Advanced Arbitrage: There and Back Again

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The Workshop

OCTOBER 18–20, 2023

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Panel Focus

I. Classes of Investments

II. Investment Options and Considerations

III. Market Trends and Investment Structures

IV. Rebate Considerations

I. Classes of Investments

Treas. Reg. 1.148-5(b)(2) states the following: "For purposes of the yield restriction rules of section 148(a) and § 1.148-2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended."

What does this mean?

It means all investments in the same class must be blended together regardless of when they are held, and despite the five-year computation date for rebate. A single yield is determined over the life of the investments.

I. Classes of Investments

What are the different "classes of investment" within the meaning of Treas. Reg. 1.148-5(b)(2)?

- Each category of yield restricted purpose investment and program investment that is subject to a different definition of materially higher under § 1.148-2(d)(2)
- Yield restricted nonpurpose investments
- All other nonpurpose investments

I. Classes of Investments

Waiver of temporary period and right to invest in higher yielding investments

What is it?

- Treas. Reg. 1.148-2(h) provides that an issuer may elect to waive the right to invest in higher yielding investments.

Why would you do it?

- If an issuer expects yields on non-yield restricted investments will be lower and is concerned that the yield on certain yield restricted investments might be higher, a waiver might be desired to treat all investments as yield restricted and bring these investments into collective yield compliance.

When do you do it?

- A waiver must occur on or before the issue date.

I. Classes of Investments

Example 1 – Unspent Project Fund Proceeds

- City issued $100mm for a revenue bond project October 2020.
- City funded COI and a reasonably required DSRF from its own cash and deposited all $100mm of the proceeds into the project fund.
- All investments to date have accrued significant negative arbitrage.
- Now, in October 2023, City has not completed the project and approximately $14mm remain in the project fund. The project is expected to take 2 more years to complete and will cost more than originally anticipated.
- City's MA says the City should consider investing remaining project fund monies above the bond yield, to fund these additional cost overruns. MA says positive arbitrage now will be offset by prior negative arbitrage.

As bond counsel, what advice do you have for the City?

I. Classes of Investments

Example 2 – Defeasance Escrow

- In 2015 County issued tax-exempt advance refunding bonds (the "2015 Bonds") to refund 2007 Bonds to their 2017 redemption date
- The 2015 escrow for the 2007 Bonds was structured containing a significant amount of negative arbitrage due to low short-term rates at the time of refunding in 2015
- In October 2023, County desires to take its own cash to defease the 2015 Bonds and call these bonds at their call date in 2025
- The County's MA suggests any investment above the arbitrage yield for the 2015 Bonds now can be blended with prior negative arbitrage. Investments now are significantly higher than those available in 2015.

As their counsel, is there a concern the amounts in the 2023 escrow could be considered replacement proceeds of the 2015 Bonds?

How would you view this set of facts?

I. Classes of Investments

Final Thoughts

A potential sanction under the anti-abuse rules is a requirement that an issuer treat each investment as a separate class, and the issuer would lose the ability to blend low-yield investments with high-yield investments. See Treas. Reg. 1.148-10(b)(1)(i).

II. Investment Options and Considerations

Common Options

- Tax-exempt bonds (Not investment property under IRC 148(b))
- Mutual Funds
- Money Market Funds
- Local Government Investment Pools
- United States Treasuries
- Certificates of Deposit
- Guaranteed Investment Contracts (GICS)
- State and Local Government Securities (SLGS)
- Other?

Remember 1.148-5(d)(6)! If the investment is not of a type traded on an established market, it is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value.

II. Investment Options and Considerations

The wonderful world of SLGS

What are they?

What kinds of SLGS can you get?

What are the benefits of SLGS?

Why invest in demand deposit SLGS?

Are there any drawbacks?

II. Investment Options and Considerations

Closure of the SLGS window

- Occurs when the federal government hits or nears the debt ceiling
- Since 1995, the SLGS window has been closed 16 times, most recently from May 2, 2023 – June 5, 2023
- Closure limits investment options and can result in potential noncompliance
- When suspended, issuers can make yield reduction payments. See Treas. Reg. 1.148-5(c)(3)(viii)

II. Investment Options and Considerations

Closure of the SLGS window, Cont.

- What happens to demand deposit SLGS?
- Conversion of demand deposit SLGS to 90-day certificates
- Are these “90-day certificates” still a “certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series”? Why does this matter?
- See Chief Counsel Memorandum No. 202326019

III. Market Trends and Investment Structures

Laddered Portfolio of U.S Treasury Securities

Laddered Portfolio of U.S. Treasury Securities and Agency Securities (i.e., Securities issued by either Fannie Mae, Freddie Mac, Farm Credit System, or the Federal Home Loan Banks)

Demand Deposit SLGS

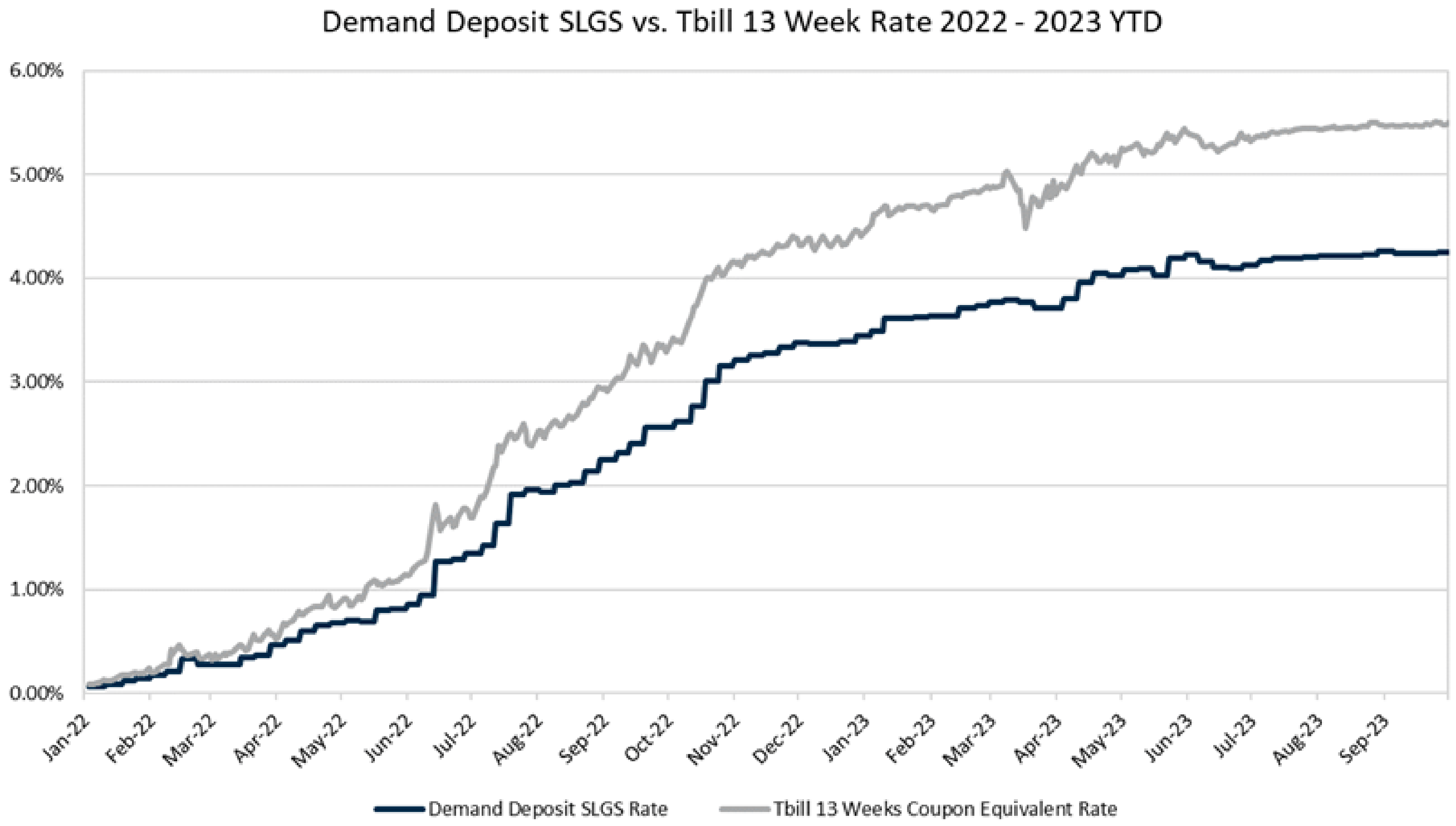
Combination of Taxable Investments and Demand Deposit SLGS

Unsecured GICs

Other Investments

III. Market Trends and Investment Structures

Significant increase in short-term rates since 2022 has created investment opportunities not available to public sector clients in years.



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III. Market Trends and Investment Structures

- Common approach is to invest a high % of the project fund in the laddered portfolio and leave the balance in money markets or a local government investment pool for liquidity purposes
- Treasury only portfolios are often utilized as they achieve the dual purpose of locking in a fixed rate on a significant portion of the fund with minimal to no credit risk – can be ideal if client knows they will NOT meet spend-down requirements and yet yields allow for equaling or exceeding the arbitrage yield on the portfolio
- Agency securities, if eligible, can be included as a means to enhance yield, especially for clients that anticipate meeting spend-down tests
- Demand Deposit SLGS afford the ability to invest funds at yields in excess of the arbitrage yield in cases where the arbitrage yield is low, especially common in 2021 and 2022 transactions
- Combination of Taxable Investments and Demand Deposit SLGS may make sense in order to re-capture some previously incurred negative arbitrage prior to the 3rd anniversary
- Unsecured GICs or REPO's can provide complete draw flexibility while remaining invested at a fixed rate over the life of the fund – challenge can be achieving 3 bid safe harbor
- Less utilized instruments included high grade commercial paper and brokered CD's when they offer incremental yield

IV. Rebate Considerations

Rebate Taxation – IRC 148(f)(5)

Exemption from gross income of sum rebated.

Gross income shall not include the sum described in paragraph (2) [i.e., the "rebate amount"].

Notwithstanding any other provision of this title, no deduction shall be allowed for any amount paid to the United States under paragraph (2)

IV. Rebate Considerations

Allocations of Proceeds to Expenditures

Three factors directly impact the amount of arbitrage rebate:

1. The amount of proceeds invested;
2. The size of the spread between the earnings rate and the arbitrage yield; and
3. The length of time that proceeds are invested.

Consequently, *the allocation* of proceeds to expenditures directly impacts rebate liability.

IV. Rebate Considerations

Allocations of Proceeds to Expenditures, Cont.

General Rules/Considerations:

1. Treas. Reg. 1.148-6(a)(1) – An issuer may use *any reasonable, consistently applied accounting method* to account for gross proceeds, investments, and expenditures of an issue.

2. Treas. Reg. 1.148-6(d)(1)(i) – Reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose *include any of the following methods if consistently applied*: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

3. Treas. Reg. 1.148-6(d)(1)(ii) – An allocation of gross proceeds of an issue to an expenditure *must involve a current outlay of cash* for a governmental purpose of the issue (defined as no later than 5 banking days as of the date of which the allocation is made).

4. Treas. Reg. 1.148-6(d)(1)(iii) – An issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service.

IV. Rebate Considerations

Allocations of Proceeds to Expenditures, Cont.

Example 1:

- City A issues bonds in excess of $5mm to fund capital expenditures in connection with the improvement of a variety of city parks.
- Proceeds are invested at a rate materially higher than the arbitrage yield.
- Proceeds are expended quickly, but not quickly enough for the issue to qualify for a spending exception to rebate.

Can City A take any action whereby it would meet all the spending exception benchmarks, allowing City A to retain the positive arbitrage? What else would you want to know?

IV. Rebate Considerations

Allocations of Proceeds to Expenditures, Cont.

Example 2:

- City B issues bonds and allocates proceeds to expenditures as they occur.
- In the process of preparing for the annual audit, City B realizes that it paid for expenditures from bond proceeds that were not eligible for that purpose.
- A correcting entry is made to return the proceeds to the Project Fund.

Does City B need to take any additional actions? What else would you want to know?

IV. Rebate Considerations

Debt Service Funds

General Rules and Considerations:

1. Treas. Reg. 1.148-1(b) – a "bona fide debt service fund" is a fund, which may include proceeds of an issue, that – (1) is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and (2) is depleted at least once each bond year, except for a *reasonable carryover amount* not to exceed the greater of: (i) the earnings on the fund for the immediately preceding bond year or (ii) one-twelfth of the principal and interest payments for the immediately preceding bond year.

2. IRC 148(f)(4)(A), Treas. Reg. 1.148-3(k) – Amounts earned on a bona fide debt service fund excluded in computing rebate in certain cases:

   (1) For bond year with earnings < \$100,000;

   (2) Average annual debt service does not exceed \$2,500,000;

   (3) Governmental fixed rate WAM > 5 years;

   (4) Spending exception met

IV. Rebate Considerations

Debt Service Funds, Cont.

Example 3:

- Hospital A issues bonds for a project and deposits related revenues into the principal and interest accounts each month.
- The lowest aggregate balance of these accounts is greater than the reasonable carryover amount.

Are the principal and interest accounts in total subject to rebate, or is a portion of the account a bona fide debt service fund, and only the excess is subject to rebate?

If only the "excess" is subject to rebate, how is such amount identified?

What yield restriction issues do we have?

IV. Rebate Considerations

Debt Service Funds, Cont.

Example 4:

- Hospital B issues bonds. To fund its debt service, Hospital B deposits 1/6th of the upcoming interest payment plus 1/12th of the upcoming principal payment each month and invests the funds in taxable instruments.

- After the principal and interest payment, the remaining balance in the account is $0.00. The average annual debt service on the bonds exceeds $2,500,000. Earnings in the Debt Service Fund for the bond year are $101,000.00.

Are amounts in the Debt Service Fund exempt from rebate? Are they subject to yield restriction?

BONUS QUESTION: If Hospital B invested the amounts in the account in taxable securities to generate earnings of $99,999.99 and then invested only in demand deposit SLGS for the remainder of the bond year, are the funds subject to rebate?

Final Thoughts?

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