Module H

Pooled Financing Issues

Overview

Introduction

Thus far, the text has discussed bond issues in which there was only one conduit borrower. However, an issuer can loan bond proceeds to more than one entity.

Pooled financings are used when an issuer wishes to:

- provide funds for related agencies at the same time,
- finance multiple projects of the same type at the same time, or
- accommodate other unrelated municipalities who are either unable or unwilling to issue bonds of their own.

Treas. Reg. section 1.150-1(b) defines a **pooled financing issue** as 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 finance a single capital project.

Although pooled financing issues include mortgage and scholarship pools, mortgage and scholarship pools have their own tax rules. Mortgage and scholarship pools are not discussed in this module. Further information about these types of bonds is available in Phase I.

Advantages of Pooled Financing Issues

Pooled financing issues may present the following advantages:

- lower costs of issuance,
- lower costs of borrowing, and
- improved marketability of the issue (i.e. longer maturity).

Disadvantages of Pooled Financing Issues

Pooled financings may have the following disadvantages:

- a borrower with a poor financial history may drag down those with better histories, and
- there are complicated federal income tax rules.

Continued on next page

Arbitrage Rules

Pooled financing issues present their own special problems with respect to arbitrage, and therefore have many special rules which apply only to them.

This course has concentrated on the application of the arbitrage rules to nonpurpose investments. In pooled financings, there are **both** purpose and nonpurpose investments. These types of investments must be separately identified, because the arbitrage rules apply differently to them.

Allocation Rule

One of the most significant rules is contained in Treas. Reg. 1.148-6(d)(2). This rule provides, generally, that gross proceeds invested in a purpose investment are allocated to an expenditure when the conduit borrower allocates the gross proceeds to an expenditure.

In other words, the mere loaning of funds by the issuer, except for qualified mortgage loans and qualified student loans, does NOT permit the proceeds to be considered spent. The proceeds have to be spent by the conduit borrower for the governmental purpose of the issue in order for the bonds to be considered spent by the issuer. **(See Treas. Reg. section 1.148-6(b)(1).)**

Further, Treas. Reg. section 1.148-6(d)(2)(iii) provides that even though the proceeds are allocated to an expenditure, they continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment. This means that as long as the loan is outstanding, it is allocated to the purpose investment. When it is repaid in full, it is deallocated.

Enterprise Zone Bonds

Special rules apply for pooled financing enterprise zone bonds. Although they are not discussed in this text, they can be found in Treas. Reg. section 1.1394-1(f), (g), (h) and (j).

Continued on next page

Objectives

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

- Identify the different types of pooled financing issues.
- Differentiate between purpose and nonpurpose investments of both the issuer and the conduit borrower.
- Apply the yield restriction rules to pooled financing issues at both the issuer and the conduit borrower levels.
- Compute the yield of purpose investments.
- Apply the small issuer and the spending exceptions to rebate to nonpurpose investments in pooled financing issues.
- Identify other rules, other than arbitrage rules, that apply to pooled financings.

In this Module

This module contains the following topics:

Section 1

Types of Pooled Financing Issues

Overview

Introduction

There are four different types of pooled financed issues:

- governmental pools,
- 501(c)(3) pools,
- qualified small issue pools, AND
- other qualified private activity bond pools.

This section gives a general description of each of these types of pools. For purposes of private activity bond pools, the discussion differentiates between small issue bond pools, 501(c)(3) pools, and other private activity bond pools.

Each type of pool must contain only one type of bond. Different types cannot be mixed in a pool. For example, an issuer cannot issue bonds and loan part of the proceeds to a governmental unit, a 501(c)(3) entity, and a small issuer and consider it a pooled financing. This is because different tax rules apply to each type of financing.

In this Section

This section contains the following topics:

Governmental Pools

Introduction

A governmental pool is one where a governmental entity issues bonds and then loans the proceeds to other governmental entities.

Example

County A issues bonds in the principal amount of $90M. The proceeds are loaned to the following cities in the following amounts:

- City A - $30M
- City B - 30M
- City C - 30M

Example

County A issues bonds in the principal amount of $75M. The proceeds are loaned to the following related governmental entities:

- Hospital Authority - $25M
- Solid Waste Authority - 25M
- Electrical Power Authority - 25M

As long as all of the borrowing entities use the funds for proper governmental purposes, County A is considered to have issued one pooled financing issue of governmental bonds in each of the above examples.

County A could also mix the borrowers shown above and still be considered to have issued one pooled financing issue of governmental bonds.

Example

County A issues bonds in the principal amount of $100M. The proceeds could be loaned to the following entities:

- City A
- Hospital Authority
- Solid Waste Authority.

As long as the borrowing entities use the funds for proper governmental purposes, County A is considered to have issued one issue of governmental bonds.

Continued on next page

Tax Treatment at the Pool Level

As stated above, an issuer of a governmental pooled financing issue is treated as issuing one governmental bond issue. This bond issue is subject to all of the tax rules that apply to any other governmental issue. Specifically, the issue is subject to the applicable rules of IRC sections 103, and 141 through 150.

Note that the issue would NOT have to meet the rules of IRC section 147 because it is NOT considered to be a private activity bond. Additionally, all rules and exceptions that apply only to governmental bonds would also apply to the pooled financing issue.

Tax Treatment at the Borrower Level

Each of the borrowers in a governmental pool is a conduit borrower, but can also be an issuer of its own tax-exempt obligation.

You will recall from Phase I of this course that a tax-exempt obligation under IRC section 103 must be issued by a valid issuer and possess the requisite characteristics of a tax-exempt debt (i.e. valid under state law, exercise of borrowing power, intent of repayment, etc.)

Therefore, each of the loans to a governmental entity also may be required to comply with the applicable provisions of IRC sections 141 through 150. For example, if a municipal borrower chooses not to file Form 8038, the issue would technically be a taxable issue. However, if the borrower earns arbitrage on the proceeds, then the pool issuer could be affected because of its purpose investment in the borrower’s taxable bonds. If bonds are taxable, how are they treated and how do they affect the pool issuer? Sections 2 and 3 discuss this latter situation in more detail.

Special Rules for Governmental Pools

Section 2 contains a discussion about additional rules that apply to governmental pools.

501(c)(3) Pools

Introduction

A 501(c)(3) pool is one in which a governmental entity issues one issue of bonds and then loans the proceeds to two or more 501(c)(3) organizations.

Example

City X issues bonds in the principal amount of $90M. The proceeds are loaned to the following entities in the following amounts:

- 501(c)(3) Hospital System - $40M
- 501(c)(3) Animal Shelter - 25M
- 501(c)(3) University - 25M

City X is considered to have issued one issue of qualified 501(c)(3) bonds that must comply with all of the rules in IRC sections 103, and 141 through 150 that normally apply to qualified 501(c)(3) bonds. Additionally, any special rules and exceptions that apply to 501(c)(3) bonds will also apply to the pool issue.

For example, IRC sections 147(a), (c), and (d) will not apply to the pool issue.

Special Rules for 501(c)(3) Pools

Special rules applicable to 501(c)(3) pools are discussed in Section 2.

Small Issue Pools

Introduction

A qualified small issue pool is one in which a governmental entity issues bonds, then loans the proceeds to businesses that qualify under IRC section 144(a).

IRC section 144(a)(6) provides that separate lots of bonds that would be treated as part of the same issue (under the rules of Treas. Reg. section 1.150-1(c)(1)) shall be treated as separate issues. That is unless the proceeds of such lots are to be used with respect to two or more facilities which are located in more than one state, or which have, or will have, as the same principal user the same person or related persons.

Example

State N proposes to issue small issue bonds, the proceeds of which will be loaned to local nonprofit industrial development corporations. The industrial development corporations will use the bond proceeds to acquire and construct projects that will be sold or leased to business corporations within State N. N will issue and market simultaneously 25 lots of general obligations bonds, each in the face amount of $1M. Each lot will be issued under a separate indenture and will be sold at substantially the same interest rate. The payment of debt service on each lot will be secured by a pledge of the amounts to be received by N as the repayment of the loans made from the proceeds of that lot of bonds (revenues from projects financed from proceeds of that lot.) In addition, each lot will be fully and unconditionally guaranteed by N both as to principal and interest.

The 25 lots of obligations are to be issued by N on the same date, at substantially the same interest rate, and pursuant to a common plan of marketing. In addition, as a result of N's guarantee of the 25 lots of obligations there will be a pooled security available to pay debt service on the 25 lots of obligations. Therefore, under Treas. Reg. section 1.150-1(c)(1), the 25 lots of obligations would be considered a single issue in the face amount of $25M.

However, IRC section 144(a)(6) permits each lot to be treated as a separate issue, thereby enabling each lot to meet the requirements of a qualified small issue bond.

Continued on next page

Principal User

In addition to the definition of principal user found in Treas. Reg. section 1.103-10(h), IRC section 144(a)(6)(B) describes other instances when a person will be a principal user.

Other Qualified Private Activity Bond Pools

Introduction

A qualified private activity bond pool is one in which a municipality issues bonds and then loans the proceeds to two or more entities, to be used for an exempt facility described in IRC section 142.

Exempt Facility Bonds

Example

City Y issues bonds in the principal amount of $65M. The proceeds are loaned to the following entities in the amounts and for the purposes indicated:

Borrower	Purpose	Amount
Corporation A	Water Furnishing Facility	$18M
Corporation B	Sewage Facility	18M
Corporation C	Electrical Energy	18M

City Y would be considered to have issued one issue of exempt facility bonds. This issue would be subject to all of the applicable rules for exempt facility bonds under IRC sections 103, and 141through 150.

Section 2

Miscellaneous Rules

Overview

Introduction

This section discusses other rules, other than arbitrage rules, that apply to pooled financings.

In This Section

This section contains the following topics:

Treatment of Certain Pooled Financing Bonds Under IRC Section 149(f)

Introduction

IRC section 149(f) provides that interest on a pooled financing bond will NOT be tax exempt, unless two requirements are met:

- Reasonable expectations requirement, and
- Cost of issuance payment requirement.

These provisions are effective for bonds that are **NOT** refunding bonds, issued after October 21, 1988.

There are no regulations to accompany this section.

Legislative History

Section 149(f) was added to the Code 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,
- allowing bonds to remain outstanding longer than necessary.

Continued on next page

Treatment of Certain Pooled Financing Bonds Under IRC Section 149(f), Continued

Definition of a Pooled Financing Bond for Purposes of IRC section 149(f)

IRC sections 149(f)(4)(A) and (B) define a "pooled financing bond" as follows:

1. the bond is one of the following types:

   - governmental,
   - qualified 501(c)(3),
   - exempt facility bonds of the following types:
     - airports,
     - docks,
     - wharves,
     - environmental enhancements of hydroelectric generating facilities, if owned by a governmental unit (if NOT owned by the governmental unit, then only 75 percent of the bond is included),
     - solid waste disposal if owned by a governmental unit, **AND**

2. more than $5,000,000 of the proceeds are reasonably expected at the time of the issuance of the bonds to be used directly or indirectly to make or finance loans to two or more ultimate borrowers.

Continued on next page

Treatment of Certain Pooled Financing Bonds Under IRC Section 149(f), Continued

The Reasonable Expectation Requirement

If the interest on a pooled financing bond is to be tax exempt, the bond must meet two requirements. The first requirement is referred to as the reasonable expectation requirement.

IRC section 149(f)(2) describes the reasonable expectation requirement as follows:

- The issuer reasonably expects that at least 95 percent of the net proceeds will be used directly or indirectly for loans to ultimate borrowers within **three years from the date of issuance**.

- An increase in interest rates or anticipated changes in federal income tax laws, regulations, or rulings, may not be used as a basis for reasonable expectations.

- “Net proceeds" means gross proceeds reduced by:

    - proceeds placed in a reasonably required reserve or replacement fund,
    - proceeds used to pay issuance costs, and
    - proceeds used to pay interest during the three-year period.

If the bond is a refunding bond, then the three-year period begins on the date of issuance of the original bond.

Note that the definition of “net proceeds” for purposes of IRC section 149(f) is different from the definition of “net sale proceeds” of Treas. Reg. section 1.148-1(b).

Continued on next page

Definition of Reasonable Expectations

Treas. Reg. section 1.148-1(b) provides that an issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Factors relevant to a determination of reasonableness include:

- issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations,
- the level of inquiry by the issuer into factual matters,
- the existence of covenants, enforceable by bondholders, that require implementation of specific expectations, and
- reasonable expectations of the conduit borrower, if it is reasonable and prudent for the issuer to rely on those expectations.

The Cost of Issuance Requirement

The second requirement to be met for the interest on a pooled financing bond to be tax exempt is the cost of issuance requirement. IRC section 149(f)(3) describes the cost of issuance requirement as follows:

- 95 percent of the reasonably expected legal and underwriting costs must be paid by 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

What Is a Loan?

IRC section 149(f)(5) provides that loans of proceeds of the issue must be used for governmental purposes, rather than investment. Additionally, the proceeds cannot be used by an agency of the issuer unless the agency is a political subdivision or instrumentality of the issuer.

Mixed Use Issues

IRC section 149(f)(5)(B) provides that if only a portion of a bond issue is reasonably expected to be used to finance loans to 2 or more ultimate borrowers, then that portion and the other portion will be treated as separate issues for purposes of testing whether the pool bond rules have been met.

Continued on next page

Example

Cities A and B each need $10 million to repair and maintain municipal buildings. Neither city has been able to obtain city council approval to issue bonds to raise funds for this purpose. They approach City C about the possibility of borrowing funds to pay for the expenses. City C was already planning a $10 million bond issue for its own purposes. City C agrees to the deal and increases the amount of its bond issue to $33.6 million. The bonds are issued at 3% on June 1, 1995. Interest is payable on September 1 and March 1 of each year. On this date, City C reasonably expects that Cities A and B will each borrow $11.2 million at 3% interest. ($1.2 million has been added to each principal amount in order to pay issuance and reserve costs.) Also on this date, $3 million is placed into a reserve fund, and all issuance costs are paid.

Issuance costs include the following:

• Underwriters discount	$300,000
• Rating Agency Fee	200,000
• Bond counsel fee	100,000
	$600,000

As of May 31, 1998 all of the cities have completed their projects, and all of the funds have been spent. Determining if the bonds meet the requirements of a pooled financing issue under IRC section 149(f) includes the following:

Continued on next page

Example (continued)

1. Does the issue meet the definition of a pooled financing issue?

According to IRC section 149(f)(5)(B) this issue will actually be two separate issues for section 149 purposes. Issue 1 will be earmarked for Cities A and B in the amount of $22,400,000 ($11,200,000 x 2).

Issue 2 is for City C in the amount of $11,200,000 (Issuance costs and the reserve proceeds have been divided equally among the three cities.) Since we need to consider Issue 1 only, the issue meets the definition because more than $5 million will be loaned to 2 or more borrowers, and it is a governmental bond.

2. Was the reasonable expectations requirement met? To answer this, we need to compute net proceeds as follows:

Gross proceeds	$22,400,000	
Less:		
Reserve fund	<2,000,000>*	
Issuance costs	< 400,000>	
Bond interest (9/1/95 – 3/1/98)	<2,016,000>**	
Net proceeds	$17,984,000	
Required loan percentage	× .95	
Required loan amount	$17,084,800	
Actual loan amount		22,400,000

* Note that the other $1M will be paid from City C's share.
** $22,400,000 x .03 = $672,000 x 3 yrs. = $2,016,000

Since the actual loan amount exceeds 95 percent of the net proceeds, the issue meets the reasonable expectations requirement.

3. Does the issue meet the cost of issuance payment requirement? This test is met because the underwriting and legal costs were paid within 180 days of the issuance date, and were not contingent on the making of the loans.

Since these bonds met all of the requirements of IRC section 149(f), the interest on the bonds is tax exempt.

Maturity Limitation Under IRC section 147(b)(4)

General Rule for Qualified 501(c)(3) Bonds

IRC section 147(b)(4) provides that a pooled financing issuer of qualified 501(c)(3) bonds may elect to comply with the 120 percent rule by comparing the average maturity of each loan to the expected economic life of the facilities being financed with the loan.

Requirements

In order to make this election, the bonds must meet the following requirements:

- 95 percent or more of the net proceeds of the pool issue must be used to finance loans to two or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations,
- the average maturity of each loan in the pool must NOT exceed 120 percent of the average reasonably expected economic life of the facilities financed by that loan,
- before the bonds are issued, there must be a demand survey which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of the pool issue,
- 95 percent or more of the net proceeds of the pool issue are to be loaned to 501(c)(3) organizations or governmental units within one year of issuance,
- any unspent proceeds after the one-year period must be used to redeem the bonds as soon as possible, but NOT later than 18 months after issuance, AND
- the maturity date of the any bond in the pool must not exceed 30 years.

Making the Election

Treas. Reg. section 301.9100-7T provides that an election under IRC section 147(b)(4)(A) must be made in the bond indenture or a related document on or before the date of issue.

Refunding a Conduit Loan

Introduction

Treas. Reg. section 1.150-1(d)(2)(iii)(A) provides that when a conduit borrower obtains subsequent financing to refund the initial loan from a pool issuer, the use of the conduit refunding proceeds by the issuer determines whether or not the refunding issue is a refunding of the pool issue.

Treas. Reg. section 1.150-1(d)(2)(iii)(B) provides that when the issuer reasonably expects to use the proceeds of the conduit refunding issue for a new loan within the applicable temporary period, then the new loan(s) will be treated as <u>proceeds of the original pool issue</u>.

If, however, the issuer does not reasonably expect to re-loan the proceeds of the conduit refunding issue, then the conduit refunding issue is treated as a <u>refunding of a portion of the pool issue</u> (in addition to a refunding of the obligation that is a purpose investment.)

<u>Example</u>

County J issues bonds that qualify as a pooled financing. The proceeds are loaned to Hospitals K and L. Loan proceeds are spent promptly on their respective projects. Seven years after receipt of the loan, Hospital K arranges with County M to borrow proceeds of its bonds. Hospital K plans to use the loan proceeds from County M to pay off its loan to County J.

When County J receives the payoff from Hospital K, it reasonably expects to loan the funds to City X for building maintenance. As long as the loan is made to City X within six months (the applicable temporary period in this case) of J's receipt of cash from Hospital K, the refunding issue proceeds are treated as proceeds of the original pool issue.

If County J did not intend to re-loan the proceeds, but rather expected to use the proceeds for its own purposes, then Hospital K's refunding issue would be treated as a refunding of a portion of the pool issue.

Section 3

Yield Restriction Rules

Overview

Introduction

Pooled financing issues consist of both purpose and nonpurpose investments. The loans to the conduit borrowers are purpose investments. Any other investments made by the issuer or the conduit borrower are nonpurpose investments. Application of the yield restriction rules differs depending on the type and nature of the investment.

This section discusses the application of the yield restriction rules to both purpose and nonpurpose investments of pooled financing issues. After determining whether the investment is a purpose or nonpurpose investment, the next step is to determine if the investment is "investment property" under IRC section 148(b)(2). This definition applies to both purpose and nonpurpose investments.

IRC section 148(b)(3) provides that investments in tax-exempt bonds will be treated as investment property only in certain cases. Because the loans to conduit borrowers in pooled financings often qualify as tax-exempt bonds, we need to find out when these tax-exempt bonds constitute "investment property." Also, because an issuer or conduit borrower may invest in tax-exempt bonds as a nonpurpose investment, we need to know if this investment constitutes investment property. If the investment is investment property, then it is subject to the yield restriction rules. If it is not investment property, then it is not subject to the yield restriction rules.

Before discussing IRC section 148(b)(3), however, we need to define "AMT bonds."

Continued on next page

AMT Bonds

IRC section 57 identifies certain tax-exempt bonds that are considered tax preference items for purposes of the alternative minimum tax ("AMT") of IRC section 55. Those bonds that are subject to the alternative minimum tax are referred to as "AMT bonds."

Generally, AMT bonds are tax-exempt private activity bonds that are issued after August 7, 1986. There are exceptions for qualified 501(c)(3) bonds, certain refundings, and certain transitioned bonds. These excepted bonds are referred to as "non-AMT bonds."

Investment Property

The definition of investment property in IRC section 148(b)(3)(A) contains a general exclusion for tax-exempt bonds. However, as summarized below, IRC section 148(b)(3)(B) provides that certain tax-exempt bonds are included as investment property:

If the pool issue consists of:	And the proceeds are invested in:	Then the investment is:
Non-AMT bonds	Non-AMT bonds (can be purpose or nonpurpose)	Not investment property (IRC section 148(b)(3)(A))
Non-AMT bonds	AMT bonds(can only be nonpurpose)	Investment property (IRC section 148(b)(3)(B))
AMT bonds	AMT bonds (can be purpose or nonpurpose)	Not investment property (IRC section 148(b)(3)(A))
AMT bonds	Non-AMT bonds (can only be nonpurpose)	Not investment property (IRC section 148(b)(3)(A))

Continued on next page

Points to Remember

Both purpose and nonpurpose investments are subject to the yield restriction rules. However, regardless of whether or not the investment is a purpose or nonpurpose investment, if it is NOT investment property, then it is NOT subject to yield restriction.

Purpose investments are not subject to rebate. Therefore, nonpurpose investments may or may not be subject to yield restriction or rebate. However, purpose investments may or may not be subject to the yield restriction rules, but are never subject to the rebate requirements.

Continued on next page

Governmental Pools

Generally, when the loans are made to governmental entities, the loans are treated by the issuer as purpose investments. If the loans themselves would qualify as governmental bonds, then these investments are not subject to the yield restriction rules. This is because:

- the loans are tax-exempt bonds, AND
- the loans are not investment property under IRC section 148(b)(3) – they are non-AMT bonds.

(See Treas. Reg. section 1.148-2(d)(2)(v).)

Similarly, if the pool issuer invested in tax-exempt non-AMT bonds with proceeds prior to loaning the funds to a conduit borrower, the investments would be nonpurpose investments, but the investments would NOT be subject to the yield restriction rules for the same reasons stated above. However, nonpurpose investments in AMT bonds would be investment property.

Example

State X issues bonds and loans the proceeds to Cities A, B, and C. Each of the cities files Form 8038 for their notes to the State. The loans to the cities are purpose investments. The loans are investments that are tax-exempt bonds and not investment property; therefore they are NOT subject to yield restriction, i.e. unlimited earnings with no temporary period. The yield that State X can earn on the loans is unlimited. Further, the loans (as purpose investments) are NOT subject to rebate.

However, the yield restriction (and rebate) rules still apply to any other nonpurpose investments made by the cities and State X during and after expiration of the temporary period, based on the yield of the pool issue.

Generally, loans to governmental entities are not subject to the yield restriction rules if the governmental borrower files Form 8038 to make its note to the issuer a tax-exempt obligation that is NOT an investment under IRC section 148(b)(3). However, if the note is NOT tax-exempt, or if the note is an AMT bond (as defined by IRC section 148(b)(3)(B)), then the note is subject to the yield restriction rules.

Continued on next page

501(c)(3) Pools

When the loans are made to 501(c)(3) organizations, the issuer's investments in the loans are treated by the issuer as purpose investments. However, these investments are subject to the yield restriction rules. This is because the loans are investment property under IRC section 148(b)(2) – they are NOT tax-exempt bonds so IRC section 148(b)(3) is not applicable. The definition of materially higher for these investments is .125 percent (under Treas. Reg. section 1.148-2(d)(2)). (If these investments are program investments, then the definition of materially higher is 1.5 percent.)

However, if the pool issuer invested proceeds in nonpurpose qualified 501(c)(3) bonds prior to loaning the proceeds to a conduit borrower, then the investment would not be subject to the yield restriction rules. This is because the bonds are not investment property (as non-AMT bonds) and because they are tax-exempt bonds, so no yield limitation applies (under Treas. Reg. section 1.148-2(d)(2)(v)). Because this would be a nonpurpose investment, it would be subject to rebate.

Other Pools

When the loans are made to entities other than the above, such as qualified small issuers, the issuer's investments in the loans are purpose investments subject to the yield restriction rules. This is because:

- they are investment property under IRC section 148(b)(3) (they are NOT tax-exempt bonds), and
- there is no specific exception for these purpose investments under Treas. Reg. section 1.148-2(d)(2)

Therefore, materially higher means .125 percent above the bond yield.

However, if the issuer invests proceeds in non-AMT bonds prior to loaning the proceeds to a conduit borrower, then the investment is a nonpurpose investment, but because it is NOT investment property, it is NOT subject to the yield restriction rules.

On the other hand, if the issuer invests proceeds in AMT bonds prior to loaning the proceeds to a conduit borrower, then the investment is a nonpurpose investment, but because it is investment property, it is subject to the yield restriction rules.

Continued on next page

In this Section

This section contains the following topics:

Temporary Period Limitations

General Rule

The general temporary periods are the same as those for traditional bond issues as provided by Treas. Reg. section 1.148-2(e).

However, in pooled financing issues, the issuer and conduit borrower share the temporary period. There are limits on the issuer's temporary period.

Proceeds at the Issuer Level

In order for the bond proceeds to qualify for any temporary period, the issuer must reasonably expect to meet the expenditure, time, and due diligence tests set forth in Treas. Reg. section 1.148-2(e)(2) with respect to each conduit loan financed by the issue. If the issuer reasonably expects that the conduit borrowers will meet these tests, then the issuer can invest the bond proceeds in nonpurpose investments for a period of **six months** without regard to the yield restriction rules. **(See IRC section 148(c)(2)(A) and Treas. Reg. section 1.148-2(e)(4).)**

Proceeds at the Conduit Borrower Level

If the issuer reasonably expects that the expenditure, time, and due diligence tests would be met, then the bond proceeds may also be invested in nonpurpose investments by each conduit borrower for up to **three years** without regard to the yield restriction rules. **(See Treas. Reg. section 1.148-2(e)(2).)** This three-year period begins on the issuance date.

This three-year period is reduced by any period of time that the issuer holds the proceeds before being loaned. The remaining portion of the three-year period begins when the issuer loans the proceeds to the conduit borrower.

Continued on next page

Example

City W issues pooled financing bonds on behalf of six conduit borrowers. Prior to issuance, City W obtains certifications from each borrower that:

- within three years, it will spend at least 85 percent of borrowed proceeds on qualified capital projects,
- within six months, it will enter into a contract with the issuer to borrow bond proceeds for the contemplated capital projects, AND
- it will proceed with due diligence to complete the capital projects by expending the bond proceeds on the project.

Since the issuer has the requisite expectations, it may invest the bond proceeds for up to six months without regard to the yield restriction rules. In addition, the conduit borrowers may invest the bond proceeds for an additional two and one-half years (or more if the loan is made earlier) without regard to the yield restriction rules.

If the issuer held the proceeds for one year instead of six months, the conduit borrower's temporary period would only be two years. **(See Treas. Reg. section 1.148-2(e)(4)(i).)**

Construction Financing

IRC section 148(c)(2)(C)(i) provides for a two-year temporary period at the issuer level for proceeds of a pooled financing issue that the issuer elects to treat as a construction issue. **(See IRC section 148(f)(4)(C) for the definition of a construction issue.)**

Remember that the two-year temporary period applies only at the issuer level. The two-year temporary period is integrated with the three-year temporary period. The conduit borrower has the rest of the three-year period i.e.; the three-year period starts when the bonds are issued, NOT when the loan is made.

Section 4 of this module contains more information regarding construction issue elections and spending exceptions to rebate.

Continued on next page

Other Temporary Periods

Treas. Reg. section 1.148-2(e)(2)(ii) provides that a five-year temporary period may apply in lieu of the three-year period, if:

- a longer period is necessary to complete the capital project, and
- there is proper certification to this effect.

Treas. Reg. section 1.148-2(e)(3) also sets forth a rule that allows a temporary period of 13 months for proceeds that are reasonably expected to be allocated to working capital expenditures within 13 months after issuance. Treas. Reg. section 1.148-2(e)(4)(i) that reduces the temporary period of the conduit borrower by the amount of time the proceeds are held by the issuer also applies for the 13-month rule. Thus, if the issuer holds the proceeds for six months, the conduit borrower would only be allowed a temporary period of seven months.

Loan Repayments Received by the Issuer

Proceeds received by the issuer as repayment of loans from the conduit borrowers may be used to make new loans. IRC section 148(c)(2)(B) and Treas. Reg. section 1.148-2(e)(4)(ii)(A) provide that proceeds from the sale or repayments may be invested by the issuer without regard to yield limitation for **three months from the date of the repayments.**

Amounts Re-loaned to Conduit Borrowers

Treas. Reg. section 1.148-2(e)(4)(ii)(B) provides that any temporary period for proceeds held by a conduit borrower under a new loan made from the sale or repayment of a loan is reduced by the amount of time the proceeds are held by the issuer following the last repayment. As previously discussed, temporary periods can be three years or longer for capital projects, or 13 months for working capital financings.

The date the new loan is made is treated as the issue date.

Permitted Yield Spreads of Purpose Investments

Program Investments

Treas. Reg. section 1.148-2(d)(2)(iii) provides that for purpose investments that are program investments, other than student loans, "materially higher" means 1.5 percent.

An issuer may waive the right to treat an investment as a program investment. The investment would then be subject to the 0.125 percent permitted yield spread of other purpose investments. **(See Treas. Reg. section 1.148-1(b) for the definition of program and purpose investments.)**

Tax-Exempt Bonds That are NOT Investment Property

Treas. Reg. section 1.148-2(d)(2)(v) provides that for investments that are tax-exempt bonds and are not investment property under IRC section 148(b)(3), no yield limitation applies.

Example

County A issues a bond issue which properly qualifies as a pooled financing. The proceeds are loaned to Cities B, C, and D. Cities B, C, and D each treat their own loans as tax-exempt obligations under IRC section 103. County A and each of the Cities file their own Form 8038-G. County A is the bondholder for the obligations of Cities B, C, and D. As bondholder, County A has made investments in tax-exempt non-AMT bonds. IRC section 148(b)(3)(A) provides that tax-exempt non-AMT bonds are not investment property. Therefore, there is no limit on the yield that County A can earn on these bonds. The investments are not subject to yield restriction. (Remember that as purpose investments, the loans are not subject to the rebate requirements either.)

Note

Most conduit loans are NOT tax-exempt because Form 8038 was not filed or for other reasons. Thus, generally the yield restriction rules will apply.

Continued on next page

All Other Purpose Investments

Treas. Reg. section 1.148-2(d)(2)(i) provides generally that for all other purpose and nonpurpose investments “materially higher” means 0.125 percent.

Example

County A issues $8M of five-year bonds at 3 percent. The proceeds are loaned to Corporations X, Y, and Z at a rate of 3.125 percent.

If County A’s loans to the corporations are purpose investments, then after the temporary period ends, the proceeds may earn no more than 0.125 percent above the bond yield.

Yield Reduction Payments

Introduction

Issuers of pooled financing bonds and conduit borrowers can reduce the yield on their **nonpurpose investments** by making yield reduction payments in accordance with Treas. Reg. section 1.148-5(c). These payments include rebate payments.

Why Yield Reduction Payments are Made in Pooled Financings

Generally, the only time that yield reduction payments would be made is if the pooled financing issuer still had proceeds on hand after the end of the six-month or the two-year temporary period that were invested above the spread allowed by the yield restriction rules. The yield reduction payment would allow the issuer to comply with the yield restriction requirements after the end of the temporary period.

Conduit borrowers can also make these payments if the borrowed proceeds were NOT spent within the appropriate temporary period, i.e. the three-year temporary period. The yield reduction payments will bring the yield of the bonds down to the permitted level.

Manner of Payment

Generally, yield reduction payments are made at the same time and manner as rebate payments, however yield reduction payments MUST be made on or before any rebate payment.

Nonpurpose Investments

Treas. Reg. section 1.148-5(c) applies to nonpurpose investments of bond proceeds that qualified for the:

- three-year or five-year temporary period available for capital projects under Treas. Reg. section 1.148-2(e)(2),
- 13-month temporary period for working capital financings under Treas. Reg. section 1.148-2(e)(3),
- six-month or two-year temporary period ONLY applicable to pooled financing issues under Treas. Reg. section 1.148-2(e)(4), AND
- one-year temporary period for investment proceeds under Treas. Reg. section 1.148-2(e)(6).

Violating the yield restriction rules causes pooled bonds to be taxable.

Continued on next page

Yield Reduction Payments Are Inapplicable to Most Purpose Investments

Issuers of pooled bonds have to be aware of yield restrictions imposed on purpose investments, i.e. the loans to the conduit borrowers. Treas. Reg. section 1.148-2(a) imposes a general restriction that investments (both purpose and nonpurpose) can't have a yield greater than 0.125 percent above the bond yield. Yield reduction payments CANNOT be made to reduce the yield on **purpose** investments, unless the purpose investments are allocable to qualified student loans. (**See Treas. Reg. section 1.148-5(c)(3).)**

Example

Assume that an issue of pooled bonds qualifies for the six-month temporary period at the pool level and the three-year temporary period at the conduit borrower level. The project fund is not depleted within the three-year period, and is invested at a yield in excess of the bond yield. A yield reduction payment may be needed to prevent the bonds from being arbitrage bonds. An overpayment of rebate at the initial computation date could count as both a rebate payment and a yield reduction payment.

Section 4

Elements of Yield Computation

Overview

Introduction

The pool issuer is required to compute the yield on the pool issue and all purpose and nonpurpose investments that are made with the bond proceeds.

The yield of the pool issue is needed in order to determine the basis for the yield restriction rules and rebate requirements.

The yields of the purpose and nonpurpose investments are computed and compared to the pool issue yield to verify that the limits on yield restriction have not been exceeded.

This section discusses the computation of yield on the pool issue and the purpose investments. The computation of yield of nonpurpose investments is the same as for other types of bond issues.

The multipurpose issue allocation rules play a big part in the yield computation of the pooled financing issue and certain purpose investments.

In this Section

This section contains the following topics:

Multipurpose Issue Allocation Rules

Introduction

The 1993 final regulations (T.D. 8476) permit the application of the multipurpose issue rules to divide certain pooled issues for yield calculation purposes.

"Multipurpose issue" means an issue the proceeds of which are used for two or more separate purposes determined in accordance with Treas. Reg. section 1.148-9(h). Generally, for purposes of IRC section 148, the multipurpose rules of Treas. Reg. section 1.148-9(h) provide that a portion of bonds reasonably allocated to a separate purposes is treated as a separate issue.

In general, Treas. Reg. section 1.148-9(h)(3) provides that separate purposes include:

- refunding a separate prior issue,
- financing a separate purpose investment,
- financing a construction issue, AND
- any clearly discrete governmental purpose reasonably expected to be financed by that issue.

Since pooled financing issues fund separate purpose investments, these rules may be applied to them. This will be discussed later in this section.

Computation of yield on the pool issue differs depending on whether or not the conduit loans are tax-exempt bonds.

Computation of Yield on the Pool Issue

General Rule (Conduit Loans are NOT Tax-Exempt Bonds)

Treas. Reg. section 1.148-9(h)(1) generally provides that *"…the portion of the bonds of a multipurpose issue reasonably allocated to any separate purpose under this paragraph (h) is treated as a separate issue for purposes of IRC section 148…"*, except when determining:

- arbitrage yield,
- rebate amount,
- minor portion, AND
- the portion of an issue eligible for investment in higher yielding investments as part of a reasonably required reserve or replacement fund.

Therefore, when computing the yield on a pooled financing issue, all of the bonds, **(unless the loans qualify as tax-exempt bonds)** even though allocated to separate purposes, are treated as a **single issue.**

Example

County A issues $50M principal amount of bonds and loans the proceeds to Hospitals X, Y, and Z. The loans to the hospitals are not tax-exempt bonds. Therefore, when County A determines the yield on the pool issue, it will treat all of the bonds in the pool issue as a single issue, computing one single yield for the pool issue.

The issuer will then determine the yield on each purpose investment (conduit loan.) The issuer must not earn more than 0.125 percent (unless they are program investments) above the bond yield on the purpose investments.

Any nonpurpose investments (except for those in non-AMT tax-exempt bonds) that are made by the **issuer** prior to loaning the proceeds to the conduit borrowers (and after the expiration of the temporary period) must also be yield restricted to no more than 0.125 percent above the pool bond yield.

Any nonpurpose investments made by the **conduit borrower** after expiration of the temporary period must also be yield restricted based on the yield of the pool issue.

Continued on next page

Conduit Loans are Tax-Exempt Bonds

If the conduit loans are tax-exempt bonds, then, according to Treas. Reg. section 1.148-9(h)(1)(i), the yield on the pool issue is determined by treating the bonds allocated to separate purposes as separate issues.

Example

County A issues $50M principal amount of bonds, and loans the proceeds to Cities B, C, and D. Each city files Form 8038-G treating its note to the county as a tax-exempt bond. When County A computes the yield on the pool issue, it will allocate the bonds of the pool issue to each separate note. Therefore, the pool issue will have three separate yields - each corresponding to a note. **(See Treas. Reg. section 1.148-9(h)(4)(iii) for the safe harbor for allocations of bonds used to finance separate purpose investments.)**

According to Treas. Reg. section 1.148-4(a), the yield on an issue that would be a purpose investment (absent IRC section 148(b)(3)(A)) is equal to the yield on the **conduit financing issue** that financed that purpose investment.

Treas. Reg. section 1.150-1(b) provides that a **conduit financing issue** means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Therefore, all nonpurpose investments made by the issuer and the conduit borrowers will be subject to yield restriction based on the yield of the applicable portion of the pool issue.

For example, if the allocated yields of the pool are six percent, but the actual yields on the notes are seven percent, the issuer and the conduit borrowers can only invest in **nonpurpose investments** yielding no more than 6.125 percent. (The notes to the cities are non-AMT bonds and not investment property, so the pool issuer is not required to yield restrict the notes themselves. Also, as purpose investments, they are not subject to rebate.)

Computation of Yield on Purpose Investments

Introduction

In a pooled financing, the issuer loans the bond proceeds to two or more conduit borrowers. Except for loans to other governmental entities that are not investment property under IRC section 148(b)(3), the yields on these purpose investments must be within the limits set forth in Treas. Reg. section 1.148-2(d).

Specifically, to comply with the yield restriction rules, the interest earned by the issuer on the loans, (if they are investment property) must be within the permitted yield spread. Note that temporary periods do not apply to purpose investments.

Remember that under IRC section 148(f)(4)(A), purpose investments are NOT subject to rebate.

Therefore, the issuer must treat each loan as a purpose (or program) investment and compute the yield on each loan. In computing the yield, the issuer must follow the specific rules outlined for purpose (or program) investments that are set forth in Treas. Reg. section 1.148-5.

These rules have been presented in Module C of this text. However, because of their specific application to pooled financings, some of these rules will be repeated in this module. This section presents a basic computation of loan yield.

Continued on next page

Basic Computation of Loan Yield

Treas. Reg. section 1.148-5(b)(1) provides that, in general, the yield on an investment is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. (Remember that yield reduction payments generally cannot be used to reduce the yield on purpose investments.)

Treas. Reg. section 1.148-5(b)(1) further provides that:

- Payments are amounts to be actually or constructively paid to acquire the investment.
- Receipts are amounts to be actually or constructively received from the investment, such as earnings and return of principal.
- Payments made by the conduit borrower are not treated as paid until the conduit borrower ceases to receive the benefit of earnings on those amounts.

Qualified Administrative Costs

Treas. Reg. section 1.148-5(e)(3)(i) provides that when computing the yield on a purpose investment, qualified administrative costs paid by the conduit borrower are taken into account. Thus, these costs increase the payments for, or decrease the receipts from, the purpose investments. This rule is applied even if the payments from the conduit borrower merely reimburse the issuer.

In other words, the issuer can recover qualified administrative costs from the conduit borrower, in addition to earning interest (to the extent of the permitted spread) on the loan itself.

Treas. Reg. section 1.148-5(e)(3)(ii)(A) provides that qualified administrative costs of purpose investments include:

- Costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment, AND
- Costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

Continued on next page

Qualified Administrative Costs for Program Investments

Treas. Reg. section 1.148-5(e)(3)(ii)(B) provides that for program investments, qualified administrative costs include only costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

Administrative costs of the investment itself are **NOT** included.

Therefore, if the conduit borrower pays these nonqualified costs, then the issuer must consider these amounts as part of the earnings allowed by the permitted spread.

As stated in Section 3, in the discussion about permitted yield spreads, an issuer may waive the treatment of an investment as a program investment. Although the investment would be subject to the 0.125 percent permitted yield spread, administrative costs of the investment itself, if paid by the conduit borrower, would be taken into account when computing the yield on the investment.

Continued on next page

Example of Accounting for Qualified Administrative Costs in the Yield Computation of Conduit Loans That are NOT Tax-Exempt Bonds

County X issues $10,500,000 ten-year bonds at 5% which qualify as a pooled financing. The arrangement requires County X to pay $500,000 of issuance costs, but the county will be reimbursed by Corporations Y and Z, the conduit borrowers. After these costs are paid, the proceeds of the bonds are split equally and loaned to Corporations Y and Z, both of which are 501(c)(3) organizations. Both loans meet the definition of a program investment under Treas. Reg. section 1.148-1(b).

The yield on the pooled financing bonds is 4.99999 percent. (**See Figure H-1.)** Remember that under Treas. Reg. section 1.148-9(h) even though this is a multipurpose issue, the bonds of the pool issue do not have to be allocated when computing the yield because the loans to Y and Z are not tax exempt bonds.

When computing the yield of the purpose investments, because they are both program investments, Treas. Reg. section 1.148-5(b)(2)(ii) permits the investments to be treated as a single investment. A portion of principal will be repaid each year along with five percent of the interest on the outstanding principal. Corporations Y and Z will each pay $725,819 as a loan repayment each year for ten years. This payment is broken down as follows:

Purpose	Amount	
Principal and interest on loan of $5M	$ 1,387,078	($693,539 x 2)
Reimbursement of Issuance Costs	64,560	(32,280 x 2)
Total payment	$ 1,451,638	($725,819 x 2)

Figure H-2 shows that the yield on each of the investments is equal to 7.42144 percent.

According to Treas. Reg. section 1.148-2(d)(2)(iii) the yield on program investments cannot exceed the bond yield by more than 1.5 percentage points. The yield on these investments exceeds the bond yield by 2.42145 percent (7.42144-4.99999.)

However, Treas. Reg. sections 1.148-5(e)(3)(i) and (ii)(B) provide that the reimbursement of issuance costs is taken into account when computing the yield on the investment, by increasing the payments or decreasing the receipts. Therefore, if each receipt is reduced by $64,560 (amount for issuance costs), then the yield becomes 6.43899, which is within the permitted spread (4.99999 + 1.5 = 6.49999.) **(See Figure H-3.)**

Continued on next page

Caution!

Note that this example is NOT illustrating the waiver of the 1.5 percent permitted spread to allow the issuer to deduct loan costs. This example illustrates the deduction of issuance costs not loan costs. The issuer is permitted to take issuance costs into account when computing the investment yield without waiving the 1.5 percent spread.

Figure H-1:

Bond Yield Computation
Issue Date: 1/1/1998 Issue Price: $10,500,000 1 compounding interval
Yield: 4.999999

Payment Date	Debt Service Payments	Present Value
1-1-1999	$1,359,798.03	$1,295,045.76
1-1-2000	1,359,798.03	1,233,376.92
1-1-2001	1,359,798.03	1,174,644.70
1-1-2002	1,359,798.03	1,118,709.25
1-1-2003	1,359,798.03	1,065,437.39
1-1-2004	1,359,798.03	1,014,702.28
1-1-2005	1,359,798.03	966,383.14
1-1-2006	1,359,798.03	920,364.90
1-1-2007	1,359,798.03	876,538.01
1-1-2008	1,359,798.03	834,798.11
	$13,597,980.00	$10,500,000.45

Continued on next page

Figure H-2:

Loan Yield Computation

Loan Date: 1/1/1998 Loan Amount: $10,000,000 1 compounding interval

Yield: 7.42144

Payment Date	Gross Loan Receipts	Present Value
1-1-1999	$ 1,451,638.00	$ 1,351,348.42
1-1-2000	1,451,638.00	1,257,987.56
1-1-2001	1,451,638.00	1,171,076.75
1-1-2002	1,451,638.00	1,090,170.35
1-1-2003	1,451,638.00	1,014,853.56
1-1-2004	1,451,638.00	944,740.18
1-1-2005	1,451,638.00	879,470.75
1-1-2006	1,451,638.00	818,710.59
1-1-2007	1,451,638.00	762,148.18
1-1-2008	1,451,638.00	709,493.51
	$ 14,516,380.00	$ 9,999,999.86

Figure H-3:

Loan Yield Computation

Loan Date: 1/1/1998 Loan Amount: $10,000,000 1 compounding interval

Yield: 6.43899

Payment Date	Net Loan Receipts	Present Value
1-1-1999	$ 1,387,078.02	$ 1,303,167.23
1-1-2000	1,387,078.02	1,224,332.59
1-1-2001	1,387,078.02	1,150,267.02
1-1-2002	1,387,078.02	1,080,682.02
1-1-2003	1,387,078.02	1,015,306.55
1-1-2004	1,387,078.02	953,885.93
1-1-2005	1,387,078.02	896,180.94
1-1-2006	1,387,078.02	841,966.79
1-1-2007	1,387,078.02	791,032.31
1-1-2008	1,387,078.02	743,179.09
	$ 13,870,780.02	$10,000,000.47

Yield Blending for Yield Restriction Purposes

General Rules

Treas. Reg. section 1.148-5(b)(2)(i) provides that yield is computed separately for each class of investments. This regulation further provides that the yield on each individual investment within the class is blended with the yield on other individual investments within the class by treating those investments as a single investment.

Program Investments

The yields on program investments can be blended for purposes of the yield restriction rules.

Tax-Exempt Bonds

Investments in some tax-exempt bonds are not subject to yield restriction because they are not considered "investment property." **(See IRC section 148(a)(3).)**

All Other Purpose Investments

The yields on all other purpose investments, excluding certain tax-exempt bonds, can be blended for purposes of the yield restriction rules.

Multipurpose Issue Rules

Treas. Reg. section 1.148-9(h) specifically provides that a pooled bond issue used for separate purposes (i.e. making separate conduit loans) is treated as **one** bond issue for yield restriction and rebate purposes.

The only exception to this is if all of the loans are tax-exempt loans. There is no yield restriction on these loans, (if they are not investment property under IRC section 148(b)(3)), and Treas. Reg. section 1.148-9(h)(1)(i) allows a separate yield on each loan. **(See also Treas. Reg. section 1.148-9(h)(4)(iii).)**

Section 5

Rebate Rules

Overview

Introduction

Special rules apply for calculating the amount of rebate due **for nonpurpose investments** of proceeds of pooled bonds made by the issuer and conduit borrowers.

Treas. Reg. section 1.148-9(h) provides that pooled bonds are treated as a single issue for purposes of determining rebate, even though the proceeds are being used for separate purposes.

The only exception to this is if all of the loans are tax-exempt bonds, then the pooled bond issue can be divided into separate issues with each issue being that portion of the bonds reasonably allocated to the conduit loan. In these cases, for rebate purposes, the yield on the loan is equal to the yield on that portion of the financing issue allocated to the loan. **(See Treas. Reg. section 1.148-4(a).)** Treas. Reg. section 1.148-9(h)(4)(iii) states that the allocation is generally reasonable if the principal and interest payments of the allocated portion of the bonds and the interest and principal payments of the loans reasonably coincide as to time and amount.

Yield Blending

For rebate purposes, the nonpurpose investments of all of the proceeds of the pooled financing issue are blended unless all of the loans are tax-exempt loans.

Co-ordination

Typically, the pooled bond issuer will require that all of the conduit borrowers use the same trustee for purposes of receipts and expenditures. This eliminates the problems with different bookkeeping methods.

Continued on next page

Options When Applying Spending Exceptions

The spending exceptions to rebate may be applied to the issue as a whole, or IF ELECTED, they may be applied separately to each loan.

Electing Separate Treatment

If the issuer elects to apply the spending exceptions separately, then:

- the spending exceptions are applied separately to each conduit loan,
- the applicable spending requirements for a loan begin on the earlier of:
  - the date the loan is made, or
  - the first day following the one-year period beginning on the issue date of the pooled bond issue **(See Treas. Reg. section 1.148-7(b)(6)(ii)(A)),**
- the proceeds are subject to rebate at the issuer level prior to the date on which the spending requirements for those proceeds begin **(See Treas. Reg. section 1.148-7(b)(6)(ii)(A)), AND**
- the entire pooled financing issue will be arbitrage bonds if **any one** of the loans fail to meet the rebate requirement. (This means that the loan can fail to meet the spending exception, as long as the rebate is paid.)

Each of the exceptions to rebate is discussed in this section.

Making the Elections

According to Treas. Reg. section 1.148-1(d), the elections must be made in writing on or before the issue date. They should be kept with the bond documents, but do NOT have to be attached to Form 8038.

Once made, the elections may not be revoked without the permission of the Commissioner. **(See Treas. Reg. section 1.148-1(d).)**

Continued on next page

In this Section

This section contains the following topics:

Six-Month Spending Exception to Rebate

Treatment of <u>Conduit Loan Proceeds</u> When Election is Made to Treat Each Loan Separately

If the issuer makes the election under Treas. Reg. section 1.148-7(b)(6)(ii) to treat each loan separately, and none of the other rebate exceptions apply to a loan, then the borrower must expend all of the gross proceeds (as defined in Treas. Reg. section 1.148-7(c)(3)) within six months of whichever is earlier:

- the loan date, or
- the first day following the one-year period beginning on the issue date of the pooled bonds.

(See Treas. Reg. section 1.148-7(b)(6)(ii).)

Treatment of <u>Bond Proceeds Prior to Loan</u> When Election is Made to Treat Each Loan Separately

If the election is made to treat each loan separately, Treas. Reg. section 1.148-7(b)(6)(ii) provides that none of the spending exceptions are available for gross proceeds of the pooled financing issue prior to the date on which the spending requirements begin for the conduit loans.

Therefore, the bond proceeds are subject to rebate in the hands of the issuer prior to the loan date(s).

Treatment of Bond Proceeds When Election is NOT Made

If the issuer does NOT make the election to treat each loan separately, then the spending exceptions apply to the pooled financing issue as a whole. **(See Treas. Reg. section 1.148-7(b)(6)(i).)**

This means that the applicable period for the spending requirements begins on the issuance date of the bonds, regardless of the loan date(s).

Two-Year Spending Exception to Rebate

Introduction

The two-year spending exception is obviously the most liberal of the spending exceptions. Therefore, if any of the proceeds of an issue are to be used for construction expenditures, then the issuer will want to try to meet this exception.

Recall from Phase I that generally in order to be a construction issue, an issuer must reasonably expect that at least 75 percent of the available construction proceeds ("ACP") will be used for construction expenditures.

This spending exception can be met by the pooled issue in various ways:

- If **more than 75 percent** of the available construction proceeds will be used for construction expenditures AND the issue is treated as a whole,
- If the issuer elects to apply the spending exceptions separately to each loan and one or more of the loans qualifies as a construction issue, OR
- If **any** of the proceeds of the **issue** will be used for construction, the issuer can elect on or before the issue date to bifurcate the issue into two (and only two) separate issues, with one issue being a construction issue.
- If **any** of the proceeds of a **loan** will be used for construction, the issuer can elect on or before the issue date to bifurcate the **loan** into two separate issues, with one being a construction issue. (The issuer would also have to make the election under Treas. Reg. section 1.148-7(b)(6)(ii) to apply the spending exceptions separately to each loan.)

Each of these options is discussed below.

Treating the Issue as a Whole

Assume that a conduit financing issuer issues bonds reasonably intending to loan the proceeds to Borrowers X and Y, neither of which is a governmental entity. Conduit Borrower X expects to use 100 percent of its loan for construction expenditures, and Borrower Y expects to use 50 percent of its loan for construction expenditures. Since at least 75 percent of the proceeds are expected to be used for construction, the entire issue is a construction issue that can use the two-year spending exception. Neither the election under Treas. Reg. section 1.148-7(b)(6)(ii) nor the election under Treas. Reg. section 1.148-7(j) needs to be made. The spending periods begin on the issuance date of the bonds, (as does the three-year temporary period).

Continued on next page

Applying the Spending Exceptions Separately to Each Loan

When the election under Treas. Reg. section 1.148-7(b)(6)(ii) is made to apply the spending exceptions separately to each loan, the two-year spending exception can apply to any one or all loans, as long as the loan(s) meet(s) the definition of a construction issue.

The proceeds while in the hands of the issuer, prior to the loan date, are subject to rebate. No rebate exception is available for these proceeds.

Continued on next page

Bifurcation of Issue into Construction/ Nonconstruction Issues

If any portion of a pooled bond issue qualifies as a construction issue, Treas. Reg. section 1.148-7(j)(1) provides that an issuer may elect to treat a portion of an issue that is not a refunding issue as two (and only two) separate issues if:

- one of the separate issues is a construction issue as defined in Treas. Reg. section 1.148-7(f),
- the issuer reasonably expects, as of the issue date, that this construction issue will finance all of the construction expenditures to be financed by the issue, AND
- the issuer makes an election to apportion the issue by identifying the amount of the issue price of the issue allocable to the construction issue.

Separating an issue into a construction and a non-construction issue in this manner is referred to as "**bifurcating**" the issue. There are two reasons why an issuer may want to elect to bifurcate an issue:

- to allow the issuer to use of the two-year spending exception to rebate for the part of the issue used for construction financing, OR
- to allow the issuer to elect to pay the one and one-half percent penalty in lieu of rebate for the construction issue.

Example

County A loans proceeds to Borrowers X and Y. Borrower X expects to use 100 percent of its available construction proceeds for construction expenditures, while Borrower Y expects to use 50 percent of available construction proceeds for construction expenditures. Assume that the issuer suspects that Borrower Y may be slow to spend its proceeds and may jeopardize the issue meeting the spending requirements of the two-year spending exception. So County A decides to bifurcate the entire issue. Borrower X's loan is the construction issue, while Borrower Y's loan is the non-construction issue.

The spending requirements begin on the issuance date. Borrower Y is precluded from using the eighteen-month exception because of Treas. Reg. section 1.148-7(d)(4). (More on this later.)

Continued on next page

Note that the bifurcation election applies to traditional bond issues as well as pooled financing issues.

Note About **Example**:

The same result could be obtained if the issuer made the election to treat each loan separately. However, the spending requirement would begin on the loan date and there would be no rebate exception available to the issuer prior to the loan date. The nonconstruction issue could use the eighteen-month exception if the spending requirements were met.

If bifurcated, the spending requirements begin on the issue date, and if met, the issuer can earn arbitrage and keep it. The eighteen-month spending exception is unavailable to the nonconstruction issue.

Bifurcation of a Loan into Construction and Non-construction Issues

If the issuer wants the two-year construction exception to apply only to a portion of a loan, the issuer must first make the election under Treas. Reg. section 1.148-7(b)(6)(ii). In that event, the issuer must expect that at least 75 percent of the portion designated as the construction issue will be used for construction expenditures.

Lets look at the example on Page H-51 again.

Example

County A loans proceeds to Borrowers X and Y. Borrower X expects to use 100 percent of its available construction proceeds for construction expenditures, while Borrower Y expects to use 50 percent of available construction proceeds for construction expenditures.

County A first makes the election under Treas. Reg. 1.148-7(b)(6)(ii) to apply the spending exceptions separately to each loan. The two-year construction exception is now available to both Borrowers. Borrower Y's loan cannot meet the definition of a construction issue because at least 75% of ACP will not be allocated to construction expenditures. Therefore only the eighteen-month and six-month exceptions are available to Borrower Y.

Continued on next page

The issuer then makes the election under Treas. Reg. section 1.148-7(j)(1) to bifurcate Y's loan into two separate issues – one construction issue and one nonconstruction issue. The deemed construction issue consists of the 50% proceeds expected to be used for construction, thus meeting the definition of a construction issue. This portion can use any of the spending exceptions, as long as the requirements are met.

The nonconstruction issue consists of the other 50% not expected to be used for construction expenditures. This deemed issue cannot use the eighteen-month spending exception even if spending requirements are met. It cannot use the two-year exception because it is the "deemed nonconstruction issue". Therefore, the only spending exception available to it is the six-month spending exception.

Arbitrage Considerations

If the entire issue is a construction issue, and the spending requirements are met by the conduit borrower (or borrowers), the issuer not only is able to invest above the bond yield, but because of the two-year spending exception, is able to keep the arbitrage earned, rather than rebating it to the government.

On the other hand, if the issuer elects to apply the spending exceptions separately to each loan, and the loans qualify as construction issues, the two-year temporary period applies at the issuer level, but the spending exceptions to rebate only apply at the conduit borrower's level. **(See Treas. Reg. section 1.148-7(b)(6)(ii).)**

If the entire issue is a construction issue, the issuer will have an economic advantage if the issuer holds the proceeds until they are ready to be spent by the borrower according to the two-year expenditure schedule.

On the other hand, if the individual loans are construction issues subject to the two-year spending exception, then the conduit borrower will not be subject to yield restriction for the period it holds the bond proceeds (the remaining portion of the three-year period) and will not be subject to rebate (or payment of a penalty) if the spending exceptions are met. Note that the two-year spending exception starts when the loan is made, but not later than one year after the date of the issue **(See Treas. Reg. section 1.148-7(b)(6)(ii)),** so that the conduit borrower will not end up with a two-year expenditure schedule that goes beyond the three-year temporary period.

Continued on next page

Arbitrage Considerations, continued

Example

Authority H issues a pooled bond issue on January 1, 1998, and reasonably expects to make loans to Cities A, B, and C. It does not reasonably expect that more than 75 percent of the proceeds of the issue will be used for construction expenditures. Thus, the entire issue cannot be a construction issue. Nevertheless, H elects (under Treas. Reg. section 1.148-7(b)(6)(ii)) to apply the spending exceptions on a loan by loan basis. Also A expects that 50 percent of the expenditures of its loan from H will be for construction. Thus, on the day the loan is made to A, H elects (under Treas. Reg. section 1.148-7(j)) to treat 50 percent of the loan to A as a separate construction issue. B expects that more than 75 percent of its loan will be used for construction expenditures. C does not expect that any of its loan will be used for construction activity. The loans to A, B, and C are made on February 1, 1998, March 1, 1998, and March 1, 1999 respectively. Since some portion of the issue will be used for construction purposes, the issuer has a two-year temporary period for all proceeds of the entire issue. A will have 35 months, B will have 34 months, and C will have 22 months of the three-year temporary period. Nevertheless, rebate will be owed by H for non-purpose investments of bond proceeds prior to when the loans were made to A, B, or C, as well as for non-purpose investments of any amounts loaned to A, B, or C that do not meet one of the spending exceptions.

Eighteen-Month Spending Exception to Rebate

Treatment of <u>Loan Proceeds</u> When Election is Made to Treat Each Loan Separately

Making the election under Treas. Reg. section 1.148-7(b)(6)(ii) allows conduit borrowers to use any of the spending exceptions that apply to them.

However, Treas. Reg. section 1.148-7(d)(4) prohibits the use of the eighteen-month exception when the two-year exception is used for another portion of the same issue.

Treatment of <u>Bond Proceeds</u> Prior to Loan When Election is Made to Treat Each Loan Separately

Treas. Reg. section 1.148-7(b)(6)(ii) specifically provides that none of the spending exceptions are available for gross proceeds of the pooled financing issue prior to the date on which the spending requirements begin for conduit loans.

Therefore, the bond proceeds are subject to rebate in the hands of the issuer prior to the loan date.

Treatment of Bond Proceeds When the Election is NOT Made

When the election is NOT made, the spending exceptions apply to the pooled financing issue as a whole.

The applicable periods for the spending requirements begin on the issuance date of the bonds.

Small Issuer Exception to Rebate

Applicability to the Pool Issuer

The small issuer exception from rebate under IRC section 148(f)(4)(D) and Treas. Reg. section 1.148-8 is NOT available to the issuer at the pool level. **(See Treas. Reg. section 1.148-8(d).)**

Treatment of Issue

Treas. Reg. section 1.148-8(d)(1) provides that the pooled financing issue is NOT counted toward the $5M size limitation of the issuer for purposes of applying the small issuer exception to its other issues if the:

- issuer is NOT an ultimate borrower in the financing, AND
- conduit borrowers are governmental units with general taxing powers and not subordinate to the issuer.

The issuer of the pooled financing issue is subject to the rebate requirement for any unloaned gross proceeds.

Treatment of Conduit Borrower

Treas. Reg. section 1.148-8(d)(2) provides that a loan to a conduit borrower in a pooled financing issue qualifies for the small issuer exception, regardless of the size of the either the pooled financing or of any loan to other conduit borrowers, if:

- the bonds of the pooled financing are not private activity bonds,
- none of the loans to conduit borrowers are private activity bonds, AND
- the loan to the conduit borrower meets all the requirements of the small issuer exception.

Continued on next page

Example

On June 1, 1998 County G issues $15M in bonds which qualifies as a pooled financing issue. On August 1, 1998 all of the proceeds of the bonds are loaned to Cities A, B, and C in amounts of $5M each. All of the bonds in the pool are governmental bonds. None of the loans to Cities A, B, and C are private activity bonds on the issuance date. Cities A and B have not and do not reasonably expect to issue any other governmental bonds during 1998. Cities A and B can qualify for the small issuer exception as long as each loan meets all of the requirements of the small issuer exception. The size of the pool issue ($15M) does not disqualify the individual cities from meeting the exception.

City C has not and does not reasonably expect to issue any other governmental bonds during 1998. However, Authority X, which is subordinate to City C, expects to issue $5M of bonds in September 1998. Because Authority X is subordinate to City C, any bonds that it expects to issue are attributed to City C. Therefore, City C does not qualify for the small issuer exception to rebate. However, City C’s failure to qualify for the exception does not affect the ability of Cities A and B to qualify for it. Each loan is treated separately.

The small issuer exception to rebate begins for Cities A and B on the loan date of August 1, 1998. The small issuer exception does not apply to County G as the issuer. Therefore, any earnings above the bond yield from June 1 to August 1, 1998 must be rebated to the United States.

City C will have to rely on one of the spending exceptions to rebate.

Rebate Computation

Introduction

The issuer is responsible for computing and paying the amount of rebate due.

All of the nonpurpose investments are included in the rebate computation. This includes investments of the issuer prior to loaning the proceeds as well as investments of the conduit borrowers after receipt and before expenditure of the loan proceeds.

Appropriate Yield When Loans are Tax-Exempt

According to Treas. Reg. section 1.148-9(h)(1)(ii), if the loans are tax-exempt obligations, then the portion of the bonds allocated to each loan is treated as a separate issue for yield and rebate purposes. Treas. Reg. section 1.148-9(h)(4)(iii) requires that the interest and principal payments of the loan coincide in time and amount to the principal and interest payments of the deemed issue. Treas. Reg. section 1.148-4(a) provides that the yield on tax-exempt loans is the yield on the portion of the bond issue allocated to the loan.

Appropriate Yield When Loans Are NOT Tax-Exempt

If all of the loans are NOT tax-exempt loans, the yield on the pool issue is used. The non-purpose investments are grouped by class. **(See Treas. Reg. section 1.148-5(b).)**

Comprehensive Example

Facts:

On January 1, 1998, County K issues $10M of 10-year bonds. The bonds are sold at par. Principal and interest payments are made on January 1 and July 1st of each year. After payment of $600,000 in issuance costs, $9.4M is available for loans to conduit borrowers. The yield on the bonds is 6.88642 percent as shown in Table H-K-1.

On January 1, 1998, County K elects to apply the spending exceptions separately to each loan under Treas. Reg. section 1.148-7(b)(6)(ii) by including a statement to this effect in its arbitrage certificate.

On February 1, 1998, County K loans $4.7M to Hospital X. Hospital X plans to use the loan proceeds to build a new cardiac rehabilitation center. Hospital X agrees to reimburse County K for $300,000 of issuance costs (in 20 equal payments), plus annual loan servicing expenses of $500. Adding these costs to the semi-annual principal and interest payment of $328,900, Hospital X's total semi-annual loan payment will equal $344,150.

On April 1, 1998, County K loans $4.7M to Hospital Y. Hospital Y plans to use the loan proceeds to purchase new equipment for the hospital. Hospital Y agrees to reimburse County K for $300,000 of issuance costs (in 20 equal payments). Hospital Y's total semi-annual loan payment will be $340,119 ($325,119 plus $15,000 for issuance costs.)

See attached schedules for investment activity, yield computations, and rebate computation.

Required:

1. Determine if County K, Hospital X, and Hospital Y have complied with the appropriate yield restriction rules.
2. Determine if there is any rebate due for County K.

Continued on next page

Resolution: The following steps should be taken to determine compliance with the arbitrage rules.

Step	Action
1	Verify that the issue is a pooled financing issue under Treas. Reg. section 1.150-1(c).
2	Determine if the issue is a pooled financing issue under IRC section 149(f)(4). If so, does it meet the pooled financing bond requirements?
3	Determine the yield on the bond issue (or issues.)
4	Isolate the proceeds that are subject to yield restriction. Include proceeds while in the hands of the issuer, as well as loan proceeds under the control of the conduit borrowers.
5	Determine the appropriate temporary periods for the proceeds subject to yield restriction.
6	Analyze the cash activity to determine if any proceeds remained unspent after the expiration of the temporary period. (Remember that proceeds are not considered spent until spent by the borrower.)
7	Compute the yield on the non-purpose and purpose investments, as necessary.
8	If the yield on investments is above the permitted spread, determine if yield reduction payments can be (and were) properly made. (If the bonds did not comply with yield restriction rules, the bonds are arbitrage bonds.)
9	Obtain documentation for any elections regarding rebate that were made by the issuer.
10	Based on the elections (or lack of), determine if the issue(s) met an exception to rebate.
11	Compute rebate on any non-purpose investments for which an exception was not met using the yield on the pool issue.

Continued on next page

TABLE H-K-1: YIELD OF POOL ISSUE

LOAN AMOUNT	$10,000,000.00
ISSUE DATE	1/1/1998
COMP INTERVALS	2
YIELD	6.88642 %

DATE	DEBT SERVICE	PRESENT VALUE	DAYS
7/1/1998	700,000.00	676,699.81	180
1/1/1999	700,000.00	654,175.19	360
7/1/1999	700,000.00	632,400.33	540
1/1/2000	700,000.00	611,350.26	720
7/1/2000	700,000.00	591,000.86	900
1/1/2001	700,000.00	571,328.82	1080
7/1/2001	700,000.00	552,311.58	1260
1/1/2002	700,000.00	533,927.34	1440
7/1/2002	700,000.00	516,155.05	1620
1/1/2003	700,000.00	498,974.32	1800
7/1/2003	700,000.00	482,365.47	1980
1/1/2004	700,000.00	466,309.46	2160
7/1/2004	700,000.00	450,787.89	2340
1/1/2005	700,000.00	435,782.97	2520
7/1/2005	700,000.00	421,277.50	2700
1/1/2006	700,000.00	407,254.87	2880
7/1/2006	700,000.00	393,698.99	3060
1/1/2007	700,000.00	380,594.33	3240
7/1/2007	700,000.00	367,925.87	3420
1/1/2008	700,000.00	355,679.10	3600
TOTALS	$14,000,000.00	$10,000,000.00	

Continued on next page

TABLE H-X-1: YIELD OF LOAN TO X (PURPOSE INVESTMENT)

LOAN AMOUNT	$4,700,000.00
ISSUE DATE	2/1/1998
COMP INTERVALS	2
YIELD	7.00640 %

DATE	CASH FLOWS	PRESENT VALUE	DAYS
7/1/1998	328,900.00	319,596.77	150
1/1/1999	328,900.00	308,779.60	330
7/1/1999	328,900.00	298,328.54	510
1/1/2000	328,900.00	288,231.22	690
7/1/2000	328,900.00	278,475.66	870
1/1/2001	328,900.00	269,050.28	1050
7/1/2001	328,900.00	259,943.92	1230
1/1/2002	328,900.00	251,145.77	1410
7/1/2002	328,900.00	242,645.41	1590
1/1/2003	328,900.00	234,432.76	1770
7/1/2003	328,900.00	226,498.07	1950
1/1/2004	328,900.00	218,831.95	2130
7/1/2004	328,900.00	211,425.29	2310
1/1/2005	328,900.00	204,269.32	2490
7/1/2005	328,900.00	197,355.56	2670
1/1/2006	328,900.00	190,675.80	2850
7/1/2006	328,900.00	184,222.13	3030
1/1/2007	328,900.00	177,986.88	3210
7/1/2007	328,900.00	171,962.68	3390
1/1/2008	328,900.00	166,142.38	3570
TOTALS	$6,578,000.00	$4,700,000.00	

Continued on next page

TABLE H-Y-1: YIELD ON LOAN TO Y (PURPOSE INVESTMENT)

LOAN AMOUNT	$4,700,000.00
ISSUE DATE	4/1/1998
COMP INTERVALS	2
YIELD	7.00442%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
7/1/1998	325,119.00	319,571.13	90
1/1/1999	325,119.00	308,757.79	270
7/1/1999	325,119.00	298,310.33	450
1/1/2000	325,119.00	288,216.39	630
7/1/2000	325,119.00	278,464.00	810
1/1/2001	325,119.00	269,041.60	990
7/1/2001	325,119.00	259,938.02	1170
1/1/2002	325,119.00	251,142.49	1350
7/1/2002	325,119.00	242,644.57	1530
1/1/2003	325,119.00	234,434.19	1710
7/1/2003	325,119.00	226,501.63	1890
1/1/2004	325,119.00	218,837.48	2070
7/1/2004	325,119.00	211,432.66	2250
1/1/2005	325,119.00	204,278.41	2430
7/1/2005	325,119.00	197,366.23	2610
1/1/2006	325,119.00	190,687.94	2790
7/1/2006	325,119.00	184,235.62	2970
1/1/2007	325,119.00	178,001.63	3150
7/1/2007	325,119.00	171,978.58	3330
1/1/2008	325,119.00	166,159.33	3510
TOTALS	$6,502,380.00	$4,700,000.00	

Continued on next page

Comprehensive Example, Continued

TABLE H-K-2: SCHEDULE OF CASH ACTIVITY OF COUNTY K

DATE	PURCHASES	EARNINGS	REDEMPTIONS	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
1/1/1998	10,000,000.00				10,000,000.00
2/1/1998		37,000.00	4,700,000.00	4,700,000.00	5,337,000.00
3/1/1998		18,000.00	600,000.00	600,000.00	4,755,000.00
4/1/1998		14,500.00	4,700,000.00	4,700,000.00	69,500.00
7/1/1998		2,300.00			71,800.00
12/31/1998		3,500.00			75,300.00
7/1/1999		3,567.00			78,867.00
12/31/1999		3,500.00			82,367.00
7/1/2000		3,700.00			86,067.00
12/31/2000		3,769.00			89,836.00
7/1/2001		3,800.00			93,636.00
12/31/2001		3,801.00			97,437.00
7/1/2002		3,850.00	5,000.00	5,000.00	96,287.00
12/31/2002		3,700.00			99,987.00
7/1/2003		2,803.00			102,790.00
12/31/2003		3,016.00	99,774.00	105,806.00	-

Continued on next page

TABLE H-K-3: YIELD ON COUNTY K's INVESTMENTS

ISSUE DATE	4/1/1998
COMP INTERVALS	2
YIELD	10.82336%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
7/1/1998	(69,500.00)	(69,500.00)	0
7/1/1998	2,300.00	2,240.18	90
12/31/1998	3,500.00	3,233.96	270
7/1/1999	3,567.00	3,126.66	450
12/31/1999	3,500.00	2,910.43	630
7/1/2000	3,700.00	2,918.79	810
12/31/2000	3,769.00	2,820.58	990
7/1/2001	3,800.00	2,697.78	1170
12/31/2001	3,801.00	2,559.95	1350
7/1/2002	3,850.00	2,459.84	1530
12/31/2002	5,000.00	3,194.59	1530
12/31/2002	3,700.00	2,242.64	1710
12/31/2002	64,500.00	39094.59	1710
	$35,487.00	$0.00	

Continued on next page

TABLE H-X-2: SCHEDULE OF INVESTMENT ACTIVITY OF HOSPITAL X - PROJECT FUND

DATE	PURCHASES	EARNINGS	REDEMPTIONS	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
2/1/1998	4,230,000.00	-	-	-	4,230,000.00
3/1/1998		15,600.00	1,000,000.00	1,000,000.00	3,245,600.00
4/1/1998		16,523.00	500,000.00	500,000.00	2,762,123.00
6/1/1998		14,508.00	500,000.00	500,000.00	2,276,631.00
12/31/1998		11,986.00	500,000.00	500,000.00	1,788,617.00
6/1/1999		10,034.00	750,000.00	750,000.00	1,048,651.00
12/31/1999		7,074.00	1,048,651.00	1,055,725.00	-
6/1/2000		-			-
12/31/2000		-	-		-
6/1/2001		-			-
12/31/2001		-	-		-
6/1/2002		-			-
12/31/2002		-			-
6/1/2003		-			-

TABLE H-X-3: SCHEDULE OF INVESTMENT ACTIVITY IN RESERVE FUND OF HOSPITAL X

2/1/1998	470,000.00				470,000.00
6/1/1998		7,833.00		7,833.00	470,000.00
12/31/1998	400,000.00	1,000.00	400,000.00	1,000.00	470,000.00
6/1/1999	400,000.00	1,300.00	400,000.00	1,300.00	470,000.00
12/31/1999		1,300.00		1,300.00	470,000.00
6/1/2000		1,200.00		1,200.00	470,000.00
12/31/2000		1,400.00		1,400.00	470,000.00
6/1/2001	450,000.00		450,000.00		470,000.00
12/31/2001		1,200.00		1,200.00	470,000.00
6/1/2002		1,375.00		1,375.00	470,000.00
12/31/2002		1,254.00		1,254.00	470,000.00
6/1/2003		1,198.00		1,198.00	470,000.00

Continued on next page

TABLE H-Y-2: SCHEDULE OF INVESTMENT ACTIVITY OF Y'S PROJECT FUND

DATE	PURCHASES	EARNINGS	REDEMPTION	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
4/1/1998	4,230,000.00	-	-	-	4,230,000.00
5/1/1998	1,928,199.00	28,199.00	2,000,000.00	100,000.00	4,158,199.00
6/1/1998	997,899.00	27,899.00	1,000,000.00	30,000.00	4,156,098.00
7/1/1998	2,003,198.00	27,706.00	2,000,000.00	24,508.00	4,159,296.00
12/31/1998	1,733,633.00	138,633.00	1,700,000.00	105,000.00	4,192,929.00
6/1/1999	3,155,000.00	155,000.00	3,000,000.00	-	4,347,929.00
12/31/1999	4,157,000.00	167,000.00	4,000,000.00	10,000.00	4,504,929.00
6/1/2000	3,515,000.00	165,000.00	3,500,000.00	150,000.00	4,519,929.00
12/31/2000	2,152,000.00	172,000.00	2,000,000.00	20,000.00	4,671,929.00
6/1/2001	4,072,000.00	182,000.00	4,000,000.00	110,000.00	4,743,929.00
12/31/2001	4,580,990.00	180,990.00	4,500,000.00	100,000.00	4,824,919.00
6/1/2002	2,570,280.00	180,280.00	2,500,000.00	110,000.00	4,895,199.00
12/31/2002	2,880,495.00	180,495.00	4,700,000.00	2,000,000.00	3,075,694.00
6/1/2003	1,900,000.00	100,000.00	2,800,000.00	1,000,000.00	2,175,694.00
12/31/2003		70,000.00	2,175,694.00	2,245,694.00	-

TABLE H-Y-3: SCHEDULE OF INVESTMENT ACTIVITY IN RESERVE FUND OF HOSPITAL Y

DATE	PURCHASES	EARNINGS	REDEMPTION	PURPOSE DISBURSEMENTS	INVESTMENT BALANCE
4/1/1998			470000.00		470,000.00
6/1/1998		6,100.00		6,100.00	470,000.00
12/31/1998	400,000.00	19,000.00	400,000.00	19,000.00	470,000.00
6/1/1999	400,000.00	19,480.00	400,000.00	19,480.00	470,000.00
12/31/1999		18,975.00		18,975.00	470,000.00
6/1/2000		18,000.00		18,000.00	470,000.00
12/31/2000		17,000.00		17,000.00	470,000.00
6/1/2001	450,000.00	17,500.00	450,000.00	17,500.00	470,000.00
12/31/2001	550,000.00	16,000.00	550,000.00	16,000.00	470,000.00
6/1/2002		16,000.00		16,000.00	470,000.00
12/31/2002		16,000.00		16,000.00	470,000.00
6/1/2003		16,000.00		16,000.00	470,000.00

Continued on next page

TABLE H-Y-4: YIELD ON HOSPITAL Y'S INVESTMENT IN PROJECT FUND

ISSUE DATE	1/1/2001
COMP INTERVALS	2
YIELD	7.58558%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
1/1/2001	(4,671,929.00)	(4,671,929.00)	0
6/1/2001	4,000,000.00	3,877,817.19	150
6/1/2001	182,000.00	176,440.68	150
6/1/2001	(4,072,000.00)	(3,947,617.90)	150
12/31/2001	4,500,000.00	4,177,131.34	360
12/31/2001	180,990.00	168,004.22	360
12/31/2001	(4,580,990.00)	(4,252,310.42)	360
6/1/2002	2,500,000.00	2,249,743.30	510
6/1/2002	180,280.00	162,233.49	510
6/1/2002	(2,570,280.00)	(2,312,988.08)	510
12/31/2002	180,495.00	155,523.64	720
12/31/2002	4,700,000.00	4,049,758.19	720
12/31/2002	(2,880,495.00)	(2,481,980.47)	720
12/31/2002	3,075,694.00	2,650,173.82	1080
	$723,765.00	($0.00)	

Continued on next page

TABLE H-Y-5: COMPUTATION OF YIELD REDUCTION PAYMENT

COMPUTATION DATE	1/1/2003
COMP INTERVALS	2
YIELD	7.01142%

DATE	CASH FLOWS	FUTURE VALUE	DAYS
1/1/2001	(4,671,929.00)	(5,362,329.16)	720
6/1/2001	4,000,000.00	4,461,151.47	570
6/1/2001	182,000.00	202,982.39	570
6/1/2001	(4,072,000.00)	(4,541,452.20)	570
12/31/2001	4,500,000.00	4,821,967.36	361
12/31/2001	180,990.00	193,939.53	361
12/31/2001	(4,580,990.00)	(4,908,752.06)	361
6/1/2002	2,500,000.00	2,602,545.73	210
6/1/2002	180,280.00	187,674.78	210
6/1/2002	(2,570,280.00)	(2,675,708.49)	210
12/31/2002	180,495.00	180,529.55	1
12/31/2002	4,700,000.00	4,700,899.79	1
12/31/2002	(2,880,495.00)	(2,881,046.45)	1
12/31/2002	3,075,694.00	3,076,282.82	1
YRP DUE		**$58,685.06**	

Continued on next page

TABLE H-Y-6: PROOF OF YIELD AFTER YIELD REDUCTION PAYMENT

ISSUE DATE	1/1/2001
COMP INTERVALS	2
YIELD	7.00150%

DATE	CASH FLOWS	PRESENT VALUE	DAYS
1/1/2001	(4,671,929.00)	(4,671,929.00)	0
6/1/2001	4,000,000.00	3,886,933.16	150
6/1/2001	182,000.00	176,855.46	150
6/1/2001	(4,072,000.00)	(3,956,897.96)	150
12/31/2001	4,500,000.00	4,200,737.16	360
12/31/2001	180,990.00	168,953.65	360
12/31/2001	(4,580,990.00)	(4,276,341.10)	360
6/1/2002	2,500,000.00	2,267,775.63	510
6/1/2002	180,280.00	163,533.84	510
6/1/2002	(2,570,280.00)	(2,331,527.34)	510
12/31/2002	180,495.00	157,286.40	720
12/31/2002	4,700,000.00	4,095,659.54	720
12/31/2002	(2,880,495.00)	(2,510,112.09)	720
12/31/2002	3,075,694.00	2,680,211.80	720
12/31/2002	(58,685.06)	(51,139.15)	720
	$665,079.94	($0.00)	

Continued on next page

TABLE H-K-4: REBATE COMPUTATION (Page 1 of 3)

COMPUTATION DATE		1/1/2003	
COMP INTERVALS		2	
YIELD		6.88642%	
DATE	CASH FLOWS	FUTURE VALUE	DAYS
1/1/1998	(10,000,000.00)	(14,028,779.49)	1800
2/1/1998	4,700,000.00	6,556,429.80	1770
2/1/1998	37,000.00	51,614.45	1770
3/1/1998	600,000.00	832,281.95	1740
3/1/1998	18,000.00	24,968.46	1740
4/1/1998	4,700,000.00	6,482,861.64	1710
4/1/1998	14,500.00	20,000.32	1710
7/1/1998	2,300.00	3,119.22	1620
12/31/1998	3,500.00	4,589.50	1441
7/1/1999	3,567.00	4,520.82	1260
12/31/1999	3,500.00	4,289.06	1081
7/1/2000	3,700.00	4,382.40	900
12/31/2000	3,769.00	4,316.34	721
7/1/2001	3,800.00	4,206.20	540
12/31/2001	3,801.00	4,068.02	361
7/1/2002	5,000.00	5,172.16	180
7/1/2002	3,850.00	3,982.56	180
12/31/2002	3,700.00	3,700.70	1
12/31/2002	64,500.00	64,512.13	1
2/1/1998	(470,000.00)	(655,642.98)	1770
6/1/1998	7,833.00	10,683.08	1650
12/31/1998	1,000.00	1,311.29	1441
6/1/1999	1,300.00	1,656.94	1290
12/31/1999	1,300.00	1,593.08	1081
6/1/2000	1,200.00	1,429.36	930
12/31/2000	1,400.00	1,603.31	721
12/31/2001	1,200.00	1,284.30	361
6/1/2002	1,375.00	1,430.39	210
12/31/2002	1,254.00	1,254.24	1
12/31/2002	470,000.00	470,088.40	1

Continued on next page

TABLE H-K-4: REBATE COMPUTATION (Page 2 of 3)

DATE	CASH FLOWS	FUTURE VALUE	DAYS
4/1/1998	(4,230,000.00)	(5,834,575.47)	1710
5/1/1998	(1,928,199.00)	(2,644,663.47)	1680
5/1/1998	2,028,199.00	2,781,820.65	1680
5/1/1998	(1,928,100.00)	(2,644,663.47)	1680
6/1/1998	1,027,899.00	1,401,905.29	1650
6/1/1998	(997,899.00)	(1,360,989.64)	1650
7/1/1998	2,027,706.00	2,749,937.90	1620
7/1/1998	(2,003,198.00)	(2,716,700.60)	1620
12/31/1998	1,838,633.00	2,410,974.62	1441
12/31/1998	(1,733,633.00)	(2,273,289.54)	1441
6/1/1999	3,155,000.00	4,021,273.55	1290
6/1/1999	(3,155,000.00)	(4,021,273.55)	1290
12/31/1999	4,167,000.00	5,106,426.81	1081
12/31/1999	(4,157,000.00)	(5,094,172.37)	1081
6/1/2000	3,665,000.00	4,365,502.64	930
6/1/2000	(3,515,000.00)	(4,186,832.68)	930
12/31/2000	2,172,000.00	2,487,421.90	721
12/31/2000	(2,152,000.00)	(2,464,517.47)	721
6/1/2001	4,182,000.00	4,655,221.25	570
6/1/2001	(4,072,000.00)	(4,532,774.02)	570
12/31/2001	4,680,990.00	5,009,834.38	361
12/31/2001	(4,580,990.00)	(4,902,809.28)	361
6/1/2002	2,680,280.00	2,788,254.98	210
6/1/2002	(2,570,280.00)	(2,673,823.63)	210
12/31/2002	4,880,495.00	4,881,412.96	1
12/31/2002	(2,880,495.00)	(2,881,036.79)	1
12/31/2002	3,075,694.00	3,076,272.50	1
4/1/1998	(470,000.00)	(648,286.16)	1710
6/1/1998	6,100.00	8,319.52	1650
12/31/1998	19,000.00	24,914.44	1441
6/1/1999	19,480.00	24,828.66	1290
12/31/1999	18,975.00	23,252.81	1081
6/1/2000	18,000.00	21,440.39	930
12/31/2000	17,000.00	19,468.77	721
6/1/2001	17,500.00	19,480.24	570

Continued on next page

TABLE H-K-4: REBATE COMPUTATION (Page 3 of 3)

DATE	CASH FLOWS	FUTURE VALUE	DAYS
12/31/2001	16,000.00	17,124.02	361
6/1/2002	16,000.00	16,644.56	210
12/31/2002	16,000.00	16,003.01	1
12/31/2002	470,000.00	470,088.40	1
1/1/1999	(1,000.00)	(1,311.04)	1440
1/1/2000	(1,000.00)	(1,225.21)	1080
1/1/2001	(1,000.00)	(1,145.01)	720
1/1/2002	(1,000.00)	(1,070.05)	360
1/1/2003	(1,000.00)	(1,000.00)	0
1/1/2003	(58,685.06)	(58,685.06)	0
REBATE DUE		**($15,429.14)**	

Summary

Review of Module H

In a pooled financing issue, the issuer loans the proceeds to two or more borrowers. The four different types of pooled financing issues are:

- governmental,
- qualified 501(c)(3),
- qualified small issues, AND
- exempt facility issues.

Generally, proceeds of a pooled financing issue may be invested at unrestricted yield during a three or five-year temporary period. Any temporary period is split between the issuer and the conduit borrower, with the issuer limited to six months (or two years for construction issues.)

The yield restriction rules are applied based on the yield of the pooled financing issue. This yield is determined differently depending on whether or not the conduit loans are tax-exempt obligations.

A pooled financing issue may qualify for any of the spending exceptions or the small issuer exception to rebate. The issuer can treat all of the loans as one issue, or elect to apply the spending exceptions separately to each loan. In addition, if any of the proceeds will be used for construction expenditures, the issuer may elect to bifurcate the issue into two issues – one construction issue and one nonconstruction issue. If the two-year spending exception is met, then the construction portion will NOT be subject to rebate. However, the eighteen-month spending exception cannot be used for the nonconstruction issue.

Other rules under IRC section 149(f) and 147(b)(4) also may apply to certain pooled financing issues.

END OF MODULE H