



Tax Exempt Bonds

Phase II - Lesson 1

Review of Arbitrage and Rebate

Yield Restriction v. Arbitrage Rebate

Dual Systems – Single Objective



Disclaimer

- The information contained in this presentation is current as of the date it was prepared.
- It should not be considered official guidance.



Objectives

At the end of this lesson you will be able to:

- Distinguish the two distinct arbitrage systems of yield restriction and arbitrage rebate
- Compare and contrast yield restriction requirements and arbitrage rebate requirements
- Identify exceptions to yield restriction rules and arbitrage rebate rules
- Compute the yield on an issue of bonds and compute the yield on an investment
- Compute the amount of Yield Reduction Payment and Rebate Amount



Yield Restriction and Arbitrage Rebate

- The two systems have a singular objective of preventing arbitrage abuse.
- Yield Restriction was imposed by the Tax Reform Act of 1969 with detailed rules established with the 1979 Regulations.
- The Arbitrage Rebate requirement was imposed by the Tax Reform Act of 1986 with rules initially established with the 1989 Regulations.
- The two systems were integrated through payments with the 1993 Regulations.



Arbitrage Bond

IRC § 148(a) provides the definition of the term “**arbitrage bond.**” Under that definition, an arbitrage bond is any bond issued as part of issue any portion of the proceeds of which are reasonably expected (at the time of the issuance of the bond), to be used directly or indirectly:

- 1) To acquire higher yielding investments, or
- 2) To replace funds which were used directly or indirectly to acquire higher yielding investments.



Gross Proceeds (Under Section 148)

We must first identify proceeds of the bond issue, then we determine how they were invested.

Gross proceeds are defined in § 1.148-1(b) to include:

- A. Proceeds as defined in § 1.148-1(b) include any sale proceeds, investment proceeds, and transferred proceeds.
- B. Replacement proceeds as defined in § 1.148-1(c).



Proceeds (Under Section 148)

Sale Proceeds as defined in § 1.148-1(b), means any amounts actually or constructively received from the sale of an issue. This includes amounts paid as underwriter's discount or other compensation, and any accrued interest (other than pre-issuance accrued interest).



Proceeds (Under Section 148) (cont.)

Investment Proceeds as defined in § 1.148-1(b), means any amounts actually or constructively received from investing proceeds of an issue.



Proceeds (Under Section 148) (cont.)

Transferred Proceeds as defined in § 1.148-9(b), means when proceeds of a refunding issue are used to make principal payments on the refunded bonds, any unspent proceeds of the refunded issue become proceeds of the refunding issue.



Replacement Proceeds (Under Section 1.148-1(c))

- Amounts will be replacement proceeds only if there is a sufficient direct nexus to:
 - The bond issue; OR
 - The governmental purpose of the issue.
- To conclude that there is a direct nexus with a governmental purpose, it must be determined that the amounts would have been used for the governmental purpose if the bonds were not used for such purpose.



Replacement Proceeds (Under Section 1.148-1(c)) (cont.)

- The mere availability or preliminary earmarking of funds for a governmental purpose, however, does not establish a sufficient direct nexus to cause the amounts to be replacement proceeds.
- If an issuer sets aside moneys to be used to pay debt service on the bonds on a particular date, such amounts are considered replacement proceeds of the bonds.



Replacement Proceeds (Under Section 1.148-1(c)) (cont.)

- Replacement proceeds include, but are not limited to, sinking funds and pledged funds. To be replacement proceeds the amounts must be held by or derived from a substantial beneficiary of the issue.



Categories of Investments

- **Purpose and Program Investments**
 - Purpose Investment is a loan of proceeds to carry out the governmental purpose of an issue.
 - Program Investment, a type of purpose investments, 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.
- **Nonpurpose Investment** is any investment property that is not a purpose investment.



Classes of Investments (1.148-5(b)(2))

- Class A – each category of yield restricted purpose investment and program investment subject to a different definition of materially higher
- Class B – yield restricted nonpurpose Investments
- Class C – all other nonpurpose Investments



Investment Property

IRC § 148(b)(2) provides that investment property generally includes:

- Any security
- Any obligation
- Any annuity contract
- Any investment-type property

For bonds that are not private activity bonds, acquisition of residential rental property not located in the jurisdiction of the issuer is investment property, unless such acquisition is pursuant to a court order.



Tax Exempt Bonds as Investment Property

- IRC § 148(b)(3)(A) provides that although any security is investment property under IRC § 148(b)(2), tax-exempt bonds are generally not treated as investment property. However, for purposes of bonds other than private activity bonds subject to the alternative minimum tax (AMT bonds), investment property includes AMT bonds.



Tax Exempt Bonds as Investment Property (cont.)

- Accordingly, if proceeds of bonds that are not subject to the alternative minimum tax (non-AMT bonds) are used to acquire AMT bonds, then the proceeds are used to acquire investment property. If proceeds of AMT bonds are used to acquire either AMT or non-AMT bonds, those investments are not considered investment property.



Yield Restriction Rules

- § 148(a) prohibits use of bond proceeds to acquire "higher yielding investments."
- If the investment property acquired with the proceeds of the bond issue produces a yield which is "materially higher" than the yield on the bond issue, then the proceeds of the bond issue are used to acquire higher yielding investments.



Materially Higher Yield

- General Rule – § 1.148-2(d)(2)(i) states that the general rule for materially higher means one-eighth of one percentage point above the bond yield.
- Exceptions – There are a number of exceptions to the general rule.



Materially Higher Yields

§ 1.148-2(d)

Type of Investment

- General Rule
- Refunding Escrow
- Replacement Proceeds
- Program Investments
(other than Student Loans)
- Qualified Student Loans
- Qualified Mortgage Loans
- Tax Exempt Obligations
(not considered investment property)

Materially Higher Rate

- 0.125 over Bond Yield
- 0.001 over Bond Yield
- 0.001 over Bond Yield
- 1.5 over Bond Yield
- 2.0 over Bond Yield
- 1.125 over Bond Yield
- No Yield Limitation



Reasonable Expectations

§ 1.148-2(b)

- Under IRC § 148(a), arbitrage determinations are made based on the reasonable expectations of the issuer at the time of issuance of the bond.
- In effect, qualification for temporary period exceptions to yield restriction are based on the issuer's reasonable expectations regarding the expected timing of expenditures, and not based on the actual timing of expenditures.



Temporary Period for Capital Projects

§ 1.148-2(e)(2)(i)

Financings of Capital Projects are eligible for 3-Year Temporary Period (for Net Sale Proceeds and Investment Proceeds)

- 85% of Net Sale Proceeds allocated to capital expenditures within 3 years
- Incur binding obligation to expend at least 5% of Net Sale Proceeds on the capital project within 6 months of issuance
- Proceed with due diligence to complete the project



Summary of Temporary Periods

§ 1.148-2(e)

- | | |
|------------------------|-------------|
| • Capital Projects | • 3 Years |
| • Working Capital | • 13 Months |
| • Replacement Proceeds | • 30 Days |
| • BFDSF | • 13 Months |
| • Investment Proceeds | • 1 Year |
| • Other | • 30 Days |



Reasonably Required Reserve or Replacement Fund § 1.148-2(f)(2)(i)

The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds.



Reasonably Required Reserve or Replacement Fund § 1.148-2(f)(2)(ii)

A reserve fund is a reasonably required reserve or replacement fund if it does not exceed the lesser of:

- 10 percent of the principal amount of the issue,
- Maximum annual debt service on the bonds, or
- 125 percent of the average annual debt service on the bonds.



Minor Portion

§ 148(e) and § 1.148-2(g)

Bonds will not be treated as arbitrage bonds if an amount which is the lesser of:

- \$100,000, or
- 5 percent of the proceeds of the issue is invested at a yield which is materially higher than the yield on the bonds.



Waivers Permitted

Temporary Periods

- 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 fund.

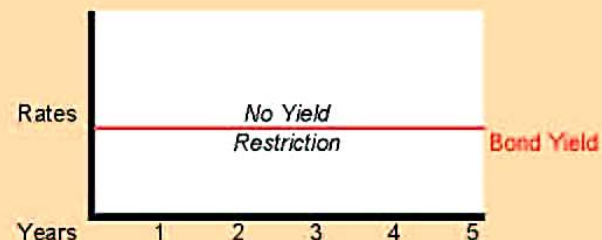
Minor Portion

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

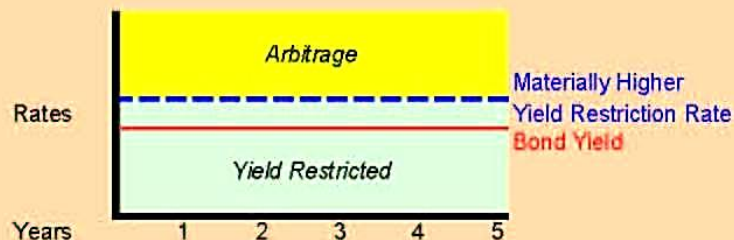
Yield Restriction Graphs



Project Fund
(3 Year Temporary Period)



4R Fund
(Exception for Reasonably Required)



Project Fund
(Elect to Waive 3 Year Temporary Period)



Coordination with Rebate Rules

- Rebate and yield reduction payments are both recognized by the other. The payment of rebate may be included in computing the yield on investments and vice versa.
- In many cases, making a rebate payment will also satisfy an issuer's yield restriction requirements. It is possible, however, that a rebate payment will not fully satisfy yield restriction or even that no rebate payment at all is due, but a yield reduction payment is required.



Arbitrage Rebate Rules

Tax Reform Act of 1986

§ 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States as rebate to prevent the bonds in the issue from being arbitrage bonds.



Rebate Amount

§ 1.148-3(a) provides that the arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.



Exceptions to Rebate

- Six-Month Exception
- Eighteen-Month Exception
- Two-Year Construction Exception
- Bona Fide Debt Service Fund Exception
- Small Issuer Exception



Comparison of Arbitrage Systems

Yield Restriction

Tax Reform Act of 1969

Purpose and Non-purpose Investments

Reasonable Expectations

Materially Higher Yield
(Investment Yield Cap)

Temporary Periods

4R Fund and Minor Portion
Exceptions

Yield Reduction Payment
(Limited)

Arbitrage Rebate

Tax Reform Act of 1986

Nonpurpose Investments

Actual Results

Bond Yield

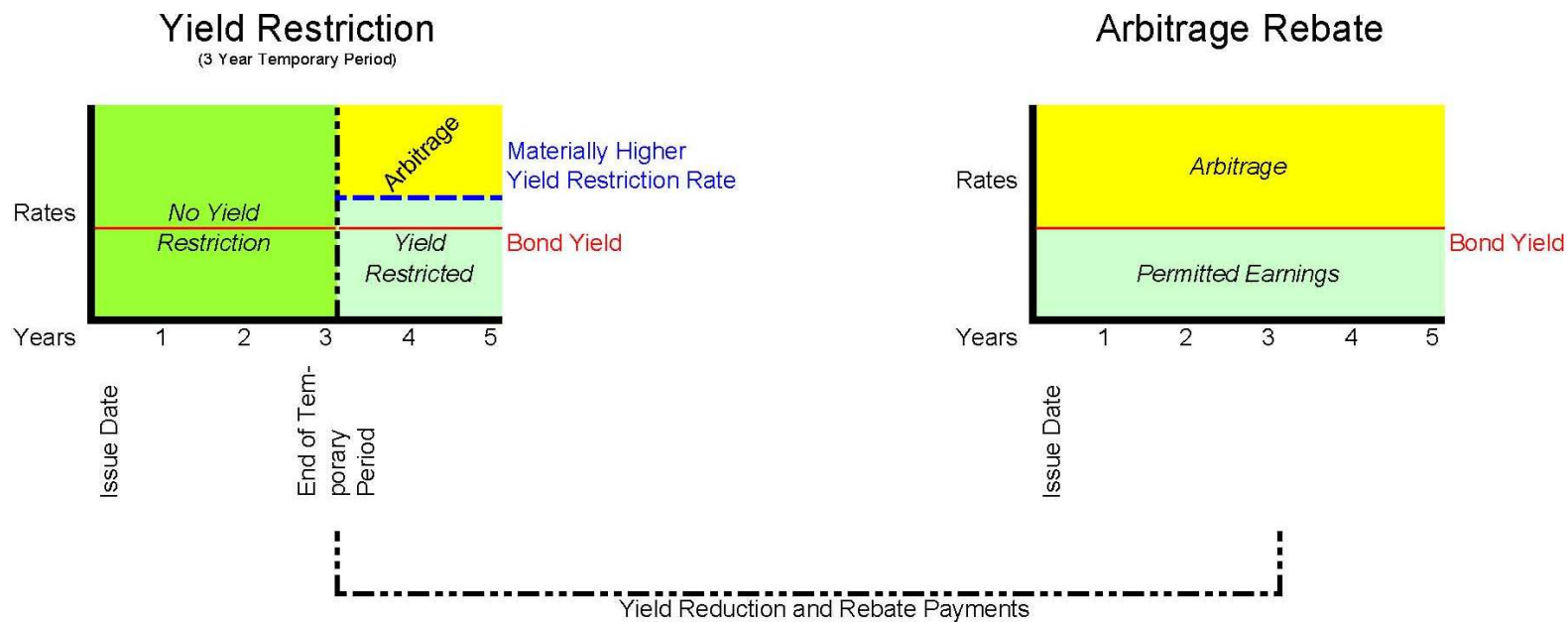
Issue Date

Certain Exceptions
(Spending, BFDSF, Small Issuer)

Rebate Payment

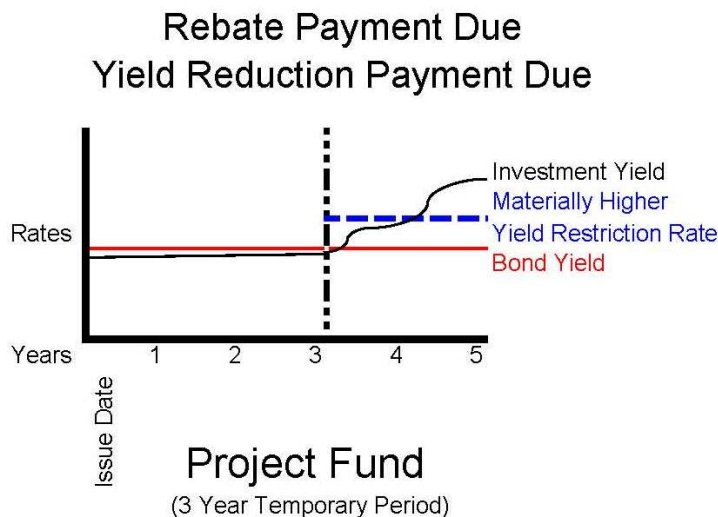
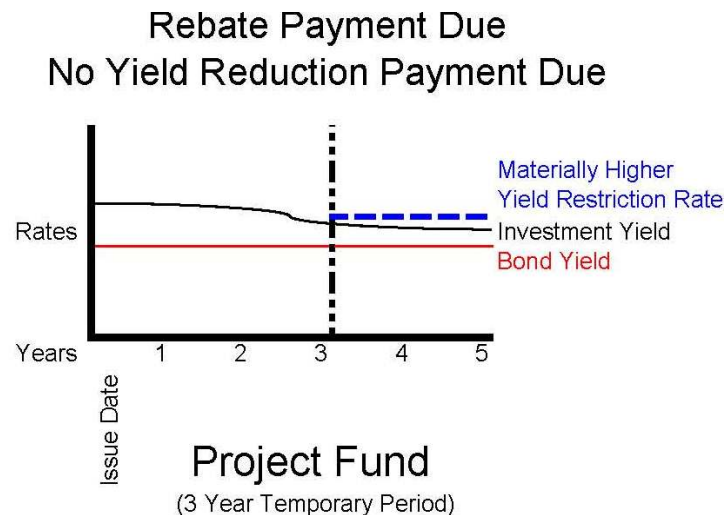
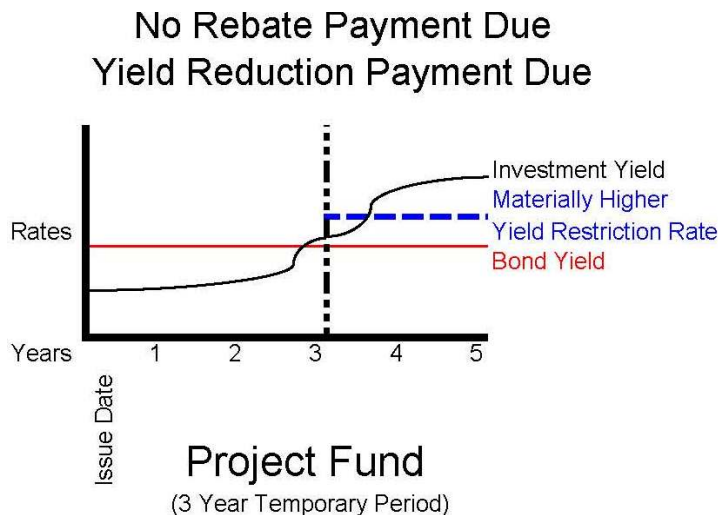
Computation Credits

Impact of the Arbitrage Systems





Rebate and Yield Reduction Payment Scenarios



Rebate Amount \$9M
Yield Reduction \$12M

*If only pay Rebate Amount of \$9M
there will be a shortfall of \$3M
when accounting for Yield Restriction
violation that requires a Yield
Reduction Payment.*



Calculating Fixed Bond Yield

The present value TOTAL of bond debt service, including cash flows from payments of:

- Principal
- Interest
- Qualified Guarantee Fees
- Qualified Hedge Payments (Net Amount)

EQUALS the sum total of:

- Par Amount of Bonds
- Less: Original Issue Discount
- Plus: Original Issue Premium



Bond Yield

Treas. Reg. § 1.148-4(b)(1)(i):

The yield on a fixed yield issue is the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue and amounts reasonable expected to be paid as fees for qualified guarantees on the issue, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price of the bonds of the issue as of the issue date.



Calculating Variable Bond Yield

Treas. Reg. § 1.148-4(c)(1):

The yield for each computation period is the discount rate that, when used in computing the present value, as of first day of the computation period of all the payments of principal and interest and fees for qualified guarantees that are attributable to the computation period, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price (or deemed issue price) of the bonds of the issue as of the first day of the computation period.



Investment Yield

- Treas. Reg. § 1.148-5(b)(1) provides that yield on investments allocated to an issue is calculated in the same manner as the yield on the bonds.
- The yield on an investment is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue.



Investment Yield (cont.)

- The yield on an investment is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment.



Yield Restriction Payments and Receipts

§ 1.148-5(b)(1)

- Payments include amounts to be actually or constructively paid to acquire the investment.
- Receipts mean amounts to be actually or constructively received from the investment, such as earnings and return of principal.
- The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue.



Definition of Rebate Amount

As of any date, the rebate amount for an issue is the excess of:

- The future value, as of that date, of all *Receipts* on nonpurpose investments over
- The future value, as of that date, of all *Payments* on nonpurpose investments.



Payments

§ 1.148-3(d)(1)

- Amounts actually or constructively paid to acquire a nonpurpose investment
- Value of a nonpurpose investment when it is first allocated to an issue (e.g., as transferred proceeds or replacement proceeds)
- Value of a nonpurpose investment at the beginning of a computation period representing a prior computation period ending value
- Computation Credit of \$1,000 (adjusted)
- Yield Reduction payments on nonpurpose investments



Receipts

§ 1.148-3(d)(2)

- Amounts actually or constructively received from the sale of or earnings on a nonpurpose investment
- Value of a nonpurpose investment when it ceases to be allocated to an issue (e.g., due to transferred proceeds, universal cap or no longer replacement proceeds no longer subject to rebate)
- Value of a nonpurpose investment held as of the end of a computation period (ending value)



General Summary

- An arbitrage bond is basically any bond the gross proceeds of which are reasonably expected to be used to acquire higher yielding investments.
- The earlier yield restriction system targeted both purpose and nonpurpose investments and was designed to define and prevent arbitrage abuses.
- The later arbitrage rebate system targeted only nonpurpose investments and was designed to limit earnings that could be kept by requiring rebate payments to the U.S. Treasury.



General Summary (cont.)

- The yield reduction payment was established 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.
- The arbitrage rules permit some proceeds to be invested without yield restriction.
- Even if arbitrage can be earned under the yield restriction rules, it may still be subject to the arbitrage rebate rules which require a rebate payment to the United States.



Yield Restriction Summary

- The yield restriction rules allow certain exceptions, including temporary periods, reasonably required reserve or replacement fund and minor portion.
- The yield restriction rules use the end of the temporary period (rather than issue date) as the start of the yield restriction period and use the materially higher yield (rather than the bond yield) as the arbitrage limit.



Arbitrage Rebate Summary

- The arbitrage rebate rules allow certain exceptions, including spending exceptions (6-Month, 18-Month and 2-Year Exceptions), bona fide debt service fund exception and small issuer exception.
- The arbitrage rebate rules use the issue date to start measuring arbitrage earnings (i.e., rebate amount) and use the bond yield as the arbitrage limit.
- The issuer is permitted to use computation credits in the calculation of rebate amount.