



Vitamin A: Often Overlooked But Essential

Arbitrage and Bond Proceeds

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Vitamin A Arbitrage

What is this animal/mineral/vitamin?

- Difference between
 - The interest rate being paid on the bonds and
 - The interest rate being earned on the investment of the proceeds
- If the earning rate is higher than the bond rate, this is arbitrage
 - May be subject to “rebate”



Vitamin A Arbitrage

What is an Arbitrage Bond?

Any bond issue for which any portion of the proceeds is reasonably expected, at the time of issuance, to be used:

- To acquire higher yielding investments, or;
- To replace funds which were used to acquire higher yielding investments.



Vitamin A Arbitrage

The basic motivation behind arbitrage rules is to:

- stop the perceived abuse of issuers of tax-exempt bonds from borrowing at tax-exempt rates and
- investing the proceeds at taxable rates,
- using the arbitrage “profits” for discretionary purposes.



Vitamin A Arbitrage

Why is Arbitrage a Concern and Who Profits?

- Investment rates are rising
- IRS giving more attention to issues
- The federal government does not want tax exempt bonds issued to make money.



Vitamin A Arbitrage

Who is subject to Arbitrage?

All issuers of Tax Exempt Debt

Arbitrage Restrictions

Yield Restriction and Rebate

- ✓ Are independent of each other
- ✓ Issuers must comply with both



Vitamin A Arbitrage

What happens if issue is in noncompliance?

- The **worst** consequence is the that the IRS will find the **bond taxable**
 - Bondholders required to pay taxes on interest received
 - Potential litigation
 - “Material Event” needs to be reported
- Interest and penalties may be imposed
- Potential bond rating consequences
- Higher interest on future bond issues



Arbitrage Definitions

- Sale Proceeds
 - Amounts received from selling bonds
- Investment Proceeds
 - Amounts received from investing the bond proceeds
- Reserve Funds
 - From bond proceeds the lesser of
 - 10% not included as “arbitrage bonds”, or
 - Maximum annual debt service, or
 - 125% of average annual p&l of the issue
 - Other funds may be put in reserve fund without limitation



Arbitrage Definitions (cont.)

- Yield Restriction
 - Proceeds must not be invested at an interest rate higher than the bond rate
 - Issue – Yield is calculated separately on each issue if sold at substantially the same time
 - Yield on Investments
 - computed on same basis as the bonds by each class of investments
 - Over the term of the issue
 - can invest at higher rate in some years if other years lower investments offset
 - Overall investment rate considered



Arbitrage Definitions (cont.)

- Rebate
 - Any investment return in excess of bond yield
 - 90% or rebate is due within 60 days of each computation date to the U.S. Treasury
 - Calculations must be completed and 100% of rebate paid within 5 years of issuance
 - Exceptions
 - Small issuers
 - Spend down
 - 1.5% Penalty in Lieu of Rebate
 - Election at issuance if construction spend down not met
 - Due within 90 days after they accrue
 - Easier to calculate



Arbitrage Rules

- Rule sites:
 - IRS Code, Section 148 and
 - Treasury Regulations, Sections 1.148 through 1-150-1
- 2 distinct sets of Rules
 - Yield Restriction Rules: govern what funds are allowed to earn at a higher rate and when
 - Rebate Rules: govern when arbitrage earnings must be sent to the Federal gvt



A + C + D = Healthy

Many vitamins need other vitamins to be effective. So it is with our Arbitrage Vitamin.

Vitamin A needs Vitamin C and Vitamin D to stay healthy

- Vitamin C = the Construction Fund
- Vitamin D = the Debt Service Fund



Vitamin C Construction Related Funds Rebate Considerations

- Generally, Tax-exempt bond issue construction proceeds are subject to rebate unless one of the following exemptions is met:
 - Small Issuer Exemption
 - Spend down Exemption
- The exemption must be declared at the time of issuance



Vitamin C Construction Related Funds Rebate Considerations

- What is included in bond proceeds?
 - Bond Sale proceeds
 - Investment proceeds – earnings on gross proceeds
 - Replacement proceeds
 - \$ pledged to the payment of bonds
 - \$ reasonably expected to pay bonds
 - \$ set aside to be reasonably expected to pay bonds



Vitamin C Construction Related Funds Rebate Considerations

- Small Issuer Exemption
 - Bond issuer must not exceed \$5,000,000 of tax exempt debt in a calendar year and
 - 95% of the net proceeds used for local gvt activities
 - \$15,000,000 for school capital expenditures



Vitamin C Construction Related Funds Rebate Considerations

- Expenditure (Spend down) Exemption
 - Interest earnings on original bond proceeds are generally exempt from rebate if spent within 2 years
- 6 Month Exception 1.148-7 (c): Gross proceeds spent within 6 months
- 18 Month Exception 1.148-7 (d): Gross proceeds spent as follows:
 - 15% within 6 months
 - 60% within 12 months
 - 100% within 18 months



Vitamin C Construction Related Funds Rebate Considerations

- 24 Month Expenditure Exemption 1.148-7 (e)
 - Gross proceeds spent as follows:
 - 10% within 6 months
 - 45% within 12 months
 - 75% within 18 months
 - 100% within 2 year
 - 75% of proceeds must be construction costs
 - After 2 years, only 5% can remain unspent.
 - 100% must be spent within 3 years.



Vitamin C Construction Related Funds Yield Restriction Considerations

- Generally, Section 1.148-2 (a) requires all gross proceeds of an issue in a higher yielding investment to be considered arbitrage bonds unless one of the following exceptions exists:
 - Three Year Temporary Period
 - Reserve Funds
 - Minor Portion



Vitamin C Construction Related Funds Yield Restriction Considerations

- Three Year Temporary Period Exception
 - At least 85% of net sale and investment proceeds are reasonably expected to be spent within 3 years
 - Time test requires issuer to expend at least 5% of proceeds within 6 months
 - Due diligence test requires completion of project and spending of funds with “due diligence”
 - 3 year period can be extended to 5 years
 - If architect and engineer certify that project requires a substantial amount of construction



Vitamin C Construction Related Funds Yield Restriction Considerations

- Reserve Funds
 - If balances fall within the lesser of the following, investments on a reasonably required reserve can earn higher rates
 - 10% of the principal amount of the issue
 - 125% of average annual debt service or
 - 100% of the maximum annual debt service
 - The exemption does not apply to the Reserve Fund if the issuer does not qualify for an exemption from rebate. (i.e.: small issuer)



Vitamin C Construction Related Funds Yield Restriction Considerations

- Minor Portion
 - Is the lesser of 5% of the sale proceeds or
 - \$100,000.
 - Issuer can invest the lesser of the above at unrestricted yields.
 - The exemption does not apply if the issuer does not qualify for an exemption from rebate. (i.e.: small issuer)



Vitamin D Debt Service Related Funds Rebate Considerations

Types of Debt Service Funds

- Bona Fide Debt Service Fund
- Excess Debt Service Fund
- Debt Service Reserve Fund



Vitamin D Debt Service Related Funds Rebate Considerations

Bona Fide Debt Service Fund

Generally may be exempt from both yield restriction and rebate if:

- Used to pay P & I on a bond
- Depleted once a year
- Carryover not to exceed greater of:
 - 1 years earnings
 - 1/12 of annual debt service



Vitamin D Debt Service Related Funds Rebate Considerations

Bona Fide Debt Service Fund

Must meet one of the previous requirements plus one of the following:

- Fund earns less than \$100,000 in calendar year
- Bond is:
 - Long term – maturity more than 5 years
 - Fixed rate – interest rate set at time of issuance



Vitamin D Debt Service Related Funds Rebate Considerations

Bona Fide Debt Service Fund

- Most issuers, bond attorneys, and other experts seem to believe that most debt service funds fit this definition.
- Doesn't appear to be closely scrutinized



Vitamin D Debt Service Related Funds Rebate Considerations

Excess Debt Service Fund

- Any amount in the Debt Service Fund over the reasonable carryover amount.
- Example is an Improvement Bond debt service fund
 - Prepaid special assessments may bring balance above exemption limit.
 - Requirement to levy 105% of debt service
- Potential arbitrage liability



Vitamin D Debt Service Related Funds Rebate Considerations

Debt Service Reserve Fund

A fund required to pay P & I if other pledged revenues are insufficient.

- May earn unrestricted interest throughout the life if the balance does not exceed the lesser of:
 - 10% of the issue proceeds, or
 - 125% of average annual debt service, or
 - The maximum annual debt service
- Must qualify as a small issuer



Vitamin D Debt Service Related Funds Rebate Considerations

Debt Service Reserve Fund

- Transfer interest earnings out of fund regularly
 - So that balance does not increase above test level
 - If balance increases, a payment may be necessary



Multi Vitamin Calculation/Payments/Hints

Calculation Basics

- Calculations completed on a 5 year basis
 - Determine if the Construction Fund met the spend down requirements
 - If not, calculate if rebate payment required
 - If rebate required send 90% to U.S. Treasury within 60 days of calculation date
 - 100% of rebate due to U.S. Treasury within 5 years of issuance



Multi Vitamin Calculation/Payments/Hints

Calculation Basics – Construction Fund

- Calculation Overview
 - Monthly Cashflow
 - Determine expenditures and balance
 - Determine future value of balance at bond yield
 - Determine interest earned
 - Interest earned calculated in 5 year periods
 - Previous 5 years interest rates were lower than bond rates.
 - Interest rate will average out



Multi Vitamin Calculation Basics

Bona Fide Debt Service Fund

- Calculation Overview
 - Monthly Cashflow
 - Transfer Interest into fund
 - Include all revenues
 - Tax Levy receipts
 - Special Assessment receipts
 - » From County
 - » Prepaid
 - Excess Debt Service Calculation
 - Determine 1/12 of Annual Debt Service amount
 - Amount over is “excess debt service” amount
 - Arbitrage rules may apply on this amount



Multi Vitamin Hints

Do the Annual Calculation

- Keep a handle on rebates
- Opportunity to Yield Restrict investments to avoid rebate payment
- Fewer entries to analyze at one time
- Monitor construction fund spend down
 - Will avoid rebate requirement
- Can take steps to be in compliance earlier




Multi Vitamin Recommended Hints

- Importance of segregating bond proceeds from other funds
 - Keep Construction and Debt Service funds separate
- Use month after principal payment as “bond month” for calculation purposes if possible.
 - Check arbitrage certificate
 - Have Bond Council consider when completing



Who Does Arbitrage Calculations


- Some Financial Advisory Firms
 - Including Ehlers
- Some CPA Firms
- Trustees – if applicable
- Occasionally – Bond Attorneys




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