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OFFICE OF TAX EXEMPT BONDS

Publication 4078

Tax-Exempt Private Activity Bonds

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INTRODUCTION

The Office of Tax Exempt Bonds ("TEB"), of the Internal Revenue Service ("IRS"), Tax Exempt and Government Entities division, offers specialized information and services to the municipal finance community.

This IRS Publication 4078, *Tax-Exempt Private Activity Bonds* (the "Publication"), provides to state and local governments that issue tax-exempt bonds and to borrowers or other users of bond proceeds (funds derived from the sale of bonds) an overview of the general federal tax law rules that apply to municipal financing arrangements commonly known as "qualified private activity bonds." Certain exceptions or additional requirements to these rules, which are beyond the scope of this Publication, may apply to particular financing arrangements. This Publication is intended to help issuers meet applicable federal tax law requirements to ensure that interest earned by bondholders is exempt from taxation under Section 103 of the Internal Revenue Code (the "Code").

This Publication is an overview of the rules; it is not official guidance that taxpayers may rely upon for planning purposes. This Publication refers to various Code sections, income tax regulations (the "Regulations"), revenue procedures and other official guidance relating to the topics discussed. Please refer to the official guidance for the rules that apply to qualified private activity bonds. Unless otherwise indicated, references in this Publication to section numbers are references to sections of the Code.

This Publication is only one of TEB's many outreach efforts. For publications regarding the general rules applicable to governmental bonds or qualified 501(c)(3) bonds, see IRS Publication 4079, *Tax-Exempt Governmental Bonds*, and IRS Publication 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations*, respectively. For an overview of the responsibilities of an issuer of tax-exempt bonds in a conduit financing arrangement, see IRS Publication 5005, *Your Responsibilities as a Conduit Issuer of Tax Exempt Bonds*. TEB also provides detailed information on specific provisions of the tax law through other IRS publications and through outreach efforts as noted on the TEB website at www.irs.gov/Tax-Exempt-Bonds. See also TEB INFORMATION AND SERVICES, at the end of this Publication.

BACKGROUND

State and local governments receive direct and indirect tax benefits under the Code that lower borrowing costs on their valid debt obligations. Because interest paid to bondholders on these obligations is not includable in their gross income for federal income tax purposes, bondholders are willing to accept a lower interest rate than they would accept if the interest was taxable. These benefits apply to many different types of municipal debt financing arrangements including bonds, notes, loans, lease purchase contracts, lines of credit and commercial paper (collectively referred to as "bonds" in this Publication).

To receive these benefits, issuers must ensure that the requirements under the Code are met, generally for as long as the bonds remain outstanding. These requirements include, but are not limited to, information filing and other requirements related to issuance, the proper and timely use of bond proceeds and bond-financed property, and limitations on how bond proceeds may be invested. Special additional rules apply to bonds that are private activity bonds for those bonds to be tax-exempt qualified private activity bonds. This Publication describes rules that apply generally to all qualified private activity bonds. Requirements applicable to particular types

of qualified private activity bonds are beyond the scope of this Publication. For information about these unique requirements, visit TEB's website. For information specific to the use requirements for qualified 501(c)(3) bonds, see IRS Publication 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations*.

This Publication also addresses practices and steps an issuer and others using bond proceeds can take to protect the tax-exempt status of qualified private activity bonds. For example, because the requirements and limitations generally apply at the time the bonds are issued and throughout the term of the bonds, this Publication encourages issuers and beneficiaries of tax-exempt bonds to create procedures for monitoring compliance throughout the life of the bonds. For more information, see the discussion below in the section titled POST-ISSUANCE COMPLIANCE MONITORING.

TAX-EXEMPT PRIVATE ACTIVITY BONDS

Interest on a private activity bond is taxable unless the bond is a qualified private activity bond and meets various other requirements, some of which apply to governmental bonds as well. In this section, we briefly discuss the tests for determining whether a bond is a private activity bond. This section also describes:

- rules an issuer must meet for interest on a private activity bond to be excluded from federal income tax, by describing rules that apply at issuance (including elections that need to be made when the bonds are issued) and rules that apply both at issuance and throughout the life of the bonds;
- rules that apply when modifications are made to bond terms;
- recordkeeping requirements; and
- rules that prevent certain bondholders from excluding interest even if all the other requirements for tax exemption are met.

When applicable, these discussions include any special remedial action provision that applies to the particular requirement. If a deliberate action that results in a violation of any of the federal tax requirements cannot be corrected under these special remedial action provisions, issuers may be able to enter into a closing agreement under the TEB Voluntary Closing Agreement Program ("TEB VCAP") described in Notice 2008-31, 2008-11 I.R.B. 592 (see WHAT TO DO UPON DISCOVERING A VIOLATION — TEB VOLUNTARY CLOSING AGREEMENT PROGRAM at the end of this Publication).

Testing for Private Activity Bonds

A state or local bond will be a private activity bond if, as of the issue date of the bonds or at any time while the bonds are outstanding, the bond issue exceeds the limits set forth in either of the private activity bond tests:

- the private business tests of Section 141(b) of the Code, which consist of the private use test and private security and payment test, or
- the private loan financing test of Section 141(c) of the Code.

For a further description of the private business tests under Section 141(b) and the private loan test under Section 141(c), see IRS Publication 4079, *Tax-Exempt Governmental Bonds*.

Requirements Related to Issuance

Some Private Activity Bonds Need to Obtain Volume Cap under Section 146. The Code limits the amount of private activity bonds that may be issued. The volume cap limit of Section 146 restricts the amount of certain qualified private activity bonds that all issuers within a state may issue during a calendar year. Generally, a state allocates that limit or volume cap among issuers in the state. Within certain restrictions, state law determines how those allocations are made. If, during a given year, an issuing authority issues more qualified private activity bonds than its allocable volume cap, the tax-exempt status of those excess bonds is jeopardized. Not all private activity bonds are subject to the volume cap limitation. The chart below describes which qualified private activity bonds are subject to volume cap under Section 146. Certain other types of bonds are subject to volume limits under other Code provisions.

Volume Cap Under Section 146	
Type of Private Activity Bonds	**Subject to Volume Cap?**
Private activity bonds financing exempt facilities (§142):	
• airports	No
• docks and wharves	No
• mass commuting facilities	Yes
• facilities for the furnishing of water	Yes
• sewage facilities	Yes
• governmentally owned solid waste disposal facilities	No
• privately owned solid waste disposal facilities	Yes
• qualified residential rental projects	Yes
• facilities for the local furnishing of electric energy or gas	Yes
• local district heating or cooling facilities	Yes
• qualified hazardous waste facilities	Yes
• governmentally owned high-speed intercity rail facilities	No
• privately owned high-speed intercity rail facilities	Yes[1]
• environmental enhancements of hydro-electric generating facilities	No
• qualified public educational facilities	No
• qualified green building and sustainable design projects	No
• qualified highway or surface freight transfer facilities	No
• qualified enterprise zone facilities	Yes
• new empowerment zone facilities	No
Qualified mortgage bonds (§143)	Yes[2]
Qualified small issue bonds (§144(a))	Yes
Qualified student loan bonds (§144(b))	Yes
Qualified redevelopment bonds (§144(c))	Yes
Qualified veterans' mortgage revenue bonds	No
Qualified 501(c)(3) bonds	No
Current refunding bonds[3] that do not exceed the outstanding amount of the refunded bonds	No[4]
Current refunding bonds in excess of the outstanding amount of the refunded bonds	Yes

1 Volume cap required for only 25 percent of the bonds.
2 The amount of volume cap allocated to an issuer is reduced when it establishes a mortgage credit certificate program under Section 25 of the Code.
3 See the subsection below, "Rules that Apply at Issuance and Throughout the Life of the Bonds - Limitations on Refunding Private Activity Bonds" for a definition of "current refunding."
4 Maturity limitations apply for refundings of qualified mortgage revenue bonds and qualified student loan bonds. Private activity bonds other than qualified 501(c)(3) bonds may not be advance refunded.

Carryforward of Unused Section 146 Volume Cap. Subject to state law requirements, an issuer may elect to carry forward any unused volume cap allocation it received in a calendar year for three calendar years. This election may be made for each of the qualified private activity bond purposes subject to volume cap except for the purpose of issuing qualified small issue bonds. This election is made by filing IRS Form 8328, *Carryforward Election of Unused Private Activity Bond Volume Cap*, by the earlier of (1) February 15th following the year in which the unused amount arises, or (2) the date of issue of bonds pursuant to the carryforward election. Once Form 8328 is filed, the issuer may not revoke the carryforward election or amend the carryforward amounts shown on the form.

Private Activity Bonds Need To Meet the Public Approval Requirements. Section 147(f) of the Code generally provides that, prior to issuance, qualified private activity bonds must be approved by (1) the governmental entity issuing the bonds or on behalf of which the bonds were issued and (2) each governmental entity having jurisdiction over the area in which the bond-financed facility is to be located (although for bonds financing certain airport and high-speed intercity rail facilities, only the entity issuing the bonds must approve them). However, if more than one governmental unit within a State has jurisdiction over the entire area within such State in which such facility is located, only one such unit need approve such issue. Current refunding bonds that meet certain maturity and principal amount limits are exempted from the public approval requirement (see below, Requirements that Apply at Issuance and Throughout the Life of the Bonds - Limitations on Refunding Private Activity Bonds, for the definition of current refunding bonds).

Approval may be accomplished by either voter referendum or by an applicable elected representative of the governmental entity approving the issue after a public hearing following reasonable notice to the public. Section 147(f) of the Code and section 5f.103-2 of the Regulations define the specific rules for this requirement.

Special Remedial Action for Failure To Meet Public Approval Requirements. If an issuer fails to comply with the public approval requirements, the issuer may be able to cure the defect. Section 1.147-2 of the Regulations provides that issuers may use the remedial action rules under section 1.142-2 of the Regulations (available to correct nonqualified uses of proceeds) to cure noncompliance with the public approval requirement (see Requirements that Apply at Issuance and Throughout the Life of the Bonds – Proceeds Must be Used for Qualified Purposes – Special Remedial Actions for Nonqualified Use).

Issuers Must File Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*. Issuers of qualified private activity bonds must comply with certain information filing requirements under Section 149(e) of the Code by filing IRS Form 8038. This form can be downloaded from TEB's website at TEB Forms and Publications. Issuers must file the Form 8038 by the 15th day of the second calendar month following the quarter in which the bonds were issued. For example, the due date of the return for bonds issued on February 1 is May 15. Issuers must file Form 8038 at the following address: Internal Revenue Service Center, Ogden UT 84201.

An issuer may request an extension of time to file Form 8038 if the failure to file the return on time was not due to willful neglect. To request an extension, the issuer must follow the procedures outlined in Revenue Procedure 2002-48, 2002-37 I.R.B. 531. These procedures generally require that the issuer: (1) attach a letter to the Form 8038 briefly explaining when the return was required to be filed, why the return was not timely submitted, and whether or not the bond

issue is under examination; (2) enter on top of the letter “Request for Relief under section 3 of Rev. Proc. 2002-48”; and (3) file this letter and the return at the Internal Revenue Service Center, Ogden UT 84201.

Private Activity Bonds Must Be in Registered Form. Section 149(a) of the Code generally provides that any tax-exempt bond, including a qualified private activity bond, must be issued “in registered form” unless the obligation (1) is of a type not offered to the public or (2) has, at the date of issue, a maturity date of not more than one year. The Regulations describe what it means to be in “registered form.” Section 5f.103-1(c)(1) of the Regulations provides that an obligation issued after January 20, 1987, pursuant to a binding contract entered into after January 20, 1987, is in registered form if:

- the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and that the transfer of the obligation to a new holder may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder; or
- the right to the principal of, and stated interest on, the obligation may be transferred only through a book-entry system maintained by the issuer (or its agent); or
- the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both methods described above.

Only a Limited Amount of Private Activity Bond Proceeds May Be Used To Pay Issuance Costs. The Code limits the amount of proceeds that may be used to finance issuance costs. Under Section 147(g) of the Code, a private activity bond is not a qualified bond if the issuance costs financed by the issue (of which such bond is a part) exceed 2 percent of the proceeds of the issue. In the case of an issue of qualified mortgage revenue bonds or qualified veterans’ mortgage revenue bonds, where the proceeds of the issue do not exceed $20 million, the issuance costs limitation is 3.5 percent of the proceeds of the issue. Issuers and borrowers of bond proceeds may finance issuance costs with funds other than the proceeds of the bond issue.

Under the Regulations, “issuance costs” means costs incurred in connection with, and allocable to, the issuance of an issue. For example, “issuance costs” include the following costs, but only to the extent incurred in connection with, and allocable to, the borrowing:

- underwriters’ spread
- counsel fees
- financial advisory fees
- fees paid to an organization to evaluate the credit quality of an issue
- trustee fees
- paying agent fees
- bond registrar, certification, and authentication fees
- accounting fees
- printing costs for bonds and offering documents
- public approval process costs
- engineering and feasibility study costs
- guarantee fees other than for “qualified guarantees”
- costs similar to those above

Issuers Must Make Certain Elections at Issuance. When an issuer considers actions it must take when it issues bonds, it should consider whether it wants to make any elections. Various provisions of the Code and Regulations require that the issuer make certain elections in writing and retain elections as part of the bond documents. Many elections have to be made on or before the issue date of the bonds. Some elections may be made by either the issuer or a conduit borrower. Others must be made by the actual issuer of the bonds. The IRS frequently observes that issuers make the written elections in the arbitrage certificate prepared pursuant to section 1.148-2 of the Regulations. Once made, elections cannot be revoked without the IRS's permission.

Examples of elections include:

- waiving the right to treat a purpose investment as a program investment
- waiving the right to invest in higher yielding investments during any temporary period
- the issuer of a pooled financing issue electing to apply rebate spending exceptions separately to each conduit loan
- applying actual facts rather than reasonable expectations for certain provisions under the two-year spending exception from rebate
- excluding the earnings on a reasonably required reserve fund from available construction proceeds under the two-year spending exception from rebate
- treating a portion of an issue as a separate construction issue under the two-year spending exception from rebate
- electing to pay one and one-half percent penalty in lieu of arbitrage rebate
- electing to treat portions of a bond issue as separate issues

Requirements that Apply at Issuance and Throughout the Life of the Bonds

Proceeds Must Be Used for Qualified Purposes. Private activity bonds are used for a qualified purpose if 95 percent or more of the net bond proceeds are to be used for one or more defined qualified purposes. The qualified purposes are described in Sections 142 through 145 and 1394 of the Code. For purposes of the 95 percent requirement, issuance costs financed with bond proceeds are generally treated as not being used for a qualified purpose. For a description of issuance costs, see Requirements Related to Issuance – Only a Limited Amount of Private Activity Bond Proceeds May Be Used to Pay Issuance Costs, above. Qualified purposes and the relevant Code section are:

- Section 142 – exempt facilities such as:
  - airports
  - docks and wharves
  - mass commuting facilities
  - facilities for the furnishing of water
  - sewage facilities
  - solid waste disposal facilities
  - qualified residential rental projects
  - facilities for the furnishing of local electric energy or gas
  - local district heating or cooling facilities
  - qualified hazardous waste facilities
  - high-speed intercity rail facilities
  - environmental enhancements of hydro-electric generating facilities
  - qualified public educational facilities
  - qualified green building and sustainable design projects
  - qualified highway or surface freight transfer facilities
- Section 143 – qualified mortgages and qualified veterans' mortgages
- Section 144 – qualified small issue manufacturing facilities, qualified small issue farm property, qualified student loans, and qualified redevelopment projects
- Section 1394 – qualified enterprise zone and empowerment zone facilities
- Section 145 – qualifed 501(c)(3) bonds. (The special rules generally applicable to qualified private activity bonds financing 501(c)(3) exempt purposes are covered in IRS Publication 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations*. Publication 4077 can be downloaded from the TEB website)

A qualified private activity bond issue can lose its tax-exempt status as of the date of issuance if, subsequent to the issue date, sufficient nonqualified use occurs to cause the issue to fail the applicable use requirements. Hence, the issue becomes a taxable private activity bond issue. Generally, nonqualified use occurs when the issuer or other entity controlling expenditure or use of the proceeds or financed property takes an action that results in insufficient bond proceeds being allocated to the qualified purpose for which the bonds were issued. However, with respect to unspent proceeds, a failure to properly use those proceeds may occur as early as the date on which the issuer or other entity controlling expenditure of the proceeds reasonably expects that the bond proceeds will not be expended on the qualified purpose for which the bonds were issued.

Special Remedial Actions for Nonqualified Use. The Regulations provide that an issuer that fails to use proceeds for a qualified purpose may, in certain cases, cure that failure using one of the prescribed remedial actions. Generally, such remedial actions consist of the redemption or

defeasance of bonds. Additionally, if bond-financed personal property is disposed of exclusively for cash, remedial action may include the alternative use of the disposition proceeds to acquire replacement property within six months of the disposition date. Other remedial actions may be available to the issuer of qualified 501(c)(3) bonds.

The following Regulations provide remedial actions available for certain qualified private activity bonds.

- Section 1.142-2 – exempt facility bonds
- Section 1.144-2 – qualified small issue bonds and qualified redevelopment bonds
- Section 1.145-2 – qualified 501(c)(3) bonds
- Section 1.1394-1(m)(4) – qualified enterprise zone facility bonds, qualified empowerment zone facility bonds and District of Columbia enterprise zone facility bonds

These Regulations can be accessed through the IRS website under Tax Code, Regulations and Official Guidance.

Proceeds May Not Be Used To Acquire Land or Other Existing Property. The Code prohibits the use of proceeds of certain types of qualified private activity bonds for certain expenditures, even if those expenditures are associated with a qualified purpose. Under Section 147(c) of the Code, a private activity bond is not a qualified bond if (1) 25 percent or more of the net proceeds of the bond issue are to be used (directly or indirectly) for the acquisition of land (or an interest therein), or (2) any portion of the proceeds of such issue is to be used (directly or indirectly) for the acquisition of land (or an interest therein) to be used for farming purposes.

However, certain exceptions to this rule are available for first-time farmers (up to a specified inflation-adjusted amount), and for land acquired for certain environmental purposes in connection with an airport, mass commuting facility, high-speed intercity rail facility, dock, or wharf. Also, the restriction on land financing does not apply to any qualified mortgage bond, qualified veterans' mortgage bond, qualified student loan bond, qualified 501(c)(3) bond, or any exempt facility bond financing qualified public education facilities.

In addition to the restriction on financing land, generally, a qualified private activity bond will not be tax-exempt if any amount of the net proceeds is used for the acquisition of existing property unless the purpose of the acquisition is the first such use of that property. This rule does not apply to qualified mortgage revenue bonds, qualified veterans' mortgage revenue bonds or qualified 501(c)(3) bonds. Additionally, Section 147(d)(2) of the Code provides an exception to this prohibition when certain rehabilitation expenditures are made.

Also, under Section 147(e) of the Code, no proceeds of private activity bonds may be used to finance any:

- airplane (other than aircraft equipped for, and exclusively dedicated to providing, acute care emergency medical services)
- skybox or other private luxury box
- health club facility (under an exception, qualified 501(c)(3) bonds may finance health club facilities)
- facility primarily used for gambling
- store the principal business of which is the sale of alcoholic beverages for consumption off premises

Special Remedial Action Rule. An issuer may be able to cure a prohibited expenditure that does not meet the exceptions noted above. Section 1.147-2 of the Regulations provides that issuers may use the remedial action rules under section 1.142-2 of the Regulations to cure noncompliance for rehabilitation expenditures, acquiring property for environmental purposes, and certain prohibited financings. See Requirements That Apply at Issuance and Throughout the Life of the Bonds – Proceeds Must be Used for Qualified Purposes – Special Remedial Actions for Nonqualified Use, above.

Proceeds Must Be Timely Allocated to Expenditures. Issuers and conduit borrowers are required to follow the rules for allocating bond proceeds. The issuer or other entity controlling expenditure of the proceeds of a qualified private activity bond issue must allocate those proceeds among the various project expenditures in a manner demonstrating compliance with the qualified use requirements. These allocations must generally be consistent with allocations made for determining compliance with the arbitrage yield restriction and rebate requirements, as well as other federal tax filings. See Proceeds Are Subject to Investment Restrictions: the Arbitrage Yield Restriction and Arbitrage Rebate Requirements, below, for an overview of those rules.

An issuer must account for the allocation of proceeds to an expenditure not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier.

Proceeds Are Subject to Investment Restrictions: the Arbitrage Yield Restriction and Arbitrage Rebate Requirements. Issuers of tax-exempt bonds, including qualified private activity bonds, are generally subject to investment, or arbitrage, limitations under Section 148 of the Code. Failure to comply with those arbitrage limitations will result in the bonds being arbitrage bonds and interest on the bonds being taxable.

In general, arbitrage is earned when the gross proceeds of an issue are used to acquire investments that earn a yield that is materially higher than the yield on the bonds of the issue. Earning arbitrage is permitted in certain circumstances, including those where arbitrage may be earned but must be paid, or rebated, to the U.S. Department of the Treasury. In some cases, an issuer may be able to reduce the yield on an investment for arbitrage purposes and thereby avoid an arbitrage violation by making a yield reduction payment to the U.S. Department of the Treasury. See Where and When To File Arbitrage Rebate and Yield Reduction Payments, below, for information on how to make yield reduction payments.

An issuer must comply with two general sets of arbitrage rules: (1) the yield restriction requirements of Section 148(a) and (2) the rebate requirements of Section 148(f). An issuer may meet the rules of one of these regimes, but still have arbitrage bonds because it failed the other. Even though interconnected, both sets of rules have their own distinct requirements. The following is an overview of the basic requirements of these two general rules. Additional requirements or exceptions, beyond the scope of this Publication, may apply in certain instances.

An issuer's reasonable expectations on the issue date regarding the amount and use of gross proceeds of the issue are used to determine whether an issue consists of arbitrage bonds. In addition, if an issuer or any person acting on behalf of the issuer takes a deliberate, intentional action to earn arbitrage after the issue date, that action will cause the bonds of an issue to be arbitrage bonds if that action, had it been reasonably expected on the issue date, would have caused the bonds to be arbitrage bonds. Intent to violate the requirements of Section 148 of the Code is not necessary for an action to be intentional.

Yield Restriction Requirements. The yield restriction rules of Section 148(a) of the Code generally provide that the direct or indirect investment of the gross proceeds of bonds in investments earning a yield materially higher than the yield of the bond issue causes the bonds to become arbitrage bonds. The chart below describes when the yield on particular investments will be "materially higher" (the chart shows the permitted yield spread between the yield on the bond issue and the yield on the particular investment; any spread beyond that stated is materially higher):

Applicable "Materially Higher" Limits	
Type of Investments	**Materially Higher When Spread Exceeds**
general rule (when other rules below don't apply)	1/8 of one percentage point
investments in a refunding escrow	1/1000 of one percentage point
investments allocable to replacement proceeds	1/1000 of one percentage point
program investments (other than qualified mortgage loans or qualified student loans)	1.5 percentage points
student loans	2 percentage points
mortgage loans	1.125 percentage points, calculated as required under Section 143(g) of the Code
investments in tax-exempt bonds	generally, no yield limitation (but for qualified 501(c)(3) bonds, tax exempt bond investments must not be subject to the alternate minimum income tax)

Certain exceptions are available under the yield restriction rules. The investment of proceeds in materially higher yielding investments does not cause the bonds of an issue to be arbitrage bonds in the following three instances: (1) during a temporary period (*e.g.,* three-year temporary period for capital projects and 13 months for restricted working capital expenditures); (2) as part of a reasonably required reserve or replacement fund; and (3) as part of a minor portion (an amount not exceeding the lesser of 5 percent of the sale proceeds of the issue or $100,000). Whether or not the arbitrage yield restrictions rules apply, issuer should consider whether the rebate requirements apply.

Rebate Requirements. The rebate requirements of Section 148(f) of the Code generally provide that, unless certain earnings on "nonpurpose investments" allocable to the gross proceeds of an issue are rebated to the U.S. Department of the Treasury, the bonds in the issue will be arbitrage bonds. Generally, nonpurpose investments are investment securities such as Treasury bonds, bank deposits or guaranteed investment contracts, etc., and do not include "purpose investments." A purpose investment is an investment that the issuer acquires to carry out the governmental purpose of an issue. Examples of purpose investments include the payment obligations created when an issuer loans proceeds of a qualified 501(c)(3) bond to a 501(c)(3) hospital or leases a manufacturing facility financed with proceeds of a qualified small issue bond to a private corporation.

The arbitrage that must be rebated is based on the excess (if any) of the amount actually earned on nonpurpose investments over the amount that would have been earned if those investments had a yield equal to the yield on the issue, plus any income attributable to such excess. Under section 1.148-3(b) of the Regulations, the future values (as of the computation date) of all earnings received and payments actually or constructively made with respect to nonpurpose

investments are included in determining the amount of rebate due. See Where and When To File Arbitrage Rebate and Yield Reduction Payments, below, for information on how to make rebate payments.

There are, however, spending exceptions to the general rebate requirements applicable to qualified private activity bonds. Whether these exceptions apply depends on the timing of expenditure of required amounts of proceeds, as follows:

Spending Exceptions	
Spending Period	**Spending Exception**
Six months	Section 1.148-7(c) of the Regulations provides an exception to rebate if the gross proceeds of the bond issue are allocated to expenditures for governmental or qualified purposes that are incurred within six months after the date of issuance.
18 months	Section 1.148-7(d) of the Regulations provides an exception to rebate if the gross proceeds of the bond issue are allocated to expenditures for governmental or qualified purposes which are incurred within the following schedule: (1) at least 15 percent within six months after the date of issuance; (2) at least 60 percent within 12 months after the date of issuance; and (3) 100 percent within 18 months after the date of issuance.
Two years	Section 1.148-7(e) of the Regulations provides an exception to rebate for construction issues financing property to be owned by a governmental entity or 501(c)(3) organization when certain available construction proceeds are allocated to expenditures within the following schedule: (1) at least 10 percent within six months after the date of issuance; (2) at least 45 percent within 12 months after the date of issuance; (3) at least 75 percent within 18 months after the date of issuance; and (4) 100 percent within 24 months after the date of issuance.
Note: Issuers may still owe rebate on amounts earned on nonpurpose investments allocable to proceeds not covered by one of the spending exceptions, which may include earnings in a reasonably required reserve or replacement fund.	

Where and When To File Arbitrage Rebate and Yield Reduction Payments. Issuers of tax-exempt bonds file IRS Form 8038-T, *Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate*, to make the following types of payments:

- yield reduction payments
- arbitrage rebate payments
- payments of a penalty in lieu of rebate
- payment in connection with the termination of the election to pay a penalty in lieu of arbitrage rebate
- payment of the penalty for failure to pay arbitrage rebate on time

A yield reduction payment and/or arbitrage rebate installment payment is required to be paid no later than 60 days after the “computation date” to which the payment relates. An issuer of a fixed yield issue may treat any date as a computation date. An issuer of a variable yield issue may treat the last day of any bond year ending on or before the latest date for making the first rebate payment (generally not later than five years after the issue date) as a computation date. Thereafter, the issuer must consistently treat either the end of each bond year or the end of each fifth bond year as a computation date. Generally, a “bond year” is a one-year period that ends

on the date that the issuer selects. If the issuer does not make a timely selection, the bond years for the issue end on each anniversary of the issue date and on the final maturity date.

Recovering an Overpayment of Rebate. If an issuer pays more than the required rebate, it may ask to recover the overpayment. In general, a request for recovery of overpayment of arbitrage rebate may be made when the issuer can establish that an overpayment occurred. An overpayment is the excess of the amount paid to the U.S. Department of the Treasury for an issue over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under Section 148 as of the date the recovery is requested. The request can be made with the IRS by completing and filing IRS Form 8038-R, *Request for Recovery of Overpayments Under Arbitrage Rebate Provisions*. An issuer must file a Form 8038-R no later than the date that is two years after the final computation date for the issue. For more information, see Revenue Procedure 2008-37, 2008-29 I.R.B. 137.

Special Remedial Action for Failure To Timely Pay Arbitrage Rebate. An issuer that fails to timely pay arbitrage rebate will be excused from having its bonds be arbitrage bonds if the failure is not due to willful neglect and the issuer submits a Form 8038-T with a payment of the rebate amount owed, plus penalty and interest. The penalty may be waived under certain circumstances. For more information, see section 1.148-3(i)(3) of the Regulations and Revenue Procedure 2005-40, 2005-28 I.R.B. 83.

Private Activity Bonds Are Subject to Maturity Limitations. Section 147(b) of the Code places limits on the maturity of qualified private activity bonds. A private activity bond is not a qualified bond (and therefore will not be tax exempt) if the average maturity of the bond issue exceeds 120 percent of the average reasonably expected economic life of the facilities being financed with such issue. This requirement does not apply to qualified mortgage bonds, qualified veterans' mortgage bonds or qualified student loan bonds. Working capital expenditures are ignored when determining the economic life of facilities.

Private Activity Bonds May Not Be Federally Guaranteed. Section 149(b) of the Code provides that any tax-exempt bond, including a qualified private activity bond, will not be treated as tax exempt if the payment of principal or interest is directly or indirectly guaranteed by the federal government or any agency or instrumentality of the federal government. Exceptions to this general rule include guarantees by certain quasi-governmental entities administering federal insurance programs, and federal guarantees for qualified residential rental projects, home mortgages and student loans. Additional exceptions apply to bond proceeds that are invested in U.S. Treasury securities or held in a bona fide debt service fund, a reasonably required reserve or replacement fund or a refunding escrow, and investments during a permitted initial temporary period.

A Private Activity Bond May Not Be a Hedge Bond. Section 149(g) of the Code states that hedge bonds will not be tax-exempt unless certain requirements, described below, are satisfied. A "hedge bond" is any bond that is part of a bond issue that fails **either** of the following requirements:

- The issuer must reasonably expect that 85 percent of the spendable proceeds of the issue will be used to carry out the qualified purpose within the three-year period beginning on the date the bonds are issued ("spendable proceeds" means proceeds from the sale of the issue, less the portion invested in a reasonably required reserve or replacement fund or as part of a permitted "minor portion").
- Not more than 50 percent of the proceeds of the issue are invested in nonpurpose investments having a substantially guaranteed yield for four or more years.

Section 149(g)(3)(B) provides an exception to the general definition of a hedge bond if at least 95 percent of the net proceeds of the issue are invested in tax-exempt bonds that are not subject to the alternative minimum tax. For this purpose, amounts held either: (1) in a bona fide debt service fund or (2) for 30 days or less pending either reinvestment of the proceeds or bond redemption, are treated as invested in tax-exempt bonds not subject to the alternative minimum tax. Additionally, a refunding bond issue does not generally consist of hedge bonds if the prior issue met the requirements for tax-exempt status and issuance of the refunding bonds furthers a significant governmental purpose (*e.g.* realize debt service savings, but not to otherwise hedge against future increases in interest rates).

Even if an issue otherwise meets the definition of a hedge bond, it will generally still be tax-exempt if two requirements are satisfied. First, at least 95 percent of the reasonably expected legal and underwriting costs associated with issuing the bonds must be paid within 180 days after the issue date *and* the payment of such costs must not be contingent upon the disbursement of the bond proceeds. Second, on the date of issuance the issuer must reasonably expect that the spendable proceeds of the issue will be allocated to expenditures for governmental or qualified purposes within the following schedule:

- 10 percent within one year after the date of issuance;
- 30 percent within two years after the date of issuance;
- 60 percent within three years after the date of issuance; and
- 85 percent within five years after the date of issuance.

Limitations on Refunding Private Activity Bonds. Qualified private activity bonds may be currently refunded, but, with the exception of qualified 501(c)(3) bonds, cannot be advance refunded. Under section 1.150-1(d)(1) of the Regulations, a refunding bond issue is an issue the proceeds of which are used to pay principal, interest, or redemption price on another issue (a prior issue), as well as the issuance cost, accrued interest, or capitalized interest on the refunding issue, a reserve or replacement fund, or any similar costs properly allocable to that refunding issue. Current and advance refunding issues are distinguished as follows:

Types of Refundings	
Current Refunding Issue	A refunding issue that is issued not more than 90 days before the final payment of principal (*e.g.*, the redemption date) or interest on the prior issue.
Advance Refunding Issue	A refunding issue that is issued more than 90 days before the final payment of principal (*e.g.*, the redemption date) or interest on the prior issue.

Thus, refundings of tax-exempt governmental bonds and qualified private activity bonds are permitted as follows:

Permitted Refundings		
Type of Tax-Exempt Bond	Current Refunding	Advance Refunding
Governmental Bonds	Yes	Yes*
Qualified 501(c)(3) Bonds	Yes	Yes*
Other Qualified Private Activity Bonds	Yes	No

* Generally, bonds of this type issued after 1985 may only be advance refunded once.

Refunding bond issues generally derive their tax-exempt status from the prior issue they refund; if the prior issue was not tax-exempt, the refunding bonds generally cannot be tax-exempt.

Private Activity Bonds May Not Be Used for Abusive Tax Transactions

The IRS, including TEB, is engaged in extensive efforts to curb abusive tax shelter schemes and transactions. Information about abusive tax-exempt bond transactions is available on the TEB website.

What Happens When the Terms of a Private Activity Bond Are Modified?

If the terms of a private activity bond are sufficiently modified, the bond will be treated as reissued. When qualified private activity bonds are reissued, either actually or in a deemed reissuance, the new bonds must be re-tested as of the date of the reissuance to determine if all the various federal tax requirements are met for the "new" issue. These include the requirements that apply when bonds are issued, such as timely filing of the Form 8038. See Requirements Related to Issuance – *Issuers Must File Information Return for Tax-Exempt Private Activity Bond Issues – Form 8038*, above.

A deemed reissuance may arise if sufficient changes are made to the terms of the bond, such as when a bondholder and issuer agree, directly or indirectly, to a significant modification of the terms of any bonds. See Reissuance of Tax-Exempt Obligations: Some Basic Concepts for examples of significant modifications. If deemed reissued, the modified bonds are deemed exchanged for the original bonds. In general, the date the issuer and bondholder enter into the agreement to modify the terms of the bonds is treated as the date of issuance of the new bonds, even if the modification is not immediately effective. At reissuance, the modified bond must meet any tax law requirements that apply upon its early retirement in connection with the reissuance, including the acceleration of any arbitrage rebate or yield reduction payment that is due. See Proceeds Are Subject to Investment Restrictions: the Arbitrage Yield Restriction and Arbitrage Rebate Requirements: Where and When To File Arbitrage Rebate and Yield Reduction Payments above. For more information on the reissuance rules, see Reissuance of Tax-Exempt Obligations: Some Basic Concepts.

Issuers Must Retain Records To Show that Requirements Are Satisfied

Section 6001 of the Code and section 1.6001-1(a) of the Regulations generally provide that any person subject to income tax, or any person required to file a return of information with respect to income (*e.g.*, the issuer filing information returns relating to its bond issues), must keep such books and records as are sufficient to establish the amount of gross income, deductions, credits or other matters required to be shown by that person in any return. Answers to Frequently Asked Questions regarding record retention requirements applicable to tax-exempt bonds are available on the TEB website.

Certain Holders May Not Exclude Interest on Qualified Private Activity Bonds from Taxable Income

Even if a private activity bond meets all other requirements for tax exemption, the Code may prohibit certain holders from excluding interest income from tax. Generally, the entity that benefits from qualified private activity bonds may not also receive an exclusion from tax for interest that it receives while holding those bonds. Specifically, Section 147(a) of the Code provides that a private activity bond is not a qualified bond (and therefore will not be tax exempt) during any period it is held by a person who is a substantial user of the facilities financed with the bond or by a person “related” to a substantial user. Generally, a substantial user of a facility includes any nonexempt person who regularly uses a part of such facility in a trade or business. See section 1.103-11(b) of the Regulations for the rules to determine whether a person is a substantial user. Section 147(a)(2) of the Code governs whether a person is treated as a “related person” to a substantial user.

The substantial user prohibition of Section 147(a) does not apply to qualified mortgage bonds, qualified veterans’ mortgage bonds, qualified student loan bonds or qualified 501(c)(3) bonds.

POST- ISSUANCE COMPLIANCE MONITORING

In this section, we discuss the importance of issuers and other parties monitoring compliance with the Code requirements and suggest steps an issuer and others may take to monitor bond issues.

Protecting Against Post-Issuance Violations

Issuers and users of bond proceeds may be concerned with how they can further protect the tax-exempt status of their qualified private activity bonds. Reliance solely on bond documents and tax certificates provided when the bonds are issued will not likely provide the assurance an issuer desires. To gain greater confidence that bonds are in compliance with federal tax laws, an issuer may adopt, or ask the entity borrowing bond proceeds or controlling the financed property to adopt, post-issuance monitoring procedures. TEB believes that issuers and other users of bond proceeds that establish and follow comprehensive written monitoring procedures to promote post-issuance compliance generally are less likely to violate the federal tax requirements related to their bonds, and are more likely to find any violations earlier, than those issuers and other users without procedures. Early discovery of a violation is a factor TEB considers in determining the appropriate resolution under its Voluntary Closing Agreement Program. For information on procedures and other options to assist issuers and other users of bond proceeds in their tax compliance responsibilities, see IRS Publication 5005, *Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds*.

Steps to Better Monitoring

In formulating procedures, issuers and other users of bond proceeds may consider:

- Designating one or more officials to assist in post-issuance compliance;
- Designating one or more officials to assist with examinations of the bond issue;
- Providing training or other technical support to designated official(s);
- Designating time intervals within which compliance monitoring activities will be completed; and
- Timely completing remedial actions (including requests under TEB VCAP) to correct or otherwise resolve identified noncompliance.

The chart below identifies particular areas for compliance monitoring procedures.

Compliance Procedures		
Type of Procedures	**Description of Procedures for Post-Closing Matters**	**Where Responsibility is Discussed in this Publication**
Information Return Filing	Procedures to ensure timely filing of information returns, including procedures concerning amended and late filed returns	TAX-EXEMPT PRIVATE ACTIVITY BONDS – Requirements Related to Issuance – Issuers Must File Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*
Change in Use of Proceeds or Bond-Financed Property	Procedures to timely identify and remediate deliberate actions	TAX-EXEMPT PRIVATE ACTIVITY BONDS – Requirements That Apply at Issuance and Throughout the Life of the Bonds – Proceeds Must Be Used for Qualified Purposes
Reissuance	Procedures to satisfy applicable tax requirements when a modification in terms results in a reissuance for federal income tax purposes	TAX-EXEMPT PRIVATE ACTIVITY BONDS – What Happens When the Terms of a Private Activity Bond Are Modified?
Elections	Procedures for timely federal income tax elections	TAX-EXEMPT PRIVATE ACTIVITY BONDS – Requirements Related to Issuance – Issuers Must Make Certain Elections at Issuance
Allocation of Proceeds	Procedures for the timely expenditure and accounting for use and investment of bond proceeds	TAX-EXEMPT PRIVATE ACTIVITY BONDS – Requirements That Apply at Issuance and Throughout the Life of the Bonds – Proceeds Must Be Timely Allocated to Expenditures
Arbitrage Compliance	Procedures for the timely computation and payment of arbitrage rebate and yield reduction payments	TAX-EXEMPT PRIVATE ACTIVITY BONDS – Requirements That Apply at Issuance and Throughout the Life of the Bonds – Proceeds Are Subject to Investment Restrictions: the Arbitrage Yield Restriction and Arbitrage Rebate Requirements
Record Retention	Procedures for the maintenance of records	TAX-EXEMPT PRIVATE ACTIVITY BONDS – Issuers Must Retain Records To Show that Requirements Are Satisfied
IRS Contacts	Procedures concerning contacts from the IRS	POST-ISSUANCE COMPLIANCE MONITORING – Steps to Better Monitoring

Additional information on Post-Issuance Compliance is available on the TEB website.

WHAT TO DO UPON DISCOVERING A VIOLATION — TEB VOLUNTARY CLOSING AGREEMENT PROGRAM

TEB is committed to resolving federal tax violations with the issuer. To that end, TEB created the TEB Voluntary Closing Agreement Program. This program, which the Compliance and Program Management ("CPM") function of TEB administers, provides remedies for issuers of tax-exempt bonds, tax credit bonds, and direct pay bonds that voluntarily come forward to resolve a violation of the Code that cannot be corrected under self-correction programs described in the Regulations or other published guidance. Notice 2008-31, 2008-11 I.R.B 592, provides information and general guidance about TEB VCAP. IRM section 4.81.6 provides general procedures under which TEB will enter into closing agreements. Closing agreement terms and amounts may vary according to the degree of the violation as well as the facts and circumstances surrounding it.

Issuers must use IRS Form 14429, *Tax Exempt Bonds Voluntary Closing Agreement Program Request*, to submit a request and provide the required information. See I.R.M. section 7.2.3.2.1 with respect to completing the March 2013 version of the form. To encourage issuers and other parties to voluntarily come forward to resolve problems, TEB VCAP also permits an issuer or its representative to initiate preliminary discussions of a closing agreement anonymously. While the IRS generally enters into closing agreements with the issuer of the bonds, in certain cases other parties to the bond transaction (including an entity borrowing the bond proceeds) may also participate in the negotiations and jointly execute the agreement.

For more information about this program, including requirements for submitting a request, case processing procedures, and resolutions standards, see IRM section 7.2.3. Additional educational resources on Voluntary Compliance (including TEB VCAP administrative procedures and resolution standards) are available on the TEB website.

TEB INFORMATION AND SERVICES

TEB offers information and services through its education and outreach programs. You can learn about these programs through the TEB website.

TEB has reading materials about the tax laws applicable to municipal financing arrangements, including revenue rulings, revenue procedures, notices and announcements, available on the TEB website under Published Guidance.

Tax forms, instructions, and publications are also available at the TEB website under Tax-Exempt Bonds Forms and Publications.

For personal assistance, you can call our Customer Account Services toll-free at (877) 829-5500, Monday through Friday, 8:00 a.m. – 5:00 p.m., your local time.

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