Arbitrage:
Can I Earn It? Can I Keep It?

PANEL CHAIR:

Adam R. Baird - Kutak Rock, LLP – Spokane, WA

PANELISTS:

David J. Cholst - Chapman and Cutler LLP – Chicago, IL

David A. Sutton - Raymond James & Associates, Inc. – St Petersburg, FL

Laurie K. Scott - Integrity Public Finance Consulting LLC – Jacksonville, FL

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The Workshop

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Introduction

Arbitrage Defined

- Exploiting the difference between two markets, where you buy cheaper on one market and sell on another market where price is higher
- Tax arbitrage involves borrowing at tax advantaged lower rate and investing at a higher rate

Purpose of the Arbitrage Rules

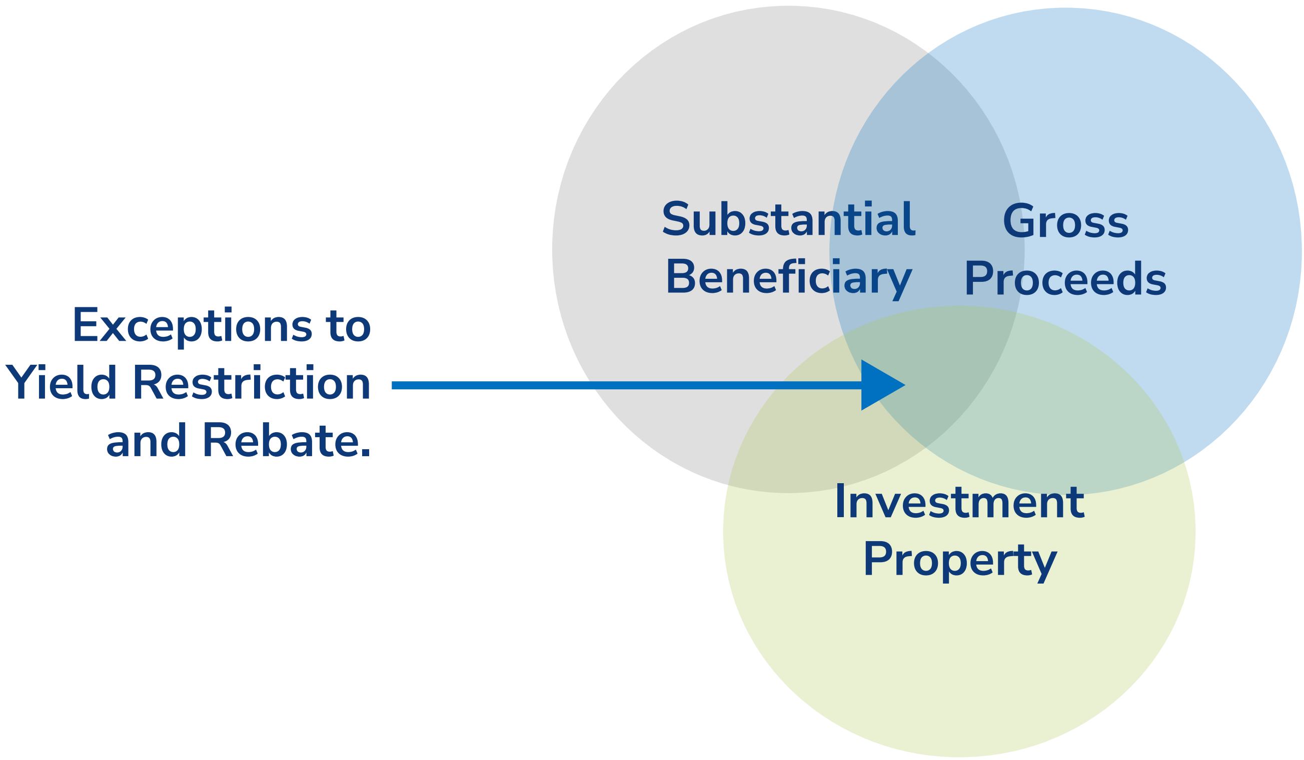
Introduction

Three Independent Sets of Arbitrage Rules

- **Yield Restriction Rules ("Can you earn it?")** – govern whether gross proceeds of a bond issue may be invested at a yield materially higher than the bonds
- **Rebate Rules ("Can you keep it?")** – govern whether arbitrage earned must be "rebated" to federal government
- **Structural Rules** – govern structure of a bond issue, and include prohibitions on overfunding a reserve, over issuance, early issuance, and leaving bonds outstanding longer than necessary

Arbitrage Rules Summarized

*If the investment of tax-exempt bond proceeds concerns Gross Proceeds, a Substantial Beneficiary, and Investment Property the Arbitrage Yield Restriction and Rebate rules apply.



Identify “Gross Proceeds”

1. What are “Gross Proceeds”?

a) Proceeds (Sale, Investment, Transferred Proceeds)

b) Replacement Proceeds

i. Sinking Funds
ii.Pledged Funds
iii.Negative Pledge
iv.Substantial Beneficiary

2. Same Definition: “Gross proceeds” has the same meaning for both the yield restriction rules and the rebate rules

Identify Substantial Beneficiary

1. What is a “Substantial Beneficiary”?

a) Bond Issuer
b) Entity borrowing the proceeds
c) State in which the issuer is located
d) “Related parties” to the above
e) Any others by reason of benefit:
- City encouraging a financing within jurisdiction by agreeing to cover part of debt service
- Seller of bond financed property

f) Does not include a Qualified Guarantor

Identify Investment Property

Obligations (debt instruments)

Securities (stock)

Annuity Contracts

Investment Type Property

- Property held for passive production of income
- Examples: Land leased out to farmers; Precious metals

Investment Property Excludes

Property actively used in the business of the Substantial Beneficiary

Tax-Exempt Bonds

- For gross proceeds of Non-AMT bonds only; Non-AMT bonds excluded
- Mutual funds where 95% of income to holder is tax-exempt

Demand Deposit (variable rate) SLGS

Yield Restriction – Can you earn it?

RULE: All Gross Proceeds of Substantial Beneficiaries in Investment Property is restricted as to yield except insofar as any of the following may apply:

a) Temporary Periods	b) 4R Funds	c) Minor Portion	D) Not Materially Higher

Yield Restriction – Temporary Periods

1. **Capital Project Fund – 3 years, Issuer reasonably expects to:**
   a) Enter into Binding Contract w/i 6 months to spend 5%
   b) Proceed with Due Diligence
   c) Spend at least 85% within 3 years
2. **Capital Project Fund – 5 years**
   a) Certification of licensed engineer or architect
3. **Current Refunding Escrow – 90 days**
4. **Bona Fide Debt Service Fund – 13 months**
5. **Sinking Funds – 30 days, unless another temporary period applies**
6. **Transferred Proceeds**

Yield Restriction – Materially Higher

What does "materially higher" mean?

1. 0.125% (1/8%) for:

a) Project Funds (or other Nonpurpose Investments)
b) Purpose Investments other than Program Investments (see below)

2. 0.001% for

a) Refunding escrows
b) Replacement Proceeds
c) NOTE: Lower limit applies to all

3. Program Investments

a) Allowable spread of 1.125%, 1.500%, or 2.000% depending on type
b) General limitation on Issuer fees
c) Applies in housing transactions, 501(c)(3) Bonds, qualified mortgage bond, student loan bonds, conduit governmental bonds

Rebate – Can you keep it?

RULE: <u>Actual earnings</u> on investments in excess of bond yield are:

- Paid to U.S. Treasury
- 5-year installments and at the end of issue
- Includes amounts which are materially higher (except for purpose investments)

QUESTION: Can you pay "rebate" in <u>any</u> circumstance where you earn materially higher than the bond yield?

*A Yield Reduction Payment might be available . . .

Rebate Exceptions

Spending Exceptions:

a) 6-Month Rule: Applies to all types of issues
b) 18-Month Rule: Applies to new money issues of all types
c) 24-Month Rule: Applies to new money governmental or 501c3 issues

Bona Fide Debt Service Fund

Small Issuer Exception

Governmental Issuers Only

Rebate vs. Yield Reduction Payments

RULE: An issuer can make a yield reduction payment (YRP) to reduce the yield on an investment if the investment yield is materially higher than the bond yield. A YRP is made at the same time and manner as a rebate payment.

A YRP is permitted:

a) Nonpurpose investment that qualified for a temporary period
b) Variable yield issues
c) Certain Overfunded Reserves
d) When SLGS window closed
e) Other instances in Treas. Reg. 1.148-5(c)(3)

Example

REBATE COMPUTATION

Date	Project Fund * Investment	Withdrawal	Rate of Return	Interest	Running Balance
5/15/2018	(50,000,000.00)				50,000,000.00
4/28/2019		15,000,000.00	3.25%	1,549,315.07	36,549,315.07
5/30/2020		12,000,000.00	3.00%	1,195,613.21	25,744,928.28
5/15/2021		12,500,000.00	3.50%	864,042.11	14,108,970.39
3/18/2022		8,500,000.00	4.50%	534,014.87	6,142,985.26
5/15/2023		6,498,941.80	5.00%	355,956.54	0.00
				4,498,941.80	

Arbitrage Yield	**4.00%**	**Rebate Accrued**	**(921,890.16)**

YIELD RESTRICTION PAYMENT COMPUTATION

Date	Project Fund * Investment	Withdrawal	Rate of Return	Interest	Running Balance
5/15/2021	(14,108,970.39)				14,108,970.39
3/18/2022		8,500,000.00	4.50%	534,014.87	6,142,985.26
5/15/2023		6,498,941.80	5.00%	355,956.54	0.00
				889,971.41	

**Allowable Yield ** **	**4.125%**	**YRP Accrued*** **	**101,139.92**

* 3 year temporary period
** Bond Yield + 0.125% per IRC Section 148
***Yield Reduction Payment (YRP) due 7/14/2023 (comp date + 60 days)

Computation of Rebate

1. When to engage expert?
2. What experts should be engaged?
3. What information is needed?
4. When to compute?
5. Scope of computation
6. Rebate and/or Yield Reduction Payments and manner of payment; Form 8038T

Hypothetical 1

Facts:

Charter School issues $100,000,000 bonds to purchase and renovate an existing campus and fund costs of issuance. It anticipates interest income of $1,000,000.00 while the project is completed. Total amounts spent are:

Date	Total Spent
6 mos	(15,100,000.00)
12 mos	(70,000,000.00)
18 mos	(100,000,000.00)

Hypothetical 1, Cont.

Question:

Does this issue qualify for the 18-Month Spending Exception?

Answer:

No. The % spending requirements include earnings. Therefore, as of the 6- month date, a total of ($101,000,000.00 x 15% = $15,150,000.00) is required. In this scenario, there would be a remaining balance = $1,000,000.00 (or whatever the actual earnings were) at the end as well.

Hypothetical 2

Facts:

City issues $100,000,000 new money bonds on Jan 15, 2018, which qualify for a 3-year temporary period. As a result of COVID delays, the project is not completed until December 31, 2022. City receives a Rebate Report showing that $3,000,000.00 negative arbitrage was generated during the first installment period (1/15/2018 – 1/15/2023).

Hypothetical 2, Cont.

Question:

Is a Form 8038T filing required?

Answer:

It depends. A filing is only required if a payment is due. In this case, there is no Rebate Payment required. However, a YRP might be due. . .

Hypothetical 2, Cont.

More Facts:

The City's Rebate Report shows the following:

Year	Annual Rebate	Cumulative Rebate	Annual YRP	Cumulative YRP
1	(1,500,000.00)	(1,500,000.00)	n/a	
2	(1,000,000.00)	(2,500,000.00)	n/a	
3	(1,000,000.00)	(3,500,000.00)	n/a	
4	400,000.00	(3,100,000.00)	400,000.00	400,000.00
5	100,000.00	(3,000,000.00)	100,000.00	500,000.00

Question:

Is the City in compliance with the yield restriction rules? What must it do to be compliant?

Hypothetical 2, Cont.

Answer:

The City must make a YRP to maintain compliance with the yield restriction rules.

A YRP must be computed and paid on the proceeds outstanding from 1/15/2021 – 1/15/2023 (i.e., years 4-5).

A YRP might exist even with negative rebate if proceeds post-temporary period are invested above the bond yield.

Final Thoughts?

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