

(j) Certain prepayments.

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#### § 1.148-1 Definitions and elections.

(a) *In general.* The definitions in this section and the definitions under section 150 apply for purposes of section 148 and §§ 1.148-1 through 1.148-11.

(b) *Certain definitions.* The following definitions apply:

*Accounting method* means both the overall method used to account for gross proceeds of an issue (e.g., the cash method or a modified accrual method) and the method used to account for or allocate any particular item within that overall accounting method (e.g., accounting for investments, expenditures, allocations to and from different sources, and particular items of the foregoing).

*Annuity contract* means annuity contract as defined in section 72.

*Available amount* means available amount as defined in § 1.148-6(d)(3)(iii).

*Bona fide debt service fund* means a fund, which may include proceeds of an issue, that—

(1) Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and

(2) Is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of:

(i) the earnings on the fund for the immediately preceding bond year; or

(ii) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

*Bond year* means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date.

*Capital project or capital projects* means all capital expenditures, plus related working capital expenditures to which the de minimis rule under § 1.148-6(d)(3)(ii)(A) applies, that carry out the

governmental purposes of an issue. For example, a capital project may include capital expenditures for one or more buildings, plus related start-up operating costs.

*Commingled fund* means any fund or account containing both gross proceeds of an issue and amounts in excess of \$25,000 that are not gross proceeds of that issue if the amounts in the fund or account are invested and accounted for collectively, without regard to the source of funds deposited in the fund or account. An open-end regulated investment company under section 851, however, is not a commingled fund.

*Computation date* means each date on which the rebate amount for an issue is computed under § 1.148-3(e).

*Computation period* means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date.

*Consistently applied* means applied uniformly within a fiscal period and between fiscal periods to account for gross proceeds of an issue and any amounts that are in a commingled fund.

*De minimis amount* means—

(1) In reference to original issue discount (as defined in section 1273(a)(1)) or premium on an obligation—

(i) An amount that does not exceed 2 percent multiplied by the stated redemption price at maturity; plus

(ii) Any original issue premium that is attributable exclusively to reasonable underwriters' compensation; and

(2) In reference to market discount (as defined in section 1278(a)(2)(A)) or premium on an obligation, an amount that does not exceed 2 percent multiplied by the stated redemption price at maturity.

*Economic accrual method* (also known as the *constant interest method* or *actuarial method*) means the method of computing yield that is based on the compounding of interest at the end of each compounding period.

*Fair market value* means fair market value as defined in § 1.148-5(d)(6).

*Fixed rate investment* means any investment whose yield is fixed and determinable on the issue date.

*Fixed yield bond* means any bond whose yield is fixed and determinable on the issue date using the assumptions and rules provided in § 1.148-4(b).

*Fixed yield issue* means any issue if each bond that is part of the issue is a fixed yield bond.

*Gross proceeds* means any proceeds and replacement proceeds of an issue.

*Guaranteed investment contract* includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract).

*Higher yielding investments* means higher yielding investments as defined in section 148(b)(1).

*Investment* means any investment property as defined in sections 148(b)(2) and 148(b)(3), and any other tax-exempt bond.

*Investment proceeds* means any amounts actually or constructively received from investing proceeds of an issue.

*Investment-type property* is defined in paragraph (e) of this section.

*Issue price* means, except as otherwise provided, issue price as defined in sections 1273 and 1274. Generally, the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. Ten percent is a substantial amount. The public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. The issue price does not change if part of the issue is later sold at a different price. The issue price of bonds that are not substantially identical is determined separately. The issue price of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. If a bond is issued for property, the applicable Federal tax-exempt rate is used in lieu of the Federal rate in determining the issue price under section 1274. The issue price of

bonds may not exceed their fair market value as of the sale date.

*Issuer* generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.

*Multipurpose issue* means an issue the proceeds of which are used for two or more separate purposes determined in accordance with § 1.148-9(h).

*Net sale proceeds* means sale proceeds, less the portion of those sale proceeds invested in a reasonably required reserve or replacement fund under section 148(d) and as part of a minor portion under section 148(e).

*Nonpurpose investment* means any investment property, as defined in section 148(b), that is not a purpose investment.

*Payment* means a payment as defined in § 1.148-3(d) for purposes of computing the rebate amount, and a payment as defined in § 1.148-5(b) for purposes of computing the yield on an investment.

*Plain par bond* means a qualified tender bond or a bond—

(1) Issued with not more than a de minimis amount of original issue discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

*Plain par investment* means an investment that is an obligation—

(1) Issued with not more than a de minimis amount of original issue discount or premium, or, if acquired on a

date other than the issue date, acquired with not more than a de minimis amount of market discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

*Pre-issuance accrued interest* means amounts representing interest that accrued on an obligation for a period not greater than one year before its issue date but only if those amounts are paid within one year after the issue date.

*Proceeds* means any sale proceeds, investment proceeds, and transferred proceeds of an issue. Proceeds do not include, however, amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under § 1.148-2(d) or section 143(g) or to qualified administrative costs recoverable under § 1.148-5(e).

*Program investment* means a purpose investment that is part of a governmental program in which—

(1) The program involves the origination or acquisition of purpose investments;

(2) At least 95 percent (90 percent for qualified student loans under section 144(b)(1)(A)) of the cost of the purpose investments acquired under the program represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, persons who provide housing and related facilities, or any combination of the foregoing;

(3) At least 95 percent of the receipts from the purpose investments are used to pay principal, interest, or redemption prices on issues that financed the program, to pay or reimburse administrative costs of those issues or of the program, to pay or reimburse anticipated future losses directly related to the program, to finance additional purpose investments for the same general

purposes of the program, or to redeem and retire governmental obligations at the next earliest possible date of redemption;

(4) The program documents prohibit any obligor on a purpose investment financed by the program or any related party to that obligor from purchasing bonds of an issue that finance the program in an amount related to the amount of the purpose investment acquired from that obligor; and

(5) The issuer has not waived the right to treat the investment as a program investment.

*Purpose investment* means an investment that is acquired to carry out the governmental purpose of an issue.

*Qualified administrative costs* means qualified administrative costs as defined in § 1.148-5(e).

*Qualified guarantee* means a qualified guarantee as defined in § 1.148-4(f).

*Qualified hedge* means a qualified hedge as defined in § 1.148-4(h)(2).

*Reasonable expectations or reasonableness.* 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 the 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, and the existence of covenants, enforceable by bondholders, that require implementation of specific expectations. For a conduit financing issue, factors relevant to a determination of reasonableness include the reasonable expectations of the conduit borrower, but only if, under the circumstances, it is reasonable and prudent for the issuer to rely on those expectations.

*Rebate amount* means 100 percent of the amount owed to the United States under section 148(f)(2), as further described in § 1.148-3.

*Receipt* means a receipt as defined in § 1.148-3(d) for purposes of computing the rebate amount, and a receipt as defined in § 1.148-5(b) for purposes of computing yield on an investment.

## § 1.148-1

## 26 CFR Ch. I (4-1-05 Edition)

*Refunding escrow* means one or more funds established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior issues. For this purpose, funds are generally not so established solely because of—

(1) The deposit of proceeds of an issue and replacement proceeds of the prior issue in an escrow more than 6 months apart, or

(2) The deposit of proceeds of completely separate issues in an escrow.

*Replacement proceeds* is defined in paragraph (c) of this section.

*Restricted working capital expenditures* means working capital expenditures that are subject to the proceeds-spent-last rule in § 1.148-6(d)(3)(i) and are ineligible for any exception to that rule.

*Sale proceeds* means any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right that is associated with a bond, and that is described in § 1.148-4(b)(4). See also § 1.148-4(h)(5) treating amounts received upon the termination of certain hedges as sale proceeds.

*Stated redemption price* means the redemption price of an obligation under the terms of that obligation, including any call premium.

*Transferred proceeds* means transferred proceeds as defined in § 1.148-9 (or the applicable corresponding provision of prior law).

*Unconditionally payable* means payable under terms in which—

(1) Late payment or nonpayment results in a significant penalty to the borrower or reasonable remedies to the lender, and

(2) It is reasonably certain on the issue date that the payment will actually be made.

*Value* means value determined under § 1.148-4(e) for a bond, and value determined under § 1.148-5(d) for an investment.

*Variable yield bond* means any bond that is not a fixed yield bond.

*Variable yield issue* means any issue that is not a fixed yield issue.

*Yield* means yield computed under § 1.148-4 for an issue, and yield computed under § 1.148-5 for an investment.

*Yield restricted* means required to be invested at a yield that is not materially higher than the yield on the issue under section 148(a) and § 1.148-2.

(c) *Definition of replacement proceeds—*

(1) *In general.* Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in paragraph (c)(4) of this section, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

(2) *Sinking fund.* *Sinking fund* includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.

(3) *Pledged fund—*(i) *In general.* A *pledged fund* is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if

the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue. A pledge of more than 50 percent of the outstanding stock of a corporation that is a conduit borrower of the issue is not treated as a pledge for this purpose, unless the corporation is formed or availed of to avoid the creation of replacement proceeds.

(ii) *Negative pledges.* An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged under this paragraph (c)(3)(ii), however, if—

(A) The issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or

(B) The amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

(4) *Other replacement proceeds—(i) Bonds outstanding longer than necessary—(A) In general.* Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that—

(1) The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

(2) There will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148-10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

(B) *Safe harbor against creation of replacement proceeds.* As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section—

(1) For the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years;

(2) For the portion of an issue (including a refunding issue) that is to be used to finance or refinance capital projects, if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined in the same manner as under section 147(b); or

(3) For the portion of an issue that is a refunding issue, if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies paragraph (c)(4)(i)(B) (1) or (2) of this section.

(ii) *Bonds financing a working capital reserve—(A) In general.* Except as otherwise provided in paragraph (c)(4)(ii)(B) of this section, replacement proceeds arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund a working capital reserve, the issuer will have replacement proceeds. To determine the amount of a working capital reserve maintained, an issuer may use the average amount maintained as a working capital reserve during annual periods of at least 1 year, the last of which ends within 1 year before the issue date. For example, the amount of a working capital reserve may be computed using the average of the beginning or ending monthly balances of the amount maintained as a reserve (net of unexpended gross proceeds) during the 1 year period preceding the issue date.

(B) *Exception to creation of replacement proceeds.* Replacement proceeds do not arise under paragraph (c)(4)(ii)(A) of this section with respect to an issue—

(1) All of the net proceeds of which are spent within 6 months of the issue date under section 148(f)(4)(B)(iii)(I); or

(2) That is not subject to the rebate requirement under the exception provided by section 148(f)(4)(D).

(d) *Elections.* Except as otherwise provided, any required elections must be made in writing, and, once made, may not be revoked without the permission of the Commissioner.

(e) *Investment-type property*—(1) *In general.* Investment-type property includes any property, other than property described in section 148(b)(2)(A), (B), (C) or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) *Prepayments*—(i) *In general*—(A) *Generally.* Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(1) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(2) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(3) The prepayment meets the requirements of paragraph (e)(2)(iii)(A) or (B) of this section.

(B) *Example.* The following example illustrates an application of this paragraph (e)(2)(i):

*Example.* Prepayment after contract is executed.

In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepay-

ment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

(ii) *Customary prepayments.* The determination of whether a prepayment satisfies paragraph (e)(2)(i)(A)(1) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (e)(2)(i)(A)(1) of this section if—

(A) The prepayment is made for—

(1) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(2) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to non-governmental persons on the same terms.

(iii) *Certain prepayments to acquire a supply of natural gas or electricity*—(A) *Natural gas prepayments.* A prepayment meets the requirements of this paragraph (e)(2)(iii)(A) if—

(1) It is made by or for one or more utilities that are owned by a governmental person, as defined in § 1.141-1(b) (each of which is referred to in this paragraph (e)(2)(iii)(A) as the issuing municipal utility), to purchase a supply of natural gas; and

(2) At least 90 percent of the prepaid natural gas financed by the issue is used for a qualifying use. Natural gas is used for a qualifying use if it is to be—

(i) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, provided, however, that gas used to produce electricity for sale shall not be included under this paragraph (e)(2)(iii)(A)(2)(i);

(ii) Used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility;

(iii) Used by the issuing municipal utility to produce electricity that will be sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser;

(iv) Sold to a utility that is owned by a governmental person if the requirements of paragraph (e)(2)(iii)(A)(2)(i), (ii) or (iii) of this section are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or

(v) Used to fuel the pipeline transportation of the prepaid gas supply acquired in accordance with this paragraph (e)(2)(iii)(A).

(B) *Electricity prepayments.* A prepayment meets the requirements of this paragraph (e)(2)(iii)(B) if—

(1) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(2) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be—

(i) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or

(ii) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

(C) *Service area.* For purposes of this paragraph (e)(2)(iii), the service area of a utility owned by a governmental person consists of—

(1) Any area throughout which the utility provided, at all times during the 5-year period ending on the issue date—

(i) In the case of a natural gas utility, natural gas transmission or distribution service; and

(ii) In the case of an electric utility, electricity distribution service; and

(2) Any area recognized as the service area of the utility under state or Federal law.

(D) *Retail customer.* For purposes of this paragraph (e)(2)(iii), a retail cus-

tomers is a customer that purchases natural gas or electricity, as applicable, other than for resale.

(E) *Commodity swaps.* A prepayment does not fail to meet the requirements of this paragraph (e)(2)(iii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas or electricity supplier), or between the gas or electricity supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas or electricity supply contract or another swap contract); provided, however, that a commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas or electricity supplier to deliver gas or electricity for which the swap contract is a hedge.

(F) *Remedial action.* Issuers may apply principles similar to the rules of §1.141-12, including §1.141-12(d) (relating to redemption or defeasance of nonqualified bonds) and §1.141-12(e) (relating to alternative use of disposition proceeds), to cure a violation of paragraph (e)(2)(iii)(A)(2) or (e)(2)(iii)(B)(2) of this section. For this purpose, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141-7(d), treating nonqualified sales of gas or electricity under this paragraph (e)(2)(iii) as satisfying the benefits and burdens test under §1.141-7(c)(1).

(iv) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

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