

Section 147. Other requirements applicable to certain private activity bonds

(a) Substantial user requirement.

(1) In general. Except as provided in subsection (h), a private activity bond shall not be a qualified bond for any period during which it is held by a person who is a substantial user of the facilities or by a related person of such a substantial user.

(2) Related person. For purposes of paragraph (1), the following shall be treated as related persons

(A) 2 or more persons if the relationship between such persons would result in a disallowance of losses under section 267 or 707(b),

(B) 2 or more persons which are members of the same controlled group of corporations (as defined in section 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein),

(C) a partnership and each of its partners (and their spouses and minor children), and

(D) an S corporation and each of its shareholders (and their spouses and minor children).

(b) Maturity may not exceed 120 percent of economic life.

(1) General rule. Except as provided in subsection (h), a private activity bond shall not be a qualified bond if it is issued as part of an issue and

(A) the average maturity of the bonds issued as part of such issue, exceeds

(B) 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of such issue.

(2) Determination of average. For purposes of paragraph (1)

(A) the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of such issue, and

(B) the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

(3) Special rules.

(A) Determination of economic life. For purposes of this subsection, the reasonably expected economic life of any facility shall be determined as of the later of-

(i) the date on which the bonds are issued, or

(ii) the date on which the facility is placed in service (or expected to be placed in service).

(B) Treatment of land.

(i) Land not taken into account. Except as provided in clause (ii), land shall not be taken into account under paragraph (1)(B).

(ii) Issues where 25 percent or more of proceeds used to finance land. If 25 percent or more of the net proceeds of any issue is to be used to finance land, such land shall be taken into account under paragraph (1)(B) and shall be treated as having an economic life of 30 years.

(4) Special rule for pooled financing of 501(c)(3) organization.

(A) In general. At the election of the issuer, a qualified 501(c)(3) bond shall be treated as meeting the requirements of paragraph (1) if such bond meets the requirements of subparagraph (B).

(B) Requirements. A qualified 501(c)(3) bond meets the requirements of this subparagraph if-

(i) 95 percent or more of the net proceeds of the issue of which such bond is a part are to be used to make or finance loans to 2 or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations,

(ii) each loan described in clause (i) satisfies the requirements of paragraph (1) (determined by treating each loan as a separate issue),

(iii) before such bond is issued, a demand survey was conducted which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of such issue, and

(iv) 95 percent or more of the net proceeds of such issue are to be loaned to 501(c)(3) organizations or governmental units within 1 year of issuance and, to the extent there are any unspent proceeds after such 1-year period, bonds issued as part of such issue are to be redeemed as soon as possible thereafter (and in no event later than 18 months after issuance).

A bond shall not meet the requirements of this subparagraph if the maturity date of any bond issued as part of such issue is

more than 30 years after the date on which the bond was issued (or, in the case of refunding or series of refundings, the date on which the original bond was issued).

(5) Special rule for certain FHA insured loans. Paragraph (1) shall not apply to any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to finance mortgage loans insured under FHA 242 or under a similar Federal Housing Administration program (as in effect on the date of the enactment of the Tax Reform Act of 1986) where the loan term approved by such Administration plus the maximum maturity of debentures which could be issued by such Administration in satisfaction of its obligations exceeds the term permitted under paragraph (1).

(c) Limitation on use for land acquisition.

(1) In general. Except as provided in subsection (h), a private activity bond shall not be a qualified bond if-

(A) it is issued as part of an issue and 25 percent or more of the net proceeds of such issue are to be used (directly or indirectly) for the acquisition of land (or an interest therein), or

(B) any portion of the proceeds of such issue is to be used (directly or indirectly) for the acquisition of land (or an interest therein) to be used for farming purposes.

(2) Exception for first-time farmers.

(A) In general. If the requirements of subparagraph (B) are met with respect to any land, paragraph (1) shall not apply to such land, and subsection (d) shall not apply to property to be used thereon for farming purposes, but only to the extent of expenditures (financed with the proceeds of the issue) not in excess of \$250,000.

(B) Acquisition by first-time farmers. The requirements of this subparagraph are met with respect to any land if-

(i) such land is to be used for farming purposes, and

(ii) such land is to be acquired by an individual who is a first-time farmer, who will be the principal user of such land, and who will materially and substantially participate on the farm of which such land is a part in the operation of such farm.

(C) First-time farmer. For purposes of this paragraph-

(i) In general. The term "first-time farmer" means any individual if such individual-

(I) has not at any time had any direct or indirect ownership

interest in substantial farmland in the operation of which such individual materially participated, and

(II) has not received financing under this paragraph in an amount which, when added to the financing to be provided under this paragraph, exceeds \$250,000.

(ii) Aggregation rules. Any ownership or material participation, or financing received, by an individual's spouse or minor child shall be treated as ownership and material participation, or financing received, by the individual.

(iii) Insolvent farmer. For purposes of clause (i), farmland which was previously owned by the individual and was disposed of while such individual was insolvent shall be disregarded if section 108 applied to indebtedness with respect to such farmland.

(D) Farm. For purposes of this paragraph, the term "farm" has the meaning given such term by section 6420(c)(2).

(E) Substantial farmland. For purposes of this paragraph, the term "substantial farmland" means any parcel of land unless-

(i) such parcel is smaller than 15 percent of the median size of a farm in the county in which such parcel is located, and

(ii) the fair market value of the land does not at any time while held by the individual exceed \$125,000.

(F) Used equipment limitation. For purposes of this paragraph, in no event may the amount of financing provided by reason of the paragraph to a first-time farmer for personal property-

(i) of a character subject to the allowance for depreciation.

(ii) the original use of which does not begin with such farmer, and

(iii) which is to be used for farming purposes.

exceed \$62,500. A rule similar to the rule of subparagraph (C) (ii) shall apply for purposes of the preceding sentence.

(3) Exception for certain land acquired for environmental purposes, et. Any land acquired by a governmental unit (or issuing authority) in connection with an airport, mass commuting facility, high-speed intercity rail facility, dock, or wharf shall not be taken into account under paragraph (1) if-

(A) such land is acquired for noise abatement or wetland preservation, or for future use as an airport, mass commuting facility, high-speed intercity rail facility, dock, or wharf, and

(B) there is not other significant use of such land.

(d) Acquisition of existing property not permitted.

(1) In general. Except as provided in subsection (h), a private activity bond shall not be a qualified bond if issued as part of an issue and any portion of the net proceeds of such issue is to be used for the acquisition of any property (or an interest therein) unless the 1st use of such property is pursuant to such acquisition.

(2) Exception for certain rehabilitations. Paragraph (1) shall not apply with respect to any building (and the equipment therefor) if

(A) the rehabilitation expenditures with respect to such building, equal or exceed

(B) 15 percent of the portion of the cost of acquiring such building (and equipment) financed with the net proceeds of the issue.

The rule similar to the rule of the preceding sentence shall apply in the case of structures other than a building except that subparagraph (B) shall be applied by substituting "100 percent" for "15 percent".

(3) Rehabilitation expenditures. For purposes of this subsection-

(A) In general. Except as provided in this paragraph, the term "rehabilitation expenditures" means any amount properly chargeable to capital account which is incurred by the person acquiring the building for property (or additions or improvements to property) in connection with the rehabilitation of a building. In the case of an integrated operation contained in a building before its acquisition, such term includes rehabilitating existing equipment in such building or replacing it with equipment having substantially the same function. For purposes of this subparagraph, any amount incurred by a successor to the person acquiring the building or by the seller under a sales contract with such person shall be treated as incurred by such person.

(B) Certain expenditures not included. The term "rehabilitation expenditures" does not include any expenditure described in section 47(c)(2)(B).

(C) Period during which expenditures must be incurred. The term "rehabilitation expenditures" shall not include any amount which is incurred after the date 2 years after the later of-

(i) the date on which the building was acquired, or

(ii) the date on which the bond was issued.

(4) Special rule for certain projects. In the case of a project involving 2 or more buildings, this subsection shall be applied on a project basis.

(e) No portion of bonds may be issued for skyboxes, airplanes, gambling establishments, etc. A private activity bond shall not be a qualified bond if issued as part of an issue and any portion of the proceeds of such issue is to be used to provide any airplane, skybox or other private luxury box, health club facility, facility primarily used for gambling, or store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(f) Public approval required for private activity bonds.

(1) In general. A private activity bond shall not be a qualified bond unless such bond satisfies the requirements of paragraph (2).

(2) Public approval requirement.

(A) In general. A bond shall satisfy the requirements of this paragraph if such bond is issued as a part of an issue which has been approved by

(i) the governmental unit

(I) which issued such bond, or

(II) on behalf of which such bond was issued, and

(ii) each governmental unit having jurisdiction over the area in which any facility, with respect to which financing is to be provided from the net proceeds of such issue, is located (except that if more than 1 governmental unit within a State has jurisdiction over the entire area within such State in which such facility is located, only 1 such unit need approve such issue).

(B) Approval by a governmental unit. For purposes of subparagraph (A), an issue shall be treated as having been approved by any governmental unit if such issue is approved

(i) by the applicable elected representative of such governmental unit after a public hearing following reasonable public notice, or

(ii) by voter referendum of such governmental unit.

(C) Special rules for approval of facility. If there has been public approval under subparagraph (A) of the plan for financing a facility, such approval shall constitute approval under subparagraph (A) for any issue

(i) which is issued pursuant to such plan within 3 years after the date of the 1st issue pursuant to the approval, and

(ii) all or substantially all of the proceeds of which are to be used to finance such facility or to refund previous financing under such plan.

(D) Refunding bonds. No approval under subparagraph (A) shall be necessary with respect to any bond which is issued to refund (other than to advance refund) a bond approved under subparagraph (A) (or treated as approved under subparagraph (C)) unless the average maturity date of the issue of which the refunding bond if part is later than the average maturity date of the bonds to be refunded by such issue. For purposes of the preceding sentence, average maturity shall be determined in accordance with subsection (B)(2)(A).

(E) Applicable elected representative. For purposes of this paragraph-

(i) In general. The term "applicable elected representative" means with respect to any governmental unit-

(I) an elected legislative body of such unit, or

(II) the chief executive officer, the chief elected State legal officer of the executive branch, or any other elected official of such unit designated for purposes of this paragraph by such chief elected executive officer or by State law.

If the office of any elected official described in subclause (II) vacated and an individual is appointed by the chief elected executive officer of the governmental unit and confirmed by the elected legislative body of such unit (if any) to serve the remaining term of the elected official, the individual so appointed shall be treated as the elected official for such remaining term.

(ii) No applicable elected representative. If (but for this clause) a governmental unit has no applicable elected representative, the applicable elected representative for purposes of clause (i) shall be the applicable elected representative of the governmental unit-

(I) which is the next higher governmental unit with such a representative, and

(II) from which the authority of the governmental unit with no such representative is derived.

(3) Special rule for approval of airports or high-speed intercity rail facilities. If-

(A) the proceeds of an issue are to be used to finance a

facility or facilities located at an airport of high-speed
intercity rail facilities, and

(B) the governmental unit issuing such bonds is the owner or
operator of such airport or high-speed intercity rail facilities,

such governmental unit shall be deemed to be the only
governmental unit having jurisdiction over such airport or high-
speed intercity rail facilities for purposes of this subsection.

(4) Special rules for scholarship funding bond issues and
volunteer fire department bond issues.

(A) Scholarship funding bonds. In the case of a qualified
scholarship funding bond, any governmental unit which made a
request described in section 150(d)(2)(B) with respect to the
issuer of such bond shall be treated for purposes of paragraph
(2) of this subsection as the governmental unit on behalf of
which such bond was issued. Where more than one governmental
unit within a State has made a request described in section 150
(d)(2)(B), the State may also be treated for purposes of
paragraph (2) of this subsection as the governmental unit on
behalf of which such bond was issued.

(B) Volunteer fire department bonds. In the case of a bond
of a volunteer fire department which meets the requirements of
section 150(e), the political subdivision described in section
150(e)(2)(B) with respect to such department shall be treated for
purposes of paragraph (2) of this subsection as the governmental
unit on behalf of which such bond was issued.

(g) Restriction on issuance costs financed by issue.

(1) In general. A private activity bond shall not be a
qualified bond if the issuance costs financed by the issue (of
which such bond is a part) exceed 2 percent of the proceeds of
the issue.

(2) Special rule for small mortgage revenue bond issues. In
the case of an issue of qualified mortgage bonds or qualified
veterans' mortgage bonds, paragraph (1) shall be applied by
substituting "3.5 percent" for "2 percent" if the proceeds of the
issue do not exceed \$20,000,000.

(h) Certain rules not to apply to mortgage revenue bonds,
qualified student loan bonds, and qualified 501(c)(3) bonds.

(1) Mortgage revenue bonds and qualified student loan bonds.
Subsections (a), (b), (c), and (d) shall not apply to any
qualified mortgage bond, qualified veterans' mortgage bond, or
qualified student loan bond.

(2) Qualified 501(c)(3) bonds. Subsections (a), (c), and
(d) shall not apply to any qualified 501(c)(3) bond and

subsection (e) shall be applied as if it did not contain "health club facility" with respect to such a bond.

Section 148. Arbitrage

(a) Arbitrage bond defined. For purposes of section 103, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly-

(1) to acquire higher yielding investments, or

(2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

For purposes of this subsection, a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in paragraph (1) or (2).

(b) Higher yielding investments. For purposes of this section-

(1) In general. The term "higher yielding investments" means any investment property which produce a yield over the term of the issue which is materially higher than the yield on the issue.

(2) Investment property. The term "investment property" means-

(A) any security (within the meaning of section 165(g)(2) (A) or (B)),

(B) any obligation,

(C) any annuity contract,

(D) any investment-type property, or

(E) in the case of a bond other than a private activity bond, any residential rental property for family units which is not located within the jurisdiction of the issuer and which is not acquired to implement a court ordered or approved housing desegregation plan.

(3) Alternative minimum tax bonds treated as investment property in certain cases.

(A) In general. Except as provided in subparagraph (B), the term "investment property" does not include any tax-exempt bond.

(B) Exception. With respect to an issue other than an issue a part of which is a specified private activity bond (as defined

in section 57(a)(5)(C)), the term "investment property" includes a specified private activity bond (as so defined).

(c) Temporary period exception.

(1) In general. For purposes of subsection (a), a bond shall not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such bond is a part may be invested in higher yielding investments for a reasonable temporary period until such proceeds are needed for the purpose for which such issue was issued.

(2) Limitation on temporary period for pooled financings.

(A) In general. The temporary period referred to in paragraph (1) shall not exceed 6 months with respect to the proceeds of an issue which are to be used to make or finance loans (other than nonpurpose investments) to 2 or more persons.

(B) Special rule for certain student loan pools. In the case of the proceeds of an issue to be used to make or finance loans under a program described in section 144(b)(1)(A), subparagraph (A) shall be applied by substituting "18 months" for "6 months". The preceding sentence shall not apply to any bond issued after December 31, 1988.

(C) Shorter temporary period for loan repayments, etc. Subparagraph (A) shall be applied by substituting "3 months" for "6 months" with respect to the proceeds from the sale or repayment of any loan which are to be used to make or finance any loan. For purposes of the preceding sentence, a nonpurpose investment shall not be treated as a loan.

(D) Bonds used to provide construction financing.

In the case of an issue described in subparagraph (A) any portion of which is used to make or finance loans for construction expenditures (within the meaning of subsection (f)(4)(C)(v))

(i) rules similar to the rules of subsection (f)(4)(C)(v) shall apply, and

(ii) subparagraph (A) shall be applied with respect to such portion by substituting "2 years" for "6 months".

(E) Exception for mortgage revenue bonds. This paragraph shall not apply to any qualified mortgage bond or qualified veterans' mortgage bond.

(d) Special rules for reasonably required reserve or replacement fund.

(1) In general. For purposes of subsection (a), a bond shall not be treated as an arbitrage bond solely by reason of the

fact that an amount of the proceeds of the issue of which such bond is a part may be invested in higher yielding investments which are part of a reasonably required reserve or replacement fund. The amount referred to in the preceding sentence shall not exceed 10 percent of the proceeds of such issue unless the issuer establishes to the satisfaction of the Secretary that a higher amount is necessary.

(2) Limitation on amount in reserve or replacement fund which may be financed by issue. A bond issued as part of an issue shall be treated as an arbitrage bond if the amount of the proceeds from the sale of such issue which is part of any reserve or replacement fund exceeds 10 percent of the proceeds of the issue (or such higher amount which the issuer establishes is necessary to the satisfaction of the Secretary).

(3) Limitation on investment in nonpurpose investments.

(A) In general. A bond which is part of an issue which does not meet the requirements of subparagraph (B) shall be treated as an arbitrage bond.

(B) Requirements. An issue meets the requirements of this subparagraph only if-

(i) at no time during any bond year may the amount invested in nonpurpose investments with a yield materially higher than the yield on the issue exceed 150 percent of the debt service on the issue for the bond year, and

(ii) the aggregate amount invested as provided in clause (i) is promptly and appropriately reduced as the amount of outstanding bonds of the issue is reduced (or, in the case of a qualified mortgage bond or a qualified veterans' mortgage bond, as the mortgages are repaid).

(C) Exceptions for temporary period. Subparagraph (B) shall not apply to-

(i) proceeds of the issue invested for an initial temporary period until such proceeds are needed for the governmental purpose of the issue, and

(ii) temporary investment periods related to debt service.

(D) Debt service defined. For purposes of this paragraph, the debt service on the issue for any bond year is the scheduled amount of interest and amortization of principal payable for such year with respect to such issue. For purposes of the preceding sentence, there shall not be taken into account amounts scheduled with respect to any bond which has been redeemed before the beginning of the bond year.

(E) No disposition in case of loss. This paragraph shall not require the sale or disposition of any investment if such

sale or disposition would result in a loss which exceeds the amount which, but for such sale or disposition, would at the time of such sale or disposition-

(i) be paid to the United States, or,

(ii) in the case of a qualified veterans' mortgage bond, be paid or credited mortgagors under section 143(g)(3)(A).

(F) Exception for governmental use bonds and qualified 501(c)(3) bonds. This paragraph shall not apply to any bond which is not a private activity bond or which is a qualified 501(c)(3) bond.

(e) Minor portion may be invested in higher yielding investments. Notwithstanding subsections (a), (c), and (d), a bond issued as part of an issue shall not be treated as an arbitrage bond solely by reason of the fact that an amount of the proceeds of such issue (in addition to the amounts under subsections (c) and (d)) is invested in higher yielding investments if such amount does not exceed the lesser of-

(1) 5 percent of the proceeds of the issue, or

(2) \$100,000.

(f) Required rebate to the United States.

(1) In general. A bond which is part of an issue shall be treated as an arbitrage bond if the requirements of paragraphs (2) and (3) are not met with respect to such issue. The preceding sentence shall not apply to any qualified veterans' mortgage bond.

(2) Rebate to United States. An issue shall be treated as meeting the requirements of this paragraph only if an amount equal to the sum of-

(A) the excess of-

(i) the amount earned on all nonpurpose investments (other than investments attributable to an excess described in this subparagraph), over

(ii) the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue, plus

(B) any income attributable to the excess described in subparagraph (A), is paid to the United States by the issuer in accordance with the requirements of paragraph (3).

(3) Due date of payments under paragraph (2). Except to the extent provided by the Secretary, the amount which is required to be paid to the United States by the issuer shall be paid in

installments which are made at least once every 5 years. Each installment shall be in an amount which ensures that 90 percent of the amount described in paragraph (2) with respect to the issue at the time payment of such installment is required will have been paid to the United States. The last installment shall be made no later than 60 days after the day on which the last bond of the issue is redeemed and shall be in an amount sufficient to pay the remaining balance of the amount described in paragraph (2) with respect to such issue. A series of issues which are redeemed during a 6-month period (or such longer period as the Secretary may prescribe) shall be treated (at the election of the issuer) as 1 issue for purposes of the preceding sentence if no bond which is part of any issue in such series has a maturity of more than 270 days or is a private activity bond. In the case of a tax and revenue anticipation bond, the last installment shall not be required to be made before the date 8 months after the date of issuance of the issue of which the bond is a part.

(4) Special rules for applying paragraph (2).

(A) In general. In determining the aggregate amount earned on nonpurpose investments for purposes of paragraph (2)-

(i) any gain or loss on the disposition of a nonpurpose investment shall be taken into account, and

(ii) any amount earned on a bona fide debt service fund shall not be taken into account if the gross earnings on such fund for the bond year is less than \$100,000.

In the case of an issue no bond of which is a private activity bond, clause (ii) shall be applied without regard to the dollar limitation therein if the average maturity of the issue (determined in accordance with section 147(b)(2)(A)) is at least 5 years and the rates of interest on bonds which are part of the issue do not vary during the term of the issue.

(B) Temporary investments. Under regulations prescribed by the Secretary-

(i) In general. An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraph (2) if

(I) the gross proceeds of such issue are expended for the governmental purposes for which the issue was issued no later than the day which is 6 months after the date of issuance of the issue, and

(II) the requirements of paragraph (2) are met with respect to amounts not required to be spent as provided in subclause (I) (other than earnings on amounts in any bona fide debt service fund).

Gross proceeds which are held in a bona fide debt service fund or a reasonably required reserve or replacement fund, and gross proceeds which arise after such 6 months and which were not reasonably anticipated as of the date of issuance, shall not be considered gross proceeds for purpose of subclause (I) only.

(ii) Additional period for certain bonds.

(I) In general. In the case of an issue described in subclause (II), clause (i) shall be applied by substituting "1 year" for "6 months" each place it appears with respect to the portion of the proceeds of the issue which are not expended in accordance with clause (i) if such portion does not exceed the lesser of 5 percent of the proceeds of the issue or \$100,000.

(II) Issues to which subclause (I) applies. An issue is described in this subclause if no bond which is part of such issue is a private activity bond (other than a qualified 501(c)(3) bond) or a tax or revenue anticipation bond.

(iii) Safe harbor for determining when proceeds of tax and revenue anticipation bonds are expended.

(I) In general. For purposes of clause (i), in the case of an issue of tax or revenue anticipation bonds, the net proceeds of such issue (including earnings thereon) shall be treated as expended for the governmental purpose of the issue on the 1st day after the date of issuance that the cumulative cash flow deficit to be financed by such issue exceeds 90 percent of the proceeds of such issue.

(II) Cumulative cash flow deficit. For purposes of subclause (I), the term "cumulative cash flow deficit" means, as of the date of computation, the excess of the expenses paid during the period described in subclause (III) which would ordinarily be paid out of or financed by anticipated tax or other revenues over the aggregate amount available (other than from the proceeds of the issue) during such period for the payment of such expenses.

(III) Period involved. For purposes of subclause (II), the period described in this subclause is the period beginning on the date of issuance of the issue and ending on the earlier of the date 6 months after such date of issuance or the date of the computation of cumulative cash flow deficit.

(iv) Payments of principal not to affect requirements. For purposes of this subparagraph, payments of principal on the bonds which are part of an issue shall not be treated as expended for the governmental purposes of the issue.

(C) Exception from rebate for certain proceeds to be used to finance construction expenditures.

(i) In general. In the case of a construction issue, paragraph (2) shall not apply to the available construction proceeds of such issue if the spending requirements of clause (ii) are met.

(ii) Spending requirements. The spending requirements of this clause are met if at least-

(I) 10 percent of the available construction proceeds of the construction issue are spent for the governmental purposes of the issue within the 6-month period beginning on the date the bonds are issued,

(II) 45 percent of such proceeds are spent for such purposes within the 1-year period beginning on such date,

(III) 75 percent of such proceeds are spent for such purposes with the 18 month period beginning on such date, and

(IV) 100 percent of such proceeds are spent for such purposes within the 2-year period beginning on such date.

(iii) Exception for reasonable retainage. The spending requirement of clause (ii)(IV) shall be treated as met if

(I) such requirement would be met at the close of such 2 year period but for a reasonable retainage (not exceeding 5 percent of the available construction proceeds of the construction issue), and

(II) 100 percent of the available construction proceeds of the construction issue are spent for the governmental purposes of the issue within the 3 year period beginning on the date the bonds are issued.

(iv) Construction issue. For purposes of this subparagraph, the term "construction issue" means any issue if

(I) at least 75 percent of the available construction proceeds of such issue are to be used for construction expenditures with respect to property which is to be owned by a governmental unit or a 501(c)(3) organization, and

(II) all of the bonds which are part of such issue are qualified 501(c)(3) bonds, bonds which are not private activity bonds, or private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization.

For purposes of this subparagraph, the term "construction" includes reconstruction and rehabilitation, and rules similar to the rules of section 142(b)(1)(B) shall apply.

(v) Portions of issues used for construction. If-

(I) all of the construction expenditures to be financed by an issue are to be financed from a portion thereof, and

(II) the issuer elects to treat such portion as a construction issue for purposes of this subparagraph,

then, for purposes of this subparagraph and subparagraph (B), such portion shall be treated as a separate issue.

(iv) Available construction proceeds. For purposes of this subparagraph-

(I) In general. The term "available construction proceeds" means the amount equal to the issue price (within the meaning of sections 1273 and 1274) of the construction issue, increased by earnings on the issue price, earnings on amounts in any reasonably required reserve or replacement fund not funded from the issue, and earnings on all of the foregoing earnings, and reduced by the amount of the issue price in any reasonably required reserve or replacement fund and the issuance costs financed by the issue.

(II) Earnings on reserve included only for certain periods. The terms "available construction proceeds" shall not include amounts earned on any reasonably required reserve or replacement fund after the earlier of the close of the 2 year period described in clause (ii) or the date the construction is substantially completed.

(III) Payments on acquired purpose obligations excluded.

The term "available construction proceeds" shall not include payments on any obligation acquired to carry out the governmental purposes of the issue and shall not include earnings on such payments.

(IV) Election to rebate on earnings on reserve. At the election of the issuer, the term "available construction proceeds" shall not include earnings on any reasonably required reserve or replacement fund.

(vii) Election to pay penalty in lieu of rebate.

(I) In general. At the election of the issuer, paragraph (2) shall not apply to available construction proceeds which do not meet the spending requirements of clause (ii) if the issuer pays a penalty, with respect to each 6 month period after the date the bonds were issued, equal to 1 1/2 percent of the amount of the available construction proceeds of the issue which, as of the close of such 6 month period, is not spent as required by clause (ii).

(II) Termination. The penalty imposed by this clause shall cease to apply only as provided in clause (viii) or after the

latest maturity date of any bond in the issue (including any refunding bond with respect thereto).

(viii) Election to terminate 1 1/2 percent penalty. At the election of the issuer (made not later than 90 days after the earlier of the end of the initial temporary period or the date the construction is substantially completed), the penalty under clause (vii) shall not apply to any 6 month period after the initial temporary period under subsection (c) if the requirements of subclauses (I), (II), and (III) are met.

(I) 3 percent penalty. The requirements of this subclause is met if the issuer pays a penalty equal to 3 percent of the amount of available construction proceeds of the issue which is not spent for the governmental purposes of the issue as of the close of such initial temporary period multiplied by the number of years (including fractions thereof) in the initial temporary period.

(II) Yield restriction at close of temporary period. The requirement of this subclause is met if the amount of the available construction proceeds of the issue which is not spend for the governmental purposes of the issue as of the close of such initial temporary period in invested at a yield not exceeding the yield on the issue or which is invested in any tax-exempt bond which is not investment property.

(III) Redemption of bonds at earliest call date. The requirement of this subclause is met if the amount of the available construction proceeds of the issue which is not spend for the governmental purposes of the issue as of the earliest date on which bonds may be redeemed is used to redeem bonds on such date.

(ix) Election to terminate 1 1/2 percent penalty before end of temporary period. If

(I) the construction to be financed by a construction issue is substantially completed before the end of the initial temporary period,

(II) the issuer identifies an amount of available construction proceeds which will not be spent for the governmental purposes of the issue,

(III) the issuer has made the election under clause (viii),
and

(IV) the issuer makes an election under this clause before the close of the initial temporary period and not later than 90 days after the date the construction is substantially completed,

Then clauses (vii) and (viii) shall be applied to the available construction proceeds so identified as if the initial temporary period ended as of the date the election is made.

(x) Failure to pay penalties. In the case of a failure (which is not due to willful neglect) to pay any penalty required to be paid under clause (vii) or (viii) in the amount or at the time prescribed therefor, the Secretary may treat such failure as not occurring if, in addition to paying such penalty, the issuer pays a penalty equal to the sum of

(I) 50 percent of the amount which was not paid in accordance with clauses (vii) and (viii), plus

(II) interest (at the underpayment rate established under section 6621) on the portion of the amount which was not paid on the date required for the period beginning on such date.

The Secretary may waive all or any portion of the penalty under this clause. Bonds which are part of an issue with respect to which there is a failure to pay the amount required under this clause (and any refunding bond with respect thereto) shall be treated as not being, and as never having been, tax-exempt bonds.

(xi) Election for pooled financing bonds. At the election of the issuer of an issue the proceeds of which are to be used to make or finance loans (other than nonpurpose investments) to 2 or more persons, the periods described in clauses (ii) and (iii) shall begin on-

(I) the date the loan is made, in the case of loans made within the 1-year period after the date the bonds are issued, and

(II) the date following such 1 year period, in the case of loans made after such 1 year period.

If such an election applies to an issue, the requirements of paragraph (2) shall apply to amounts earned before the beginning of the periods determined under the preceding sentence.

(xii) Payments of principal not to affect requirements. for purposes of this subparagraph, payments of principal on the bonds which are part of the construction issue shall not be treated as an expenditure of the available construction proceeds of the issue.

(xiii) Refunding bonds.

(I) In general. Except as provided in this clause, clause (vii)(II), and the last sentence of clause (x), this subparagraph shall not apply to any refunding bond and no proceeds of a refunded bond shall be treated for purposes of this subparagraph as proceeds of a refunding bond.

(II) Determination of construction portion of issue. For purposes of clause (v), any portion of an issue which is used to refund any issue (or portion thereof) shall be treated as a separate issue.

(III) Coordination with rebate requirement on refunding bonds. The requirements of paragraph (2) shall be treated as met with respect to earnings for any period if a penalty is paid under clause (vii) or (viii) with respect to such earnings for such period.

(xiv) Determination of initial temporary period. For purposes of this subparagraph, the end of the initial temporary period shall be determined without regard to section 149(d)(3)(A)(iv).

(xv) Election. Any election under this subparagraph (other than clauses (viii) and (ix)) shall be made on or before the date the bonds are issued; and, once made, shall be irrevocable.

(xvi) Time for payment of penalties. Any penalty under this subparagraph shall be paid to the United States not later than 90 days after the period to which the penalty relates.

(D) Exception for governmental units issuing \$5,000,000 or less of bonds.

(i) In general. An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraphs (2) and (3) if-

(I) the issue is issued by a governmental unit with general taxing powers.

(II) no bond which is part of such issue is a private activity bond,

(III) 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and

(IV) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such unit during the calendar year in which such issue is issued is not reasonably expected to exceed \$5,000,000.

(ii) Aggregation of issuers. For purposes of subclause (IV) of clause (i)-

(I) an issuer and all entities which issue bonds on behalf of such issuer shall be treated as 1 issuer,

(II) all bonds issued by a governmental unit to make loans to other governmental units with general taxing powers not subordinate to such unit shall, for purposes of applying such subclause to such unit, be treated as not issued by such unit,

(III) all bonds issued by a subordinate entity shall, for purposes of applying such subclause to each other entity to which such entity is subordinate, be treated as issued by such other entity, and

(IV) an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of such subclause (IV) and all other entities benefiting thereby shall be treated as 1 issuer.