Tools for Investing Proceeds of Tax-Exempt Bonds

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04/17/2024

In a previous article, we introduced the fundamental concepts of the yield restriction and rebate rules set out in the Internal Revenue Code and Treasury Regulations and how tax-exempt bonds may be affected by high interest rates. But, as the saying goes, for every rule there is an exception, and there are several exceptions to the yield restriction rule that provides helpful tools for issuers investing the proceeds of tax-exempt bonds.

If you will remember, the yield restriction rule prohibits the proceeds of tax-exempt bonds from being invested at a yield higher than the yield on the bonds by more than 0.125 percent. Such investments are called higher yielding investments. If tax-exempt bond proceeds are invested in higher yielding investments, the bonds may become arbitrage bonds and risk losing their tax-exempt status.

Issuers must be aware of a few definitions to understand how to use the exceptions to the yield restriction rule. The yield restriction rule applies to the gross proceeds of the tax-exempt bonds. Gross proceeds include sale proceeds, investment proceeds, transferred proceeds and replacement proceeds. Sale proceeds are amounts paid for the bonds by the purchasers of the bonds, and investment proceeds are amounts received from the investment of gross proceeds. Transferred proceeds and replacement proceeds are beyond the scope of this article and will not be discussed.

Exceptions to the yield restriction rule allow gross proceeds to be invested in higher yielding investments. These exceptions include the exception for reasonably required reserve funds, the minor portion exception, and the temporary period exceptions. Under these exceptions an issuer may invest the gross proceeds covered by an exception in higher yielding investments therefore earning arbitrage.

Two of the exceptions have no time limit meaning the exception applies throughout the period that the bonds are outstanding. The first such exception is for reasonably required reserve funds. A reasonably required reserve fund is not subject to the yield restriction rule if the amount of proceeds held in such fund does not exceed the lesser of (i) 10 percent of the principal amount of the bonds, (ii) the maximum annual debt service of the bonds, or (iii) 125 percent of the average annual debt service of the bonds. Any amount in a reasonably required reserve fund in excess of such limited amounts must be invested at a yield less than the yield on the bonds. It is important to note that no more than 10 percent of the sale proceeds of the bonds can be used to fund a reasonably required reserve fund.

The minor portion exception is the second exception having no time limit. Under the minor portion exception, an issuer is allowed to invest a minor portion of its proceeds in higher yielding investments without worrying if the bonds will become arbitrage bonds. A minor portion is generally defined as the lesser of $100,000 or 5 percent of the sale proceeds of the bonds.

The temporary period exceptions to the yield restriction rule provide that proceeds may be invested in higher yielding investments for a permitted period without causing the bonds to become arbitrage bonds. Under the first temporary period exception an issuer can deposit sale proceeds and investment proceeds in a fund to be used to pay the acquisition or construction costs of a capital project and invest such proceeds in higher yielding investments for a period of three years beginning on the date the bonds are issued.

The three year temporary period applies as long as the issuer reasonably expects to (i) to spend 85 percent of the sale and investment proceeds on the capital project within three years of the date the bonds are issued, (ii) make binding commitments to spend 5 percent of such proceeds within six months of the date the bonds are issued, and (iii) proceed with due diligence in completing the capital project and spending such proceeds on the capital project. An issuer may extend the three year period to up to five years if the issuer and a licensed architect or engineer certify that a longer period is necessary to complete the capital project.

Other temporary period exceptions to the yield restriction rule include:

(1) 13-month temporary period exception for a bona fide debt service fund which is a fund used to achieve proper matching of revenues with principal and interest payments and is depleted at least once during each year the bonds are outstanding;

(2) 1- year temporary period exception for investment proceeds beginning on the date of receipt; and

(3) 30-day temporary period exception for gross proceeds that do not qualify for any other special temporary period exception beginning on the date of receipt.

These temporary period exceptions may allow issuers to invest in higher yielding investments for a specific period of time; however, just because issuers can earn arbitrage under the temporary period exceptions does not mean they can keep it. An exception to the rebate rules must apply for issuers to be able to keep any arbitrage earned. The yield restriction rule and the rebate rule each independently apply to tax-exempt bonds and must be analyzed separately. Whether an issuer may keep arbitrage under an exception to the rebate rule will be the topic of future articles.

Any gross proceeds that do not qualify for an exception to the yield restriction rule and any proceeds remaining after the end of a temporary period may not be invested in higher yielding investments. These proceeds are generally referred to as yield restricted. If it is determined that gross proceeds have not been yield restricted, another helpful tool for an issuer is making a yield reduction payment o the Internal Revenue Service. By making the yield reduction payment, the issuer effectively reduces the return on such investment to a yield that is not materially higher than the yield on the bonds. Yield reduction payments must be made at the same time as the payment of arbitrage to the Internal Revenue Service.

To remain in compliance with the many requirements and timing limitations associated with investing proceeds of tax-exempt bonds, issuers must plan and monitor the investment of such proceeds or risk its tax-exempt bonds becoming arbitrage bonds and the interest being subject to federal income taxes.

This article is intended to provide a general explanation of a complex area of federal tax law. For guidance or more in-depth understanding of these concepts, contact Attorney Ashley Edwards or Attorney John Bryant.