ARBITRAGE:

Eating an Elephant One Bite at a Time

SFGFOA Finance and Investment Seminar

August 18, 2016

ARBITRAGE COMPLIANCE SPECIALISTS INC.
BOND COMPLIANCE SERVICES

LEARNING OBJECTIVE

When you hear arbitrage, do words like complicated, confusing, and downright daunting, come to mind? This session will break down the process into bite-sized pieces by demystifying the components such as rebate requirements, calculation process, yield restrictions, payments and record retention. Thus making arbitrage more easily digestible…bon appetite!

Type of Program:	Intermediate.
Designed for:	Tax-Advantaged Bond Issuers and Professionals.
Prerequisites:	None.

INSTRUCTOR –
STEPHEN H. BRODEN, VICE PRESIDENT

Mr. Stephen Broden's experience includes four years of management at a Colorado special district, six years of management at First Bank of Colorado and Wachovia Bank as well as seven years of arbitrage rebate management at ACS. Mr. Broden's knowledge of banking regulations, investment structure and strategies provide invaluable insight when analyzing issuer debt portfolios for compliance with IRS arbitrage rebate regulations. While at ACS, Mr. Broden has specialized in the intricacies of all types of tax credit bonds and regularly instructs on these complicated debt structures and related bond compliance requirements to organizations across the country. Mr. Broden also has extensive experience with continuing disclosure and compliance concerning private business use.

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LEARNING CHECKLIST

- ❑ What are Tax-Advantaged Bonds?
- ❑ Arbitrage Rebate Requirements
- ❑ Arbitrage Rebate Calculation Process
- ❑ Yield Restriction Requirements
- ❑ Payment Process
- ❑ Record Retention

WHAT ARE TAX-ADVANTAGED BONDS?

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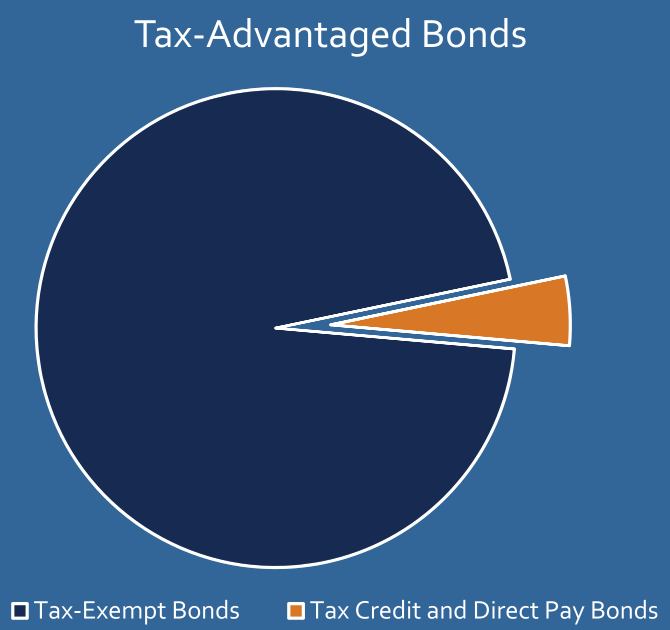
TAX-ADVANTAGED BONDS

Tax-advantaged bonds (tax-exempt, tax credit and direct pay designations) are bonds that receive preferential tax treatment under the Internal Revenue Code (IRC).

These bonds, generally issued by or on behalf of state and local governments, are subject to applicable federal tax and securities requirements both at the time of issuance and as long as the bonds remain outstanding.

Most tax-advantaged bonds maintain a designation of tax-exempt.



TAX-EXEMPT BONDS

Tax-exempt bonds are bonds that receive preferential tax treatment under the IRC, and in many cases, state and local taxes as well.

- ✓ Tax-exempt financings are not always in the form of long term bonds as they also can be structured as short term leases, loans, commercial paper, notes or other similar structures.
- ✓ Typically issued as either general obligation or revenue bonds.
- ✓ Also known traditionally as municipal bonds or Munis.

TAX CREDIT BONDS

Tax credit bonds are federally taxable bonds that still receive some type of preferential tax treatment under the IRC, and in many cases, state and local taxes as well.

✓ Typically issued as either general obligation or revenue bonds.

✓ Mostly for energy and education.

DIRECT PAY BONDS

Direct pay bonds are federally taxable bonds that still receive some type of preferential tax treatment under the IRC, and in many cases, state and local taxes as well.

- ✓ Typically issued as either general obligation or revenue bonds.
- ✓ Added IRC Section 6431 which allowed for a direct credit subsidy, with respect to each interest payment, for qualified taxable bonds to be provided to the issuer.
- ✓ Supported qualified taxable bonds further defined in Subsection 54AA(g) of the IRC as any build America bond (BAB) issued after February 17, 2009 and specified tax credit bonds issued after March 18, 2010.
- ✓ Issues were qualified if 100% of available project proceeds were spent on capital expenditures (within the defined time period) and the issuer made an irrevocable election to apply this section.

ARBITRAGE REBATE REQUIREMENTS

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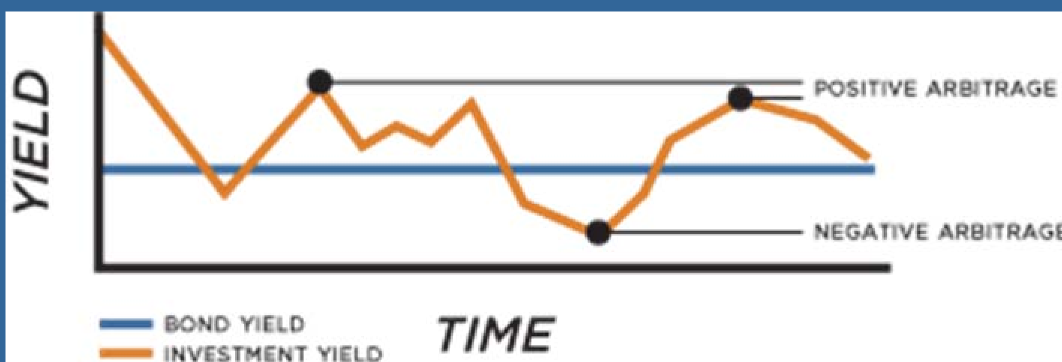
ARBITRAGE BOND

Arbitrage bonds are any bond issued as part of an issue were any portion of the gross proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly to:

- ✓ To acquire higher yield investments; or
- ✓ To replace funds which were used directly or indirectly to acquire higher yielding investments.

The arbitrage rebate rules were put in place to discourage issuers and borrowers from creating arbitrage bonds. Three circumstances in which arbitrage bonds are created (in recognition of the definition provided above) are issuing too much debt, issuing debt before a legitimate need and allowing debt to stay outstanding longer than necessary.

ARBITRAGE



Arbitrage is the profit made from investing inherently lower yielding tax-advantaged bond gross proceeds in higher yielding taxable investments.

ARBITRAGE REBATE

As of any computation date, the arbitrage rebate amount for an issue is the excess of the future value of all receipts on non-purpose investments over the future value of all payments on non-purpose investments. These rules have been in place for all tax-advantage bonds as of the Tax Reform Act of 1986.

ARBITRAGE REBATE QUESTIONS

- ❑ What are gross proceeds?
- ❑ Are there exceptions?
- ❑ What are non-purpose investments?
- ❑ What is a receipt?
- ❑ What is a payment?
- ❑ What is a computation date?

GROSS PROCEEDS

What are gross proceeds ?

Gross proceeds are comprised of proceeds, replacement proceeds and sometimes disposition proceeds.

- ✓ Proceeds are comprised of sales proceeds (examples include construction fund, cost of issuance fund, escrow fund, or debt service reserve fund), investment proceeds and transferred proceeds (created as a result of a refunding bond).
- ✓ Replacement proceeds are comprised of funds with a sufficient direct nexus to the bond issue or the governmental purpose (i.e. debt service related funds).
- ✓ Disposition proceeds are comprised of funds identified from a sale of bond-financed property under the private activity bond rules.

EXCEPTIONS

Are there exceptions?

There are a number of different exceptions that may apply on a bond or fund level as follows –

✓ Small Issuer Exception for the entire bond

✓ Spending Exceptions for specific funds

✓ Bona Fide Debt Service Fund Exception

✓ Available Project Proceeds Exception (Tax Credit Bonds)

OR

✓ Sinking Fund Reserve Exception (Tax Credit Bonds)

SMALL ISSUER EXCEPTION

Main criteria for exception include –

- ✓ Government purpose;
- ✓ **95%** of the Proceeds spent within boundaries;
- ✓ Maintains general or limited **taxing** power; and
- ✓ Calendar year limit of **$5,000,000.**

GENERAL PURPOSE 6-MONTH EXCEPTION

If all gross proceeds and actual/expected earnings are spent within 6 months according to the timetable below, the interest earned during that period is not subject to rebate.

✓ 100% within 6 months*

* For governmental bonds (except tax and revenue anticipation notes) and qualified 501(c)(3) bonds, the 6-month time period is extended to one year for an amount of gross proceeds that does not exceed 5 percent of the proceeds.

NON-REFUNDING PURPOSE
18-MONTH EXCEPTION

If all gross proceeds and actual/expected earnings are spent within 18 months according to the timetable below, the interest earned during that period is not subject to rebate.

✓ 15% within 6 months;

✓ 60% within 12 months; and

✓ 100% within 18 months*†

* De Minimis carryover amount of $250,000 or 3 percent of the issue price (whichever is less) permitted if the issuer uses due diligence to complete the project.

† Extension of time when remaining gross proceeds do not exceed 5 percent of the issue price (up to 2 additional 6 month periods) for reasonable retainage.

CONSTRUCTION ONLY PURPOSE 24-MONTH EXCEPTION

If an issue qualifies as a construction issue where **<u>75%</u>** of the issue is spent on actual construction, and all gross proceeds and actual and expected earnings are spent within 2 years according to the timetable below, then interest earned during that period is not subject to rebate.

- ✓ 10% within 6 months;
- ✓ 45% within 12 months;
- ✓ 75% within 18 months; and
- ✓ 100% within 24 months*†

* De Minimis carryover amount of $250,000 or 3 percent of the issue price (whichever is less) permitted if the issuer uses due diligence to complete the project.

† Extension of time when remaining gross proceeds do not exceed 5 percent of the issue price (up to 2 additional 6 month periods) for reasonable retainage.

BONA FIDE DEBT SERVICE FUND EXCEPTION

According to the Treasury Regulations, a bona fide debt service fund is used primarily to achieve a proper matching of revenues with debt service payments and is depleted annually to a **reasonable carryover amount**. Reasonable carryover amount is defined as an amount up to the greater of –

- ✓ the earnings on the fund for the immediate preceding bond year; or
- ✓ 1/12 of the principal and interest payments on the issue for the immediate preceding bond year.

AVAILABLE PROJECT PROCEEDS EXCEPTION

According to the IRC, an issue shall not be treated as failing to meet the requirements of IRC Section 148 by reason of any investment of available project proceeds during the 3 year expenditure period. Failure to spend required amounts of bond proceeds within 3 years will occur if the following conditions are not met –

- ✓ 100% of available project proceeds should be expended for a qualified purpose by the close of the 3 year expenditure period or the extension period, if applicable; and
- ✓ A binding commitment to spend at least 10% of the available project proceeds within the first 6-month period beginning on the date of issuance.

SINKING FUND RESERVE EXCEPTION

According to the IRC, an issue shall not be treated as failing to meet the requirements of IRC Section 148 by reason of any fund which is expected to be used to repay such issue if –

- ✓ Such fund is funded at a rate not more rapid than equal annual installments;
- ✓ Such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and
- ✓ The yield on such fund(s) is not greater than the discount rate determined by the Secretary of the Treasury.

NON-PURPOSE INVESTMENTS

What are non-purpose investments?

Non-purpose investments are investments in securities, bank deposits, or other investments which have nothing to do with the purpose of the issue.

RECEIPT

What is a receipt?

Positive numbers in the calculation cash flows that are derived from the following –

- ✓ Amounts actually or constructively received from a non-purpose investment, such as earnings and return of principal;
- ✓ The value of a non-purpose investment as of the date that the investment ceases to be allocated to an issue; and
- ✓ The value of that investment at the end of a computation period for a non-purpose investment that is held at the end of a computation period.

PAYMENT

What is a payment?

Negative numbers in the calculation cash flows that are derived from the following –

- ✓ Amounts paid to acquire a non-purpose investment;
- ✓ The value of a non-purpose investment on the date after it is actually acquired or that becomes subject to the rebate requirement;
- ✓ The value of that investment at the beginning of a computation period for a non-purpose investment;
- ✓ Computation date credit(s); and
- ✓ Yield reduction payments on non-purpose investments.

COMPUTATION DATE

What is a computation date?

The last day of any bond year ending on or before the first required rebate payment date, thereafter, the end of each bond year or the end of each fifth bond year.

ARBITRAGE REBATE CALCULATION PROCESS

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FIRST STEP

Determine Whether a Calculation is Required –

✓ If there are gross proceeds of an issue that do not qualify for an exception, calculation of rebate is required.

✓ Issuers of bonds must pay to the Federal government an amount equal to the amount earned on all non-purpose investments less the amount that would have been earned if the non-purpose investments were invested at a rate equal to the yield on the bonds.

SECOND STEP

Determine the Computation Period, Payment Period, and Type of Bond Yield –

- ✓ The computation period starts on the issue delivery date and ends on the first computation/bond year end date. The first date is generally within one year of the delivery date or based upon a specifically elected date.
- ✓ The payment period, at a minimum, is based on a computation period of 5 years from the issue delivery date (installment date) or as of the final maturity/installment date.
- ✓ If the issue maintains a fixed yield, the issuer can define any date as the computation date.
- ✓ If the issue maintains a variable yield, the issuer must decide on a specific bond year end date. After the first installment date has passed the issuer must consistently treat the end of each bond year or the end of each fifth bond year as computation dates.

THIRD STEP

Calculate the Bond Yield –

- ✓ If an issuer does not possess the necessary systems for calculating the yield, either, the yield found on IRS Form 8038-G or the yield disclosed in the Federal Tax Certificate will be most appropriate.

- ✓ Example: Calculation of the bond yield using the earliest redemption date.

DATE	PAYMENTS	PRESENT VALUE (5.9126%)
1/1/95	1,800,000.00	$1,698,113.25
1/1/96	1,800,000.00	$1,601,993.68
1/1/97	1,800,000.00	$1,511,314.83
1/1/98	1,800,000.00	$1,425,768.75
1/1/99	31,800,000.00	$23,762,813.15
TOTAL	39,000,000.00	$30,000,003.67

FOURTH STEP

Allocate the Gross Proceeds for the Issue –

✓ Different funds or types of proceeds will require specific accounting methods. In all cases reasonable, consistently applied accounting methods should be used to account for the gross proceeds.

✓ Some examples include the following –

- **Project Fund:** First in first out, last in first out, ratable, or specific tracing.
- **Debt Service Fund:** Average excess, year-end excess, excess over maximum annual debt service, original principal, maximum debt service, or relative value of principal and interest.

FIFTH STEP

Creation of Cash Flow Schedules –

✓ Enter all payments (shown as negative numbers); and

✓ Enter all receipts (shown as positive numbers).

Date	Receipts (Payments)
1/1/04	($49,000,000)
2/1/04	3,000,000
5/1/04	5,000,000
1/1/05	5,000,000
1/1/05	(1,000)
9/1/05	20,000,000
1/1/06	(1,000)
3/1/06	22,000,000
1/1/07	(1,000)

SIXTH STEP

Future Value the Cash Flow Schedules –

- ✓ Take the previously created cash flow schedules and future value everything to the computation date and at the bond yield; and
- ✓ Net the future values of the payments and receipts to obtain the net amount (otherwise known as the arbitrage rebate amount).

Date	Receipts (Payments)	FV(7%)
1/1/04	($49,000,000)	($69,119,339)[a]
2/1/04	3,000,000	4,207,602[b]
5/1/04	5,000,000	6,893,079
1/1/05	5,000,000	6,584,045
1/1/05	(1,000)	(1,317)[c]
9/1/05	20,000,000	25,155,464
1/1/06	(1,000)	(1,229)[c]
3/1/06	22,000,000	26,735,275
1/1/07	(1,000)	(1,148)[c]
Rebate amount (1/1/09)		**$ 452,432**

[a] This is the same as the amount you would receive on 1/1/09 if you invested the proceeds from the sale of the bonds at 7 percent (the yield on the bonds) from 1/1/04 to 1/1/09.

[b] This amount, and the four following amounts, is what you would receive if you took your investment receipts (which are composed of both principal and interest from the investments) and invested them at 7 percent (the yield on the issue), compounded semiannually, from the date you received the money through the date of the rebate calculation.

[c] Computation credit.

YIELD RESTRICTION REQUIREMENTS

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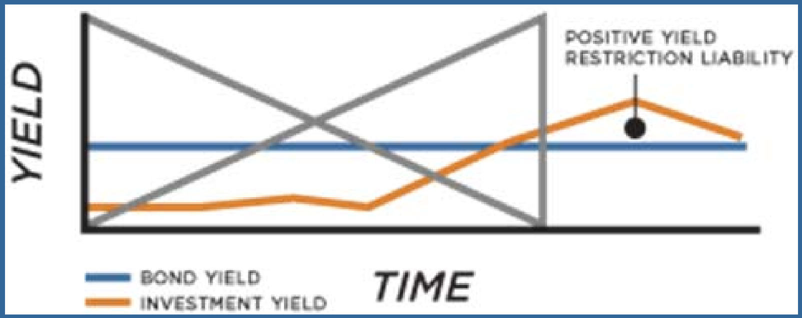
YIELD RESTRICTION



Yield restriction is the profit made from investing tax-advantaged bond gross proceeds in higher yielding taxable investments, above a specific materially higher yield, after a designated temporary period and above the minor portion. These rules have been in place since the Tax Reform Act of 1969.

YIELD RESTRICTION QUESTIONS

- ❑ What is materially higher yield?
- ❑ What is a temporary period?
- ❑ What is the minor portion?

MATERIALLY HIGHER YIELD

What is materially higher yield?

A materially higher yield occurs when an investment purchased with gross proceeds of tax-advantaged bonds produces a yield which is at or above a specified percent above the bond yield after the temporary period.

TEMPORARY PERIOD

What is a temporary period?

A temporary period defines the period of time for unrestricted investment per fund/proceed type.

MINOR PORTION

What is the minor portion?

The minor portion is a small amount, specifically the lesser of $100,000 or 5% of the proceeds of the issue which does not have to be yield restricted.

IRS PAYMENT PROCESS

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PAYMENTS

The purpose of submitting IRS Form 8038-T is to provide the IRS a payment necessary to remain compliant with arbitrage rebate and/or yield restriction requirements.

IRS Filing Period –

✓ Every 5 years; and

✓ Maturity date of the issue.

Timing –

Within sixty days of the end of the installment period or the final maturity date of the bond issue.

RECOVERY OF OVER PAYMENTS

The purpose of submitting IRS Form 8038-R is to recover prior payment amounts from the IRS.

Circumstances that allow for recovery of over payment of arbitrage rebate and/or yield restriction –

✓ Refund as a result of mistake in law or fact; and/or

✓ Refund as a result of declining investment yield.

Timing –

✓ Generally completed shortly after the final maturity date of the bond issue.

✓ Must be submitted to the IRS within two years of the final maturity date of the bond issue.

RECORD RETENTION

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IRC SECTION 6001

IRC Section 6001 provides record retention requirements for federal tax purposes necessary for maintaining the applicable tax-advantaged status.

- ✓ Retention period is the life of the bond *plus* three (3) years.
- ✓ Extended for refunding circumstances - the new retention period for the refunded bond is the life of the **refunding bond** *plus* three (3) years.

BASIC RECORDS TO BE RETAINED

- ✓ Basic records relating to the bond transaction;
- ✓ Documentation evidencing expenditure of bond gross proceeds ;
- ✓ Documentation evidencing use of bond-financed property by both public and private sources;
- ✓ Documentation evidencing all sources of payment or security for the bonds; and
- ✓ Documentation pertaining to any investment of bond gross proceeds (including the purchase and sale of securities, SLGs subscriptions, yield calculations for each class of investments, actual investment income received the investment of gross proceeds , guaranteed investment contracts, and rebate calculations).

USEFUL IRS PUBLICATIONS

1 Your Rights as a Taxpayer

http://www.irs.gov/pub/irs-pdf/p1.pdf

4077 Tax-Exempt Bonds for 501(c)(3) Charitable Organizations

http://www.irs.gov/pub/irs-pdf/p4077.pdf

4078 Tax-Exempt Private Activity Bonds

http://www.irs.gov/pub/irs-pdf/p4078.pdf

4079 Tax-Exempt Governmental Bonds

http://www.irs.gov/pub/irs-pdf/p4079.pdf

5005 Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds

http://www.irs.gov/pub/irs-pdf/p5005.pdf

5091 Voluntary Compliance for Tax-Exempt and Tax-Credit Bonds

http://www.irs.gov/pub/irs-pdf/p5091.pdf

LEARNING CHECKLIST RECAP

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BOND COMPLIANCE RULES ARE COMPLEX AND DETAILED, THEREFORE IT IS IMPORTANT TO REVIEW THE SPECIFIC GUIDANCE PROVIDED BY THE REQUIREMENTS OF THE INTERNAL REVENUE SERVICE AND THE SECURITIES AND EXCHANGE COMMISSION.

Revised in 2016 by Arbitrage Compliance Specialists, Inc., Inc.

For questions regarding this training presentation, please contact Mr. Stephen H. Broden at: (303) 867-7530 or stephen@rebatebyacs.com.

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