Bond Proceeds Management and Arbitrage

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2023 ANNUAL CONFERENCE

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Introductions

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Objective

Provide a high-level view of the basic rules regarding arbitrage and yield restriction and the steps a school district should take when investing bond proceeds.

Agenda

- What is arbitrage and yield restriction?
- Why is it such an issue currently?
- IRS rules and regulations
- Managing bond proceeds

What is arbitrage?

- Arbitrage: Difference between (i) what would have been earned if tax-exempt bond proceeds were invested at bond yield and (ii) the earnings on the investment of such **tax-exempt** bond proceeds in higher yielding securities.
- Rebate: Issuer must pay (or rebate) arbitrage profits to federal government.
- Anything above bond yield gets paid to the US Treasury, unless you meet one or more exceptions:
  - Small issuer exception
  - Spend-down exceptions

What is yield restriction?

In relation to bond proceeds, yield restriction limits the investment yield that may be earned.

Three year temporary period is available if the proceeds are expected to be spent in 3 years. During a "temporary period," the issuer may invest bond proceeds at an unrestricted yield without causing the bonds to be arbitrage bonds under the yield restriction rules.

Why is arbitrage and yield restriction relevant now?

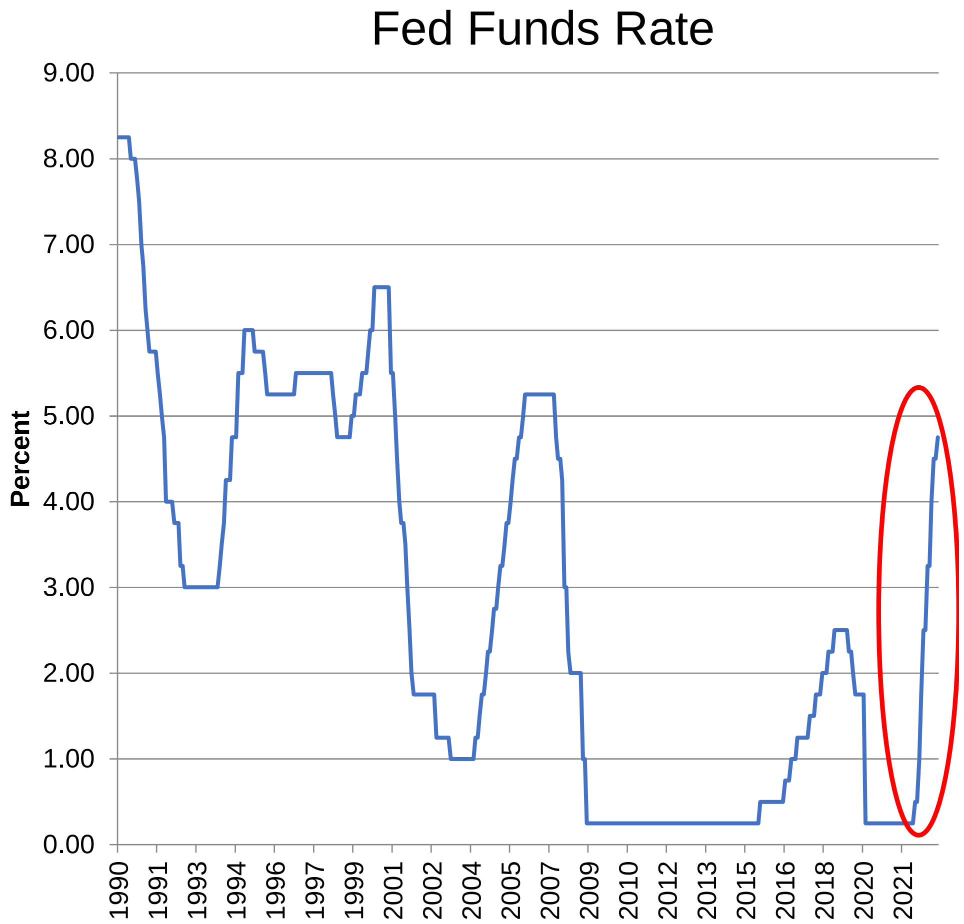
Current Market

Why is arbitrage and yield restriction such a hot topic right now?

- How quickly the Fed raised the Fed Funds rate in such a short time
- Current inverted yield curve allows districts to borrow at lower rates in the long term and earn higher rates in the short term.

Increase in Fed Funds Rate

- Rates near 0% following pandemic
- Global Central Banks shift to fighting inflation
- Historic rise in interest rates
- Federal Reserve raises rate 4.50% in 12 months



Source: Bloomberg

Yield Curve

Source: Bloomberg 4/17/23

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WASHINGTON DC

IRS tax-exempt division will be growing

By Kyle Glazier October 13, 2022, 1:45 p.m. EDT 2 Min Read

Issuers and bond lawyers should expect to notice an increased presence of revenue agents both in the near future and in the longer term, as the Internal Revenue Service's Tax-Exempt Bond office completes a current round of hiring and benefits from federal money authorized earlier this year.

That news was delivered as part of a presentation delivered by TEB Manager Allyson Belsome. The event was part of the National Association of Bond Lawyers' The Workshop conference, which is being held this week both in person in Chicago and virtually.

"We're hiring revenue agents, we're hiring tax law specialists," Belsome told attendees.

IRS Rules and Regulations

Small Issuer Exception

If bond proceeds amount is less than limits, the issuer is exempt from having to invest below arbitrage allowable yield

- Currently at $15 million for school districts; $10 million must be construction expenditures

- Based on all tax-free borrowing in a single calendar year
  - Includes TAW proceeds
  - Advanced refunding issues count, current refunding issues do not

Spend Down Exception

- 6-Month Exception - no rebate payment required if all proceeds of the issue are spent within 6 months of the issue date.
- 18-Month Spend-down Exception

Period	Spend-down Requirement
6 months	15%
12 months	60%
18 months	100%

Spend Down Exception

- Two-Year Construction Spend-down Exception
  - At least 75% of the proceeds must be spent on construction expenditures

Period	Spend-down Requirement
6 months	10%
12 months	45%
18 months	75%
24 months	100%

Yield Restriction

- Borrowers receive a 3 year "temporary period" of unrestricted investments if the issuer <u>reasonably expects</u> to:
  - Within 6 months, incur a binding obligation to a third party to expend at least 5% of the net sale proceeds on capital projects
  - Spend at least 85% of the net sale proceeds on capital projects within three years

- If issuer meets these requirements, the issuer may invest its proceeds in any investment that adheres to their investment policy

Rebate Payment

- Any excess interest that the issuer earns will be considered arbitrage and must be rebated to the Federal Government (IRS) unless the issuer meets one of a list of exceptions
  - Issuer must file a 8038-T Form; check payable to U.S. Treasury
- If the issuer is in positive arbitrage status at **5 year anniversary** dates – must make arbitrage rebate payment regardless if spent bond proceeds or not
- Payments are then due every five years, as long as issuer is in positive status
  - 90% of rebate amount is due within 60 days of anniversary date, with remaining 10% allowed to be paid at a later date plus interest

Managing Bond Proceeds

Managing Bond Proceeds

1. Open a segregated account for proceeds to be directly deposited at closing
    - Helps track transfer of expenses against the spend down exceptions
    - Ability to keep bond proceeds investments separate from operating investments

2. Project spend schedule
    - Can request from architect or construction manager

Managing Bond Proceeds

3. Know what investments are allowable under the district's investment policy and Illinois State Statute

4. Determine comfortable liquidity level
   - This amount may be different for each issuance but 10-15% is a good rule of thumb to have in investments that are more liquid

5. Have your investment provider search all allowable markets and place investments based on the expected spend schedule

Managing Bond Proceeds

6. Continue to track expenses monthly and how they are lining up with the spend down requirements
   - Track the specific expenses specifically tied to the project

7. Track the interest earned against the maximum allowable interest amount to determine if an arbitrage rebate is necessary
   - This needs to be tracked regularly as it changes with expenditures and the interest rate environment

Managing Bond Proceeds

8. After the 3 year anniversary of the issuance begin to track for yield restriction.
    - The district will be limited in the types of investments that can be placed and rate that can be earned
9. When bond proceeds have been fully spent, finalize your calculations to determine if the district will owe an arbitrage rebate or yield restriction payment
    - This payment would be due at the 5 year anniversary mark (and every 5 years after that as long as there are still outstanding proceeds)

Monthly Bond Proceeds Report

Investment Earnings Detail	
$2,258,108.13	Current Portfolio Interest Income Estimate
$1,197,876.17	Potential Interest Income on Balances (4.75%)
$3,455,984.29	Estimated Interest Income (Not including Rebate)
4.268%	Total Return for Arbitrage Purposes
319	Weighted Avg Life of Future Projected Expenses

Investment Proceeds Information		
	09/28/22	Closing Date - Investment Proceeds Received
	$60,002,244.65	Investment Proceeds Received
+	$2,951,470.78	Total Interest Income Net of Rebate
=	$62,953,715.43	Total Funding Available as of 04/07/23
-	$3,682,935.26	Cumulative Expenses Through 04/07/23
=	$59,270,780.16	Outstanding P & I Net of Rebate after 04/07/23

Portfolio Arbitrage Status

Yield Restriction: **The bond proceeds currently fall under the three year temporary period and are therefore not yield restricted.**

Arbitrage Rebate: **The proceeds are subject to arbitrage rebate. The district has not met the two year exception and does expect to pay arbitrage.**

$3,455,984.29	Estimated Interest Income (Not including Rebat	$3,455,984.29	4.268%	Current Interest Estimate for Arbitrage Purposes
$504,513.52	Anticipated Arbitrage Rebate Liability	$2,951,470.78	3.670%	Maximum Interest Limited by Arbitrage Yield
$2,951,470.78	Total Interest Income Net of Rebate	$504,513.52	0.597%	Potential Arbitrage Rebate Liability

Regulatory Requirement			Actual/Projected Portfolio Status			Regulatory Status as of 04/07/23
Estimated Spend-Down Requirements			Cumulative Expenses			$3,682,935.26 Expenses to Date: 5.80%
03/28/23	10%	$6,000,224.47	5.80%	$3,682,935.26	Actual Expense	Not met regulatory requirement
09/28/23	45%	$27,001,010.09	21.77%	$13,814,577.26	Projected Expense	Not met regulatory requirement
03/28/24	75%	$45,001,683.49	51.35%	$32,584,194.26	Projected Expense	Not met regulatory requirement
09/28/24	100%	$63,458,228.94	86.73%	$55,034,170.26	Projected Expense	Not met regulatory requirement

Final Thoughts

- Arbitrage is not a bad thing if you are prepared!
- Generating arbitrage means that the district was able to maximize the amount of interest that could be earned.
- How arbitrage becomes a bad word:
  - When it is not properly tracked and the district is caught off guard with a rebate payment.
  - When there could have been an opportunity to meet one of the exceptions that would allow the district to keep the additional interest.
  - When the district is audited by the IRS and has to recreate tracking

Questions and Answers

We thank you for your time!

Resources

https://www.irs.gov/pub/irs-pdf/p5271.pdf

Presenters:

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