refunding issues.
8. Explain the reporting requirements of bonds.
9. Identify a hedge bond.
10. Determine whether or not the interest on a hedge bond is tax exempt.

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Legislative History

The Tax Reform Act of 1986 added IRC section 149 to the Code. IRC sections 149(a) through (e) were originally included by the Tax Reform Act of 1986, with an effective date of August 15, 1986.

Subsequently, IRC section (f) was added by the Technical and Miscellaneous Revenue Act of 1988.

Finally, IRC section (g) was added by the Omnibus Budget Reconciliation Act of 1989.

Prior to being included in section 149, these provisions were found in the Code as shown below:

Subject	IRC 1986	IRC 1954
Registration	149(a)	103(j)
Federally guaranteed bonds	149(b)	103(h)
Tax exemption only under this title	149(c)	103(m)
Advance refundings	149(d)	N/A
Information reporting	149(e)	103(l)
Pooled financing bonds	149(f)	N/A
Hedge bonds	149(g)	N/A

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Section 1

Registration

General Rules

Introduction

IRC section 149(a) requires that the principal and interest of certain bonds be registered in order for the interest to be tax-exempt. These "registration-required" bonds include all bonds except the following:

- bonds not of a type offered to the public,
- bonds with a maturity of not more than one year,
- bonds described in IRC section 163(f)(2)(B),
- bonds issued before January 1, 1983 (Treas. Reg. Section 5f.103-1(d))

IRC section 163(f)(2)(B) states that:

- There must be arrangements reasonably designed to ensure that the bonds will be sold only to a person who is NOT a United States (U.S.) person,
- If the bonds are not in registered form:
  - interest is payable only outside the U.S. and its possessions, and
  - there must be a statement on the bond which states that any U.S. holder will be subject to limitations under the U.S. income tax laws.

IRC section 7701(a)(30) defines a U.S. person as

- a citizen or resident of the U.S.,
- a domestic partnership, and
- any estate or trust (other than a foreign estate or trust).

Example

County A decides to issue twenty-year bonds to finance the construction of a sanitary sewer system. The Federal Housing Administration agrees to purchase the bonds for investment only. The bonds are freely transferable by the owner upon presentation and surrender. Even though these bonds were not offered to the public for sale, they are typical of bonds that are offered to the public, and therefore must be registered to be tax exempt.

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Legislative History

Prior to the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, most bonds were "bearer bonds." The interest on bearer bonds was paid to whomever was holding the bonds. So that interest was only paid once, each bond came with coupons that were redeemable for the interest. This presented problems for the IRS in tracking down the recipients of the income.

Congress included the registration requirements in the TEFRA in order to:

- limit the number of bearer bonds that were issued, and to
- help ensure compliance with the federal income tax laws.

The introduction of a system which recorded the names of the purchasers, and thus the recipients of the interest income, would:

- preclude opportunities to shield income from federal taxes, and
- prevent bonds from being transferred to another person without the knowledge of the bond trustee.

Note that this amendment, although primarily directed toward taxable bonds, also applies to bonds described in IRC section 103(a).

Registration Requirement Upheld by Supreme Court

In South Carolina v. Baker, 485 US 505, 108 S. Ct. 1355 (1988), South Carolina objected to the federal government's restrictions concerning registration of municipal securities. The Supreme Court, however, upheld the TEFRA provisions regarding the registration requirement.

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Registered Form

Treas. Reg. section 5f.103-1(c) provides two acceptable systems for the registration of tax-exempt obligations. These two systems can be described as:

- the certificate system, and
- the book entry system.

Under the **certificate system**, the obligation is registered with the issuer (or its agent) as to both principal and any stated interest. A certificate evidencing the right to such principal and interest is issued to the holder.

Transfer of the obligation may be effected by either:
- the current holder surrendering the obligation to the issuer, who then reissues the old instrument to the new holder, OR
- the current holder surrendering the obligation to the issuer, who then redeems the old instrument and issues a new instrument to the new holder.

In a **book entry system**, the ownership of the bond is required to be reflected in a book entry, whether or not physical securities are issued. The right to principal and interest on a bond may be transferred only through a book entry system. A book entry is a record of ownership that identifies the owner of an interest in the obligation.

Obligations that do not meet either of these requirements are considered to be in bearer form. However, terms can be changed during the life of the bonds to meet the above requirements, and the bonds will be considered to be in registered form from that point on.

Book-Entry System vs. Certificate System

Figure C-1 presents the mechanics of both the book-entry system and the certificate system of bond issuance. It also illustrates the similarities and differences between the two systems.

A description of the book-entry system or certificate system usually appears in every Official Statement.

Continued on next page

Registration, General Rules, Continued

Figure C-1

Comparison of the Book-Entry System with the Certificate System of Bond Issuance		
Component	**Book-Entry System**	**Certificate System**
Printing	Issuer prints one bond for each maturity (for example, $22,000,000 term bond @ 5% maturing on 7/1/99).	Issuer prints one bond of a certain denomination for each maturity (for example, 4,400 term bonds worth $5,000 each).
Delivery	One day before closing, bond counsel delivers bonds to Depository Trust Company ("DTC").	One day before closing, bond counsel delivers bonds to underwriter.
Closing	Financing is closed when issuer receives purchase price from bondholders and DTC receives the bonds.	Financing is closed when underwriter has delivered purchase price to issuer and underwriter receives the bonds.
Ownership	Purchaser's name is recorded in a register kept by the registrar, usually the trustee.	Purchaser receives a certificate (bond) with his name on it, showing that he is the registered owner.
Payments	Purchaser receives interest and principal payments according to bond provisions, and registrar notes the payments in the bond register.	Purchaser receives interest and principal payments according to bond provisions, and registrar notes the payments in the bond register.
Trading	If original purchaser trades (sells) the bond, registrar changes the name of the bondholder in the register.	If traded, the seller surrenders the certificate. The registrar either: • changes the name of the owner on the bond, or • cancels the surrendered bond, and issues a new bond to the new owner with his name on it.

Section 2

Federally Guaranteed Bonds

Overview

Introduction

IRC section 149(b)(1) provides that the interest on bonds which are federally guaranteed is not tax exempt.

In this section

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General Rules

Legislative History

Congress became concerned about instances where bond proceeds were deposited into Federally insured accounts in financial institutions, and Federal agencies provided additional security for tax-exempt bonds through various methods.

It believed that the Federal government was indirectly providing a double subsidy for certain activities. Without IRC section 149(b), a federally guaranteed state or local bond is more attractive than either taxable federal securities or other state and local bonds lacking federal guarantees, because the bonds will have the backing and safety of a federal obligation plus the federal tax exemption of a state or local obligation.

The Deficit Reduction Act of 1984 eliminated the tax exemption for interest on bonds where a substantial portion of the issue was deposited in Federally insured deposits or accounts, or where the bonds were guaranteed directly or indirectly by the Federal government. They did, of course, provide for some exceptions. (House Rep. No. 98-432, Part 2, March 5, 1984, pages 1689 and 1690.)

When Are Bonds Federally Guaranteed?

IRC section 149(b)(2) provides that bonds are federally guaranteed if:

- the payment of the principal or interest is guaranteed, in whole or in part by the United States, or any of its agencies or instrumentalities, or
- the payment of the principal or interest is otherwise indirectly guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
- five percent or more of the bond proceeds are either:
    - used to make loans, and the principal and interest payments on the loans are guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
    - invested directly or indirectly in federally insured deposits or accounts.

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Federally Insured Deposits or Accounts

IRC Section 149(b)(4)(B) defines "federally insured deposits or accounts" as those insured under Federal law by the Federal Deposit Insurance Corporation, The Federal Savings and Loan Insurance Corporation (since abolished), The National Credit Union Administration, or any similar federally chartered corporation.

Instrumentalities

Statutory Definition

IRC Section 149(b)(4)(A) states that:

- any entity with authority to borrow from the United States will be considered to be an instrumentality of the United States; However,

- the District of Columbia and possessions of the United States will only be considered to be instrumentalities with respect to the following types of bonds:

  - exempt facility bonds,
  - qualified small issue bonds,
  - qualified student loan bonds.

Possessions of the United States include the Virgin Islands, Guam, American Samoa, and Puerto Rico.

Example

The District of Columbia is not permitted to issue exempt facility, qualified student loan, or qualified small issue bonds, if secured by the full faith and credit of the District. Other types of qualified private activity bonds are permitted, as are governmental bonds.

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Instrumentality Criteria

Further guidance regarding the definition of "instrumentality" can be found in:

- Rev. Rul. 57-128, 1957-1 CB 311 which discusses state and local instrumentalities,
- Dept. of Employment v. United States, 385 US 355 (1966) which discusses the Red Cross as a federal instrumentality, and
- Rev. Rul. 84-109, 1984-2 CB 7, which discusses federal instrumentalities.

In determining whether or not the entity is an instrumentality of the United States, the following factors should be considered:

- the entity is used for a governmental purpose and performs or assists in the performance of a governmental function;
- any private interests are involved, or the government involved has the powers and interests of an owner;
- control and supervision of the entity is vested in the government;
- express or implied statutory or other authority is necessary (and exists) for the creation or use of the entity;
- the entity receives substantial material or financial assistance from the government; and
- other government agencies recognize and rely on the entity as an arm of the government.

Exceptions to the General Rule

Introduction

The bonds described below are still tax exempt, even though they are federally guaranteed.

Exceptions for Certain Federal Programs

Guarantees by the following federal programs are permitted by IRC section 149(b)(3)(A):

- Federal Housing Administration,
- Veterans Administration,
- Federal National Mortgage Association,
- Federal Home Loan Mortgage Corporation,
- Government National Mortgage Association,
- any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans, AND
- Bonneville Power Authority, pursuant to Northwest Power Act, as in effect as of the date of enactment of the Tax Reform Act of 1984.

Exceptions for Certain Investments of Bond Proceeds

IRC section 149(b)(3)(B) provides that certain bond proceeds may be invested (and federally guaranteed) as follows:

- proceeds invested during the initial temporary period,
- investments of a bona fide debt service fund,
- investments of a reserve which meets the requirements of IRC section 148(d), OR
- investments in US Treasury bonds.

In addition, the regulations provide that the following investments may be federally guaranteed:

- investments in a refunding escrow (Treas. Reg. Section 1.149(b)-1(b)(2), OR
- investments in obligations issued pursuant to Section 21 B(d)(3) of the Federal Home Loan Bank Act, as amended by Section 511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision (Treas. Reg. Section 1.149(b)-1(b)(1))

Continued on next page

Exceptions for Certain Investments of Bond Proceeds, continued

Example

State K issues $5M principal amount of bonds, depositing the funds as follows:

- $500,000 Reserve Fund
- $50,000 Bona Fide Debt Service Fund
- $4,450,000 Project Fund

All of the funds are invested in government securities, except for the project fund. The project fund proceeds are deposited into a bank's money market account. The proceeds invested in the reserve and debt service funds are federally guaranteed, but meet the exceptions of IRC section 149(b)(3)(B)(ii) and (iii), so the bond interest is tax-exempt.

The project fund, even though insured by the FDIC, meets the exception of IRC section 149(b)(3)(B)(i), only during the temporary period provided by Treas.Reg. section 1.148-2(c)(1). At the end of the temporary period (three years) the funds remaining in this account would be considered to be federally guaranteed. This could affect the tax-exemption of the bond interest.

Exceptions for Housing Programs

The prohibition of a federal guarantee for tax exempt bonds does not apply to the following, unless the proceeds of the bonds are deposited into federally insured accounts: (IRC section 149(b)(3)(C))

- private activity bonds for qualified residential rental projects or housing program obligations under section 11(b) of the United States Housing Act of 1937,
- qualified mortgage bonds (section 143(a),
- qualified veterans' mortgage bonds (section 143(b).

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Exceptions for Loans to, or Guarantees by Financial Institutions

IRC Section 149(b)(3)(D) provides that, except as provided in IRC section 149(b)(2)(B)(ii), a bond which is issued as part of an issue shall not be treated as federally guaranteed merely because the proceeds are used to make loans to a financial institution, or there is a guarantee by a financial institution, unless such guarantee constitutes a federally insured deposit or account.

In FDIC v. Philadelphia Gear Corp., 476 US 426, (1986), the Court determined that a standby letter of credit issued by a bank whose deposits were insured by the FDIC did not constitute an FDIC-insured deposit.

Other Exceptions

Notice 88-54, 1988-1 C.B. 539, provides that regulations to be issued will provide that capitalization grants awarded by the EPA through its State Water Pollution Control Revolving Fund Program under Title VI of the Water Quality Act of 1987 would not constitute a federal guarantee.

Notice 88-114, 1988-2 C.B. 449, provides that regulations will provide that bonds that are insured, reinsured, or guaranteed by the Connie Lee Insurance Company, a wholly owned subsidiary of the College Construction Loan Insurance Association, would not be considered to be federally guaranteed.

Section 3

Tax Exemption Derived Only from this Title

General Rules

Introduction

IRC Section 149(c)(1) provides that with certain exceptions, interest on bonds is exempt from federal tax only if the exemption is provided by the Code, even though an exemption may be provided by another federal statute.

Legislative History

Prior to the Deficit Reduction Act of 1984, there were two types of tax-exempt bonds on the market:

- those whose exemption was derived directly from IRC section 103(a), AND
- those whose exemption was derived from other federal statutes, such as:
    - obligations of the Federal Home Loan Bank,
    - obligations of the Federal Savings and Loan Association, and
    - obligations of the Central Bank of Cooperatives.

Those bonds whose exemption was derived from IRC section 103(a) were required to comply with all of the provisions of IRC section 103. (IRC sections 141-150 after the TRA 1986.)

Bonds whose exemption was derived from other federal statutes were not subject to the provisions of IRC section 103. (IRC sections 141-150 after the TRA 1986.)

The DRA 1984 changed this requiring generally, that all tax-exempt bonds comply with the provisions of IRC section 103, (IRC sections 141-150 after the TRA 1986) regardless of the source of their tax-exemption.

Bonds Issued Before 1984

Generally, bonds issued before 1984 whose exemption is derived from statutes other than the Code continue to be treated as bonds described in IRC section 103(a), without having to comply with present IRC sections 141-150.

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Tax Exemption Derived Only From This Title, General Rules,
Continued

Bonds Issued After 1983

IRC Section 149(c)(2) provides generally that bonds issued after 1983 will NOT be considered to be tax exempt under section 103(a) unless they comply with present IRC sections 141-150.

Exceptions are provided for the following bonds:

1. Any bond issued pursuant to Northwest Power Act, <u>as in effect on July 18, 1984</u> (IRC section 149(c)(2)(C)(i)),

2. Any bond issued pursuant to section 608(a)(6)(A) of Public Law 97-468, <u>as in effect on the date of the enactment of TRA 1986,</u> pertaining to the transfer of the Alaska Railroad from federal to state control (IRC section 149(c)(2)(C)(ii)),

3. Any bond issued <u>before June 19, 1984</u>, under section 11(b) of the US Housing Act of 1937 (IRC section 149(c)(2)(C)(iii)).

<u>Example 1</u>

County C issues bonds pursuant to section 11(b) of the US Housing Act on June 1, 1992. These bonds must meet all of the provisions of IRC sections 141-150, in order for the interest on the bonds to be tax-exempt, because they were issued after June 19, 1984.

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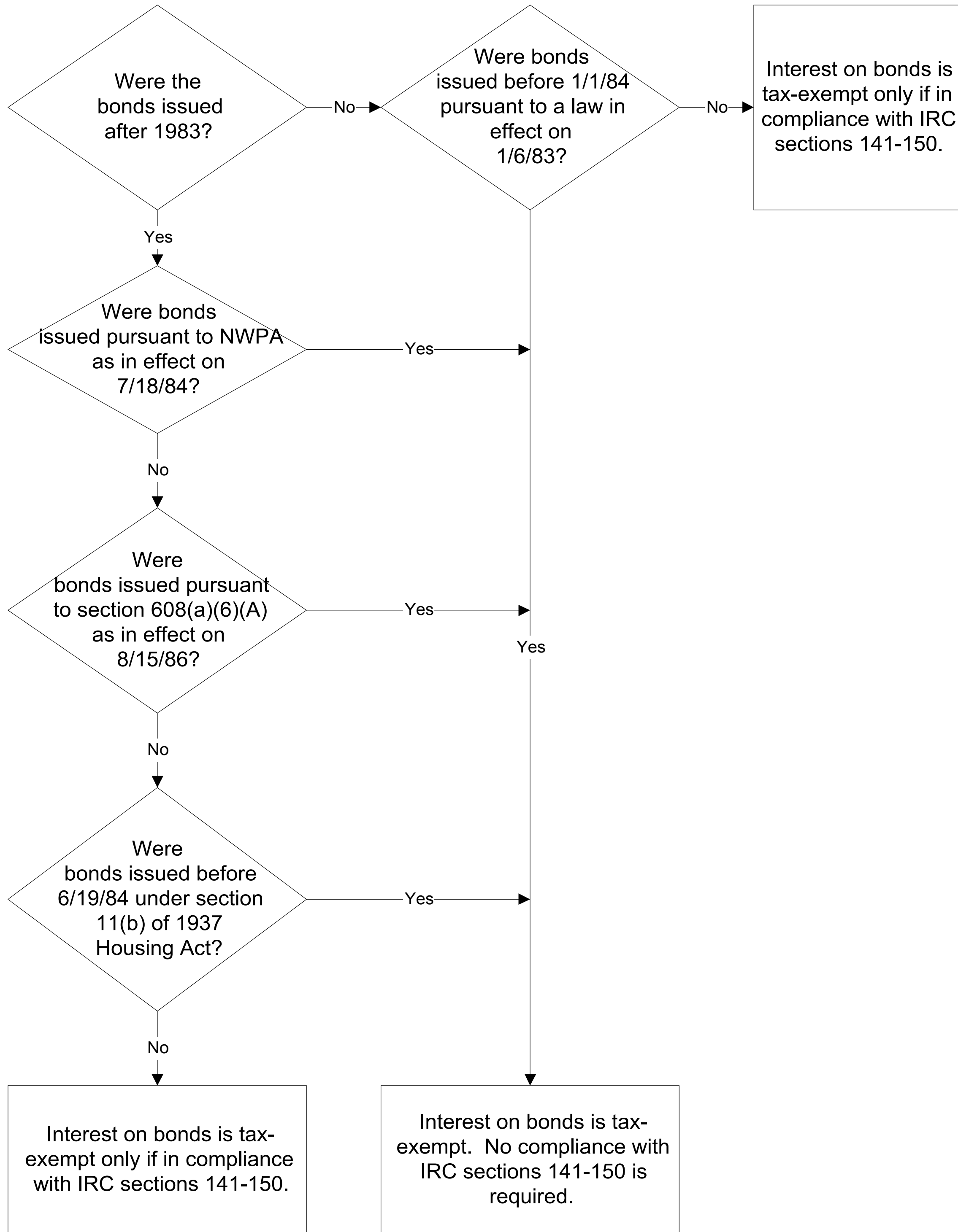
Flowchart

If you encounter bonds whose exemption is derived from statutes other than IRC section 103(a), refer to **Figure C-2** to determine if the bonds are subject to the provisions of IRC sections 141-150.

Continued on next page

Tax Exemption Derived Only From this Title, General Rules,
Continued

FIGURE C-2: DETERMINING WHETHER OR NOT BONDS WHOSE EXEMPTION IS DERIVED FROM **STATUTES OTHER THAN IRC SECTION 103(a)** MUST COMPLY WITH SECTIONS 141-150.



Section 4

Refundings

Overview

Introduction

IRC section 149(d) provides that the interest on bonds that are not properly advance refunded is not tax-exempt. Advance refundings can be complicated and can present problems, particularly where arbitrage is concerned. For this reason, a complete discussion of them has been reserved for Phase II of this course.

For the moment, though, you need to have a general understanding of refundings, in case you encounter one during an examination. Although IRC section 149(d) applies only to advance refundings, this section also briefly discusses current refundings, and explains how they work.

Generally a refunding is a new borrowing to pay off an old borrowing. For example, when you refinance the mortgage on your home, you enter into a new loan to pay off an old loan with a higher interest rate.

There are two types of refundings:

- current, AND
- advance.

There are some disadvantages to being a refunding bond, such as:

- the temporary periods are shorter,
- the yield is more restricted, AND
- numerous other requirements must be met.

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What is a Refunding?

Treas. Reg. section 1.150-1(d)(1) provides that a **refunding issue** means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (prior issue) including the following costs or similar costs if properly allocable to that refunding issue:

- issuance costs,
- accrued interest,
- capitalized interest on the refunding issue, or
- a reserve or replacement fund.

Transactions Which Are NOT Refundings

Treas. Reg. section 1.150-1(d)(2) describes certain situations which are NOT refundings. These include:

- payments of certain interest,
- certain issues with different obligors,
- certain refundings of conduit financing issues, AND
- certain integrated transactions in connection with asset acquisitions.

Obligors

Treas. Reg. section 1.150-1(d)(2)(ii)(A) provides that an issue is NOT a refunding issue to the extent that the obligor of one issue is neither:

- the obligor of the other issue, NOR
- a related party to the obligor of the other issue.

An obligor for this purpose may mean either the issuer or the conduit borrower.

If new bonds are issued by one obligor to refund the debt of an unrelated obligor, the issuer is treated more liberally, as a new money issue.

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TRA 1986 Transitional Rules

Section 1313 of the TRA 1986, 1986-3CB Vol. 1, 578 contains transitional rules applicable to current and advance refundings generally issued after August 15, 1986. These rules provide that certain refunding bonds issued to refund bonds issued before August 15, 1986 will not be subject to the amendments made by section 1301 of the TRA 1986 if certain requirements are met. However, whether or not the bonds meet the transitional rules, both current and advance refundings must still comply with the following Code sections:

- IRC section 147(f),
- IRC section 147(g),
- IRC section 148,
- IRC section 149(e), AND
- IRC section 150(b).

In addition to the above rules, advance refundings must also comply with IRC sections 149(d)(3) and (4).

The transitional rules can usually be found among the amendments after IRC section 103.

In this section

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Current Refundings

Scenario

Refunding bonds that pay off the prior bonds (refunded bonds) within 90 days of issuance are called **current refundings.** Usually, bonds are refunded to take advantage of drops in interest rates, but sometimes refunding issues are planned ahead of time.

Example

In 1997, City A needs money to construct a sewer system. The EPA offers a $10M grant if the city can raise another $10M on its own by the end of the year. City A wants this grant and needs to start work on the sewer system, but is not prepared to issue long-term bonds right now. The main reason is that it believes that long-term interest rates are too high right now. So City A issues $10M Bond Anticipation Notes with a two-year maturity. Issuing these notes allows City A to qualify for the $10M grant, and it now has $20M to begin the project.

Two years later, interest rates have dropped to a point where the city feels comfortable issuing long-term bonds. Within 90 days of the redemption date of the notes, City A issues $10M principal amount of bonds. The $10M in proceeds are used to pay off the notes. Interest due on the notes is paid with other funds.

This is a current refunding because the proceeds of the bonds ("refunding issue") were used to pay off ("refund") the notes ("refunded issue") within 90 days of issuance.

(Prior to January 1, 1986, the refunded bonds had to be redeemed within 180 days of the issuance of the refunding bonds in order to be a current refunding.)

See Figure C-3 for a diagram of a current refunding.

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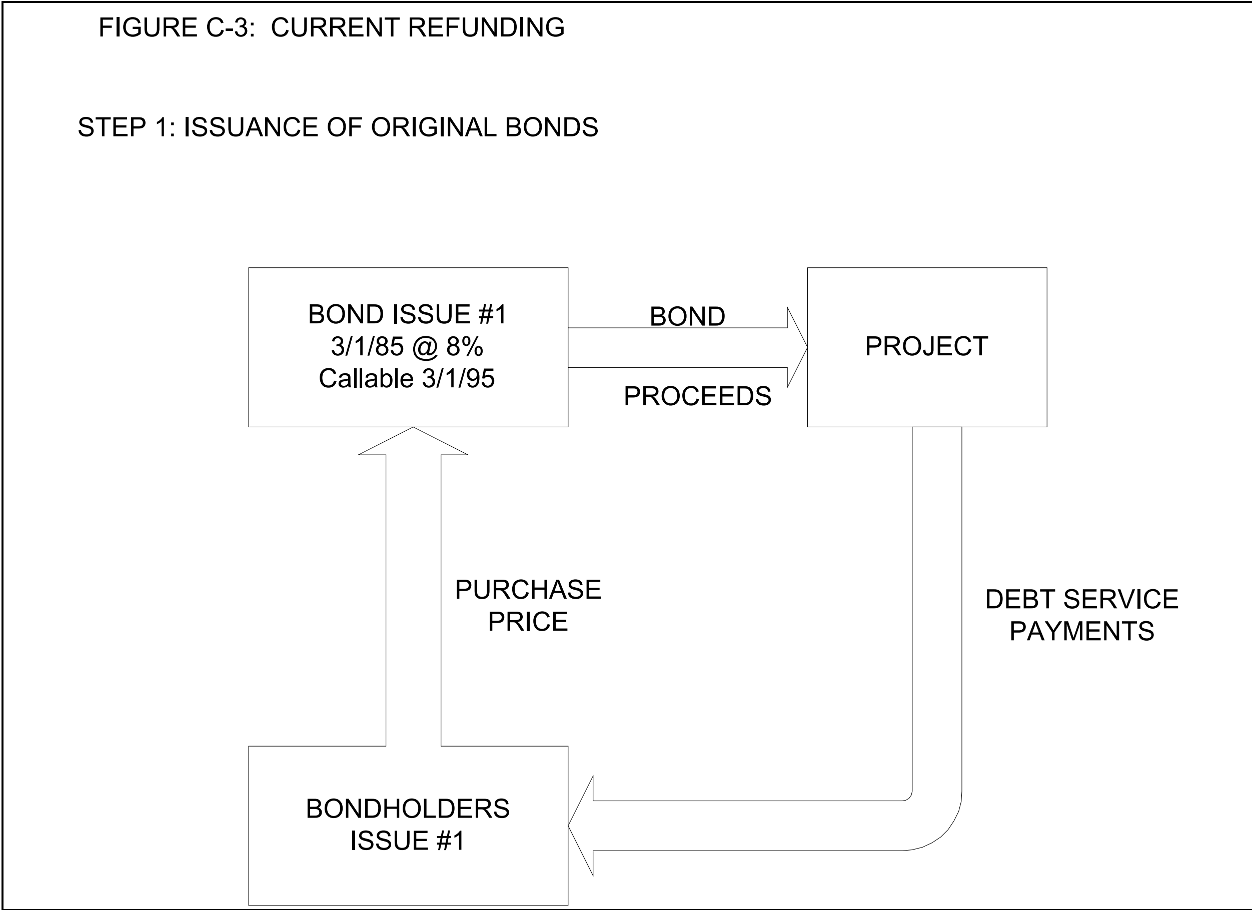

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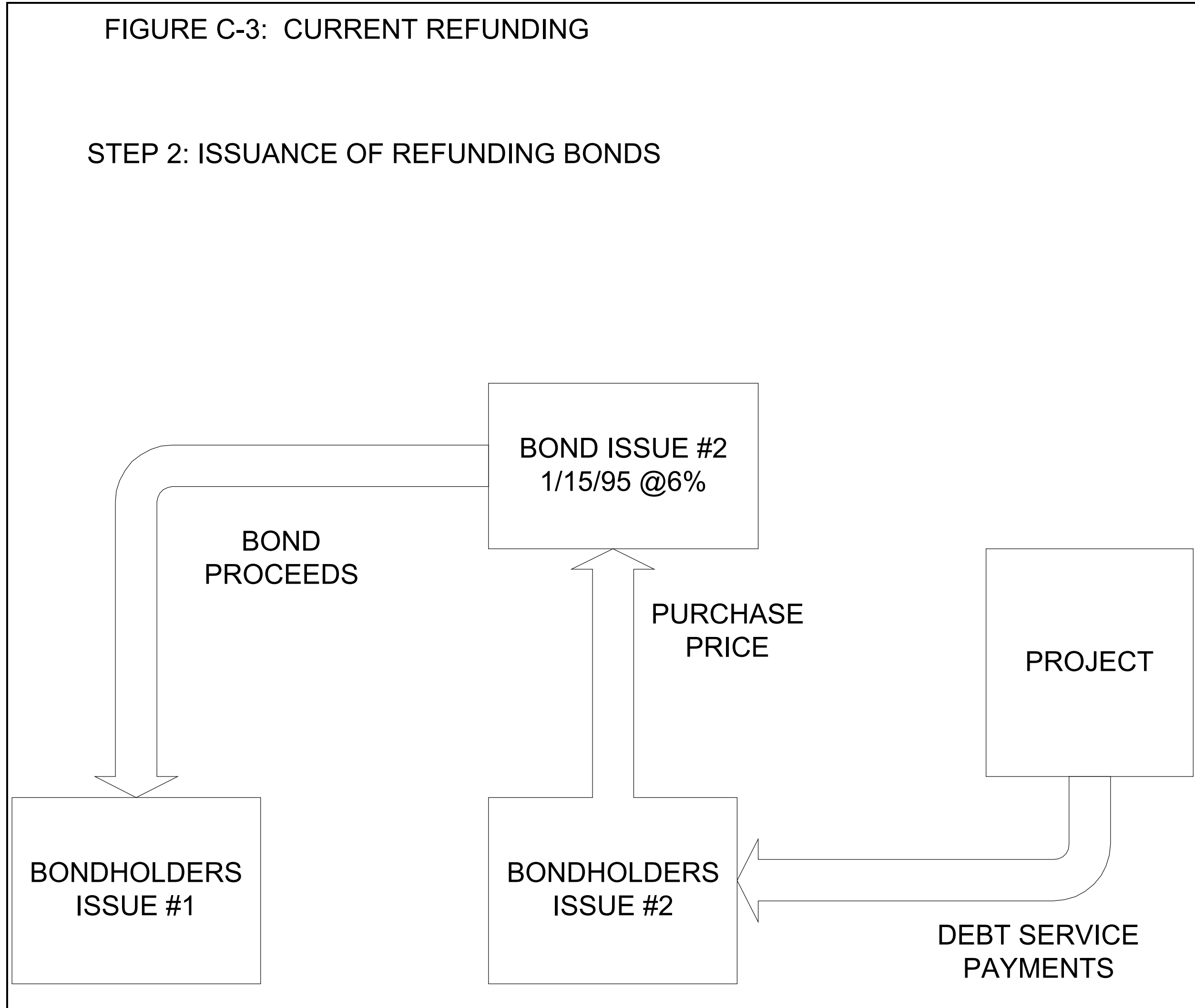

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Temporary periods

Treas. Reg. section 1.148-9(d) provides, in general, that the temporary period for investing proceeds of a refunding issue (other than transferred proceeds) is 30 days beginning with the issue date of the bond.

Notwithstanding this general rule, proceeds of a current refunding issue (other than transferred proceeds) may be invested in higher yielding investments for 90 days.

If the current refunding issue has an original term to maturity of 270 days or less, the temporary period may not exceed 30 days. The aggregate temporary period for proceeds of a series of current refundings is limited to 90 days.

Transferred proceeds retain the same temporary period that they had under the original issue. The refunding has no effect on this period.

Exceptions from Rebate

Treas. Reg. section 1.148-7(b)(1)(ii) provides that proceeds of a current refunding issue qualify for the six-month spending exception from rebate.

However, Treas. Reg. section 1.148-7(c)(4) provides that if a principal purpose of a series of refundings is to exploit the difference between taxable and tax-exempt interest rates by investing proceeds during the temporary periods, then the six-month spending exception for ALL issues in the series will begin on the issue date of the first issue in the series.

Continued on next page

Current Refundings, Continued

Call Protection

While current refundings are efficient if interest rates have dropped, they may not always be possible. The purchasers of the prior bonds may have required **call protection** when the bonds were marketed. Call protection is protection for the investor against having bonds paid off early.

Example

City N issues 20 year bonds at 9% in 1991. Investors are attracted to these bonds because the rate is higher than it has been in recent years. They want to receive interest payments of 9% for the life of the bonds. The city does not want to guarantee that the bonds will be outstanding that long. So the parties compromise and agree to call protection. The City guarantees that the bonds will remain outstanding (and will not be called) for 10 years.

It would seem that investors would always want call protection - and they do! However, that doesn't mean that municipalities are always stuck with their bonds until they can be called. This is where advance refundings come in.

Advance Refundings

Definition of Advance Refunding

When any of the proceeds of a refunding issue are held longer than 90 days before being used to pay debt service on a prior issue, the issue is an advance refunding issue. Advance refundings allow municipalities to lock in lower interest rates or get out from under burdensome covenants, while still honoring the call protection of the bonds. When advance refundings are issued, the prior bonds (refunded bonds) remain outstanding until they are called and replaced by the advance refunding bonds.

How Advance Refundings Work

Suppose that City N has $100M of 10% bonds outstanding. These bonds were issued in 1983 and mature in 2003. The bonds are callable in 1995. In 1990, tax-exempt interest rates fall to 7.5% and the city starts to count down the days until the bonds can be called. In January 1993, rates fall to 4%, and the city decides that something has to be done. It does not want to continue to pay interest at 10%, when it can borrow today at only 4%. But according to the terms of the indenture, the bonds can't be called for another 2 years. The city has paid off $50M in principal, but another $50M is still outstanding. So the city decides to issue $60M of new bonds at 4% due in 1998. Look at the savings:

Facts	1983 Bonds	1993 Bonds
Annual Principal Payment	$5M	$12M
Annual Interest Payment	$10M	$2.4M
Total Annual Payment	$15M	$14.4M

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How Advance Refundings Work, (continued)

The city saves $600,000 ($15M-14.4M) each year by issuing new bonds. But, wait a minute: These bonds can't be called until 1995. So how can issuing new bonds help? Well, it won't help right away. Until 1995, the city will have to pay debt service on both bond issues. Additionally, the city has to borrow $60M in order to be able to pay both the debt service and the principal on the prior bonds. (The $60M can only be invested at 4%.)

But the savings will occur once the 1983 bonds are retired in 1995. That is when the city will reduce its debt from 11% to 4%. In the meantime, the city will take the proceeds from the new bonds, and place them in an "escrow" account. These proceeds will be earmarked only for debt service on the 1983 bonds, and will be invested in safe government securities. In 1995, when the bonds can be called, the proceeds will be used to redeem the 1983 bonds entirely.

At the same time, the 1993 bonds have their own source of debt service. Because the 1983 bonds ("the refunded bonds") will not be redeemed until a date which is more than ninety days after the issuance date of the 1993 bonds ("the refunding issue"), this is an "advance refunding."

Municipal bond refundings are usually done to save money when interest rates drop. You should be aware, however, that sometimes refundings are done for other reasons, such as to eliminate restrictive covenants.

Continued on next page

Eliminating Restrictive Covenants

Local governments may have reasons to refinance even when interest rates are rising. They may wish to get out from under covenants that they agreed to in an earlier financing, but have now become burdensome.

Example

Assume that in 1980 City M issued $10M of revenue bonds (prior bonds). Proceeds of the prior bonds were used to build an electric generating facility. Revenue from the facility was used to pay debt service on the prior bonds. In order to market the prior bonds, the city had to covenant that it would not issue any additional debt unless revenue available for debt service was 2.0 times the highest annual debt service.

That was a long time ago and the credit worthiness of the city electric system has increased. Current investors would only require a ratio of 1.25. Even though interest rates have risen, the city needs to refinance so that it can avoid the restrictive covenant and issue new debt for new projects. When the refunding bonds are issued, the relationship between the revenue stream and the prior bonds will, in most cases, be severed. The refunding bonds and any future borrowing will not have the 2.0 debt service ratio requirement and revenue will be able to support more municipal projects.

Defeasance

On the date that the refunding bonds are issued, the refunded bonds have a new status. They are no longer considered to be outstanding, nor are they redeemed (retired.) They are "defeased." This means that the source of income that was pledged to pay debt service on the refunded issue is no longer reserved for it. (It will probably be used to pay the debt service on the refunding issue.) Now, however, the debt service on the refunded issue will be paid by the income generated from the proceeds invested in government securities.

Continued on next page

Refunding Escrows

The proceeds of an advance refunding bond are:

- typically deposited into a refunding escrow account that is invested in high grade US Treasury securities.
- pledged irrevocably to pay off the prior bonds.
- often invested for 5 years or longer until the prior bonds are called.

When advance refundings are used to relieve restrictive covenants, and not to take advantage of lower interest rates, the prior bonds might not be redeemed until maturity. In these so-called "low-to-high" advance refundings, the bond proceeds may be invested in the refunding escrow for 20 years or more.

See Figure C-4 for a diagram of an advance refunding.

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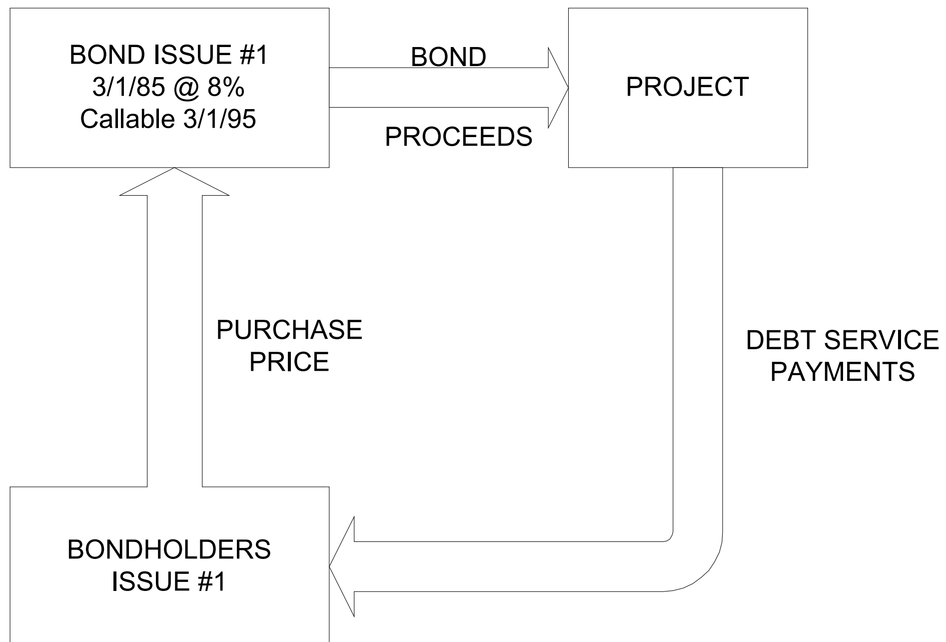
Advance Refundings

FIGURE C-4: ADVANCE REFUNDING

STEP 1: ISSUANCE OF ORIGINAL BONDS



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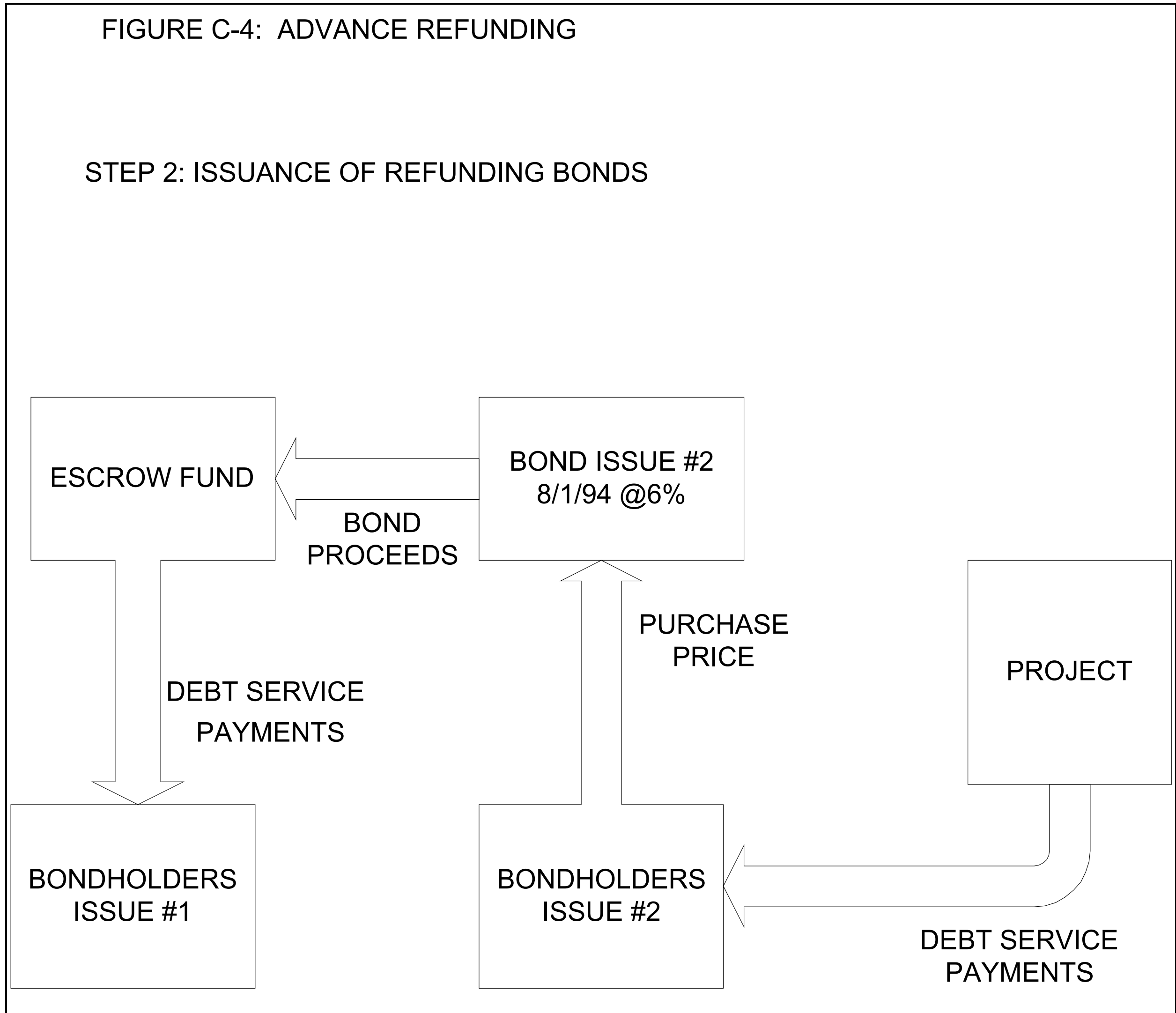

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Temporary Periods

Treas. Reg. Section 1.148-9(d)(2)(i) provides a general temporary period for proceeds (other than transferred proceeds) of a refunding issue of 30 days.

Treas. Reg. section 1.148-9(d)(2)(iii)(B) provides that the initial temporary period under Treas. Reg. sections 1.148-2(e)(2) and (3) for the proceeds of a prior issue that is refunded by an advance refunding issue (including transferred proceeds) terminates on the issue date of the advance refunding issue.

Temporary periods of advance refundings will be discussed in more detail in Phase II.

Exceptions from Rebate

Treas. Reg. section 1.148-7(b)(1)(ii) provides that the only spending exception applicable to refunding issues is the 6-month exception.

The special rules applicable to transferred proceeds of the refunding issue will be discussed in Phase II.

Problems with Advance Refundings

Over the years, restrictions on advance refunding bonds have increased. This is because:

- a large portion of the bond proceeds is commonly invested for a long time, **and**
- more than one set of tax-exempt bonds remain outstanding at the same time.

This increases the burden on the tax-exempt market. There is more room for financial maneuvering with advance refundings. This is different from most "new money" financings, where the bond proceeds are only invested for a short time before they are spent on a governmental project. Because the proceeds of the advance refunding bonds are used to invest and grow to pay off the prior bonds, the arbitrage possibilities have received a lot of attention.

Limitations on the Number of Advance Refundings

Private Activity Bonds

IRC section 149(d)(2) prohibits advance refundings for private activity bonds, except for qualified 501(c)(3) bonds. Private activity bonds may be advance refunded only with taxable refunding bonds.

However, there are no such limitations with respect to current refundings.

Governmental and Qualified 501(c)(3) Bonds

IRC section 149(d)(3) provides limitations on the number of times a bond may be advance refunded, as shown in the table below:

Limitations on the Number of Advance Refundings

If the original bond is issued...	Then it can be advance refunded...
Before 1986	twice
Before 1986 and it was already advance refunded two or more times before March 15, 1986	once
After 1985	once

Example

In 1990, City B has outstanding bonds originally issued in 1984. The bonds have never been advance refunded. Therefore, two advance refundings are permitted.

Example

In 1996, City C had bonds that were originally issued in 1975. These bonds were advance refunded in 1978, 1981, and 1985. Because these bonds were issued before 1986, and because they were advance refunded at least twice prior to March 15, 1986, the original issue can be advance refunded one more time. (Section 149(d)(6)(B) counts all advance refundings of bonds issued before 1986 only once.)

Continued on next page

Governmental and Qualified 501(c)(3) Bonds

Example

In 1996, City A has outstanding bonds that were originally issued in 1986 and have never been advance refunded. The bonds can be advance refunded only once. Assume that the bonds are advance refunded in 1997, and retired in 1999. The city has used its one permitted advance refunding, and the 1997 bonds cannot be advance refunded, even after the original bonds are retired in 1999. However, a current refunding of the 1997 bonds could be issued.

First Call Date Requirement

IRC Sections 149(d)(3)(A)(ii) and (iii) provide that if the advance refunding results in present value debt service savings to the issuer, then the prior bonds must be called as shown in the table below:

First Call Date Requirement

If the original bond is issued...	Then the prior bond must be redeemed not later than...
Before 1986	the earliest date on which the bond may be redeemed: • at par, **or** • at a premium of 3% or less.
After 1985	the earliest date on which the bond may be redeemed.

Example

In the example above, City A's bonds would have to be called on the earliest call date if:

- there is present value debt service savings for the issuer, **and**
- if the issuer expects to treat the advance refunding as a tax-exempt issue.

Note that in order to be considered an advance refunding, the original bonds must be retired more than 90 days after the date the refunding bond is issued. (Otherwise, the refunding issue would be a current refunding.)

Continued on next page

Limitations on the Number of Advance Refundings, Continued

Abusive Transactions Prohibited

IRC section 149(d)(4) provides that the interest on an advance refunding issue will not be excluded from gross income under section 103(a) if a device is employed in connection with the issuance of the advance refunding issue to obtain a material financial advantage. The material financial advantage is based on arbitrage concepts under section 148, and does not include savings attributable to lower interest rates.

Treas. Reg. section 1.149(d)-1(b) provides that an advance refunding issue violates IRC section 149(d)(4) if:

- the issue violates any of the anti-abuse rules under Treas. Reg. section 1.148-10,
- the issue fails to meet the rebate requirements under Treas. Reg. section 1.148-3, **or**
- the proceeds of the issue are invested in a certain type of escrow that contains both nonpurpose investments and tax-exempt obligations.

You will learn about the rebate requirements later in this text. The anti-abuse rules and refunding escrows will be covered in Phase II of this course.

Section 5

Information Reporting Requirements

Overview

Introduction

Section 149(e) provides specific reporting requirements for tax exempt issues.

The interest on bonds which do not meet the reporting requirements will not be tax exempt.

Although IRC section 149(e) generally applies to bonds issued after August 15, 1986, the regulations apply to bonds issued after December 31, 1986. Rules for bonds issued prior to this date and after December 31, 1982 are in section 103(1) of the 1954 Code and Treas. Reg. section 5f.103-3.

IRS Has Authority to Designate Information Reporting Requirements

Although section 149(e)(2) specifies certain information which must be reported, the statute grants full authority to the Secretary of the Treasury (Internal Revenue Service) to designate exactly what items of information are required to be reported. **(See section 149(e)(2)(G) and the flush language below that subparagraph.)**

Regulations

The Service has put forth its reporting rules in Treas. Reg. section 1.149(e)-1 of the regulations. The regulations, in turn, state that the information must be reported on the appropriate prescribed form, and that the instructions to the form should be followed.

Continued on next page

Who Must File

The **Issuer** is required to file a "completed reporting form prescribed for this purpose" for **all** tax exempt issues issued after December 31, 1986. Since the regulations specifically require a prescribed form, no letters or issuer-designed forms are permitted.

Note that **prior to this date**, only issuers of the following types of bonds were required to file information returns:

- industrial development bonds (known as "private activity bonds" after TRA '86),
- those used to finance loans to individuals for educational expenses,
- those used by section 501(c)(3) organizations.

(See section 103(l) of the 1954 Code.)

Remember that most bonds whose tax exemption is derived from non-Code provisions are also subject to the reporting requirements.

In this section

This section contains the following topics:

Topic	See Page
Overview	C-38
Required Forms	C-40
Filing Dates	C-43

Required Forms

Form 8038-Series

The table below shows the appropriate forms to be filed by issuers of tax exempt bonds: (Samples of forms 8038-GC and 8038-T are at the end of this section. **See Exhibits C-1 and C-2.** Samples of Forms 8038 and 8038-G are in Module B. **See Exhibits B-1 and B-2)**

Form Number	Purpose of Form
8038	Any and all types of private activity bonds.
8038-G	All governmental issues with an issue price of $100,000 or more.
8038-GC	All governmental issues with an issue price of less than $100,000.
8038-T	For the following payments: • yield reduction payments, • arbitrage rebate, • penalty in lieu of rebating arbitrage, • penalty to terminate the election to pay a penalty in lieu of rebating arbitrage • penalty for late payment of above penalties.

What Does "Completed" Mean?

Treas. Reg. section 1.149(e)-1(d)(1) describes when an information reporting form will be considered to be "completed." The table below outlines the responsibilities of the issuer when completing the forms:

- the issuer makes a good faith effort to complete the form, taking into account the instructions to the form,

- the form is completed on the basis of available information and reasonable expectations as of the date of issue, except for consolidated returns, which should be completed based on information readily available to the issuer at the close of the year, supplemented by good faith estimates.

Continued on next page

Special Requirements for Form 8038

Issuers of private activity bonds subject to the volume cap must attach a copy of the certification by a state official which states that the bonds meet the requirements of IRC section 146 (volume cap.)

Issuers of qualified mortgage bonds and qualified veterans' mortgage bonds must submit the annual report containing information on the borrowers of the original proceeds of the issue as required under Treas. Reg. sections 1.103A-2(k)(2)(ii) and (k)(3) through (k)(6).

Form 8038-GC Options

An issuer has two options when reporting several issues of less than $100,000 that were issued during a calendar year. The issuer may file:

- a separate Form 8038-GC for each issue with an issue price of less than $100,000, or
- a consolidated return which includes all issues with issue prices of less than $100,000.

Exceptions:

1. A separate Form 8038-GC must be filed for those issues for which the issuer has elected to pay a penalty in lieu of rebating arbitrage.
2. The separate return option is not available for issues issued prior to January 1, 1992.

Example

County X issues the following bonds during the calendar year ending December 31, 1996:

- $2,000,000 for sewer line repairs,
- $6,000,000 qualified hospital bonds,
- $95,000 for transportation repairs,
- $90,000 for new police cars,
- $92,000 for construction of city hall annex

The County has elected to pay the penalty in lieu of rebate for the $92,000 construction bonds.

Continued on next page

Required Forms, Continued

Example (continued)

County X must file the following forms regarding the bond issues:

Bond Issue	Required Form
$2,000,000 for sewer line repairs	8038-G
6,000,000 qualified hospital bonds	8038
$92,000 for construction of city hall annex	8038-GC (separate)

County X then has the option to file a separate Form 8038-GC for each of the remaining issues. Alternatively, the County can file a consolidated form 8038-GC, which includes both issues.

Filing Dates

Filing Dates: 8038, 8038-G, 8038-GC

Forms 8038, 8038-G, and Forms 8038-GC filed for a single issue are due by the 15th day of the second calendar month following the close of the calendar quarter in which the bonds were issued.

Consolidated Forms 8038-GC are due by February 15th of the calendar year following the year in which the issues are issued.

Filing Dates: Form 8038-T

All Forms 8038-T are accompanied by a payment of some sort. The filing date of the return actually depends on the due date of the payment.

Payment Included With Filing	Filing Date
Arbitrage rebate	Installments are due sixty days after the end of every 5th bond year during the life of the bond. Generally, the final installment is due sixty days after the date the last bond in the issue is discharged.
Yield reduction	Generally, the same schedule as arbitrage rebate.
Penalty in lieu of rebating arbitrage	No later than 90 days after the end of each 6-month period.
Penalty to terminate the election to pay a penalty in lieu of rebating arbitrage	No later than 90 days after the end of the initial temporary period or the date of the termination election.
Penalty for late payment of any of the above	As soon as discovered.

Continued on next page

Filing Extensions for Forms 8038, 8038-G, and 8038-GC

There are no provisions for a request for an extension prior to the filing date. However, Revenue Procedure 88-10, 1988-1 CB 635 describes the steps that should be taken to obtain an extension to file Form 8038, 8038-G, or 8038-GC after the filing date has passed. (**See Exhibit C-3)** Basically, this is a request for a determination that the failure to file timely was not due to willful neglect. If granted, then the information reporting requirements are considered to be met, and the interest on the bonds is tax exempt. If the Service is unable to grant the request, then the reporting requirements would not be satisfied, and the interest on the bonds would not be tax exempt.

Special Extension for Bonds Issued from January 1–June 30, 1992

Information returns for bonds issued within this period had a special extended filing date of November 16, 1992.

Where to File

All returns are filed with the Ogden Service Center.

Penalties for Failure to File

None of the penalties provided by sections 6652, 6721, or 6723 apply to these forms. Thus, the only sanction for delinquent filings would be that the interest on the bonds would not be considered to be tax exempt.

Section 6

Treatment of Certain Pooled Financing Bonds

Overview

What are Pooled Financing Bonds?

Treas. Reg. section 1.150-1(b) defines "pooled financing issue" to mean an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to financed a single capital project.

How Pooled Financing Bonds are Used

Some municipalities need funds, but are unable to issue bonds for various reasons. Maybe they have had financial problems, which would result in a low bond rating. This would require the municipality to pay a higher interest rate to compensate bondholders for the increased risk.

Some municipalities may need cash, but are unwilling to pay the additional costs associated with a bond issue. Rather than borrowing from a bank, a municipality will sometimes make arrangements with another municipality to borrow some of its funds. The lending municipality issues the bonds for an amount which includes the loan amount.

Sometimes a municipality arranges with two or three conduit borrowers to fund their projects. These projects can be exempt facilities, manufacturing facilities (qualified small issuers), or 501(c)(3) organizations. If the projects are similar in type, the issuer may decide to issue only one bond issue, splitting the proceeds among two or more conduit borrowers.

All of the above are examples of pooled financing issues.

Continued on next page

IRC Section 149(f), in General

IRC section 149(f) provides that the interest on a pooled financing bond will NOT be tax exempt unless it meets two specific requirements:

1. The reasonable expectations requirement, and
2. The cost of issuance requirement.

These provisions are effective for bonds issued after October 21, 1988.

There are no regulations to accompany this section.

Specific Applicability

The provisions of IRC section 149(f) do NOT apply to all pooled financing bonds. Generally, they apply only to those issues not subject to the volume cap, namely, governmental, 501(c)(3), and certain exempt facility pools.

Legislative History

IRC section 149(f) was enacted to curb the following abuses by governmental issuers:

- Issuing bonds without immediate need for the funds,
- Issuing bonds without written commitments from potential borrowers to use the funds for governmental purposes,
- Issuing bonds for the sole purpose of "locking in" current low interest rates, OR
- Allowing bonds to remain outstanding longer than necessary.

Phase II

There are many arbitrage rules that apply to pooled financing issues. For this reason, there is a module in Phase II of this training devoted exclusively to pooled financings. Further discussion of the provisions of IRC section 149(f) are included in that module as well.

Section 7

Hedge Bonds

Overview

General Rule

IRC Section 149(g) provides that the interest on hedge bonds will not be tax exempt unless certain requirements are met. With some exceptions, this section generally applies to bonds issued after September 14, 1989. The regulations which accompany this section generally apply to bonds issued after June 30, 1993.

Legislative History

Prior to IRC section 149(g), municipalities could issue bonds when interest rates were low, even though there was not an immediate need for financing. They were "hedging" against the risk that interest rates would increase in future years. Congress viewed this practice as a drain on the Federal treasury, because the bonds were outstanding longer than necessary. The hedge bond rules were enacted to make sure that bond issues were reasonably sized and timely issued.

A Word About Semantics

While IRC section 149(g) identifies "hedge bonds", Treas. Reg. section 1.148-4(h) defines "qualified hedging transactions." When there is a qualified hedge related to a bond issue, the bonds are often referred to as "hedged bonds." These terms must NOT be confused! "Hedged" bonds are NOT the same as "hedge" bonds. Qualified hedging transactions are discussed in Phase II of this course.

In this section

This section contains the following topics:

Topic	See Page
Overview	C-47
Hedge Bond Requirements	C-48
Exception to the General Rule	C-49
Interest on a Hedge Bond Can Still Be Tax-Exempt	C-50
Determining if Your Original Issue Bond Meets the Hedge Bond Rules	C-53
Hedge Bond Rules for Refunding Issues	C-55
Summary	C-56

Hedge Bond Requirements

What is a Hedge Bond?

To avoid being a hedge bond, a bond must meet BOTH of the following tests:

1. The issuer must reasonably expect to spend 85 percent of spendable proceeds for the governmental purposes of the issue within 3 years of the issuance date; AND

2. 50 percent or less of the proceeds are invested in nonpurpose investments with a guaranteed yield for at least four years ("Investment test").

If either of these tests is NOT met, then the bonds are hedge bonds.

Reasonable Expectations

Treas. Reg. section 1.149(g)-1(a) states that "reasonable expectations" has the same meaning as set forth in Treas. Reg. section 1.148-1, along with the modification described in IRC section 149(f)(2)(B). You will remember that IRC section 149(f)(2)(B) concerns pooled financing issues, and provides that expectations about changes in interest rates and tax laws cannot be considered when determining whether expectations are reasonable.

What Are Spendable Proceeds?

When defining "spendable proceeds," Treas. Reg. section 1.149(g)-1(a) refers to the definition of "net sale proceeds" in Treas. Reg. section 1.148-1. Net sale proceeds are sale proceeds (including underwriter's discount and accrued interest) less proceeds placed into a reasonable required reserve and replacement fund.

Nonpurpose Investments

Nonpurpose investments are investments in securities, bank deposits, or other investments which have nothing to do with the purpose of the issue. Guaranteed yields may result from any type of investment. Some examples are guaranteed investment contracts, government securities, or even other bonds.

You will learn more about nonpurpose (and purpose) investments later in this text.

Exception to the General Rule

Exception to Hedge Bond Status

IRC Section 149(g)(3)(B) provides that a bond which otherwise meets the definition of a hedge bond, will not be considered a hedge bond if at least 95 percent of the net proceeds are invested in tax-exempt bonds that are not subject to the Alternative Minimum Tax under section 57.

Amounts in the following funds are treated as invested in non-AMT bonds:

- amounts in bona fide debt service funds, and
- earnings held for less than 30 days pending reinvestment or bond redemption.

This test is based on **actual** investments, and not the issuer's expectations.

Definition of "Net Proceeds"

Net proceeds are the same as "net sale proceeds."

Bonds Subject to the Alternative Minimum Tax ("AMT Bonds")

"AMT bonds" are those bonds which are considered tax preference items under section 57. Those items included in IRC section 57 are subject to the Alternative Minimum Tax of IRC section 55.

Generally, AMT bonds are private activity bonds issued after August 7, 1986, except for:

- qualified 501(c)(3) bonds, and
- refunding bonds, if the original bond was issued before August 8, 1986.

Therefore, non-AMT bonds would be:
- 501(c)(3) bonds,
- certain refunding issues, AND
- governmental bonds.

Interest on a Hedge Bond Can Still be Tax-Exempt

Two Tests

IRC Section 149(g)(1) provides that if a bond meets the definition of a hedge bond, the interest will be considered to be tax exempt if the bond meets two requirements:

1. Five-year reasonable expectations test, and

2. Cost of issuance payment requirements

5-Year Reasonable Expectation Test

IRC Section 149(g)(2) provides more liberal expectations regarding spending requirements than those stated in IRC section 149(g)(3). Basically, the issuer is required to expect to spend 85 percent of the spendable proceeds within five years from the issuance date, as long as progressive spending is accomplished throughout the five-year period. The table below shows the percentage of spendable proceeds which must expect to be used for governmental purposes within each specific period. (Each time period begins with the issuance date.)

Percentage of Spendable Proceeds	Time Period
10%	1 year
30%	2 years
60%	3 years
85%	5 years

Cost of Issuance Requirements

The cost of issuance requirements for purposes of IRC section 149(g) are exactly the same as that for pooled financing issues. These requirements were discussed in the prior section. To review, these requirements are:

- At least 95 percent of the reasonably expected legal and underwriting costs associated with the issue are paid not later than the 180th day after the date of issuance, AND
- the payment of legal and underwriting costs are NOT contingent on the disbursement of the proceeds.

Continued on next page

Interest on a Hedge Bond Can Still be Tax-Exempt, Continued

Example

City X plans a $59 million bond issue at 6% on January 1, 1994. The proceeds will be used to build a qualified multi-purpose recreational complex. Negotiations between landowners and contractors, and architectural plans are not yet finalized. The complex will be quite large, and the city expects that the negotiations will continue for a few months yet. As a result, on January 1, 1994, the issuance date, the City cannot reasonably expect to substantially finish the project within three years. However, since the city believes that significant progress can be made on the project within five years, the bonds are issued anyway. Financial data regarding the issue is as follows:

Proceeds from sale	$59,000,000	(includes underwriters discount)
Accrued interest	330,000	
Gross proceeds	$59,330,000	
Deposit to reserve	<5,900,000>	
Spendable proceeds	$53,430,000	
Issuance costs paid by January 31, 1994	$1,135,327	

In order to meet the 5-year reasonable expectations test of IRC section 149(g)(2), city must expect to spend according to the following schedule:

Amount to be spent	Date
$ 5,343,000 *	December 31, 1994
16,029,000	December 31, 1995
32,058,000	December 31, 1996
45,415,500	December 31, 1998

* $53,430,000 × 10% = $5,343,000

Because City X reasonably expects to spend the amounts shown above, and the cost of issuance test was met, the interest on the bonds will be tax exempt, even though the bonds are still considered to be hedge bonds.

Continued on next page

Additional Notes About This Section

There is no effect on the bond's status if the actual disbursements do not meet the above spending schedule, unless the circumstances surrounding the actual events cast doubt on the reasonable expectations on the issuance date.

The allocation and accounting rules of Treas. Reg. section 1.148-6 apply to expenditures for purposes of IRC section 149(g). There is an exception for some expenditures which create replacement proceeds.

IRC Section 149(g)(4)(A) provides that issuers of construction projects which are expected to take longer than five years, may request a ruling regarding hedge bond status. The issuer must reasonably expect that the spendable proceeds will be spent over a reasonable construction period, which is specified in the request.

Determining if Your Original Issue Meets the Hedge Bond Rules

Use Figure C-5 for Original Issues

Use this flowchart f[illegible]sues only — **no refundings**.

Answering the first four questions will tell you whether or not the hedge bond rules apply to your bond. The effective dates of IRC section 149(g) are included as well as the transition rules.

If you determine that the rules do not apply to your bond, do not continue with the flowchart. How[illegible] may wish to research the artifice or device rules in the arbitrage regulations to see if they apply to your issue. These rules discuss overburdening of the market. For bonds issued prior to June 30, 1993, check Treas. Reg. section 1.103-13(j), as long as the issuer did not elect to apply the 1993 regulations. If this election was made, or if the bonds were issued after June [illegible] Treas. Reg. section 1.148-10. (1993 regulations)

If IRC section 149(g) does apply to your bond, continue with the flowchart.

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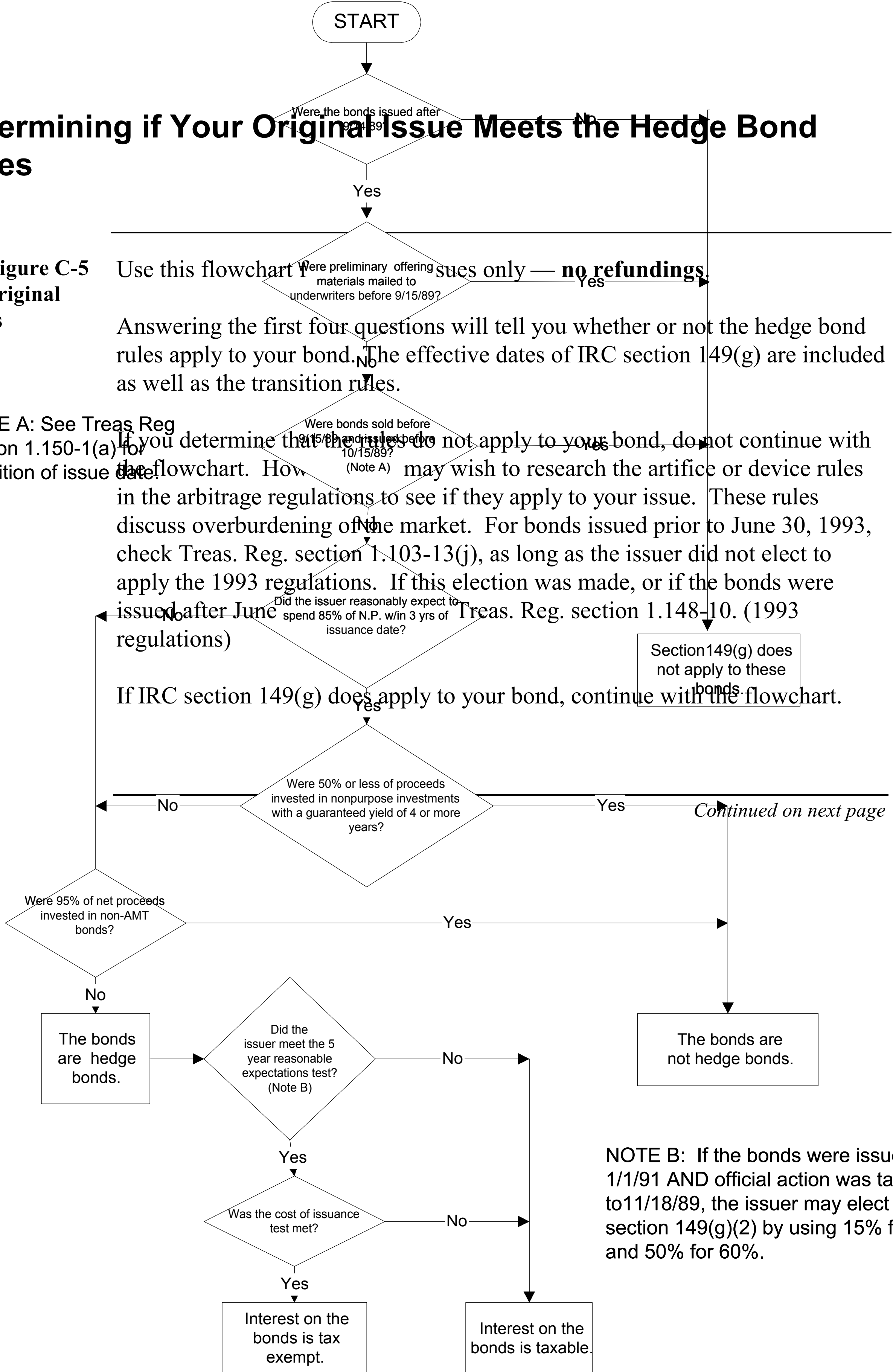

Hedge Bond Rules for Refunding Issues

Introduction

If you are examining a refunding issue, the determination of whether or not the issue meets the hedge bond requirements depends on the original issue.

Treatment of the refunding issue differs depending on whether or not IRC section 149(g) applies to the refunded issue.

Refer to Module E of Phase II of this course for guidance regarding whether or not a refunding bond is a hedge bond.

Summary

Review of Module C

Module C discussed the various provisions of IRC section 149. All municipal bonds are subject to these provisions.

IRC section 149(a) requires that most tax-exempt municipal bonds be registered. The regulations provide that issuers can use either the certificate or the book-entry system of registration.

IRC section 149(b) provides that tax-exempt municipal bonds cannot be federally guaranteed. There are many exceptions to this general rule.

IRC section 149(c) provides that all tax-exempt bonds must be tax-exempt under IRC section 103(a), even though tax-exempt status is provided under another federal statute. Most bonds issued after 1983, therefore, must comply with sections 141-150.

IRC section 149(d) provides the rules for advance refundings. Advance refundings are bonds issued to refund prior bonds, when the proceeds are held more than 90 days in advance of the maturity or call date of the refunded bonds. In a current refunding, the proceeds of refunding bonds are used to pay off prior bonds within 90 days of issuance of the refunding bonds.

IRC section 149(e) provides the information reporting requirements of municipal bonds. They are required to file one of a series of Forms 8038 when the bonds are issued. Form 8038-T is required to be filed when an issuer makes yield reduction or rebate payments, or is paying an arbitrage penalty.

IRC section 149(f) provides the rules for pooled financings. These are bonds the proceeds of which are loaned to two or more borrowers. They can be governmental or qualified private activity bonds.

IRC section 149(g) provides the rules for hedge bonds. Hedge bonds are bonds which are issued prior to the need for financing. The interest on a hedge bond may or may not be tax-exempt, depending on the circumstances.

Continued on next page

Preview of Module D

Module D is a very important module, because it discusses the private activity bond tests of IRC section 141. The interest on a bond which meets one of the tests cannot be exempt, unless it is a qualified private activity bond.

All examinations of governmental bonds will use these tests if there is any evidence of private or disproportionate use of tax-exempt bond-financed property.

Class Exercises and Problems

Exercise 1

City A issues bonds in bearer form. A foreign person buys some of the bonds, and shortly thereafter sells them to a United States person. Upon receipt, the US person delivers the bonds to City A. City A gives the US person identical bonds, except the new bonds are registered as to both principal and interest, and may be transferred only upon surrender to the issuer.

At what point are these bonds considered to be in registered form?

Answer:

Exercise 2

County B issues general obligation bonds which are sold to an underwriter in a negotiated sale. The bonds are backed by the full faith and credit of the county, and a portion of property taxes are pledged for debt service. The underwriter subsequently sells the bonds to the Farmers Home Administration for investment only.

Are these bonds federally guaranteed? If so, is the interest tax exempt?

Answer:

Exercise 3

City C issues the following bonds during the calendar year ending December 31, 1995:

- $20,000,000 to refund a $35,000,000 1985 issue
- $45,000,000 qualified 501(c)(3) bonds
- $15,000,000 for construction of parking facility. The issuer does not elect to pay a penalty in lieu of rebate.

Indicate the forms which the city is required to file for these issues.

Answer:

Continued on next page

Exercise 4 The following data pertains to City K's bond issues. Review the data, then answer the questions below:

Issuance Date	First Call Date	Maturity Date	Purpose
12/1/86	12/1/91	12/1/96	build city hall
10/1/91	10/1/96	10/1/2001	retire 1986 issue to eliminate a restrictive provision
12/1/95	12/1/2000	12/1/2010	retire 1991 issue for debt service savings

1. What type of issue is the 1991 issue?

   Answer:

2. What type of issue is the 1995 issue?

   Answer:

3. In order for the 1995 issue to be tax-exempt, when must the 1991 issue be retired?

   Answer:

4. Can the 1995 bonds be refunded with tax-exempt bonds issued on November 1, 2000? August 1, 2000?

   Answer:

END OF MODULE C