Chapman and Cutler LLP

Chapman Client Alert

July 20, 2016 Current Issues Relevant to Our Clients

Final Arbitrage Regulations Released

On July 18, 2016, the U.S. Treasury and the Internal Revenue Service published final arbitrage regulations (the *"Final Regulations"*) that contain revisions to the tax-exempt bond regulations relating to, among other things, working capital financings, including long-term working capital financings, the treatment of swaps and other hedges, recovery of overpayments of arbitrage rebate, the calculation of bond yield and the valuation of investments allocated to a bond issue. The Final Regulations finalize and amend certain proposed regulations that were published in 2007 and 2013.

Many provisions in the Final Regulations address working capital financings (*e.g.*, tax-exempt bond financings for operating expenses of an issuer or borrower or extraordinary, non-recurring working capital expenditures). Generally, for bond issuers and borrowers to finance operating expenses with the proceeds of tax-exempt bonds, the issuer or borrower must demonstrate that it would have no other amounts available to allocate to such working capital expenditures on the date the bond proceeds are allocated to such expenditures. If an issuer or borrower has other available amounts to allocate to those expenditures, bond proceeds generally are not spent for arbitrage purposes. The Final Regulations include provisions that (i) amend the temporary period safe harbor (during which bond proceeds can generally be invested above bond yield) for certain working capital financings, (ii) provide certain safe harbor maturity limitations for working capital financings, (iii) set forth procedures to annually monitor available amounts and remediate excess balances if deficits are not met for long-term working capital financings and (iv) simplify the calculation of the amount treated as an unavailable working capital reserve.

The Final Regulations also include a number of provisions addressing the treatment of interest rate swaps and other hedges. Generally, payments made and received on a "qualified hedge" may be taken into account in computing the yield on an issue of bonds and may be paid from bond proceeds. For a hedge to be a qualified hedge, among other requirements, the hedge must be entered into primarily to modify interest rate change risk and must be primarily interest based, the timing of payments on the hedge must closely correspond with the timing of payments on the hedged bonds, the issuer must identify the hedge on its books and records, and the hedge may not contain a significant investment element (with certain exceptions). The Final Regulations include provisions addressing (i) the treatment of a taxable index hedge as an interest-based contract, (ii) when payments closely correspond on the hedge and the hedged bonds, (iii) the extension of the period of time for identification of a qualified hedge, (iv) required hedge counterparty certifications, (v) continuation of a qualified hedge for a refunding bond issue when it is not terminated in connection with a refunding and (vi) when modifications or amendments to a qualified hedge result in a deemed termination of the hedge.

Other provisions addressed in the Final Regulations include: (i) the calculation of bond yield in certain circumstances, (ii) expanded situations in which an issuer may make yield reduction payments, (iii) provisions addressing the valuation of certain investments, the arbitrage rebate computation credit and recovery of overpayment of rebate, (iv) the safe harbor fair market value requirements for guaranteed investment contracts, (v) the small issuer rebate exception for pooled financings, (vi) anti-abuse rules under the arbitrage regulations, (vii) state perpetual trust funds and (viii) grants and the treatment of grants.

The Final Regulations generally apply to bonds sold, or hedges entered into or modified, on or after October 17, 2016. The Final Regulations also permit issuers to apply certain of the provisions of the Final Regulations prior to October 17, 2016.

For More Information

If you would like further information concerning the matters discussed in this article, please contact a member of our Public Finance Group or visit us online at chapman.com.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®