

§ 1.148-2 General arbitrage yield restriction rules.

(a) *In general.* Under section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. The investment of proceeds in higher yielding investments, however, during a temporary period described in paragraph (e) of this section, as part of a reasonably required reserve or replacement fund described in paragraph (f) of this section, or as part of a minor portion described in paragraph (g) of this section does not cause the bonds of the issue to be arbitrage bonds. Bonds are not arbitrage bonds under this section as a result of an inadvertent, insubstantial error.

(b) *Reasonable expectations*—(1) *In general.* Except as provided in paragraph (c) of this section, the determination of whether an issue consists of arbitrage bonds under section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue.

(2) *Certification of expectations*—(i) *In general.* An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's expectations as of the issue date. The certification must state the facts and estimates that form the basis for the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.

(ii) *Exceptions to certification requirement.* An issuer is not required to make a certification for an issue under paragraph (b)(2)(i) of this section if—

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., equipment lease financings in which the issuer purchases equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed \$1,000,000.

(c) *Intentional acts.* The taking of any deliberate, intentional action by the

issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional.

(d) *Materially higher yielding investments*—(1) *In general.* The yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of *materially higher* set forth in paragraph (d)(2) of this section. If yield restricted investments in the same class are subject to different definitions of *materially higher*, the applicable definition of *materially higher* that produces the lowest permitted yield applies to all the investments in the class. The yield on the issue is determined under § 1.148-4. The yield on investments is determined under § 1.148-5.

(2) *Definitions of materially higher yield*—(i) *General rule for purpose and nonpurpose investments.* For investments that are not otherwise described in this paragraph (d)(2), *materially higher* means one-eighth of 1 percentage point.

(ii) *Refunding escrows and replacement proceeds.* For investments in a refunding escrow or for investments allocable to replacement proceeds, *materially higher* means one-thousandth of 1 percentage point.

(iii) *Program investments.* For program investments that are not described in paragraph (d)(2)(iv) of this section, *materially higher* means 1 and one-half percentage points.

(iv) *Student loans.* For qualified student loans that are program investments, *materially higher* means 2 percentage points.

(v) *Tax-exempt investments.* For investments that are tax-exempt bonds and are not investment property under section 148(b)(3), no yield limitation applies.

(3) *Mortgage loans.* Qualified mortgage loans that satisfy the requirements of section 143(g) are treated as

meeting the requirements of this paragraph (d).

(e) *Temporary periods*—(1) *In general.* During the temporary periods set forth in this paragraph (e), the proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds. This paragraph (e) does not apply to refunding issues (see § 1.148-9).

(2) *General 3-year temporary period for capital projects and qualified mortgage loans*—(i) *In general.* The net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of 3 years beginning on the issue date (the *3-year temporary period*). The 3-year temporary period also applies to the proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting *qualified mortgage loans* in each place that *capital projects* appears in this paragraph (e)(2). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. These rules apply separately to each conduit loan financed by an issue (other than qualified mortgage loans), with the expenditure and time tests measured from the issue date of the issue.

(A) *Expenditure test.* The expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period.

(B) *Time test.* The time test is met if the issuer incurs within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds of the issue on the capital projects. An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control.

(C) *Due diligence test.* The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceed with due diligence.

(ii) *5-year temporary period.* In the case of proceeds expected to be allocated to a capital project involving a substantial amount of construction ex-

penditures (as defined in § 1.148-7), a 5-year temporary period applies in lieu of the 3-year temporary period if the issuer satisfies the requirements of paragraph (e)(2)(i) of this section applied by substituting "5 years" in each place that "3 years" appears, and both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project.

(3) *Temporary period for restricted working capital expenditures*—(i) *General rule.* The proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Paragraph (e)(2) of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

(ii) *Longer temporary period for certain tax anticipation issues.* If an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the temporary period under paragraph (e)(3)(i) of this section is extended until the maturity date of the issue.

(4) *Temporary period for pooled financings*—(i) *In general.* Proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of 6 months while held by the issuer before being loaned to a conduit borrower. Any otherwise available temporary period for proceeds held by a conduit borrower, however, is reduced by the period of time during which those proceeds were held by the issuer before being loaned. For example, if the proceeds of a pooled financing issue loaned to a conduit borrower would qualify for a 3-year temporary period, and the proceeds are held by the issuer for 5 months before being loaned to the conduit borrower, the proceeds qualify for only an additional 31-month temporary period after being loaned to the conduit borrower. Except as provided in paragraph (e)(4)(iv) of this section,

this paragraph (e)(4) does not apply to any qualified mortgage bond or qualified veterans' mortgage bond under section 143.

(ii) *Loan repayments*—(A) *Amount held by the issuer*. The temporary period under this paragraph (e)(4) for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans is 3 months.

(B) *Amounts re-loaned to conduit borrowers*. Any temporary period for proceeds held by a conduit borrower under a new loan from amounts described in paragraph (e)(4)(ii)(A) of this section is determined by treating the date the new loan is made as the issue date and by reducing the temporary period by the period the amounts were held by the issuer following the last repayment.

(iii) *Construction issues*. If all or a portion of a pooled financing issue qualifies as a construction issue under § 1.148-7(b)(6), paragraph (e)(4)(i) of this section is applied by substituting “2 years” for “6 months.”

(iv) *Amounts re-loaned for qualified mortgage loans*. The temporary period under this paragraph (e)(4) for proceeds from the sale, prepayment, or repayment of any qualified mortgage loan that are reasonably expected to be used to make or finance new qualified mortgage loans is 3 years.

(5) *Temporary period for replacement proceeds*—(i) *In general*. Except as otherwise provided, replacement proceeds qualify for a temporary period of 30 days beginning on the date that the amounts are first treated as replacement proceeds.

(ii) *Temporary period for bona fide debt service funds*. Amounts in a bona fide debt service fund for an issue qualify for a temporary period of 13 months. If only a portion of a fund qualifies as a bona fide debt service fund, only that portion qualifies for this temporary period.

(6) *Temporary period for investment proceeds*. Except as otherwise provided in this paragraph (e), investment proceeds qualify for a temporary period of 1 year beginning on the date of receipt.

(7) *Other amounts*. Gross proceeds not otherwise eligible for a temporary period described in this paragraph (e)

qualify for a temporary period of 30 days beginning on the date of receipt.

(f) *Reserve or replacement funds*—(1) *General 10 percent limitation on funding with sale proceeds*. An issue consists of arbitrage bonds if sale proceeds of the issue in excess of 10 percent of the stated principal amount of the issue are used to finance any reserve or replacement fund, without regard to whether those sale proceeds are invested in higher yielding investments. If an issue has more than a de minimis amount of original issue discount or premium, the issue price (net of pre-issuance accrued interest) is used to measure the 10-percent limitation in lieu of stated principal amount. This rule does not limit the use of amounts other than sale proceeds of an issue to fund a reserve or replacement fund.

(2) *Exception from yield restriction for reasonably required reserve or replacement funds*—(i) *In general*. The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds. A reasonably required reserve or replacement fund may consist of all or a portion of one or more funds, however labelled, derived from one or more sources. Amounts in a reserve or replacement fund in excess of the amount that is reasonably required are not part of a reasonably required reserve or replacement fund.

(ii) *Size limitation*. The amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue. If an issue has more than a de minimis amount of original issue discount or premium, the issue price of the issue (net of pre-issuance accrued interest) is used to measure the 10 percent limitation in lieu of its stated principal amount. For a reserve or replacement fund that secures more than one issue (e.g. a parity reserve fund), the size limitation may be measured on an aggregate basis.

(iii) *Valuation of investments.* Investments in a reasonably required reserve or replacement fund may be valued in any reasonable, consistently applied manner that is permitted under § 1.148-5.

(iv) *150 percent debt service limitation on investment in nonpurpose investments for certain private activity bonds.* Section 148(d)(3) contains additional limits on the amount of gross proceeds of an issue of private activity bonds, other than qualified 501(c)(3) bonds, that may be invested in higher yielding nonpurpose investments without causing the bonds to be arbitrage bonds. For purposes of these rules, *initial temporary period* means the temporary periods under paragraphs (e)(2), (e)(3), and (e)(4) of this section and under § 1.148-9(d)(2)(i), (ii), and (iii).

(3) *Certain parity reserve funds.* The limitation contained in paragraph (f)(1) of this section does not apply to an issue if the master legal document authorizing the issuance of the bonds (e.g., a master indenture) was adopted before August 16, 1986, and that document—

(i) Requires a reserve or replacement fund in excess of 10 percent of the sale proceeds, but not more than maximum annual principal and interest requirements;

(ii) Is not amended after August 31, 1986 (other than to permit the issuance of additional bonds as contemplated in the master legal document); and

(iii) Provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under the document without satisfying the reserve fund requirements of the indenture.

(g) *Minor portion.* Under section 148(e), a bond of an issue is not an arbitrage bond solely because of the investment in higher yielding investments of gross proceeds of the issue in an amount not exceeding the lesser of—

(1) 5 percent of the sale proceeds of the issue; or

(2) \$100,000.

(h) *Certain waivers permitted.* On or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period under paragraph (e) of this section or as part of a reasonably

required reserve or replacement fund under paragraph (f) of this section. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion under paragraph (g) of this section.

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§ 1.148-3 General arbitrage rebate rules.

(a) *In general.* Section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds. The arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

(b) *Definition of rebate amount.* As of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

(c) *Computation of future value of a payment or receipt.* The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received (or treated as paid or received), plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and financial conventions used to compute that yield.

(d) *Payments and receipts—* (1) *Definition of payments.* For purposes of this section, payments are—

(i) Amounts actually or constructively paid to acquire a nonpurpose investment (or treated as paid to a commingled fund);

(ii) For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired (e.g., an investment that becomes allocable to transferred proceeds or to replacement proceeds) or that becomes subject to the rebate requirement on a date