



First Southwest Asset Management, Inc.

An Affiliate of First Southwest Company

Basic Arbitrage Rebate on Bond Issues

Texas Association of County Auditors

October 19, 2006

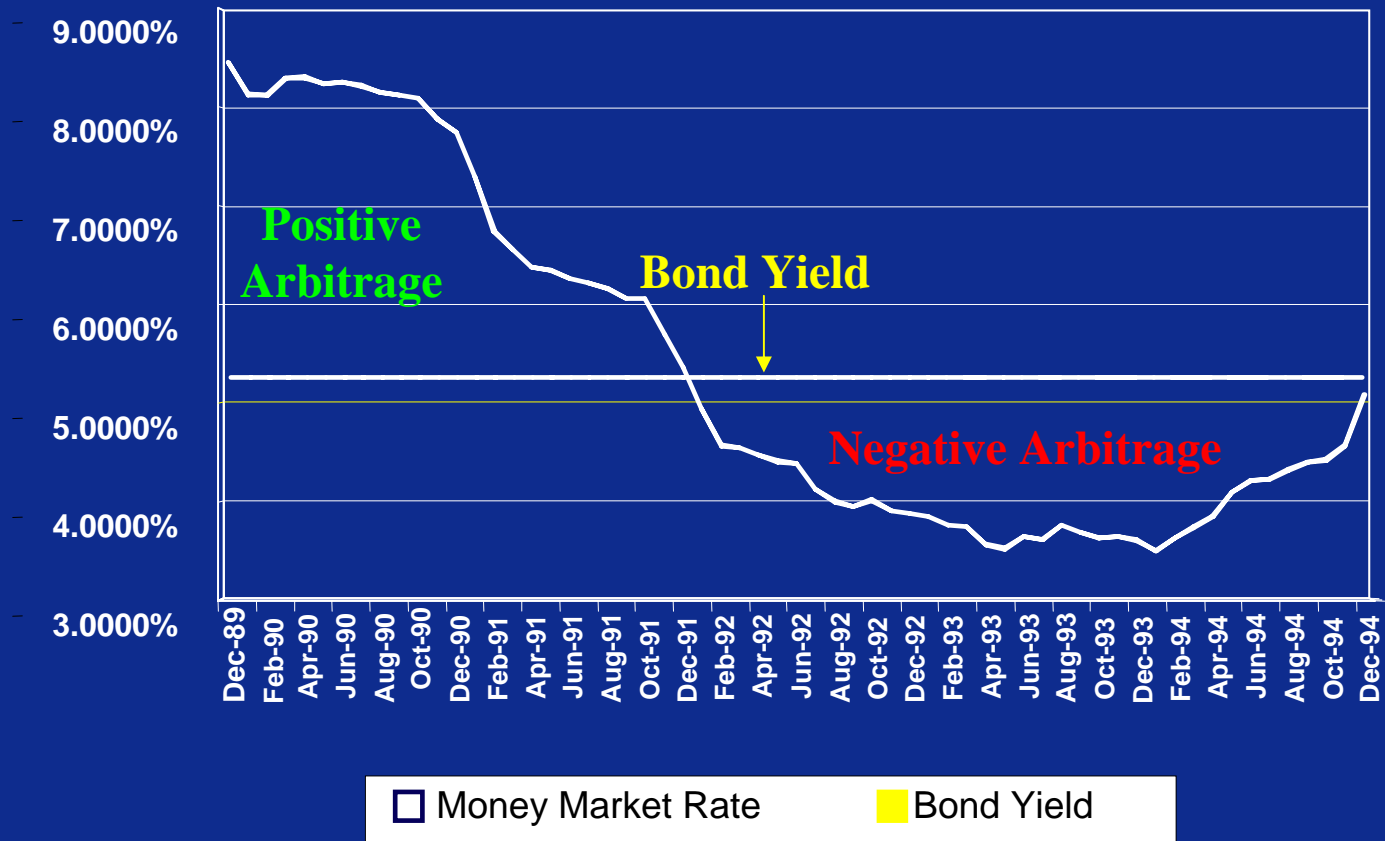


Definition of Arbitrage for Tax-Exempt Bonds

Investing tax-exempt proceeds in taxable securities, resulting in a profit or loss.

What is Arbitrage?

December 1989 to December 1994



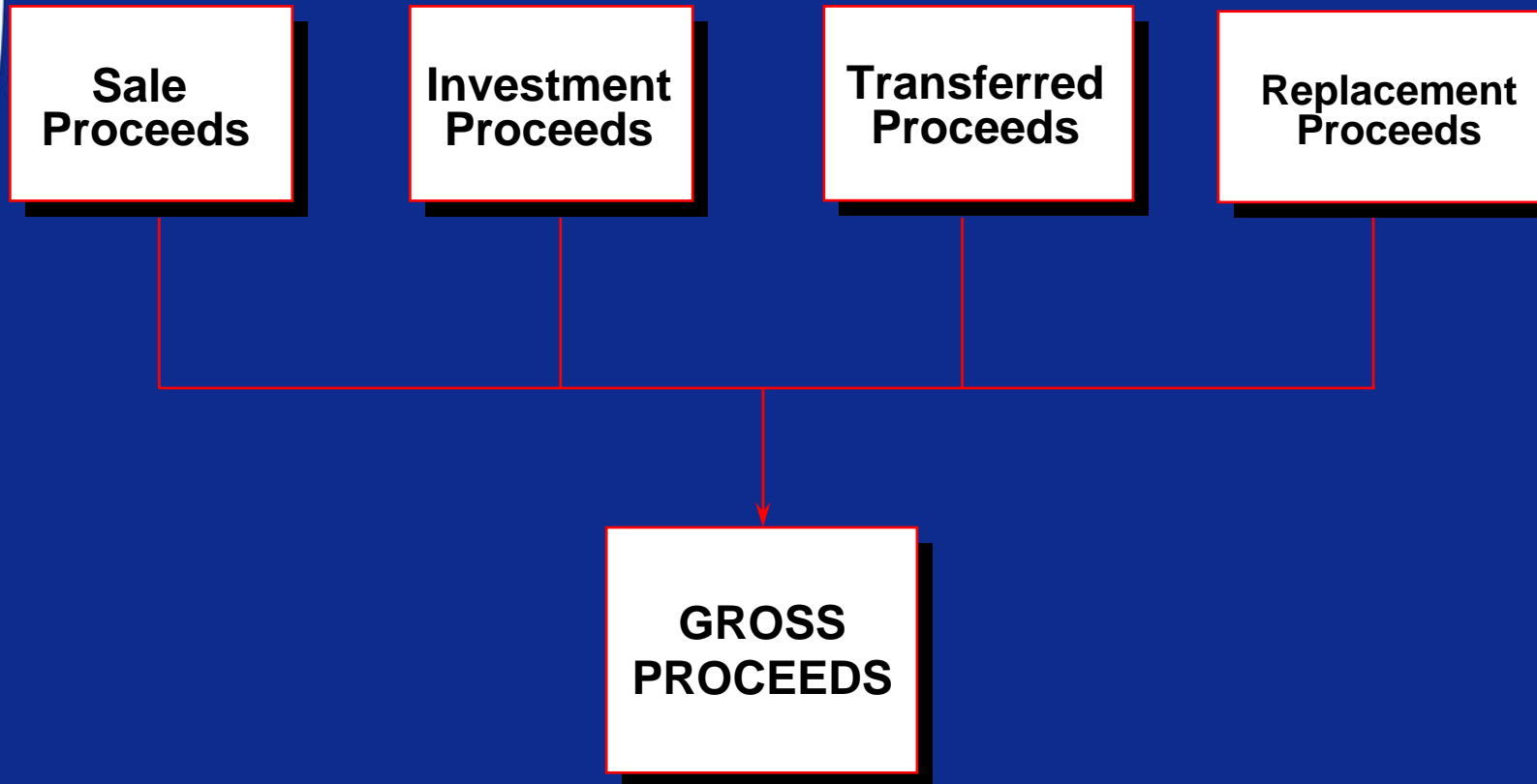
Basic Purpose of the Arbitrage Laws

- ◆ Minimize benefit of investing bond proceeds; and
- ◆ Remove incentives to:
 - issue more bonds;
 - issue bonds earlier; or
 - leave bonds outstanding longer than necessary.

History of Rebate Regulations for Governmental Bonds

Year	Description	Effective Date
1986	Internal Revenue Code Section 148	08/31/86
1989	Temporary Regulations Section 1.148	06/14/89
1992	Final Regulations Section 1.148	06/17/92
1993	Revised Regulations Section 1.148	07/01/93
1994	Amended Regulations Section 1.148	06/06/94
1997	Internal Revenue Code Section 1.148	12/31/97
1997	Revised Regulations Section 1.148	07/08/97
1999	Revised Regulations Section 1.148	03/01/99
2001	Internal Revenue Code Section 1.148	12/31/01

Funds Subject to Arbitrage Requirements (“Gross Proceeds”)



General Arbitrage Rebate Requirements

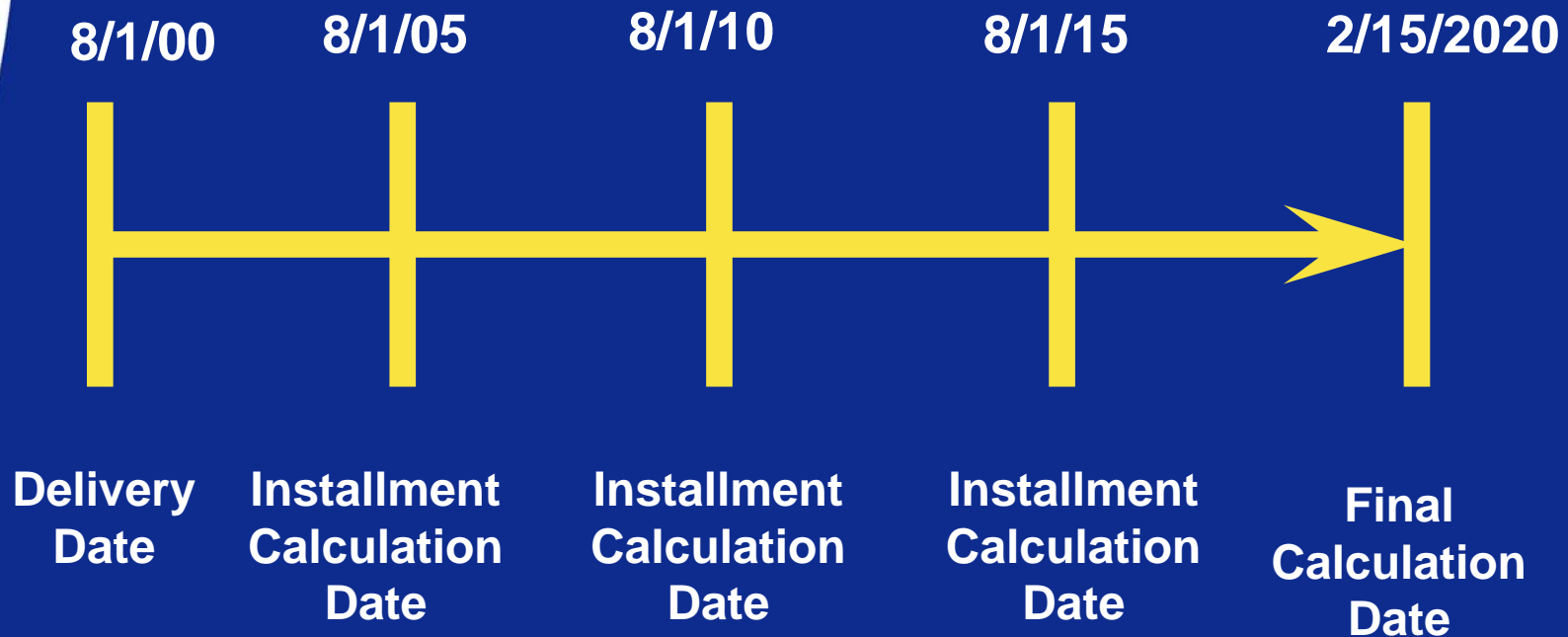
Installment Calculation Dates

- ◆ Installments must be paid at least every 5th bond year.
- ◆ Bond year is each one-year period ending on the date selected by the Issuer.
- ◆ If no date is selected by the Issuer, bond year ends on each anniversary date of the issue.
- ◆ Installment payable within 60 days.

Final Computation Date

- ◆ Date all bonds of an issue have been retired (matured or redeemed early).
- ◆ Cash defeasance or refunding may accelerate.
- ◆ Payment due within 60 days.

Required IRS Reporting Dates for Arbitrage Rebate Payments



Required Payment Amounts

- ◆ Installment Date: 90% of cumulative rebate.
- ◆ Final Computations: 100% of unpaid rebate amount.

Rebate Credits

1992 Regulations:

\$3,000 every five years.

1993 Regulations:

\$1,000 annually in each year gross proceeds are present plus \$1,000 on final computation date.

Payments to the IRS

- ◆ Make check payable to the United States Treasury.
- ◆ Complete Form 8038-T.
- ◆ Mail Rebate Payments to IRS Center in Ogden, UT.
- ◆ Mail Yield Reduction Payments to IRS Center in Ogden, UT.

Penalties for Noncompliance of Arbitrage Regulations

- ◆ Loss of tax-exemption on the issue; or
- ◆ Assessment of penalties and interest.

Failure to Pay Rebate

- ◆ Bonds will be declared taxable unless:
 - failure was not due to willful neglect; and
 - issuer pays a penalty to the United States.

Penalty Assessment Rates

- ◆ Penalty equal to:
 - 50 percent for governmental bonds; or
 - 100 percent for private activity bonds, excluding qualified 501(c)(3) bonds.

Interest also payable on correction amount.

Waiver of the Penalty

- ◆ Automatically waived if rebate amount, plus interest, paid within 180 days of the failure's discovery.
- ◆ Waiver not allowed if IRS determines the failure was due to willful neglect or issuer is under examination by the IRS.

Recovery of Overpayments

- 1992 Regulations:** Only permitted for mathematical errors.
- 1993 Regulations:** Permitted whenever an overpayment can be demonstrated.
- 1994 Corrections:** Clarified recovery available under prior regulations.

Exceptions to the Rebate Requirements

Small Issuer Exception

- ◆ Governmental entity with general taxing powers (no private activity bonds).
- ◆ Issued \$5 million or less in tax-exempt debt during a calendar year.
- ◆ Subordinate entity debt included.

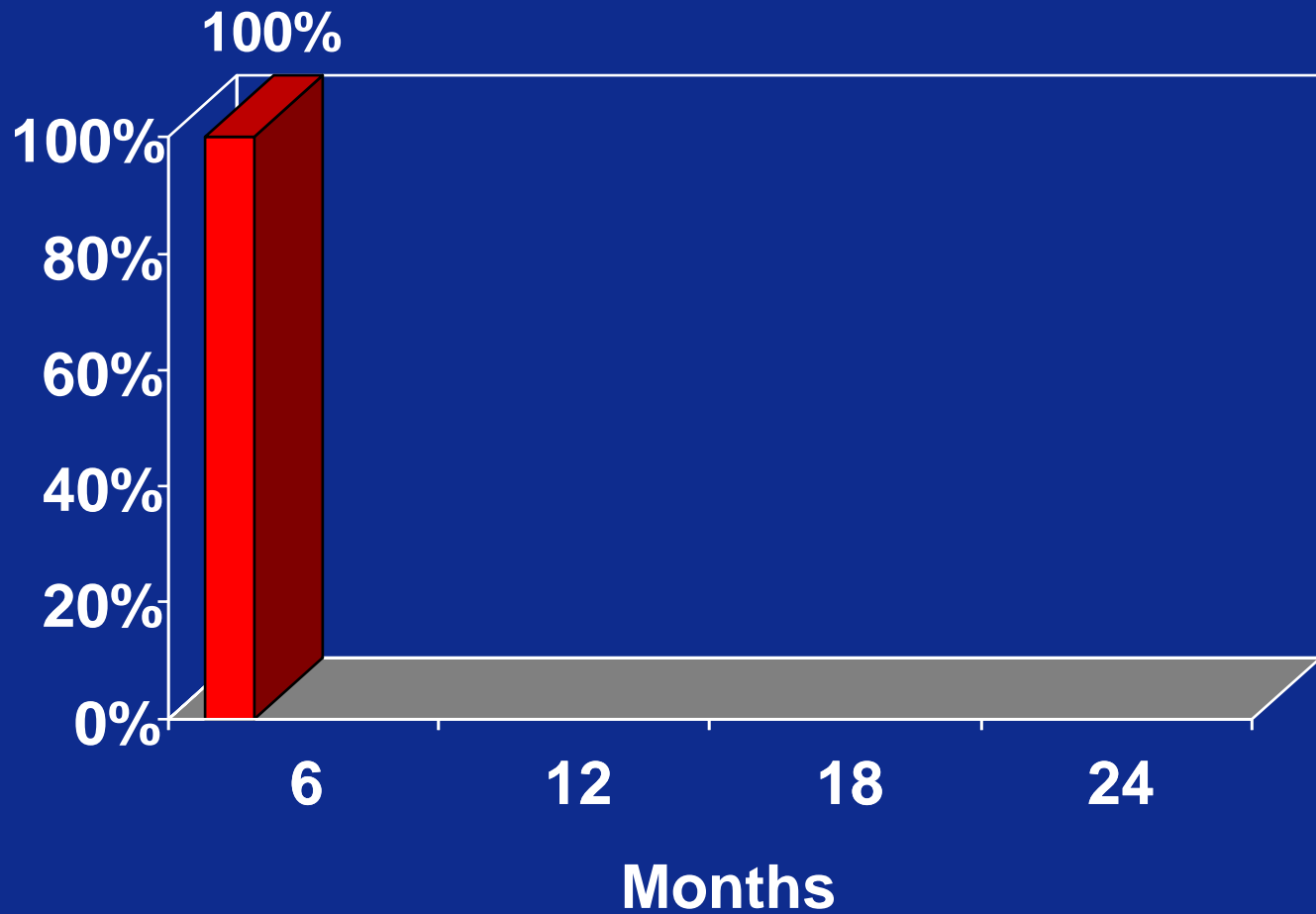
Subordinate Entities

- ◆ Subordinate if directly or indirectly controlled by another entity.
- ◆ Direct control includes power to approve or remove controlling portion of governing body, or
- ◆ Power over use of funds or assets of the controlled entity.
- ◆ Not controlled if subordinate entity possesses taxing and police powers.

6-Month Spending Exception

- ◆ Gross proceeds (including earnings) spent for governmental purpose within six months.
- ◆ Minor portion (less than 5% of issue size) given additional six months.
- ◆ Reserve Fund/Debt Service Fund ignored for test. (Reserve subject to rebate from delivery)

6-Month Spending Exception



24-Month Spending Exception

- ◆ Applies to construction bond issues delivered after **December 19, 1989**.
- ◆ Gross proceeds exempt from rebate if all semi-annual spending requirements met (including reasonably expected earnings).

24-Month Spending Exception

Period	Cumulative Expenditures
6 months	10 %
12 months	45 %
18 months	75 %
24 months	100 %

Available Construction Proceeds

ACP =

Issue Price

- + earnings on amounts in reserve fund not funded from issue
- proceeds deposited into reserve fund
- costs of issuance
- + reasonably expected earnings

Sample 24-Month Spending Exception

Available Construction Proceeds (ACP)				10,490,000.00
Actual Earnings During 24-Month Period:				775,000.00
Required Cumulative Expenditures:				
6 Months	10%	=		1,049,000.00
12 Months	45%	=		4,720,500.00
18 Months	75%	=		7,867,500.00
24 Months	100%	=		10,465,000.00 (a)

(a) (proceeds plus actual interest earned)

Final Spending Period Exceptions

- ◆ Reasonable Retainage rule (less than 5% net sales proceeds) – additional year to spend.
- ◆ De Minimis Amount rule (lesser of 3% of issue price or \$250,000) – proceeds deemed spent.

Reasonable Retainage

- ◆ Amount retained for reasonable business purposes relating to the property financed with the proceeds of the issue.
- ◆ Example – may include a retention to ensure compliance with a construction contract in circumstances in which the retained amount is not yet payable, or in which a dispute exists regarding completion or payment.

Construction Issue

- ◆ At least 75% of the available construction proceeds will be used to finance construction expenditures.
- ◆ Applies to private activity bonds issued to finance property to be owned by a governmental unit.

Construction Expenditures

- ◆ Capital expenditures charged as part of the basis of real property.
- ◆ Excludes land and equipment costs.
- ◆ Certain constructed personal property (e.g., buses).
- ◆ Specially developed computer software.

Elections Available for 24-month Exception

- ◆ Exclude interest earnings on a reserve fund.
- ◆ Bifurcate between construction and non-construction issues.

Bifurcation

- ◆ An election to treat the issue as two issues when less than 75% to be used for construction.
- ◆ Election made on or before delivery date.
- ◆ Includes all construction expenses.
- ◆ Issuer identifies amount of issue price allocable to the construction issue.

Bifurcation Example

Description	Amount	Percent
Reasonable Expectations:		
Construction	\$12,000,000	60%
Acquisition	8,000,000	40%
	<hr/>	
	\$20,000,000	100%
	\$12,000,000	
	÷ 0.75	
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Maximum Available Proceeds for Construction Portion	\$16,000,000	

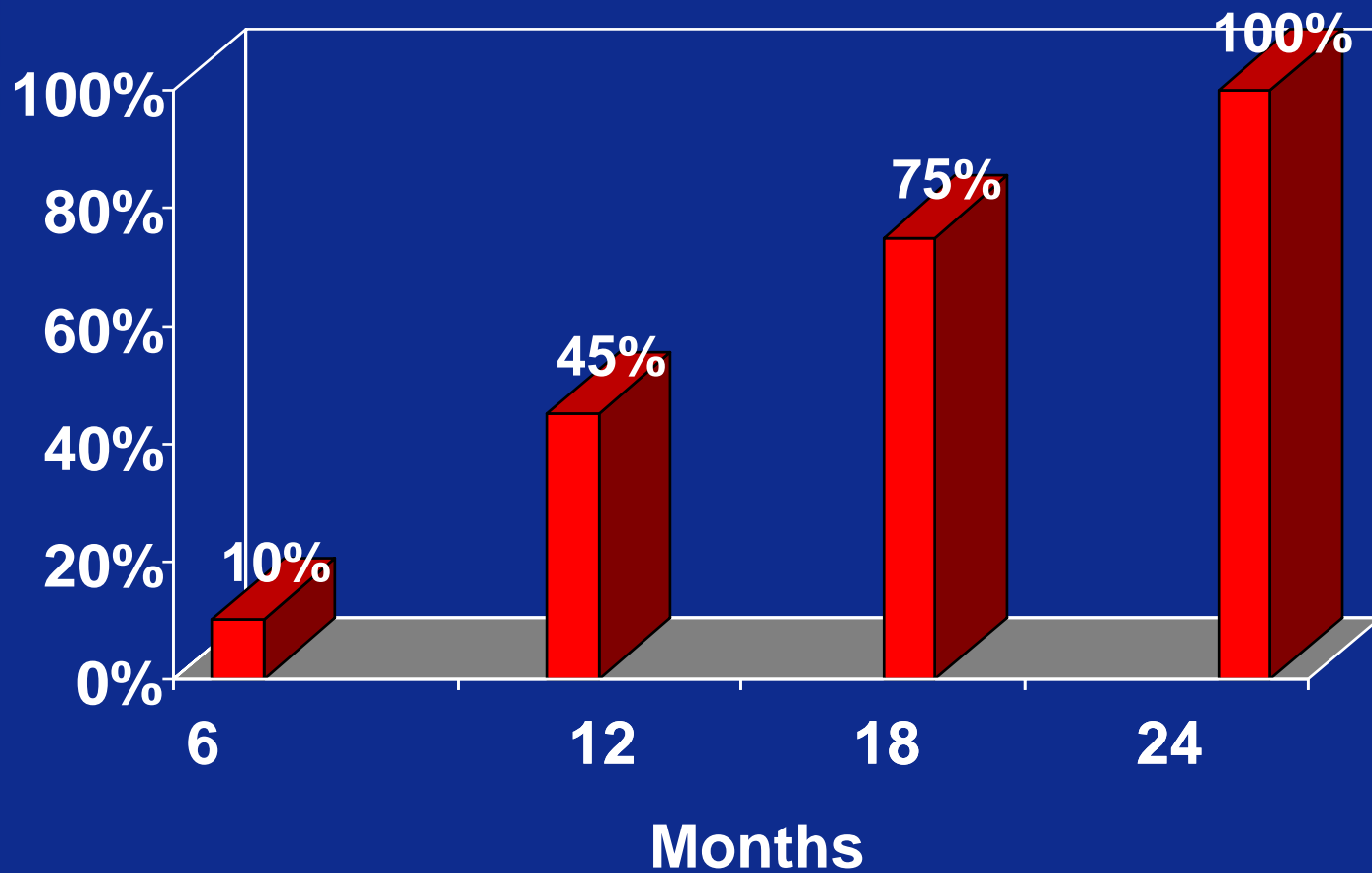
Application to Multipurpose Issues

- ◆ An issuer CANNOT apply both the 18-month and the 2-year spending exceptions to the same issue.
- ◆ An issue CAN apply the 6-month exception in conjunction with the 18-month or 2-year exception.

Items to Consider About the 24-Month Elections

- ◆ Unexpected delay.
- ◆ Elections are irrevocable.
- ◆ Must include projected interest earnings.
- ◆ Negative arbitrage position.

24-Month Spending Exception



18-Month Spending Exception

- ◆ Applies only to bonds issued after June 30, 1993.
- ◆ Gross proceeds exempt from rebate if all semi-annual spending requirements met.
- ◆ Must include reasonably expected earnings in determining benchmarks.

18-Month Spending Exception

Period	Cumulative Expenditures
6 months	15 %
12 months	60 %
18 months	100 %

Sample 18-Month Spending Exception

Gross Proceeds				\$10,200,000
* Plus - Expected Earnings				<u>700,920</u>
				10,900,920
Actual Earnings During 18-Month Period				850,000
Required Cumulative Expenditures:				
6 Months	15%	=		1,635,138
12 Months	60%	=		6,540,552
18 Months	100%	=		11,050,000 (a)

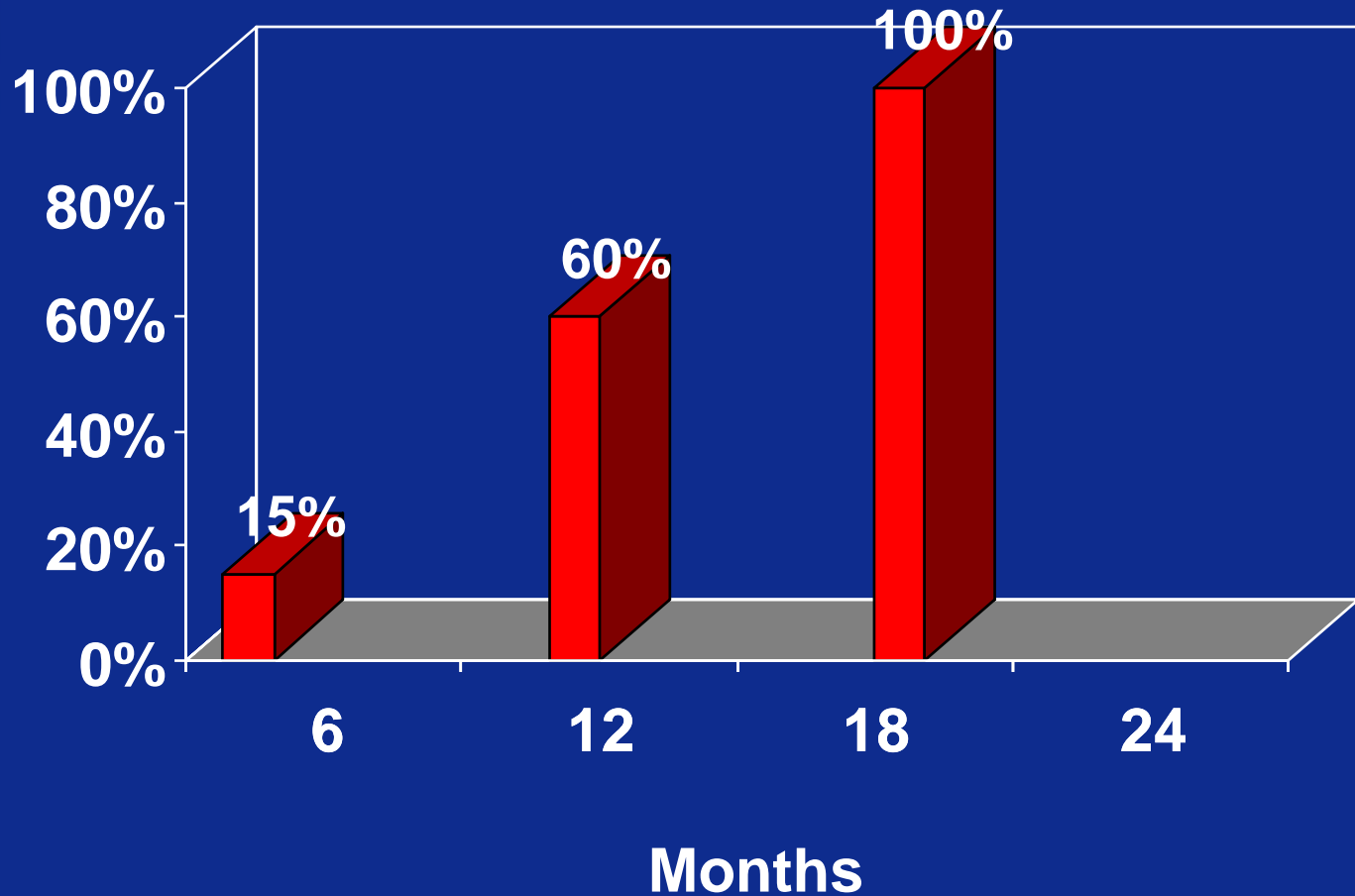
(a) (proceeds plus actual interest earned)

* Reasonably expected earnings for 1st 2 spending Periods

Final Spending Period Exceptions

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18-Month Spending Exception





Debt Service Fund Limitations

Bona Fide Debt Service Fund Exclusion

- ◆ Definition: A fund used primarily to achieve a proper matching of revenue and debt service within each bond year.
- ◆ Depleted at least once a year except for a reasonable carryover amount.

Reasonable Carryover Amount

Greater of:

- ◆ Earnings on fund for preceding bond year; or
- ◆ $\frac{1}{12}$ th of principal and interest payments for preceding bond year

Debt Service Residual

Amounts in excess of the bona fide amount are considered “replacement proceeds” and are subject to arbitrage rebate.

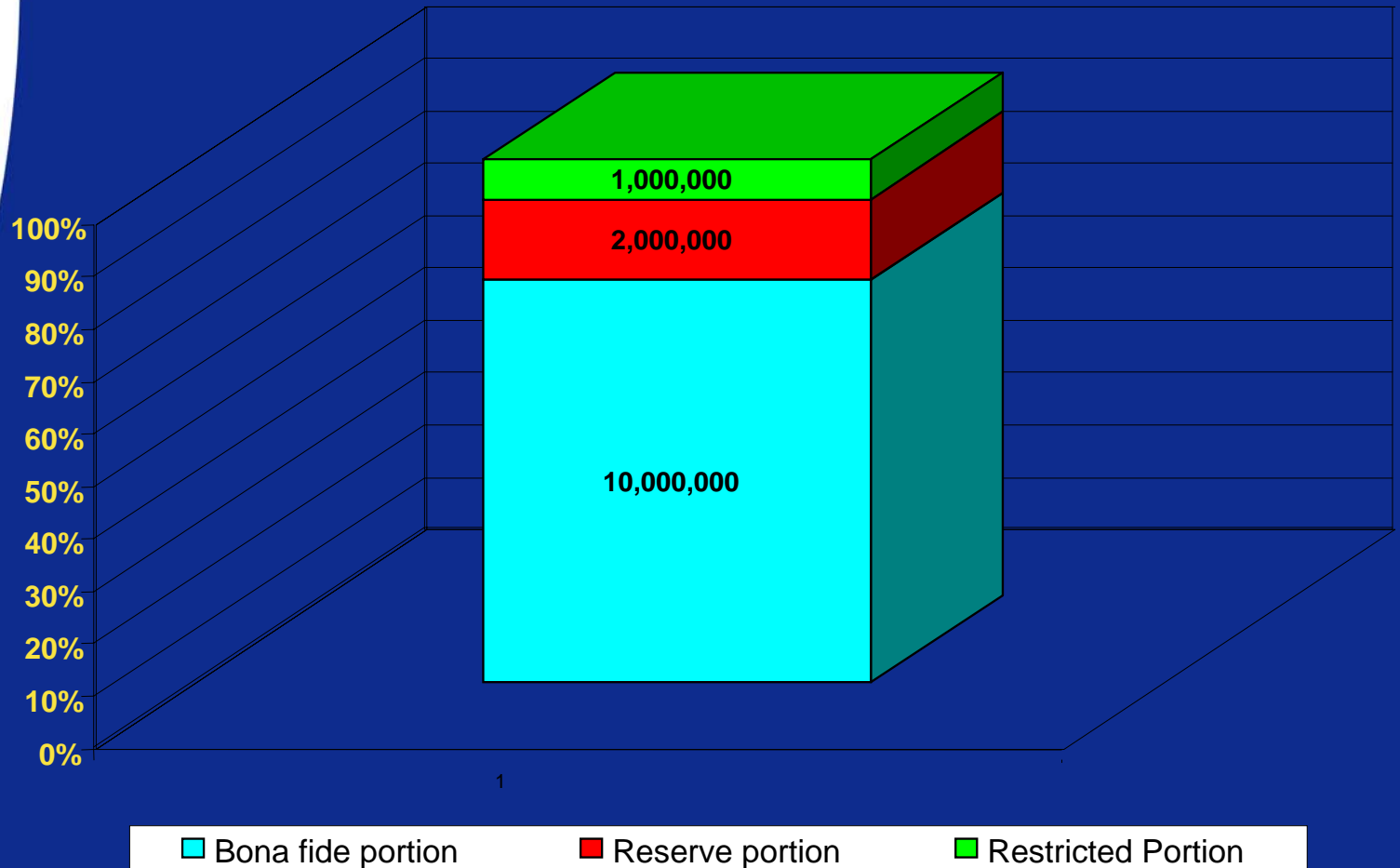
Footnote 160 of the Blue Book to the Federal Taxation of Municipal Bonds

Congress understood that in certain cases where bonds are repaid from a tax of general application, which tax is levied by the voters of a governmental unit specifically for the purposes of paying debt service in conjunction with the unit's issuance of bonds, State law may be interpreted to preclude the governmental unit from using those taxes (or income derived from investments of the taxes pending payment of debt service) for any purpose other than payment of debt service while such "tax bonds" are outstanding. In such cases, the governmental unit's inability to predict precisely the extent to which there will be nonpayments or a delay in payment of taxes may lead to the establishment of a tax rate which results in tax collections in any given year exceeding the debt service on its bonds during that year. These circumstances may, in turn, result in an accumulation of taxes and investment income in a fund dedicated to repayment of the bonds. Congress intended that the Treasury Department will adopt rules that will treat such excess amounts as part of a reasonably required reserve or replacement fund. This treatment does not, however, increase the maximum amount that may be invested in a reserve fund for any bond issue or the maximum amount that may be invested without regard to yield restrictions. Additionally, amounts treated as a reserve fund pursuant to such rules are subject to the rebate requirement applicable generally to gross proceeds invested as part of a reserve fund.

Sample Reasonable Carryover Amount 2005

Interest Earned 2004	326,000
Debt Service Payments 2004	<u>5,250,000</u>
Greater of:	
1/12 th prior year debt svc. pmts	<u>437,500</u>
Interest Earned 2004	326,000

Debt Service Fund Residual



Other Items to Consider

- ◆ Yield Restriction vs. Rebate
- ◆ Reserve Fund Allocation
- ◆ Advance Refunding Escrows
- ◆ Transfer Proceeds
- ◆ Variable Rate vs. Fixed Rate
- ◆ Universal Cap