

Understanding Arbitrage and Bond Compliance

Presented to



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Rationale for Legislation – *Why are we here?*

- Arbitrage rules were written into the Internal Revenue Code of 1986 and multiple versions of Regulations so borrowers would not:
 - Borrow more funds than needed
 - Borrow funds earlier than needed
 - Borrow funds for a longer term than needed
- Borrowing tax-exempt is a subsidy from the federal government
- The government does not want its generosity abused

- Non-Compliance Penalty
 - Revoke Tax-Exempt Status
 - Enter into IRS Settlement Agreement to pay taxpayer exposure or other amount.

Arbitrage Rules Scope – *What do the rules apply to?*

Arbitrage rules apply to all tax-exempt and tax-advantaged debt, including, but not limited to:

- Bonds
- Notes
- BANs, RANs, TANs
- Bank Loans
- Certificates of Participation
- Capital Leases
- Taxable issues receiving subsidies (for example, Build America Bonds)

Arbitrage – *What is the focus of the rules?*

- Arbitrage is the spread between the tax-exempt borrowing rate and taxable earnings rate. When taxable investments generate a yield in excess of tax-exempt borrowing rate, the **dollar value of the difference** is paid back to the IRS as a Rebate.
- Taxable investments are captured for many types of “gross proceeds”, as described later, for the life of the issue.



Illustration of Arbitrage Excess Proceeds **Concept**

(Concept only – this does not represent the methodology in the Tax Code)

For \$1,000,000 proceeds
outstanding for 1 year:

	Yield	Earnings
Bonds	2.5%	\$25,000
Investments	3.5%	\$35,000
	Excess Earnings	\$10,000

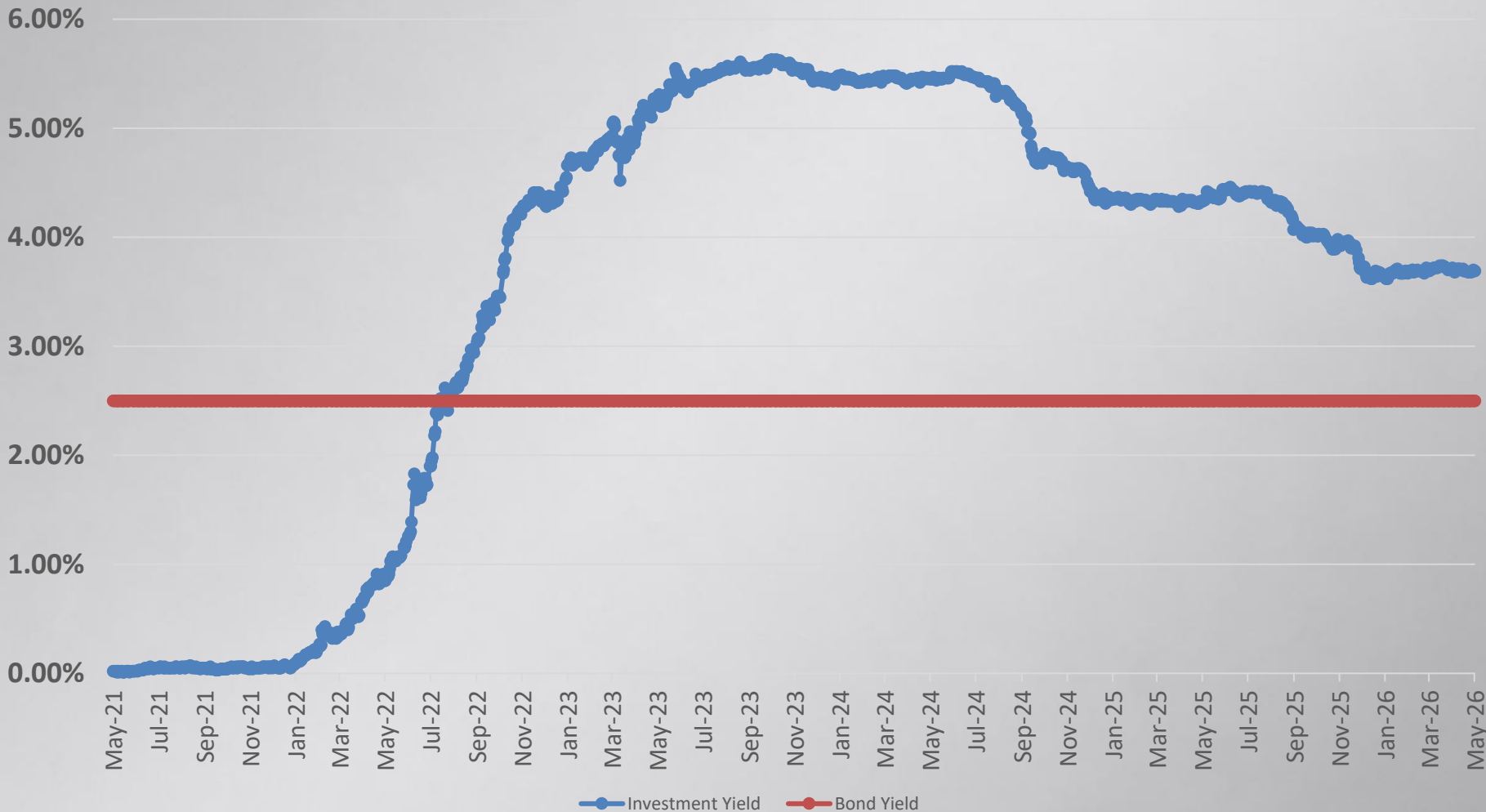
Arbitrage/excess earnings are affected by:

- 1) Amount of proceeds included
- 2) Length of time proceeds included
- 3) Magnitude of spread between
Investment Return and
Bond/Arbitrage Yield

5-Year Lookback – 3 Mo Treasury Returns

Arbitrage Illustrated

Yield Relationships



How and When Do I Prove Compliance?

Calculation required at least every 5 bond years and at maturity;
recommended annually [Note: Bond Year might be selected in
documents]

Form 8038-T must be filed within 60 days of 5th bond year end if
a payment is due.

Note: If bonds are refinanced, an IRS filing calculation is needed as of
the final redemption to confirm compliance of the refinanced issue.

Computation Credits annually offset Rebate Payments = \$2,170
for calendar year 2026 (adjusts for CPI)

Calendaring Computation Periods:

Bonds Issued 4/25/2021, due 10/1/2040

Installment Comp Date (1st Bond Year* + 5 Years)	Payment Date (Computation Date + 60 Days)
4/25/2026	6/24/2026
4/25/2031	6/24/2031
4/25/2036	6/24/2036
10/1/2040	11/30/2040

Types of Proceeds

What do I need to know to confirm I am compliant?

1. Bond Yield
2. What happened to Proceeds →

Sale Proceeds	Amounts Borrowed - Project Fund, Capitalized Interest, Reserve Fund, Refunding Escrow, Costs of Issuance
Investment Proceeds	Earnings on Proceeds
Transferred Proceeds	Unspent amounts of a refunded issue - Reserve/Project Funds
Replacement Proceeds	Funds not borrowed, but that have a direct nexus to the issue Pledged amounts in Debt Service, Reserve, Residual Funds
Disposition Proceeds	Proceeds from sale of bond-financed assets

Sample Rebate Computation

Date	Project Fund	Rate of Return	Interest	Running Balance	FV Factor	Future Value 5/15/26 at 3.00% Bond Yield
5/15/2021	50,000,000.00			50,000,000.00	1.1605408	(58,027,041.25)
4/28/2022	(15,000,000.00)	2.50%	1,191,780.82	36,191,780.82	1.1280777	16,921,165.72
5/30/2023	(12,000,000.00)	3.00%	1,180,942.77	25,372,723.59	1.0920875	13,105,049.41
5/15/2024	(12,500,000.00)	3.50%	853,983.31	13,726,706.90	1.0613636	13,267,044.38
3/18/2025	(8,500,000.00)	4.50%	519,546.45	5,746,253.36	1.0350937	8,798,296.43
5/15/2026	(6,079,221.19)	5.00%	332,967.83	-	1.0000000	6,079,221.19
			4,079,221.19			143,735.88
	Computation		5/15/2022	(1,830.00)	1.1264926	(2,061.48)
	Credits:		5/15/2023	(1,960.00)	1.0934433	(2,143.15)
			5/15/2024	(2,070.00)	1.0613636	(2,197.02)
			5/15/2025	(2,120.00)	1.0302250	(2,184.08)
			5/15/2026	(2,170.00)	1.0000000	(2,170.00)
						(10,755.73)
					Total Rebate	132,980.15

Arbitrage Exceptions

- **Exempt issues**
- **Exempt accounts**
- **Exempt investments**

How can I minimize payments?

Arbitrage Exceptions - Issue

- **Small Issuer Exception (Governmental Issues only)**
 - Aggregate face amount of all tax-exempt bonds (excluding private activity bonds) issued during the calendar year will not exceed \$5,000,000 (exception to **rebate**, not yield restriction)
- **Spending Exceptions - *Planning Opportunities***
 - 6 Month (100% as of 6 month anniversary)
 - 18 Month (15% as of 6 months, 60% as of 12 months, 100% as of 18 months)
 - 2 Year (10 % as of 6 months, 45% as of 12 months, 75% as of 18 months and 100% as of 2 years)
 - **If all parameters are met, excess earnings may be retained by the borrower**
 - If not met, funds are subject to rebate starting at the issue date
 - **May be applied optionally – not beneficial in negative arbitrage environment**
- **Benefit**
 - By meeting an exception to rebate, any **positive Rebate Amount** accrued **will be retained** by the Issuer/Borrower.

Arbitrage Exceptions – Debt Service Fund

Bona-fide Debt Service Funds (Section 1.148-1(b) of the Regulations)

- A bona-fide debt service fund is defined as a fund, which may include proceeds of an issue that –
 - Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and
 - Is depleting at least once each bond year; except for a reasonable carryover amount not to exceed the greater of:
 - The earnings on the fund for the immediately preceding bond year; or
 - One-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Arbitrage Exceptions – Investments

- **Non-AMT Tax-exempt securities**
- **Demand Deposit State and Local Government Securities (SLGS)**
 - **U.S . Treasury Securities**
 - **Purchased through subscription process using SLGSafe system**
 - **Fully liquid (but allow a few days for transfers of funds)**
 - **Daily reset of rate of return based on adjustment to yield on 13-week T-Bills (Rate 5/30/2025 = 3.36%)**

Expenditure of Proceeds – Current Outlay of Cash

- Expenditure of Proceeds requires a “current outlay of cash” for the governmental purpose of the issue (i.e., the Project).
- Alignment of investment records with expenditure records is crucial.

Expenditure of Proceeds – Allocation

- Allocation of Proceeds to expenditures must occur not later than 18 months after the date the expenditure is paid or the project is placed in service, but in no case later than 60 days after the 5th anniversary date of the issue.
- Multiple sources of funds for the Project requires a reasonable accounting method to allocate Proceeds to Expenditures –
 1. Specific Tracing
 2. Gross Proceeds Spent First
 3. First-In, First-Out
 4. Ratable Allocation

Expenditure of Proceeds - Reimbursement

- Arbitrage regulations dictate the extent to which amounts spent prior to closing can be deemed paid from Bond Proceeds
- “Preliminary Expenditures” up to 20% of the Issue Price
 - Architectural and engineering costs, survey costs, soil testing and other costs prior to start of construction but not land acquisition or site preparation
- Official Intent Resolution
 - Capital Expenditures contemplated in an Official Intent Resolution dating no earlier than 60 days prior to the Resolution AND the reimbursement is made not later than 18 months after the original expenditure.

Yield Restriction

- Similar but different requirement than Rebate
- Arbitrage from non-restricted proceeds cannot be blended with arbitrage from restricted proceeds
- Restricted/Non-Restricted vary by issue and are laid out in the Tax Documents

Non-Yield Restricted	Yield Restricted
Project Fund during Temporary Period	Project Fund after Temporary Period
Reasonably Required Reserve Funds	Overfunded Reserve Funds
Current Refunding Escrow	Advance Refunding Escrow
Minor Portion (generally \$100,000)	Replacement Proceeds including Non-Bona Fide Debt Service Funds

Positive Arbitrage is Positive!

	Sample Rebate Calculation 4.00% Bond Yield, Various Investment Returns and Deposits/Withdrawals from Prior Slide	Rebate Calculation with Same Parameters as other Sample but consistent 4.5% Interest Return
Sale Proceeds	\$50,000,000.00	\$50,000,000.00
Investment Proceeds (Earnings)	4,498,941.80	6,125,959.55
<i>Rebate Amount</i>	<i>(921,890.16)</i>	<i>705,127.59</i>
<i>Computation Credits</i>	<i>(9,799.68)</i>	<i>(9,799.68)</i>
Rebate Payment	<u>0.00</u>	<u>(695,327.91)</u>
Proceeds Available for Project	\$54,498,941.80	\$55,430,631.64

Net proceeds for project after Rebate Payment exceed proceeds in negative arb environment by \$931,689.84

Questions?

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