ARBITRAGE BOOTCAMP

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7th ANNUAL POST-ISSUANCE COMPLIANCE WORKSHOP

A Comprehensive Overview of Post-Issuance Tax Law and SEC Secondary Market Disclosure for 501(c)(3) Organizations and State and Local Government Issuers Who Utilize Tax-Exempt Financing

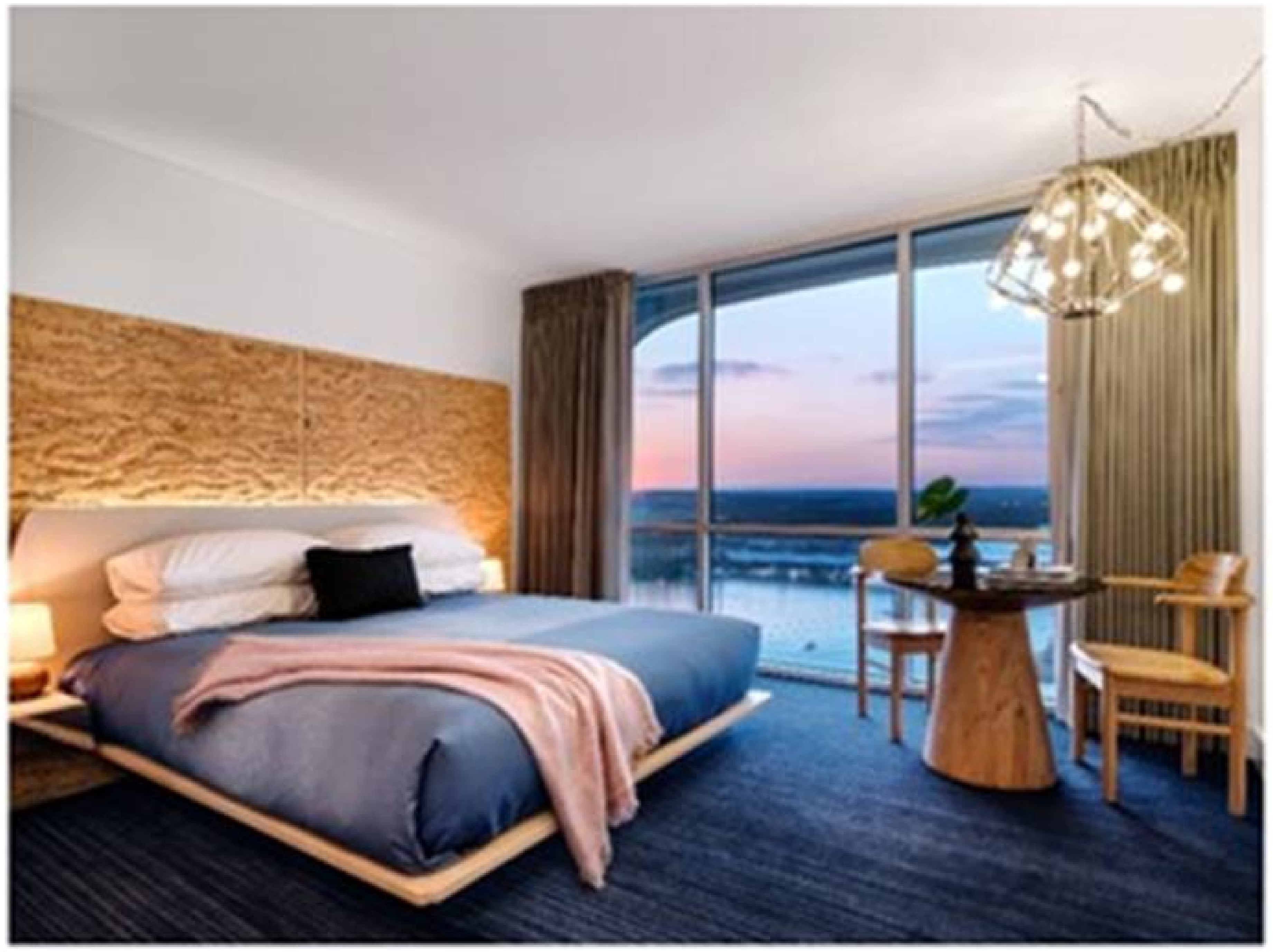
WHEN: **November 14 and 15, 2019**

WHERE: **The LINE Hotel | Austin, Texas**

For information, please visit:

https://www.blxgroup.com/event/blx-orrick-7th-annual-post-issuance-compliance-workshop/

** Earn CPE/CLE credits*



Introduction

Impact of Changing Interest Rates

- For the first time in more than a decade, rebate and yield restriction are beginning to matter

- Few issuers are going to be prepared, especially to make yield restriction or yield reduction payments

Why Does the IRS Care?

- Tax-exempt bonds are viewed as a federal subsidy to state and local governments

- IRS cares about ***who gets the benefit of that subsidy*** (private business tests), ***how much subsidy is received*** (arbitrage rules) and whether certain procedural requirements are met

- Arbitrage rules are designed to identify situations in which the issuer improperly increases the subsidy received

- Private business tests are designed to identify situations in which too much subsidy is received by nongovernmental entities

What is Arbitrage?

- Investing funds borrowed at lower, tax-exempt interest rates in higher-yielding, taxable investments to earn a profit without incurring any additional risk

- Allows investors to profit from the disparity between markets (e.g., positive and negative arbitrage)

- Generally, when the yield curve is upwards sloping, tax-exemption of bond interest allows for positive arbitrage in project funds

- Generally, when yield curve is downwards sloping, tax-exemption of bond interest allows for positive arbitrage in refunding escrows

Arbitrage Overview

- The arbitrage rules are concerned about issuers taking advantage of more federal subsidy than allowed

- Most important arbitrage concepts are
  - Yield Restriction - May issuers earn it?
  - Rebate - May issuers keep it?
  - Exceptions to yield restriction and rebate are different depending on the purpose for which the dollars (i.e., gross proceeds) are being held.

What is Arbitrage Yield?

	Arbitrage Yield	TIC	All-in TIC
Par	√	√	√
Accrued Interest	√	√	√
Net OID/OIP	√	√	√
Qualified Insurance/ Surety Fees	√	√	√
UW Compensation		√	√
Other COI			√

Arb yield is intended to measure the subsidy and not the issuer's cost.

Why both Rebate and Yield Restriction

- Yield restriction came first and was difficult to comply with
- Rather than repeal-and-replace, Congress imposed rebate in addition to yield restriction and allowed for yield reduction payments
- Then Congress created SLGs to allow compliance with yield restriction when yield reduction payments not available
- Then Congress changed rules to allow for yield reduction payments when SLGs not available
- Must comply with both rebate and yield restriction to remain tax-exempt

Rebate versus Yield Restriction

- Arbitrage rebate – issuers can achieve compliance by remitting a rebate payment to the IRS

- Yield restriction – issuers can achieve compliance by
  - Investing yield restricted amounts at a yield at or below the arbitrage yield, or
  - Remitting a yield reduction payment to the IRS (not available in all cases)

Goal of Arbitrage Restrictions

How does the IRS drive behavior?

- Arbitrage rebate and yield restriction requirements remove "arbitrage" incentives by…
  - ✓ Requiring certification that proceeds will be spent timely
  - ✓ Requiring timely arbitrage rebate and yield reduction payments
  - ✓ Requiring monitoring yield on investments after temporary periods
  - ✓ Allowing retention of earnings if bond proceeds spent quickly

Goal of Arbitrage Restrictions

– Minimizing tax-exempt bonds in the market by removing an issuer's incentive to…
  - ✓ Issue more bonds than needed
  - ✓ Issue bonds sooner than needed
  - ✓ Keep bonds outstanding longer than needed

Yield Restriction

Yield Restriction

Unless an exception applies, issuers must limit the yield at which gross proceeds may be invested to no more than a "materially higher yield"

Compliance with Yield Restriction

1. Identify proceeds of the bond issue
2. Determine type of investment
3. Determine “materially higher yield” limit for type of investment
4. Determine if an exception is available
5. Determine if yield reduction payments are available

Which Dollars are Proceeds?

- **Gross proceeds** are all proceeds, including sale proceeds, investment proceeds, transferred proceeds and replacement proceeds
  - **Sale proceeds** – amounts received from the sale of the bonds, including amounts used to pay underwriters' discount and certain accrued interest on the bonds
  - **Investment proceeds** – amounts received from investing proceeds
  - **Transferred proceeds** – unspent proceeds of prior bonds that become proceeds of the refunding bonds
  - **Replacement proceeds** – monies that would have been used to finance the project if the bonds had not been issued; also includes amounts expected to pay debt service on the bonds and pledged funds

Materially Higher Yields

- The definition of "materially higher yield" changes based on the type and purpose of the investment
- Investments of bond proceeds can be purpose or nonpurpose investments
  - A <u>purpose investment</u> is one acquired for the governmental purpose of an issue, which include
    - A <u>program investment</u>, *a type of purpose investment*, generally represents one or more loans of bond proceeds to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, or persons who provide housing and related facilities
    - Student loans that are program investments
    - Qualified mortgage loans
  - A <u>nonpurpose investment</u> is an investment that is not a purpose investment, for example
    - Refunding escrows
    - Investments of replacement proceeds
    - Project fund investments

Materially Higher Yields

Type of Investment	Materially Higher Yield
Nonpurpose Investments	
General Rule	0.125% over arbitrage yield
Refunding Escrow	0.001% over arbitrage yield
Replacement Proceeds	0.001% over arbitrage yield
Purpose Investments	
General Rule	0.125% over arbitrage yield
Program Investments (other than Student Loans)	1.5% over arbitrage yield
Qualified Student Loans	2.0% over arbitrage yield
Qualified Mortgage Loans	1.125% over arbitrage yield

Materially Higher Yields

Exceptions	
Tax Exempt Obligations (not considered investment property)	No yield limitation
Reasonably Required Reserve and Replacement Funds	No yield limitation
Minor Portion	No yield limitation

Reasonably Required Reserve or Replacement Fund

- Reasonably required reserve and replacement funds (a.k.a. 4R Funds) provide money to pay the debt service due on bonds if revenues or assessments are insufficient
- No more than 10% of sale proceeds may be deposited into a 4R Fund
- 4R Funds may be invested for the term of the bonds at yields that exceed the bond yield if the amount of money in the reserve fund does not exceed the smallest of:
  - *10% of the principal amount of the bonds,*
  - *An amount equal to maximum annual principal and interest requirements on the bonds, or*
  - *An amount equal to 125% of average annual principal and interest requirements on the bonds.*
- If money accumulates in a 4R Fund in excess of this limitation, the investments in the reserve fund must be limited to the bond yield or else yield reduction payments must be made to the IRS.

Minor Portion

- A “minor portion” of gross proceeds may be exempt from yield restriction for the term of the bonds
- A minor portion equals the lesser of 5% or $100,000

Temporary Periods

- Gross proceeds may be exempt from yield restriction for a "temporary period" or for the term of the bonds

Fund	Applicable Temporary Period
Project Funds for Capital Projects	3 years
Project Funds for Long-term Construction Projects	5 years (requires special certifications)
Investment Proceeds	1 year
Bona Fide Debt Service Fund and Working Capital	13 months
Current Refunding	90 days
Replacement Proceeds	30 days
Transferred Proceeds	Check with the tax lawyer
All Other Proceeds	30 days

Three-Year Temporary Period

- A three-year temporary period is available for <u>sale proceeds</u> and <u>investment proceeds</u> deposited in a construction or project fund when those proceeds are expected to be allocated to acquisition or construction costs of a capital project
- The temporary period begins on the date the bonds are issued and ends three years later.
- The 3-year temporary period applies as long as the issuer meets the **<u>Three Part Test</u>**

Three-Part Test

- The 3-year temporary period applies as long as the issuer reasonably expects as of the issue date to:
  - allocate at least 85 percent of the bond's net sale proceeds for expenditures on the capital project within three years of the bond's issue date,
  - have a binding obligation to a third party within six months of the bond's issue date to allocate at least 5 percent of the net sale proceeds to expenditures for the capital project, and
  - proceed toward completing the project and allocating the net sale proceeds to expenditures with due diligence.

Waivers Permitted

- Note that on or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve and replacement fund.

- At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion.

Yield Reduction Payments

- Yield reduction payments were created to allow easier compliance with yield restriction rules

- A yield reduction payment effectively reduces an investment yield that otherwise exceeds the materially higher yield limitation

- Yield reduction payments are available only for **certain *nonpurpose* investments**

- *Check with your tax lawyer to see if yield reduction payments are available*

Yield Restriction is Easily Forgotten

- <u>Example 1: Project fund is yield restricted after three years</u>

- Facts: District issued $10 million of bonds at a 3.5% yield. For the first three years, the District invested the unspent proceeds at an average rate of 1.0%. On the third anniversary $2.5 million remained unspent due to construction delays. Two months later interest rates rose so that the unspent proceeds could be invested at 3.8%. All net interest earnings after the third anniversary date attributable to the 0.3% "spread" between the bond yield and the investment yield must be paid to the federal government.

  – No exceptions apply-but a waiver of the temporary period may help
  – Investment yield after 3 years may not be "blended down" with the investment yields during the first three years.

Yield Restriction is Easily Forgotten

- Example 2: District's only issue of bonds in 2019 is a $3.5 million issue of new money bonds. For reasons beyond the control of the issuer, none of the proceeds of the bonds were spent during the first three years.

  – *There is no small issuer exception to yield restriction*
  – The issue is subject to yield restriction after the expiration of the three-year temporary period

Rebate

Rebate

Unless an exception applies, issuers must rebate earnings above the bond yield to the federal government.

Exceptions to Rebate

Exceptions to rebate requirement:

- **Small issuer exception**: $5,000,000 of tax-exempt obligations in calendar year; $15,000,000 for bonds for construction of public school facilities
- Spending exceptions:
  - **6-month**: Any issue, including refunding issue
  - **18-month**: Capital projects only
  - **24-month**: Governmental, 501(c)(3) and certain other private activity bonds for construction issues only
- Bona fide debt service fund exception

No exception to rebate requirement:

- **Reasonably required reserve fund**

Small Issuer Exception

Requirements

- Bonds must be issued by a governmental unit with general taxing powers,
- At least 95 percent of the proceeds of the issue (other than those in a reasonably required reserve or replacement fund) must to be used for the issuer's local governmental activities, and
- Only available for governmental bonds

Notes

- TRANs and lease financings count against $5 million limit
- Certain refundings are excluded from limitations

Six-Month Exception

- <u>Available to all issues, including working capital</u>
- Generally, the issuer must meet both of the following requirements:
  - The issuer must allocate the gross proceeds to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date, and
  - The issuer meets the rebate requirements for the issue's proceeds (excluding earnings on amounts in any bona fide debt service fund) not covered by the 6-month exception
- If the issue is a governmental bond issue other than TRANs or if the issue is qualified 501(c)(3) bonds, the 6-month time period is extended to one year for up to 5% of proceeds
- Payment of costs of issuance does count towards spending thresholds

Eighteen-Month Exception

Eighteen-month exception. Issuers do not have to rebate arbitrage earnings on its project fund if all sale proceeds and investment proceeds are spent within eighteen months of the date of issuance, and all proceeds are spent according to the following schedule:

At least:	Spent within:
15% of all proceeds	6 months of issuance
60%	12 months
100%	18 months

- Failing to meet any one of the targeted expenditure dates results in failure of the entire rebate exception

Eighteen-Month Exception

- Only applies to issues that finance capital expenditures
- The issuer must meet the rebate requirement for all proceeds not required to be spent within the 18-month spending period (excluding earnings on a bona fide debt service fund)
- The spending requirement for a third and final period allows limited unspent proceeds for a "reasonable retainage" (retention to ensure compliance with a construction contract), if the reasonable retainage is less than 5% and is allocated to expenditures within 30 months after the issue date
- In addition, can miss the final spending requirement by a de minimis amount if does not exceed the lesser of 3 percent of the issue price or $250,000, and the issuer exercises due diligence to complete the project

Eighteen-Month Exception

- Amount of investment proceeds taken into account for each spending period can be determined based on actual facts or investment earnings reasonably expected on date of issue (must be documented at closing)

- All the bond's gross proceeds, as defined for the 18-month spending exception, must also qualify for the 3-year temporary period available under the yield restriction requirements

- Payment of costs of issuance does count towards spending thresholds

Two-Year Construction Exception

Two-year construction exception. Issuers do not have to rebate arbitrage earnings on project funds if at least 75% of sale proceeds and investment proceeds are spent for construction (i.e., not land), all proceeds are spent within two years of the date of issuance, and the bond proceeds are be spent according to the following schedule:

At least:	Spent within:
10% of all proceeds	6 months of issuance
45%	1 year
75%	18 months
100%	2 years

- Failing to meet any one of the targeted expenditure dates results in failure of the entire rebate exception.

Two-Year Construction Exception

- Only applies to non-refunding construction issues that finance property owned by a governmental unit or a 501(c)(3) organization and certain other private activity bonds.
- The spending requirement for this fourth and final period allows limited unspent proceeds for a “reasonable retainage” not in excess of 5% for reasonable business purposes, such as
  - A retention to ensure compliance with a construction contract, or
  - If the issuer reasonably determines that a dispute exists regarding completion or payment
- The reasonable retainage must be spent within three years of the issue date
- An issuer of a construction issue may elect by the issue date to pay a “penalty in lieu of rebate” under the 2-year construction spending exception. ***THIS IS RARELY, IF EVER, USED***

Two-Year Construction Exception

- Amount of investment proceeds taken into account for each spending period can be determined based on actual facts or investment earnings reasonably expected on date of issue (must be documented at closing)
- If more than 25% of the bond proceeds are intended to be used for land acquisition, it may still be possible to avail of the 2-year construction expenditures exception with respect to the balance of the bond issue by making a multipurpose election
- Available for governmental bonds, 501(c) bonds and private activity bonds for governmentally owned facilities (e.g., airports, docks, etc.)

Two-Year Construction Exception

- Issuer may elect to exclude investment income from reserve fund in 2 year calculations
- Bona fide debt service fund is automatically exempt if spending exception met
- Payment of capitalized interest counts towards spending thresholds
- Payment of principal does not
- Payment of costs of issuance does not count towards spending thresholds
- Can split into a construction portion and a non-construction portion if elect by the date of issue (see above for more info)

Bona Fide Debt Service Fund

A bona fide debt service fund is defined as a fund that

- Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and
- Is depleted 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.

Bona Fide Debt Service Fund

- Certain earnings on bona fide debt service funds are exempt from the rebate requirement if the issue meets either of the following criteria:
  - The gross earnings on the fund for a bond year are less than $100,000,
  - The issue has an average annual debt service not greater than $2,500,000, or
  - The issue consists of governmental bonds, the issue has an average maturity of at least five years, and the bonds bear interest at a fixed rate.

Reasonably Required Reserve and Replacement Fund

- 4R Funds are subject to rebate unless the small issuer rebate exception applies
  - Regardless of whether they are funded with original bond proceeds or equity and
  - Regardless of whether such fund qualifies to be invested at yields that exceed the bond yield

Rebate and Yield Restriction Strategies (Tax Hacks)

General Strategies

- Spend quickly
- Empty project fund when project is complete
- Watch short-term notes and variable rate debt
  - ✓ less than 5 years for computation period
  - ✓ lower arbitrage limit
- Bona Fide Debt Service Fund
  - ✓ Proper matching of inflows and outflows
  - ✓ No excess carryover
  - ✓ Limits ability to earn positive arbitrage
- Sweep earnings on reserve funds

Five-Year Reimbursement Period

There is a special reimbursement rule for long-term construction projects.

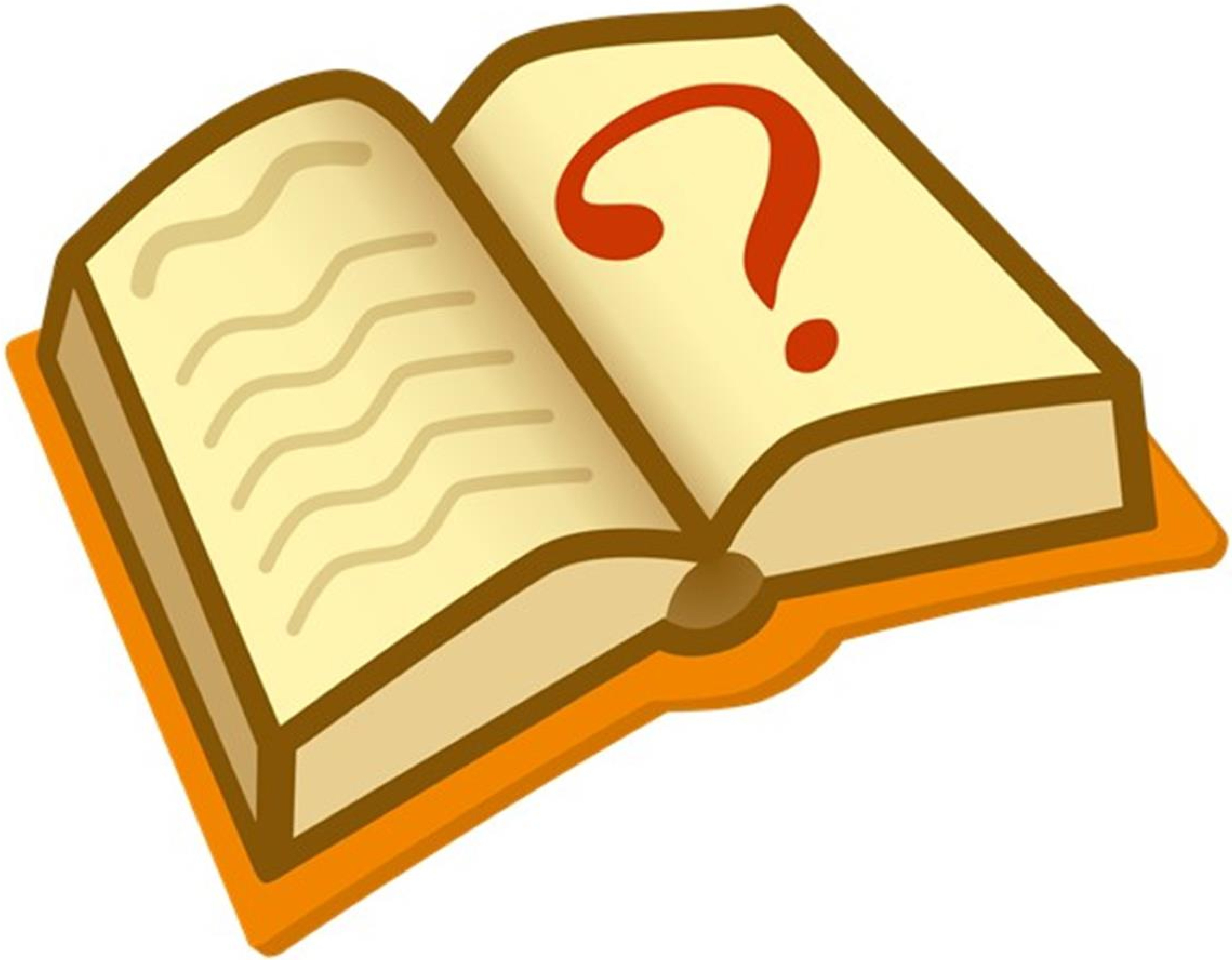
- If both the issuer and a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project, the maximum reimbursement period is extended
- Modified rule is that the reimbursement allocation is made not later than 18 months after the later of -
  - The date the original expenditure is paid; or
  - The date the project is placed in service or abandoned,

  but in no event more than 5 years after the original expenditure is paid
- Certifications generally are made when reimbursement resolution adopted

Five-Year Temporary Period

- In addition, in the case of certain long-term construction projects, the initial 3-year temporary period may be extended to 5 years if
  - The issuer reasonably expects to allocate at least 85 percent of the net sale proceeds to expenditures on the capital projects by the end of the 5-year temporary period,
  - The issuer reasonably expects to incur within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds on the capital projects,
  - The issuer reasonably expects to complete its capital projects and to allocate net sale proceeds to expenditures with due diligence, and
  - **Both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project**.
  - Certifications made before issue date of bonds.

Questions?



Barbara Jane League

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Honors

- Martindale-Hubbell, Client Distinction Award, 2012
- "40 Under 40 Up and Comers," *Jacksonville Business Journal*, 2008

Practice Areas

- Public Finance
- Tax

Admissions

- Florida
- Texas

Experience

Barbara provides tax advice in connection with tax-exempt financing transactions for cities, counties, states, school districts, charter schools, housing authorities, higher education authorities, state agencies and other tax-exempt organizations.

She also has significant experience representing nonprofit organizations. Formerly an attorney with the Chief Counsel of the Internal Revenue Service, Barbara has represented clients before the IRS in a variety of matters involving tax-exempt bonds, including audits and private letter ruling requests. She has participated in all facets of the tax analysis associated with the issuance of governmental purpose bonds, certain tax credit bonds, qualified 501(c)(3) bonds, qualified residential rental bonds and qualified small issue bonds.

Barbara has served on the Steering Committee and has chaired the Working Capital panel and the Bond Direct Purchase - Advanced Tax Topics panel for the Bond Attorneys' Workshop, the oldest and largest annual gathering of bond lawyers. She is the Chair of the 2020 NABL Essentials conference.

Aviva Roth

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Honors

- 2008 Department of Treasury Legal Division Award for Research and Writing

Practice Areas

- Public Finance
- Tax

Admissions

- District of Columbia
- New York

Experience

Aviva Roth is a career associate in the Washington, D.C., office and a member of the Tax Group. She focuses her practice on the taxation of municipal finance.

Aviva has experience in governmental and exempt facility bonds, including general governmental facilities, 501(c)(3) bonds, tobacco asset securitizations, capital funds financing, arbitrage and post-issuance compliance relating to private use issues.

Prior to joining Orrick, she was a docket attorney at the Internal Revenue Service Office of Chief Counsel where she drafted regulations, notices and private letter rulings.

Sandee Stallings

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FINRA Licenses

- Series 50 Municipal Advisor Rep (August 2017 to Present)
- Series 63 Uniform Securities Rep (2004 to Present)
- Series 65 Investment Advisor Rep (1996 to Present)
- Series 7 General Securities Rep (1990 to 2015)

Memberships

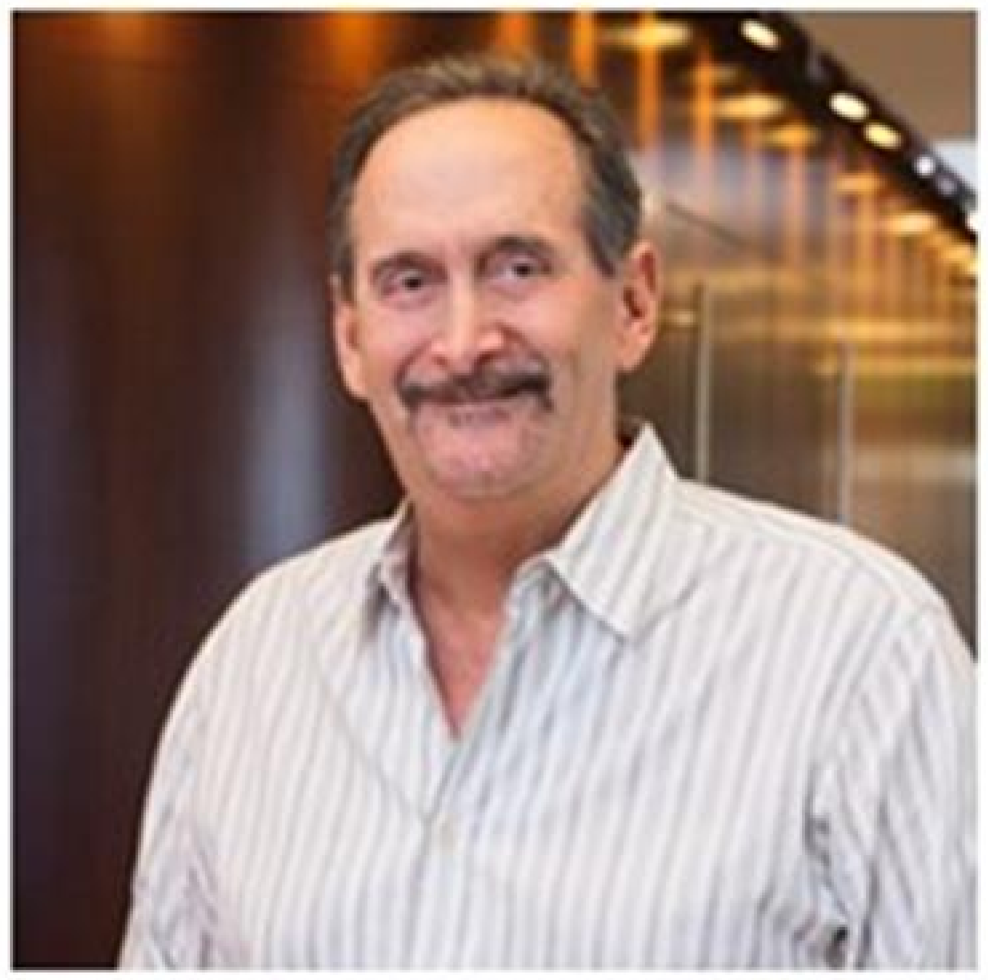
- GTOT
- , NABL,
- GFOA
- Texas Women in Public Finance

Experience

Sandee is BLX's Chief Operating Officer. A senior member of BLX's management team with 30 years of public finance experience, she heads BLX's Compliance Services, which encompasses Arbitrage Rebate and Yield Restriction Compliance, Post-Issuance Compliance, Secondary Market Disclosure, and Program Administration Services. Sandee is responsible for all aspects of project management, client services, work quality and the overall operations of our compliance and consulting services nationwide. She oversees production in the Los Angeles, Phoenix, Dallas, Tampa, and New York offices.

In addition to her management responsibilities, Sandee is an industry leader in monitoring compliance of tax-exempt financings for all types of issuers of municipal bonds. Her expertise, which includes the highly complicated areas of student loan and housing bond structures, is enhanced by her close working relationship with Orrick Tax Partners.

Larry Sobel



Partner

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Practice Areas

- Public Finance
- Tax

Admissions

- Texas
- California
- Florida

Experience

Larry has more than 35 years of experience in federal tax laws and regulations relating to all types of tax-exempt financings, particularly public power, private activity bonds such as airport facilities, colleges and universities and hospitals and exempt organizations and advance refunding issues.

As both bond counsel and underwriter's counsel, he has been responsible for structuring and analyzing the tax aspects of many tax-exempt financings throughout the country.

Larry has extensive experience in handling IRS audits of bond transactions. He has represented issuers in dozens of audits all of which have ended favorably either with the IRS issuing a "no change" letter or by negotiating a reasonable settlement when needed. Larry also has handled a number of submissions under the IRS' Voluntary Closing Agreement Program (or VCAP).

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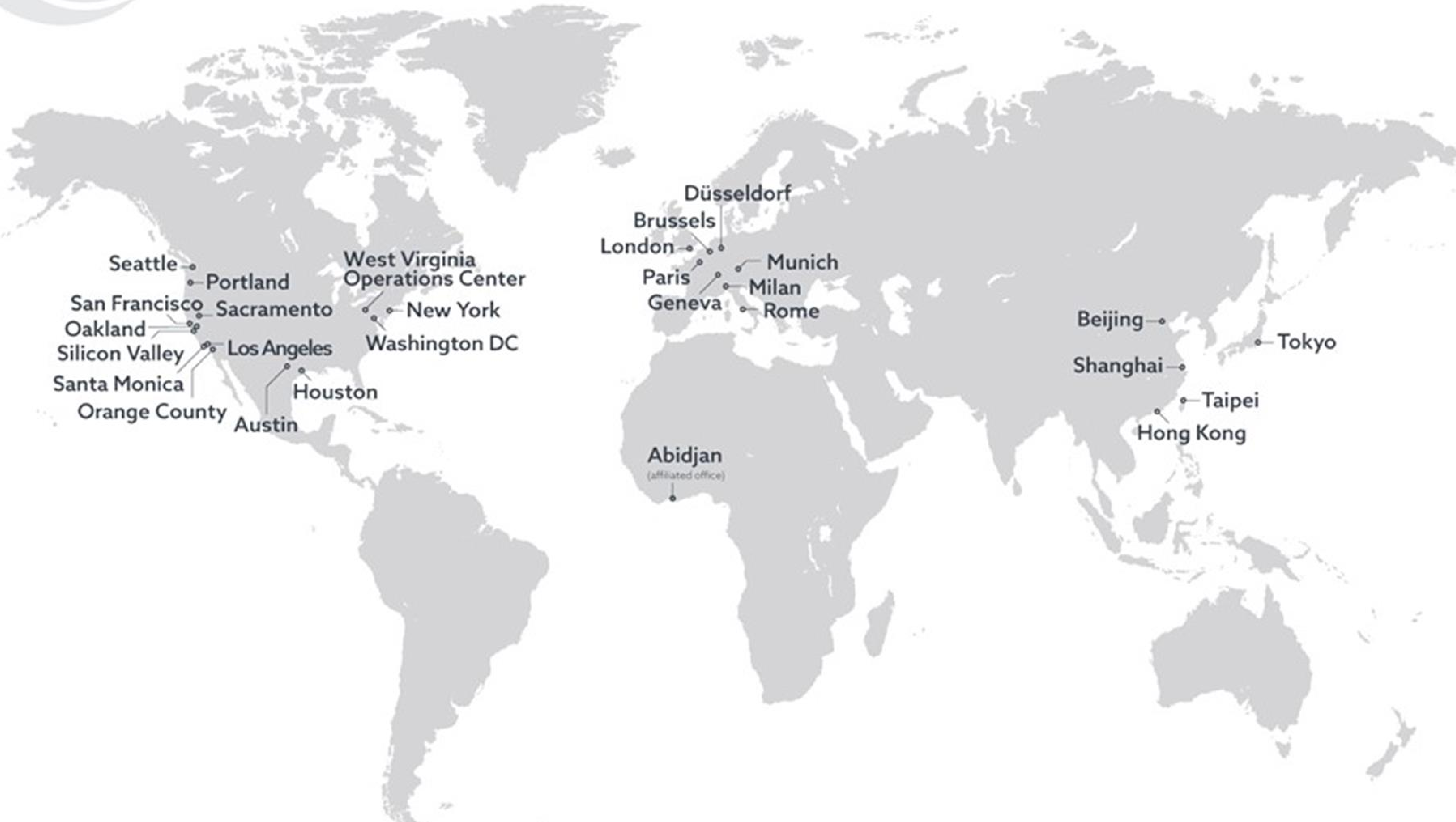
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