



Managing Debt Proceeds Effectively

Why Investing & Arbitrage Matter

Arbitrage Regulations: Conceptual Framework



Arbitrage: How it's Created

ARBITRAGE CREATION



Investment of
Bond Proceeds

Interest Earnings



TAXABLE
SECURITIES MARKET

Issuance of
Municipal Debt

Interest Payments

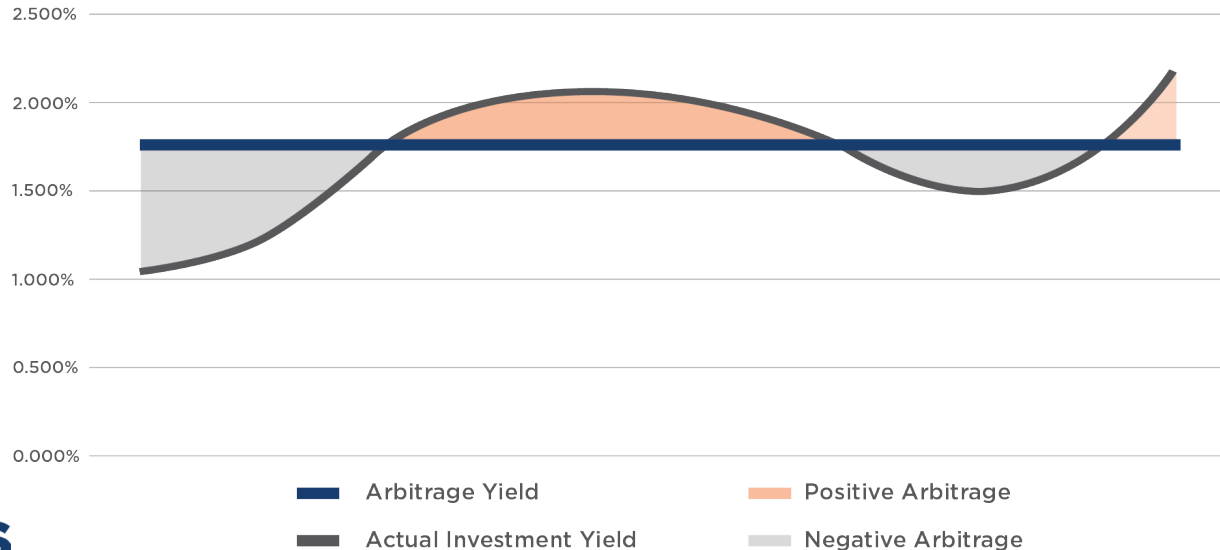


TAX-EXEMPT
SECURITIES MARKET

Arbitrage: What it Looks Like...

ARBITRAGE MONITORING

It's ALWAYS been a “thing.”



Arbitrage: Why it Matters...

Issuer tax covenants associated with ALL tax-exempt debt

12.1. The County covenants and agrees with the holders from time to time of the Bonds that it will not take or permit to be taken by any of its officers, employees or agents any action which would cause the interest on the Bonds to become subject to taxation under the Internal Revenue Code of 1986, as amended (the Code), and the Treasury Regulations promulgated thereunder, in effect at the time of such actions, and that it will take or cause its officers, employees or agents to take, all affirmative action within its power that may be necessary to ensure that such interest will not become subject to taxation under the Code and applicable Treasury Regulations, as presently existing or as hereafter amended and made applicable to the Bonds.

12.2. The County will comply with requirements necessary under the Code to establish and maintain the exclusion from gross income of the interest on the Bonds under Section 103 of the Code, including without limitation requirements relating to temporary periods for investments, limitations on amounts invested at a yield greater than the yield on the Bonds, and the rebate of excess investment earnings to the United States.

Explicit language:
***Tax-exempt* bond sale
resolution**

Arbitrage: Why it Matters More Now...

Yield environment for borrowing & reinvestment

Project/materials procurement delays extending expenditure periods = increased interest earnings potential

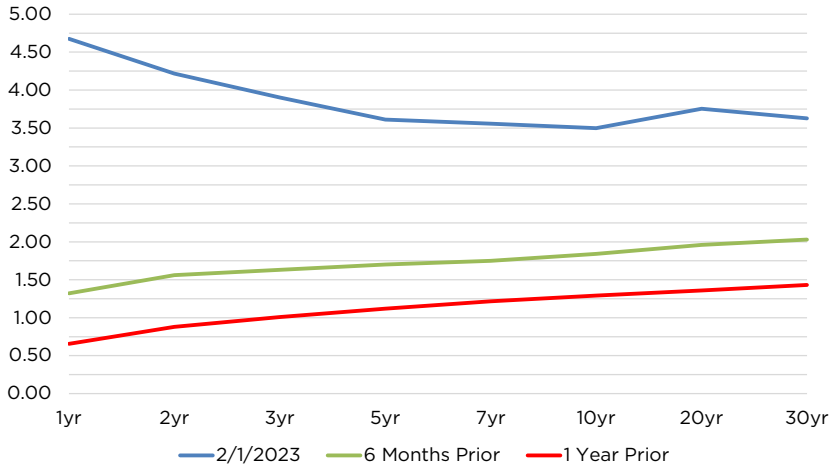
Earnings on ALL funds & accounts likely to increase due to higher short-term yields (debt service, reserve, etc.)

87,000 additional IRS employees = more audit eyes!

Yield Environment: A Brief History

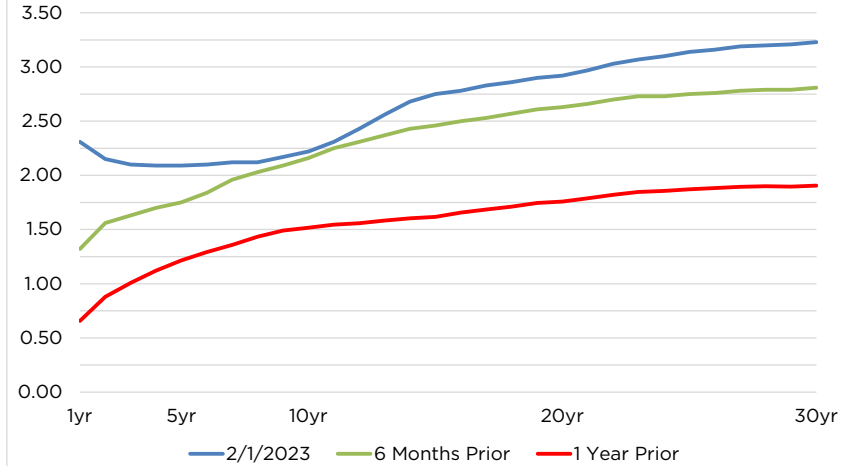
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US Treasury Yield Curve

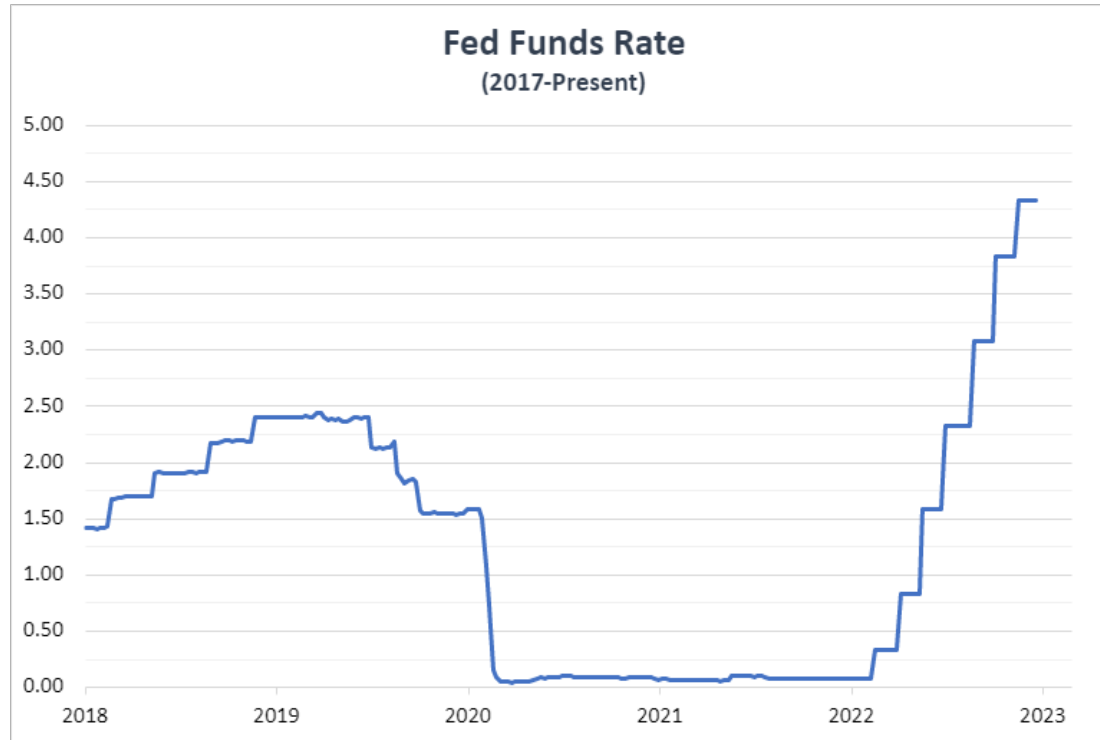


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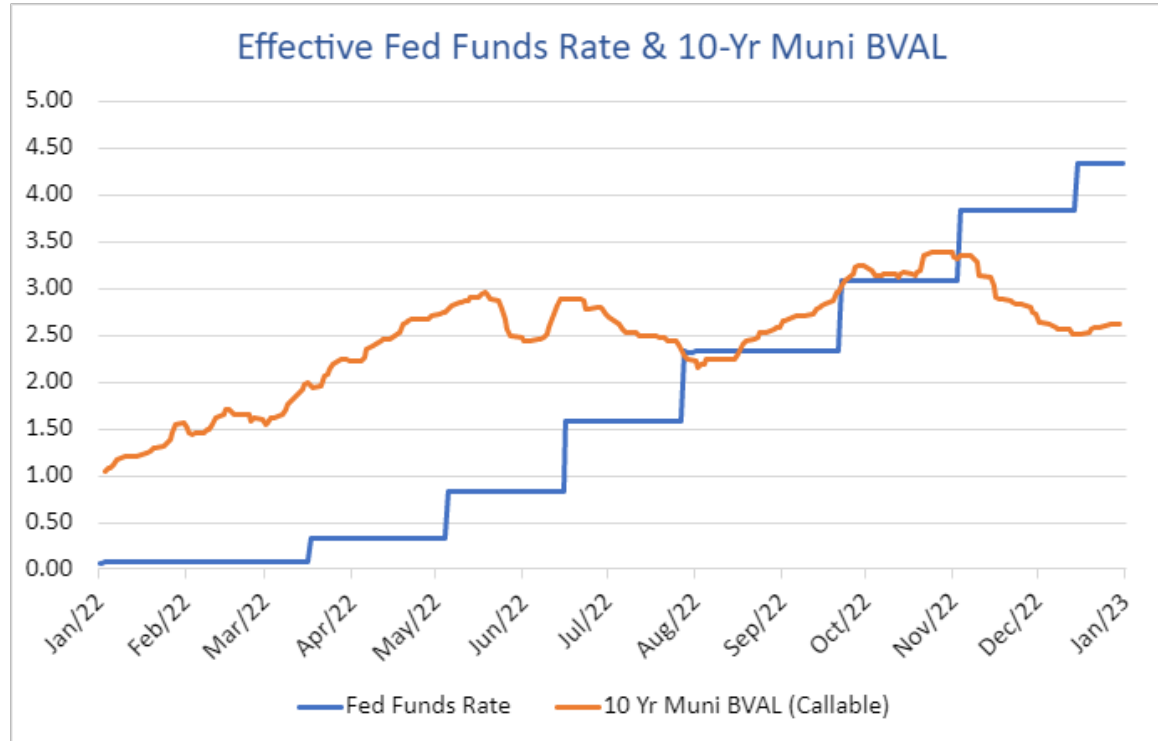
AAA BVAL Muni Yield Curve



Yield Environment: Changes in Fed Funds Rate



Yield Environment: Fed Funds & 10-yr UST



Basic Principles: Arbitrage & Yield Restriction

- Prohibits “abuse” associated with investing proceeds of a tax-exempt issue in higher yielding taxable securities
- IRS limitations related to:
 - ✓ Issuing earlier than necessary
 - ✓ Issuing more than necessary
 - ✓ Keeping proceeds invested longer than necessary
- Must reasonably establish each tax-exempt issue complies with requirements

Basic Principles: Gross Proceeds



Bond Sale Proceeds

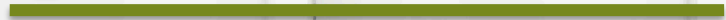


Investment Proceeds



Transferred Proceeds

Replacement Proceeds



Gross Proceeds



Basic Principles: Temporary Periods

Expenditure Test

- 85% of sale proceeds must be allocated to expenditures within three years

Time Test

- Must expend at least 5% of sales proceeds within six months of date of issue

Due Diligence Test

- Project completion & sale proceeds allocation to expenditures must proceed with “due diligence”

Basic Principles: Exceptions to Rebate

Small Issuer Status:

Applies to issuers that reasonably expect to issue no more than \$5MM in tax-exempt debt during a calendar year

(\$15MM for public school construction projects)

Current refundings generally excluded from \$5 million limit.

Basic Principles: Exceptions to Rebate

Spending Exceptions:

6-Month Exception

- Must spend 100% of gross proceeds within 6 months of issuance date

18-Month Exception

- Must spend at least 15% within 6 months of issuance date
- 60% within 12 months...
- 100% within 18 months

Basic Principles: Exceptions to Rebate

24-Month Exception

Must reasonably expect at least 75% of “construction proceeds” will be used for construction expenditures

- Must spend at least 10% of construction proceeds within 6 months of issuance date
- 45% within 12 months...
- 75% within 18 months...
- 100% spent within 24 months

NEW TERM!

Issue Price



Earnings



Deposit to Reserve Fund



Proceeds Used to Finance Issue Costs

Construction Proceeds

Basic Principles: Exceptions to Rebate

- Establishing reasonable expectations at time of issuance
- Bifurcating & applying different exceptions to respective purposes
- Paying penalty in lieu of rebate
 - ✓ 1.5% penalty at time of issuance
 - ✓ Can be difficult to calculate in advance
 - ✓ Risk of any deviation from construction schedule

Basic Principles: Spending Gross Proceeds

Involves cash outlay to a governmental expenditure purpose

Reasonably expected to occur within five banking days of allocation

Exceptions apply, particularly for working capital borrowings

Basic Principles: Maintaining “Bona Fide” Status

Funds & accounts related to a bond issue...

Debt Service

- Should be depleted each bond year to maintain arbitrage & yield restriction exemptions
- Reasonable “carry-over” amount permitted (1/12th of annual)

Reserve

- Earnings should be regularly transferred to debt service fund to maintain compliance with traditional “three-pronged” test

Basic Principles: Maintaining “Bona Fide” Status

Common pitfalls for Minnesota issuers...

105% Over-Levy Requirement:

- Be careful or you may exceed reasonable carry over after two years

Assessment Bonds:

- Don't let assessments accumulate in your debt service fund

Bond-funded Capital Projects

- Close out funds & allocate unspent proceeds timely

Basic Principles: Monitoring & Reporting

- Rebate/Yield Restriction Payments (IRS Form 8038-T)
 - ✓ Sent to IRS no later than 60 days after soonest of:
 - Each five-year anniversary date of issue; or
 - Date in which bonds are no longer outstanding
- IRS Compliance Checks
 - ✓ Questionnaires
 - ✓ Audits & investigations

Basic Principles: Non-Compliance

A myriad of potential consequences...

Fines

Bonds deemed
taxable

Bonds
removed from
market by
issuer

Bondholder
lawsuits

Required
securities
disclosures

Credit rating
risks

Reputational
risk

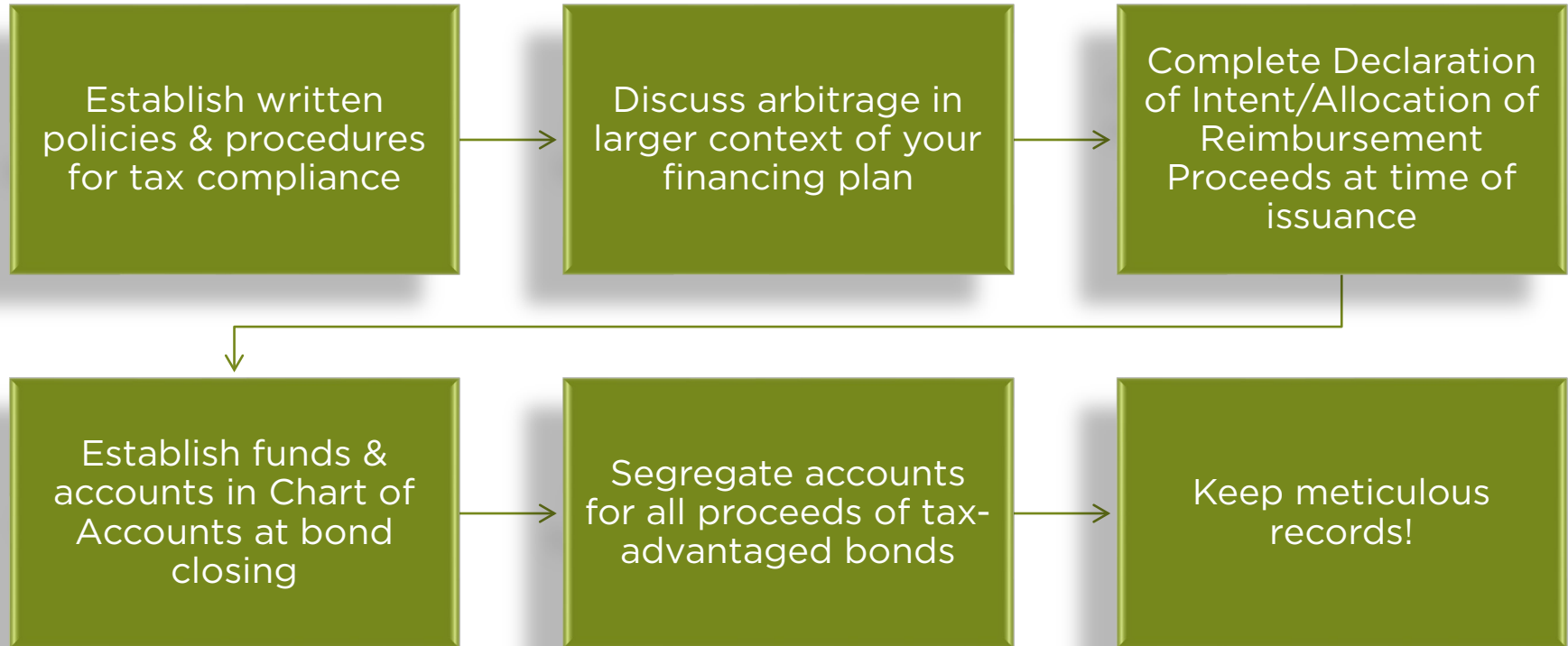
Difficulty
accessing
capital

Lessons Learned: IRS Examinations & Audits

- Commingled funds permitted, but NOT recommended
- Fund transfers & journal entries DO NOT = EXPENDITURES
- Performing accurate arbitrage reporting is an essential function
- Staff education is critical
- IRS Information Document Request (IDR) = AUDIT LETTER!



Arbitrage Compliance: Best Practices Process



Arbitrage Compliance: Monitoring & Reporting

Develop plan & procedures for lifespan of project, bond issue.

- Monitor spend-downs & adjust investing strategy/portfolio, as warranted
- When unspent funds remain after project completion, transfer to debt service fund or repurpose to other eligible expenditures
- Monitor all funds & accounts at least annually to maintain bona fide status
- File all required reporting! Monitoring DOES NOT = Reporting





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