PFM InvestEd
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Proactive Tax Planning:

Important Considerations Regarding Yield Restriction Can Help You Avoid an Unnecessary IRS Bill

This edition of InvestEd from PFM Asset Management LLC (PFMAM) summarizes yield restriction requirements as they relate to tax-exempt and tax-advantaged bonds (for example, Build America Bonds). It also explains certain tax elections available to issuers and the potential benefits and drawbacks of these elections. Please note that each municipal entity and bond issuance has unique circumstances requiring specific review and advice in coordination with accounting, legal and investment professionals.

Yield Restriction Background

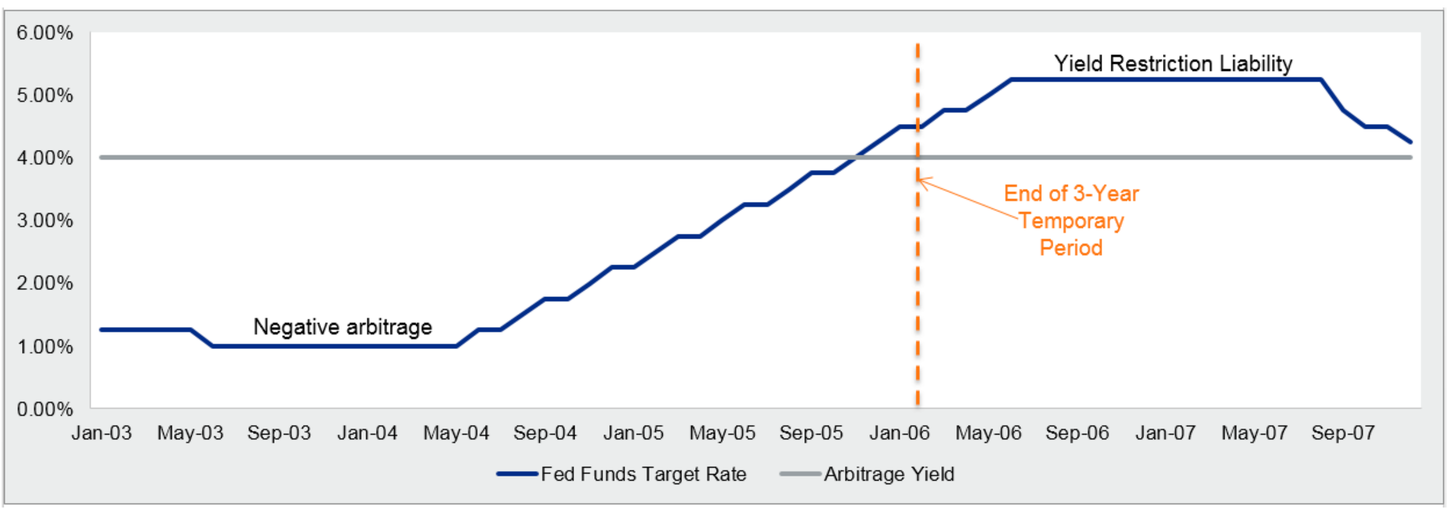
All tax-exempt bond issues must comply with two separate sets of requirements: arbitrage rebate and yield restriction[1]. Both sets of rules limit earnings on the investment of tax-exempt bond proceeds. While arbitrage rebate requirements begin on the bond's issue date, yield restriction requirements do not apply until the end of an applicable "temporary period," which is three years for most project funds. It is important to note that the calculations of each liability are separate and do not offset each other. A positive yield restriction liability (earnings above the bond yield) cannot be blended down with a negative arbitrage rebate liability (earnings below the bond yield). The temporary periods for common yield-restricted funds are shown in the table below:

Type of Fund	Temporary Period
Project/Construction Fund	Three years[2]
Current Refunding Escrow	90 days
Advance Refunding Escrow	30 days

While this memorandum focuses on project/construction funds, an issuer may elect to waive any of the allowable temporary periods described above — but must do so in writing (typically in the tax certificate) by the bond issue's delivery date.

Yield Restriction in Rising Interest Rate Environments

If interest rates rise above the bond yield, it is possible for a positive yield-restriction liability to accrue on unspent proceeds after the three-year temporary period — despite the proceeds being invested below the bond yield during the early years of the project. Because a negative arbitrage-rebate liability cannot offset a positive yield-restriction liability, the result would be a payment due to the Internal Revenue Service (IRS) for the excess earnings after the end of the temporary period. The chart below shows a hypothetical bond issue during the last period of rate hikes from the Federal Reserve (Fed).



[1] According to Section 148 of the Internal Revenue Code.
[2] Unless extended to five years with an engineer's or architect's certification due to a longer project period.

In the scenario illustrated in the chart on the previous page, the proceeds of a hypothetical bond issue initially accrued a negative arbitrage rebate liability due to low interest rates. However, once the temporary period ended, the proceeds accrued a positive yield-restriction liability because interest rates rose above the bond yield. In this case, the issuer would owe the IRS a yield-restriction payment for excess earnings.

Waiving the Temporary Period

At the time of issuance, issuers have the option of waiving the right to invest proceeds in higher yielding investments for the initial three-year temporary period. When the temporary period is waived, the arbitrage rebate and yield restriction calculations both begin on the issue date, and the liabilities mirror one another. The potential benefit of waiving the temporary period is that lower earnings during the project's early years can be used to blend down higher earnings in the project's later years for the purpose of computing the yield restriction liability. Waiving the temporary period can be an appealing option for issuers with a high level of certainty that after three years, they will have unspent proceeds that would become subject to yield restriction. For those issuers, waiving the temporary period could prevent a surprise yield restriction liability resulting from rising interest rates, as depicted in the chart on the previous page.

Draw Schedule Confidence

Understanding the draw schedule is key when considering the election to waive the temporary period. The election can be detrimental to issuers if proceeds spend down too quickly and interest rates rise rapidly above the bond yield. If draws accelerate enough that the proceeds qualify for a spending exception to arbitrage rebate, waiving the temporary period initially could result in a yield restriction payment to the IRS when none would have been due otherwise. Therefore, it is important for issuers to consider potential changes to the actual draw schedule and the likelihood of spending proceeds faster than anticipated. It is essential to keep in mind that waiving the temporary period benefits issuers only if unspent proceeds remain three years after the bond issue date. For example, if an issuer has a high degree of confidence in an 18-month draw schedule and it is highly unlikely that any proceeds would remain unspent in three years, then waiving the temporary period may not be beneficial for this bond issue.

Timing

The election to waive the three-year temporary period on project fund proceeds must be done in writing at the time the bonds are issued. The election cannot be made retroactively. For this reason, be sure to discuss the election with your bond and tax counsel prior to the transaction's closing.

PFMAM's Arbitrage & Tax Compliance Group is available to answer any questions.