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PUBLIC FINANCE

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## Services

Public Finance Tax

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# Guaranteed Investment Contract (GIC) Tax Rules[1]

Higher interest rates, coupled with an inverted yield curve not seen for decades, have resulted in increased interest in the use of Guaranteed Investment Contracts ("GIC"). A GIC is a contract and type of investment where the provider of the GIC (usually a highly rated bank or insurance company) receives bond proceeds (or other moneys) from a bond issuer and agrees to repay the principal at par, on a fixed date or upon request, with a fixed or floating rate of interest until repayment. A GIC allows a bond issuer to invest bond proceeds without risk of adverse market rate liquidation loss when the investment proceeds are needed to finance the issuer's project or program.

The arbitrage provisions of the Internal Revenue Code and corresponding Treasury Regulations (the "Regulations") limit the return that can be earned on investments of an issuer's tax-exempt bond proceeds. These provisions seek to address the possible abuses where issuers of tax-exempt bonds borrow funds at tax-exempt rates and invest such funds at higher taxable rates (or third parties similarly benefit from such investment). The following is (1) an overview of the relevant tax rules applicable to the investment of tax-exempt bond proceeds in a GIC, (2) an overview of the fair market value and brokerage fee safe harbors and rules applicable to such GICs, and (3) a brief review of possible options and considerations should elements of the GIC fair market value safe harbor not be satisfied.

## 1. General Overview

The Regulations restrict the yield on the investment of tax-exempt bond proceeds, as well as their corresponding expenditure. Investing in a GIC is not an "expenditure" of bond proceeds for tax purposes; it is merely an investment of proceeds pending use. Investment of bond proceeds in a GIC at a yield which is materially higher than the yield of the related tax-exempt bonds, without a corresponding temporary period of permitted non-restricted investment or a spending exception to rebate, can result in the requirement to make a rebate payment to the IRS or even a determination of taxability of the bonds.

The arbitrage provisions of the Regulations specify how the yield on investments and how the yield on bonds must be determined and calculated. Section 1.148-5(d)(6) of the Regulations requires that the yield on investments be based on their fair market value, which is generally "the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction." Importantly, Section 1.148-5(d)(6) of the Regulations also states that "[except] as otherwise provided . . ., an investment that is not of a type traded on an established securities market . . . is *rebuttably*

[1] This document is intended as a summary only and is not to be construed as comprehensive legal advice. The content is current as of January 10, 2023.

*presumed* to be acquired or disposed of for a price that is *not equal to its fair market value*." GICs are not traded on an established market, so there is a rebuttable presumption that the acquisition of a GIC is not at fair market value for the purpose of these regulations.

## 2. GIC Safe Harbors for Establishing Fair Market Value of Investment and Reasonableness of Brokerage Fees

### *Safe Harbor for Determining Fair Market Value*

Section 1.148-5(d)(6)(iii) of the Regulations provides a safe harbor for establishing the fair market value of a GIC. Accordingly, the purchase price of a GIC will be treated as acquired for its fair market value on the purchase date if all of certain safe harbor requirements are satisfied. These requirements are:

(A) The issuer makes a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation which satisfies all of the following requirements:

1. The bid specifications are in writing and timely disseminated to potential providers.
2. The bid specifications include all material terms of the bid.
3. The bid specifications include a statement notifying potential providers that submission of a bid represents that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any agreement, formal or informal, that the potential provider has with the issuer or anyone else, and that the bid is not being submitted solely as a courtesy to the issuer or anyone else.
4. The terms of the bid specifications are commercially reasonable. A term is "commercially reasonable" if there is a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of an investment.
5. The terms of the solicitation take into account the issuer's reasonably expected deposit and drawdown schedule for the amounts to be invested.
6. All potential providers have an equal opportunity to bid, and there is not a mutually exclusive "last look" for a particular bidder with respect to the other bids.
7. At least three reasonably competitive providers are solicited for bids. A "reasonably competitive" provider is one that has an established industry reputation in providing GICs.

(B) The bids received by the issuer meet all the following requirements:

1. The issuer receives at least three bids (the "three-bid requirement") from providers that do not have a material financial interest in the issue (and are not related to providers which have a material financial interest in the issue). A lead underwriter in a negotiated underwriting transaction is deemed to have a "material financial interest" in the issue until 15 days after the issue date of the issue, and any entity acting as a financial advisor with respect to the purchase of the investment at the time the bid specifications are forwarded to potential providers is also considered to have a "material financial interest" in the issue. In most instances, a lender in a direct placement transaction could also be considered to have a material financial interest.
2. At least one of the three bids is from one of the reasonably competitive providers mentioned above.
3. If the issuer used an agent to conduct the bidding process, the agent did not bid to provide the GIC.

(C) The winning bid is the highest yielding bona fide bid (determined net of any broker's fees). The "highest yielding" bid generally means the bid that provides the GIC with the highest rate of return at the lowest price.

(D) The provider of the GIC or the obligor on the GIC certifies the administrative costs that it pays or expects to pay (if any) to third parties in connection with supplying the GIC.

(E) The issuer retains the following records with the bond documents until three years after the last outstanding bond is redeemed:

1. A copy of the GIC;
2. A record of the amount actually paid by the issuer for the GIC (including any administrative costs), and the certification required in (D) above;
3. Information pertaining to the bids received, including: the name of the person and entity submitting the bid, the time and date of the bid, and the bid results; and
4. The bid solicitation form, and in the case of any deviation from the form or if a submitted bid is modified, a brief statement explaining the deviation or modification and the purpose for the deviation or modification.

It is important to note that the three-bid requirement described above does not prevent a party with a material financial interest in the bond issue (or a related party), like an underwriter, from bidding on the GIC. However, in order for a party with a material financial interest in the issue to have their bid win and preserve compliance with the safe harbor, there must be at least three *other* bids from providers that are otherwise compliant under the rule (so, in this instance, a total of at least four bids must be received, including the bid from the provider with the material financial interest).

***Safe Harbor for Determining Reasonableness of Brokerage Fees***

In addition to the fair market value rule described above, Section 1.148-5(e)(1) of the Regulations provides that the administrative costs associated with a nonpurpose investment, such as a GIC, are generally not taken into account when computing the yield of the investment. However, Section 1.148-5(e)(2) of the Regulations provides that "qualified" administrative costs can be taken into account. These qualified administrative costs include reasonable, direct administrative costs that include brokerage or selling commissions but do not include legal and accounting fees, recordkeeping, custodial, and other similar costs. For brokerage fees paid in connection with GICs, Section 1.148-5(e)(2)(iii)(B) of the Regulations provides a safe harbor to determine if the brokerage fee is "reasonable" and therefore a qualified administrative cost. This safe harbor states that for tax year 2023 (note – the following safe harbor numbers are annually adjusted by the IRS based upon the cost of living changes) a brokerage fee for a GIC will be considered reasonable if:

(A) The amount of the fee that the issuer will treat as a qualified administrative cost does not exceed the lesser of:

1. $46,000 and
2. 0.20% of the computational base, or, if more, $5,000; and

(B) For any issue, the issuer does not treat more than $130,000 in brokers' commissions or similar fees as qualified administrative costs for all GICs and yield restricted investments purchased with gross proceeds of the issue.

The "computational base" for a GIC is the amount of gross proceeds that the issuer reasonably expects, as of the date the GIC is acquired, to be deposited into the GIC over the term of the contract.

For example, if for a particular bond issue an issuer pays a $46,000 fee for a $25,000,000 construction GIC and a $5,000 fee for a $1,000,000 float GIC, the issuer has complied with the brokerage fee safe harbor because each of these fees equals the lesser of $46,000 and 0.20% of the computation base (or, if more, $5,000), and the total fees of $51,000 are less than $130,000. The $46,000 fee is less than 0.20% of the computation base of the $25,000,000 construction GIC (where the computation base is $50,000), and the $5,000 fee is more than the computation base of the float GIC ($2,000) but less than $46,000.[2]

3. <u>Evaluation of a GIC Acquired Outside the Fair Market Value Safe Harbor</u>

If at least one of the requirements for the GIC safe harbor has not been met. In these instances, each scenario needs to be evaluated on a case-by-case basis because any acquisition of a GIC outside of the safe harbor is "rebuttably presumed" to be acquired for a price that is not equal to its fair market value. The Regulations do not provide any standard method for an issuer to rebut this presumption. However, the Treasury Department has suggested that all reasonable actions taken by the issuer under the circumstances of the purchase may be considered in determining whether the issuer paid a fair market price.

If the issuer does not receive three bids in connection with the bid solicitation process. If fewer than three bids are submitted in response to an issuer's solicitation, based upon various facts it nevertheless may be reasonable to conclude that the purchase price reflects a fair market price if the issuer expected that there would be at least three reasonably competitive providers for the requested investment. For example, one possible explanation could be that federal agency announcements were anticipated at bidding time that caused providers to hold back bids.

If the issuer's solicitation permitted providers to bid on differing terms of investments, and if fewer than three bids were submitted for the investment the issuer intends to select (even though at least three bids were submitted for all types of investments combined), the issuer's bidding process does not satisfy the three-bid requirement. However, it may be reasonable to select the desired investment, but also make practical sense to assume (for yield restriction and arbitrage rebate calculation purposes) that the investment has a yield equal to the yield of the highest-yielding investment for which a bid was received.

If the issuer's solicitation was made with the expectation that only one reasonably competitive provider for the solicited investment exists, it may be very difficult or even impossible to overcome the presumption that the issuer paid more than a fair market price. It is possible that the issuer may be able to support its investment decision by providing reliable market data that sufficiently explains that the cost of the investment approximates the cost of similar investments that are available in established securities markets.

An issuer may receive bids from providers with differing credit profiles. The provider with a higher credit rating may or may not be the provider with the highest-yielding bid. The Regulations require the issuer to

[2] For an additional sample of how these fee thresholds are applied, see Example 1 in Section 1.148-5(e)(2)(iii)(C) of the Regulations.

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select the bid with the highest yield, net of any broker's fee and other third party's fee, without taking into consideration any other factors such as provider credit ratings unless provided in the bid requirements. The issuer should have already addressed these factors in the form of limitations and requirements in the solicitation for bids.

If the investment is for a yield restricted account (such as a defeasance escrow), the issuer and bond counsel typically will be much more sensitive to any variance from the three-bid requirement. Unlike in unrestricted yield accounts, investments for restricted accounts are subject to a strict limit on investment returns and typically rise to a greater level of scrutiny by the Internal Revenue Service.

Regardless of the circumstances in which failure to comply with the safe harbor occurs, many issuers still proceed with the acquisition of the investment if all other requirements of the GIC safe harbor are satisfied. Each scenario, however, should be thoroughly reviewed on a case-by-case basis before proceeding, and on the basis of all the related facts and circumstances which should be properly examined and documented in consultation with qualified counsel.

If you have questions about any of the foregoing, please contact any of the attorneys in Kutak Rock's National Public Finance Tax Group or National Public Finance Practice Group. You may also visit us at www.KutakRock.com.