

Arbitrage Overview

Robin Schlimgen, Managing Director
rschlimgen@blxgroup.com
480.539.4084



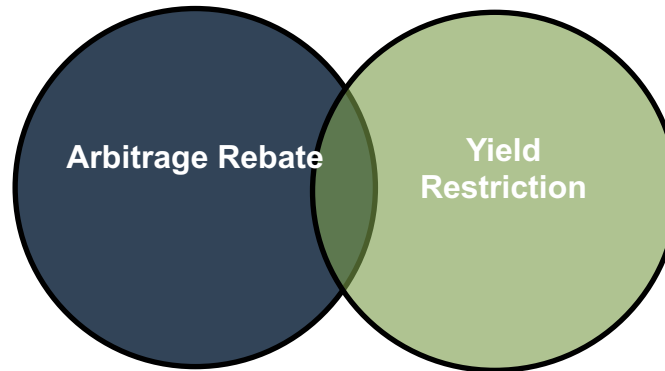


- Arbitrage - borrow at tax-exempt rate and invest proceeds in higher yielding taxable securities, resulting in a profit
- Arbitrage Regulations -- governed by Section 148(a) of the Internal Revenue Code. Two separate requirements (Rebate and Yield Restriction) -- need to comply with both requirements to avoid bonds being declared “Arbitrage Bonds” = “Taxable Bonds”
- Why is the Internal Revenue Service (IRS) / Treasury interested?
 - Tax-exempt interest seen as a federal subsidy

Arbitrage Overview



- **Yield Restriction** -- An issuer can not invest tax-exempt bond proceeds at a yield materially higher than the yield on the bonds after the end of the temporary period (window of opportunity to invest without limiting yield) – issuers can achieve compliance by...
 - Investing yield restricted amounts at a yield below the bond yield or...
 - Remitting a yield reduction payment to the IRS
- **Arbitrage Rebate** -- The dollar profit earned from arbitrage which must be paid back (rebated) to the federal government – issuers can achieve compliance by ...
 - Remitting a rebate payment to the IRS



- Issue by issue determination
- Significant negative arbitrage over the past 10 to 15 years
- Interest rates sharply increased over last 6 months
- Historically low-weighted, average bond yields on recent issuances
- Watch short-term notes and variable-rate debt (less than 5 years for computation period and lower arbitrage limit)

Arbitrage Overview



- Installment Computation Date = every 5th Bond Year
 - Bond Year = a 1-year period that ends on the day as defined in the bond documents (e.g. Tax Certificate)
 - First Bond Year may be a short year
 - Final Computation Date = final redemption/retirement date of the bonds
- Retain records to support your tax position – if you don't, IRS can draw their own conclusions.....Challenges created by:
 - Accounting system changes
 - Staff turnover



What proceeds are subject to the requirements

Arbitrage Rebate

- Gross proceeds
 - Sale proceeds – amounts received from the sale of the bonds
 - Investment proceeds – earnings on sale proceeds
 - Replacement proceeds – typically amounts pledged to pay debt service
 - Transferred proceeds – prior bond proceeds that become proceeds of the refunding bonds

Yield Restriction

- Amounts remaining beyond applicable “temporary period” (3 years)
- Amounts beyond the “reasonably required reserve”, the lesser of ...
 - 10% of par amount
 - 125% of average annual debt service
 - Maximum annual debt service
- Advance-refunding escrows
- Transferred proceeds



- Information required to complete arbitrage calculations
 - Final Official Statement
 - Tax Certificate
 - IRS Form 8038-G/8038
 - Trust Indenture
 - Verification Report (if applicable)
 - Other Special Documents (Investment Agreement, Swap Agreement, etc.)
 - Copy of 8038-T/Check (if applicable)
 - All Investment Data (entire calculation period)

Arbitrage Overview



- How are the bond proceeds invested?
 - Rate of return on investments vs arbitrage limit
 - Direct securities, money market, county pool
- How are bond proceeds tracked?
 - By issuance
 - Commingled Fund
 - ✓ Direct Trace
 - ✓ FIFO
 - ✓ Pro-Rata
- What kind of investment documentation is required?
 - Investment records spanning the calculation period
 - Daily activity showing purchases/sales, interest earnings (reinvested?)
 - Beginning and ending investment balances

Arbitrage Overview



- Exemptions
 - Small Issuer
 - ✓ General taxing authority
 - ✓ \$5,000,000 (\$15,000,000 public education limitation with conditions) per calendar year limitation (subordinate entity debt included)
 - ✓ Reasonable expectations - document in Tax Certificate
 - ✓ Private activity bonds – not eligible for small issuer allowance
 - ✓ Is **NOT** an exception for Yield Restriction or Post Issuance Compliance

Arbitrage Overview



- Exemptions (cont.)
 - Bona Fide Debt Service Fund
 - ✓ Proper matching of revenues to principal and interest payments within each bond year
 - ✓ Annual depletion requirement to bring account balance below a reasonable carryover amount (1/12th of preceding year's debt service payments)
 - ✓ Private activity, short-term, and variable-rate obligations have additional \$100,000 earnings test - If bona fide debt service fund earns less than \$100,000 in a given bond year it shall not be taken into account for rebate purposes
 - ✓ Limits ability to earn positive arbitrage



- Exemptions (cont.)
 - Six-Month Spending Exception
 - ✓ 100% in 6 months - Another six months for de minimis amount (less than 5% of proceeds of issue)
 - ✓ Only exception available for refundings
 - Eighteen-Month Spending Exception
 - ✓ 15% in 6 months
 - ✓ 60% in 12 months
 - ✓ 100% in 18 months (de minimis allowance of lesser of 3% of issue price or \$250,000)
 - ✓ Time extension for reasonable retainage – up to another year, not to exceed 5% of the proceeds subject to the 18-month exception



- Exemptions (cont.)
 - Two-Year Construction Spending Exception
 - ✓ Fairly limiting as only applies to construction issues (75% or more used for construction purposes)
 - ✓ 10% in 6 months
 - ✓ 45% in 12 months
 - ✓ 75% in 18 months
 - ✓ 100% in 24 months (de minimis allowance of lesser of 3% of issue price or \$250,000)
 - ✓ Time extension for reasonable retainage – up to another year, not to exceed 5% of available construction proceeds



Does arbitrage ever stop?

- A refunding may accelerate the final computation date
- Arbitrage requirements may cease for outstanding bonds if all the following criteria is met:
 - All bond proceeds have been spent
 - No Reserve Fund has been funded
 - Debt Service Funds are 100% bona fide (Bona Fide Debt Service Fund Exception) and \$100k limitation met in a bond year
 - No other proceeds arise (replacement, transferred proceeds)

Arbitrage Overview



- Most Common Compliance Mistakes
 - Failure to retain legacy access with accounting system change
 - Failure to keep adequate records (or failure to keep accurate records available)
 - Paying off bonds and failing to do final arbitrage report timely
 - Failure to transfer funds out of project accounts
 - Overfunding debt service accounts
 - Failure to take advantage of spending exceptions when available
 - Failure to check rebate and yield reduction payment liability annually and being surprised by having to make a payment
 - Responding to IRS audit phone call before doing due diligence
 - Establishing post-issuance compliance policies and failing to follow them

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