[Bond Case Briefs]

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[Final Arbitrage Regulations Require "Look Through" to a Grantee's Use of Bond Proceeds: A Big "So What?": Squire Patton Boggs]

From time to time, issuers will use bond proceeds to make grants to accomplish a governmental purpose. For example, a State bond issuer may make grants to various counties and cities to help with the cost of local transportation improvements. Under the arbitrage regulations ([Reg. 1.148-6(d)(4)]), the bond proceeds are treated as spent once an issuer makes a grant of bond proceeds to an unrelated party, so long as it is truly a grant (and not an advance that must be repaid). This means that the issuer can stop monitoring the investment yield that it receives from those proceeds once it makes the grant.`

Contrast this with the case in which an issuer transfers bond proceeds to a recipient in the form of a loan. In that case, the loan will be treated as an investment of bond proceeds. This means that the issuer must continue to monitor the investment yield that it receives on the loan, in the form of debt service payments from the recipient. In addition, in the case of a loan, it is clear under other provisions that apply to tax-exempt bonds that the issuer must look through to examine what the loan recipient does with the proceeds that it receives. For example, the issuer must look through to the status of the loan recipient as a governmental person or a private person for purposes of the private business use rules. However, once the loan recipient then spends the bond proceeds on something that counts as an expenditure under the arbitrage rules (for example, by paying them to a construction company in exchange for the company's services in building capital assets of the bond-financed project), at that point the bond proceeds are treated as spent for the purpose to which the loan recipient applied them. In other words, neither the issuer nor the loan recipient would need to look through to examine how the construction company invested and spent the proceeds that were transferred.

Prior to [2013 proposed arbitrage regulations] covering the point, the Code and Treasury Regulations were silent on how to treat bond proceeds that are used to make a grant for purposes other than when to treat the proceeds as spent for arbitrage purposes. Faced with this silence, issuers or conduit borrowers that made a grant of bond proceeds had basically two choices: (1) treat the arbitrage rule as applying for all tax-exempt bond purposes, so that once the issuer or conduit borrower made the grant, the grant recipient would be treated like the construction company in the above example (for example, its identity as a private person would not affect the private business use analysis, and its further investment and use of the proceeds could not affect the tax status of the bonds that financed the grant), or (2) treat the arbitrage rule as applying for arbitrage purposes relating to the timing of the expenditure of bond proceeds (and any purposes that explicitly tie to that arbitrage treatment, such as the "hedge bond" rules (see [Reg. 1.149(g)-1(b)]), but look through to the grantee's use for other purposes, such as private business use. (One supposes that a particularly cheeky issuer might have cherrypicked Choice (1) or (2) depending on the tax issue in question, but we will rule that out in the interest of good manners.)

Choice (2) was the predominant choice, both out of conservatism in the face of uncertainty, and because Choice (1) leaves us with an entirely unsatisfying answer on one particular issue: the useful life of the bond-financed assets. Under Choice (1), there is no easy way to determine the useful life to the issuer (which is the grantor) of bond proceeds, without looking to see what the grantee does with the bond proceeds.

Now, in governmental bond financings, the useful life of the bond-financed assets is of some interest, although it is not what Mike likes to call a "third-rail" issue[1] as it is in private activity bond financings, where the bonds become taxable if the weighted average maturity of the bonds exceeds 120% of the useful life of the bond-financed assets.

Nevertheless, it is still in an issuer's interest to ensure that the useful life of the bond-financed assets is not wildly out of sync with the weighted average maturity of the bond issue. Compliance with the 120% useful life test will shelter a governmental bond issue within several safe harbors that protect the bond issue from several anti-abuse type rules (for example, the rule in Reg. 1.148-1(c)(4)(i) that can magically transform "available amounts" of the issuer into replacement proceeds of the bond issue that are therefore subject to yield restriction and rebate where bonds are deemed to be outstanding longer than necessary).

In contrast, because of the way that a "grant" is defined under the arbitrage rules, even prior to the 2013 Proposed Regulations, for private business use purposes, an issuer would be in the same place whether it looked through to the grantee's use of the proceeds or not. Recall that, to raise significant tax problems under the private activity bond rules, an issue must exceed the private loan limit, or **both** of the private business use limit **and** the private payment limit. Because even prior to the 2013 Proposed Regulations, a "grant" is not a "grant" unless the recipient doesn't have to pay it back, it is (a) by definition not a loan, so that it cannot be a private loan, and (b) will not generate a stream of private payments coming back to the issuer. Thus, for private business use purposes, if an issuer chose Choice (1) and didn't look through to the grantee's use for private business purposes (treating the grantee like the construction company in our hypothetical above), then no private business use would result, and if an issuer chose Choice (2) and looked through, then, even though private business use might result, there would be no private payments. In each case, the grant is a grant, and thus is not a loan so that it cannot be a private loan.

The 2016 Final Regulations adopt the position of the 2013 Proposed Regulations and force issuers to choose Choice (2). These regulations confirm that a grantor of bond proceeds must look through to the grantee's use of proceeds for all purposes other than determining when the bond proceeds are spent for arbitrage purposes and any other purposes (such as hedge bonds) that relate to the timing of the expenditure of bond proceeds. These rules are now in new subsection 1.150-1(f). So in some sense, the rule on grants in the Final Regulations might have been a big "so what."

However, there is value in certainty. Although even under prior law issuers essentially had to look through for useful life purposes and it may not have mattered whether they looked through for private activity bond purposes, the clarification in the 2016 Final Regulations is still helpful because it finally puts to rest any lingering uncertainty about the scope of the rules. In addition, the look-through rule will provide certainty in the case where there are unexpected repayments of a grant from a private person that might be characterized as private payments that could give rise to private activity bond problems.

Moreover, the 2016 Final Regulations also give us answers to some questions lingering at the fringes. (As my grandmother used to tell me, there's more to life than private activity bond tests and the question of when proceeds are spent for arbitrage purposes.) For example – before the proceeds are spent for a grant, can the issuer invest those proceeds at an unrestricted yield during a temporary period? If so, what temporary period applies? Does that depend on the issuer's expectations, or the grantee's expectations? To take a specific case, does the 3-year temporary period in Reg. 1.148-2(e)(2) for bond proceeds to be used for a capital project apply based on when the issuer expects to make the grant of bond proceeds, or does it depend on what the grantee plans to do with the granted bond proceeds (and when it plans to do it)? Based on the phrasing of the Final Regulations ("Except as otherwise provided . . . "), and based on the fact that there is no other Regulation or guidance that answers this question about temporary periods, the answer now seems clear. The three-year temporary period will be available based on the grantee's expectations.

So, even though the choices that issuers made in the face of uncertainty and the interaction of the grant rules and the private activity bond rules may have made the rule for grants in the final regulations a "so what," there are still aspects of the rule that are interesting; this is a phenomenon that someone who writes for a public finance tax blog can relate to.

[1] Mike tells me that, years ago, he saw an interview of Eugene Levy in which Mr. Levy said that he knew that the critically acclaimed SCTV program had become too self-referential, and therefore doomed, when it did a parody of an SCTV cameraman's mother. Could the same fate befall a critically acclaimed legal blog?

Squire Patton Boggs

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