Positive Arbitrage!

Chair:

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Panelists:

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For the first time in over a decade we are in a period where investment rates may easily exceed bond yields. This panel is designed to look at the compliance issues and investment opportunities generated by or particular to a "positive arbitrage" environment.

BACKGROUND:

Yield-Restriction and Rebate

As a general rule, Section 148 of the Code works so that an issuer is either (i) prohibited from earning a yield on investments of the gross proceeds of a tax-exempt bond issue that is materially higher than the bond yield ("yield-restriction"), or (ii) if the issuer is permitted under Section 148 to earn an investment yield materially higher than the bond yield, the resulting excess earnings must be rebated to the federal Treasury. However, (i) there are rebate exceptions and (ii) yield-restriction and rebate rules are both applied over time so that higher earnings now may offset earlier or later "negative arbitrage" of the issue.

The Old and New Investment Environments

For years issuers have lived with "negative arbitrage," avoiding issuing bonds until the latest possible time, using draw-down structures to avoid having funds earning almost nothing compared with the interest paid on the issue, using surety bonds to avoid bond-funding of debt service reserve funds, or reducing or eliminating reserves wherever possible.

Now bond counsel may find issuers increasingly motivated by arbitrage considerations. For example, issuers are asking whether they can issue for that project that may get done (but likely will not start for a year or more) as an add-on to a bigger issue, perhaps with an excess proceeds call if the project does not get done.

Issuers are asking about investing in guaranteed investment contracts, and about why they must select the highest return if they bid out investments if the excess return simply must be paid to the federal treasury. They are looking at the benefits and drawbacks of short term vs long term investments.

They are also asking how to reach the "sweet spot" – that is how to avoid negative arbitrage without creating excess yield or otherwise causing non-compliance with Section 148.

Of course, they cannot have it all, but they may be able to make this investment environment work for them in many situations if they are careful.

THE BASIC LEGAL FRAMEWORK

Yield-Restriction

Generally, the yield on investments is computed on the same basis as yield on bonds and is determined separately for each separate class of investments. Yields on investments in separate classes may not be blended for arbitrage purposes, although they may for rebate purposes. Separate classes of investments include each category of yield restricted purpose investments and program investments subject to a different yield limit, yield restricted nonpurpose investments, and all other nonpurpose investments. Section 1.148-5(b)(2). An issuer may waive temporary periods and other exceptions to yield restriction under Section 1.148-3(h). Note that yield reduction payments may be available (see below) to reduce yield. All investments in a refunding escrow must be treated as one investment.

It is the yield on investments "over the term of the issue" that is relevant under § 148(b)(1). Under this rule, it is permissible to have proceeds invested in higher yielding investments for a period of time so long as later (or earlier) investments in lower yielding investments offset the higher yielding investments and result in an overall investment yield over the term of the issue that is not materially higher than the bond yield. An issuer that intends to blend after a rebate computation date (other than with respect to proceeds in a refunding escrow and a sinking fund expected on the issue date to reduce the escrow yield) may be required to actually make a rebate payment despite the intended future blending. The Regulations effectively allow yield blending to be broken up into 5-year computation periods for variable rate bonds. If investments within the same class have different "materially higher" standards, the lowest prevails.

Yield-Reduction Payments

Although an issuer may not be allowed to invest gross proceeds above the bond yield, in certain cases, Section 1.148-5(c) allows an issuer to make a "yield reduction payment" to the United States to reduce the yield on yield-restricted investments to the appropriate rate. Not all "gross proceeds" are eligible for yield reduction payments. The major categories of investments or issues that are eligible for such yield reduction payments are (1) investments entitled to an initial temporary period (such as most new money construction funds), (2) investments allocable to most variable yield issues, (3) investments in a reasonably required reserve fund not meeting the size limit in Section 1.148-2(f)(2)(ii), but only to the extent that the amounts are less than or equal to 15% of the principal of the issue or are not (except for investment earnings) expected to pay debt service on the issue, and (4) certain transferred and replacement proceeds in the context of a refunding. The major categories of investments generally not eligible to use yield reduction payments are replacement proceeds and proceeds of an advance refunding issue (although the ability to issue tax-exempt advance refundings of other tax-exempt bonds was repealed effective January 1, 2018). The yield reduction payment rules are particularly useful in three areas that

historically have required yield restriction: (1) unexpended proceeds in a construction fund after the three-year temporary period expires; (2) variable yield issues with yield restricted pledged funds; and (3) "transferred proceeds" held in a prior escrow as a result of a current refunding.

Rebate

Rebate, introduced first in the Mortgage Subsidy Bond Tax Act of 1980 for single family mortgage bonds and extended to virtually all tax-exempt bonds by the 1986 Act, has a similar economic effect for issuers as does yield restriction: investment return over the yield on the issue, if earned, is paid over, or rebated, to the U.S. Treasury. Failure to rebate arbitrage profits may result in taxability of the bonds (or loss of related tax credits or subsidies). Further, compliance with the rebate requirement does not obviate the need for compliance with the yield restriction rules (through making yield reduction payments where available) and, to that extent, the two rules are duplicative. Thus, the rebate requirement primarily impacts proceeds that are entitled to a temporary period, such that the issuer was allowed to invest the proceeds at a higher yield than the yield on the bonds.

The "One-Issue Rule" and the "Universal Cap" Rule

The arbitrage provisions in Section 148 of the Code generally govern investment of all gross proceeds of an issue (sale, investment, transferred and replacement proceeds). They also address what amounts count as gross proceeds of a particular issue. The "universal cap" rule provides an overall limitation on the amount of gross proceeds allocable to an issue. Under the general rule, nonpurpose investments which are allocable to the gross proceeds of an issue are allocable to such issue only to the extent the value of such nonpurpose investments does not exceed the value of the issue. For purposes of the universal cap rule, "nonpurpose investments" also include gross proceeds allocable to cash, tax-exempt bonds, qualified student loans and qualified mortgage loans.

Section 1.148-6(b)(1) of the Regulations provides generally that moneys can be gross proceeds of only one bond issue at a time, thus codifying a logical principle long followed by the Section 103 bar. (The preamble to the originally proposed allocation regulations indicates that the one issue rule "generally continues principles of existing law.") Thus, funds which under general definitions are simultaneously proceeds of one issue and replacement proceeds of another issue are treated only as proceeds of the first issue.

Gross proceeds remain allocated to an issue until an event occurs that de-allocates those gross proceeds. There are two basic rules of de-allocation:

- amounts cease to be proceeds of an issue only when they are allocated to an expenditure for a governmental purpose, allocated to transferred proceeds of another issue, or cease to be allocated to the issue as a result of the retirement of the issue or the application of the universal cap rule; and

- amounts cease to be replacement proceeds of an issue only when such amounts are spent for a governmental purpose, are no longer used as replacement proceeds or as a result of the retirement of the issue or the application of the universal cap rule.

Amounts that cease to be allocated to one issue are eligible for allocation to another issue.

The preceding accounting rules, however, do not apply in certain (but as yet unspecified) cases involving abusive arbitrage devices.

HYPOTHETICALS AND DISCUSSION POINTS:

HYPO A:

EXISTING ISSUE WITH ACCUMULATED NEGATIVE ARBITRAGE

Issuer A has an outstanding issue "Utility Series 2014A" for a now decommissioned coal-fired power plant which has new money and advance refunding components as well as a reserve fund. The advance refunding escrow has been paid out in full, but during its existence, it generated significant negative arbitrage ($1,000,000) as did the construction fund ($2,000,000 fully-expended within the temporary period) and the reasonably required reserve fund ($3,000,000).

Issuer A regularly uses excess revenues to effect the defeasance of the debt of its decommissioned facilities.

It asks its financial advisor ("FA") to look at the possibility of taking excess revenues and effecting the defeasance of a portion of the remaining original Utility Series 2014A Bonds to their first call date (May 1, 2024).

FA points out that investment rates are now above the bond yield and suggests calling bond counsel to see if this will present arbitrage issues but hopes that it will not given that yield is calculated over time. FA knows that yield-restriction rules are complex and that a defeasance escrow may raise tax issues.

Questions:

1. Is the defeasance escrow subject to yield restriction? Answer – Yes, it is a sinking-fund and the amounts deposited to the escrow would be replacement proceeds of the Utility Series 2014A Bonds.

2. If so, does that mean it must be invested below the bond yield? – Answer – Yes, unless the defeasance escrow can be looked at as a single investment with another account that had or has a yield below the bond yield.

3. Can the yield on the defeasance escrow be "blended" with the yield in any of the other funds that held proceeds of the Utility Series 2014A Bonds? Which ones? Answer - Only the advance refunding escrow (unless the issuer waived the temporary period on the construction fund)?

4. Are there any rebate issues? Answer - Likely not at least at this stage. What could make it an issue?

5. What investments might make sense here? SLGS, Open markets? Anything else?

HYPO B

NEW MONEY ISSUES FOR LONG TERM CONSTRUCTION PROJECT

Issuer B wants to issue a $115,000,000 general obligation bond issue ("Series 2023A) for a long-term construction project that will likely cost $150,000,000 of which $100,000,000 will be funded from the sale proceeds of the issue and remainder will come from investment earnings and revenues or a later issue. B reasonably expects the project will take over five years to complete but that at least 85% of the $100,000,000 construction fund will be spent within three years. There is also a $10,000,000 reserve fund to be funded and costs of issuance.

Questions:

1. Is B issuing too early?

2. How should B invest the construction fund? For how long? Does B need to worry about yield-restriction? What if B intended to use some of the other funding sources first and the proceeds a little later and wanted to use the five-year temporary period? Does this raise potential temporary period, hedge bond, or other issues?

3. What if B believes that once the project is complete it might qualify for a reimbursement grant of up to $75,000,000 that might be applied to effect a defeasance of a portion of Series 2023A? Should B consider waiving the temporary period for the construction fund?

4. What about the reserve fund? How should it be invested? For how long?

5. What about rebate – could that be an issue? It looks likely that rebate will be owed, but this issue would likely be outstanding in part for at least 10 years, and rates could drop. How should B minimize any potential compliance issues?

HYPO C

MULTISOURCE CONSTRUCTION FUND WITH SINKING FUND

Multifamily developer C is using $10 million of tax-exempt bonds, $12,000,000 taxable subordinate conventional debt (consisting of Sub Loan A of $1,900,000 being advanced in full at closing and Sub Loan B of $10,000,000 to be advanced and deposited to the Collateral Fund as the proceeds of the tax-exempt bonds are spent) and tax credit equity, all to fund new construction of a residential rental facility. The plan is that the Sub Loan B debt will initially be used as a source of cash-collateral to be held in the Collateral Fund to secure the short term publicly offered tax-exempt bonds, and Sub Loan A will be used during construction for nonqualified or excess costs and would be held in a subaccount of the Construction Fund (the "Sub Loan Account"). All proceeds of the subordinate debt are required to be deposited with the bond trustee and as such would be pledged to pay the bonds whether or not held in the Collateral Fund but only the Collateral Fund will be expected to be needed to secure or pay debt service on the tax-exempt bonds.

The tax-exempt bonds are variable rate tender bonds and will be sold with a fixed rate until the two-year mandatory tender date with a possible remarketing for one more year until the final maturity date of the bonds if the project is not yet in service at the tender date.

At closing, all $10 million of the tax-exempt bonds are issued and deposited to the Proceeds Account of the Construction Fund, and $1.5 million of the tax-exempt bonds is immediately drawn from the Proceeds Account of the Construction Fund for project costs, and an equal amount of Sub Loan B is deposited to the Collateral Fund. In addition, $200,000 of Sub Loan A and $500,000 of equity is spent for closing costs, and the remainder of Sub Loan A ($1.7 million) is deposited to the Subordinate Loan Account of the Construction Fund. As amounts are drawn from the Proceeds Account of the Construction Fund, amounts will be drawn under Sub Loan B so that the amount in the in the Proceeds Account plus the amount in the Collateral Fund will always equal principal plus interest due on the tax-exempt bonds on the mandatory tender date (or the maturity date after the mandatory tender date).

1. The Construction Fund qualifies for a temporary period but the Collateral Fund does not. Can the investments for the two be treated as a single investment? Will all amounts in these funds be treated as gross proceeds of the tax-exempt bonds? What amounts will be? Answer: the universal cap rule in 1.148-6 will limit the amount treated as gross proceeds of the tax-exempt bonds to the outstanding amount of the tax-exempt bonds. Generally, all sale and investment proceeds of the tax-exempt bonds will be gross proceeds (absent an early, unexpected redemption, they will always be less than the outstanding amount of the tax-exempt bonds), and all (or almost all) of the amounts in the Collateral Fund will be treated as gross proceeds and amounts in the Sub Loan Account will not be treated as gross proceeds of the tax-exempt bonds.

2. Assuming the issuer waives the Construction Fund temporary period, the investments in the funds up to the universal cap amount can be treated as a single investment over time. Does this "single investment" qualify for yield-reduction payments? Answer: it should. What if the tax-exempt issue was a fixed rate issue?

3. What are the best options for this investment? Can the gross proceeds and other amounts be invested together? Does that make sense?

4. Assume the investment has a yield materially in excess of the tax-exempt bond yield. When would the yield-reduction payment need to be made? Should it be made earlier? What about if the bonds are remarketed at a rate below the bond yield?