11/8/11 CDIAC Webinar Transcript

Slide # 1 & 2

I want to welcome everybody to the CDI AC webinar, "*Not Concerned about Arbitrage Rebate*". I want to cover a couple of housekeeping items and for those of you that have participated in our previous webinars this is old material. However, if you look at the navigation toolbar at the top right of your screen you will see a feedback button, and if you are having problems with the audio, or the pace of the presentation is too fast or too slow, please let us know by clicking on those items and we will try and respond accordingly. In addition, and throughout the webinar you will have the opportunity to ask questions again by utilizing the toolbar just to the left you will see Q&A feature that allows participants to present questions to the speakers throughout the presentation and we will try and address those questions as we can. Furthermore, for questions we cannot answer or do not get a chance to respond to during the course of the presentation we will try and capture these at the end of the presentation. Again, this is Mark Campbell Executive Director with CDIAC, And the CDIAC webinar program compliments our classroom-based training and provides us an opportunity to do more timely seminar topics, and allows us to drill down into some more complicated material. This webinar today will provide more detailed information on arbitrage than we may have the opportunity to do in some of our basic debt programs classes.

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Today we have two presenters, Anne Pelej, the Senior Vice President of compliance with Wilidan Financial Services. Anne joined Wilidan Services in 1994 and is currently the group manager of the federal compliance group focusing on arbitrage rebate and continuing disclosure. Her expertise is in the field of post-issuance compliance and is responsible for the firm's nationwide growth. Prior to joining Wilidan Financial Services she served 10 years in the credit insurance industry in both actuarially and policy owner services departments. In addition, she has an extensive background in credit analysis specifically in federal tax reporting as well as financial statement preparation. Furthermore, she is a frequent presenter on the topic of post-issuance compliance. Also with Ann is Carol Lew, a shareholder with Straddling Yocca Carlson & Rauth in Newport Beach where she currently leads the practice. She is also nationally recognized for her work on federal income tax issues relating to tax exempted debt financing. She has related expertise in financial transactions and nonprofit issues and more than 21 years of experience practicing federal tax law relating to municipal finance.

Before we start today's program we are going to ask a few polling questions to give the speakers an idea of our audience that are participating today.

First we're going to start with how many of you are participating today, more specifically and to help us understand the full number of participants, if you are a single person at your computer click one. For those with more than one in the room identify that number and enter this on the polling question. It appears that most of the participants today are individuals on a computer.

Alright we will go on to the next question. This will give us an idea of your current understanding on this particular topic

Question: What is your current understanding of arbitrage rebate?

Question: With regard to your organization affiliations, are you a public entity or a private entity.

Question: Okay and our last poll if you are a representative of a public agency are you from a state, federal, city, County, special district or other.

With that I'm going to ask everybody to make sure their microphones are muted and I will turn it over to Anne and Carol.

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Thank you Mark. I really appreciate your allowing us to have this time here and thanks to all of you who have joined us. It looks like we have about 95 people logged on plus all the others that are sitting in the room so it is pretty exciting to be sitting at my desk in speaking to all of you today. Obviously the type of person that I am, I can talk about arbitrage all day long. But the important concepts that we have decided to discuss today have to do with the basic Arbitrage Math Concepts. The Internal Revenue Service IRS, hot buttons as well as the documentation and the Securities Exchange Commission, SEC disclosure. This session is intended to give you some basic knowledge about arbitrage math, but a lot of rule of thumb of how to look at your portfolio and then decide without actually spending all the staff time, and what it takes to run a calculation or spending your time to understand all of the regulations. What's the rule of thumb in your toolbox so that you can quickly analyze what your arbitrage positions are?

Carol and I are going to tag-team this presentation as we discuss the mechanics of arbitrage computation versus the thought process behind the regulations. I will be the voice of rule covering the arbitrage math concepts, Carol will be the voice of reason explaining the IRS and SEC hot buttons and documentation and basically the method behind the madness. We would like to encourage all of you to ask questions as we move through the presentation. What we would like to do is be able to answer all of these questions at the end. So there is a button for feedback. Please do not hesitate to send in your questions and we will be sure to try to get to all of them during the presentation.

What I would like to do first is run an audience poll question here.
Question: What is arbitrage rebate? I saw that there were quite a few people that had some knowledge of arbitrage and some that felt that they were novices at it. Your options to answer are:

A) Unspent proceeds of tax-exempt bonds
B) Monies earned from tax-exempt investments
C) Unretired bonded debt
D) None of the above.

This was a trick question. What is arbitrage rebate? Arbitrage Rebate: <u>It is not Monies Earned from Tax-Exempt</u>; it's Monies Earned from Interest in Tax-Exempt Bond Proceeds into Taxable Investments. It's a BIG distinction, so those of you that answered none of the above you got the answer correct.

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Arbitrage rebate. The payment that is needed to be made to the IRS if you have earned more from investing bonds proceeds in taxable securities than you have paid in tax-exempt interest to your bondholders. You are not going to be running arbitrage computations or arbitrage analysis on a taxable bond with one exception and that is a Build America Bonds (BAB). Even though those bonds are considered taxable, they do fall under the arbitrage regulations because of the credit coming back to you from the federal government. So we used to be able to say no taxable bond was subject to rebate, however, we cannot exactly say that anymore. Basically, if the government's going to give bond holders a break on their federal income tax returns they want to make sure they can also profit from this tax break. As a result of the bond issue the federal government want to make sure that they've got control of the investment. That said, what you don't want to do is manage your bond proceeds and your tax-exempt portfolio for the sole purpose of avoiding arbitrage rebate. It is going to end up that you will be leaving money on the table and in this day and age you need to be able to earn as much as you possibly can and keep as much as you possibly can, remembering to set enough aside so that the IRS gets their piece as that is what they want.

There are hundreds of pages of arbitrage rules and regulations for how to do this calculation. The regulations came into being in 1986. They were revised in 1989, again in 1992, final regulations came out in 1993 and final, final regulations came out in 1997 and so on and we continue to have more revisions to these regulations. Within the revisions are little tweaks and twists there for the math concepts that happen within the computation but there are basically four areas of math concepts that I want to go through today. After I go through the tools of how you do these mechanics I've got three life examples here from our portfolio that we do a rebate on, of how this has all worked out in relation to how you spend your bond proceeds. So the concepts that we are going to be dealing with today are arbitrage rebate, yield reduction payments, spending exceptions and the transferred proceeds regulation.

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The next slide that you see here is just an example of an arbitrage rebate calculation. Arbitrage spans the life of the bond. So in order to compute what the rebate amount is going to be at the end of every five years you have to take into account what the transaction is worth on the computation date. It is only fair that if you have bond proceeds on a certain date and expenditures on the same date that five years down the road if you are looking at what you have earned on your balance you need to move the expense amount forward. You need to, if you will future value it to, so that it is comparable to where you are in the current point in time. Certain elements or key components, the delivery date, what that is if you can see here and what I am pointing to is the date on which the bond was issued. Computation date is vital. What point in time are you looking at this arbitrage calculation? Like I said the bond can be out there for 20 or 30 years you're going to be making payments every five years you make 90% payments. The reason being is the IRS realizes that it is a moving target what you're going to owe them so they only have you ante up 90% at that point. The percent at that point and you settle up with 10% at the end of the year, or the end of the computation period. The arbitrage yields also referred to as the bond yield for a fixed-rate bond, this can be determined at issue and it is something that is put on your form 8038G and the tax certificate and should be inclusive of all credit enhancements in premiums and discounts etc. This is the yield that the IRS says you may run your rebate against. If you were, for instance in a $10 million bond issue and you were to take your $10 million and have to pay your bondholders over the next 30 years at certain increments. This is the interest rate that you would have to invest your money at in order to have exactly the right amount of money to pay your bondholders. The investment yield is what your investments have earned as you go through this time period. You're going to have some investments that stay very liquid because you are in construction and you will have reserve funds that are out there mandated so you can run those long for the life of the bond, and this is a cumulative investment yield of all of those investments. The other key parts of the calculation like I said are the transaction date and then obviously the transaction amount. What this report shows here is we have the transaction dates, the receipts, the monies coming in, this is for a particular fund, the payments that are going out of the fund, the interest earnings that have been posted on the fund, the running balance in then that key component, the future value. You sum up all the future values and you get the total debatable arbitrage and in this case and the fund did earn a total of some $190, 000 the total remediable arbitrage is a $-12. The future value computation, what that does is compounds the purchase price of the investments at the bond yield to the computation date. The receipts from the investments are also compounded to the computation date. Using the same rate, any investment held on the computation date it is treated as sold on that date and then immediately repurchased the next day. Which is why if you were to hold up two arbitrage rebate computations say one going through in this case November 2006 and November 2^{nd} and you see the next years computation, it would pick up from this same date with a beginning balance which in this case it has nothing left in it but if there was a balance it would have a beginning balance and run forward this takes into account the fact that you are running your arbitrage over the full period of the bonds. The difference between the aggregate future value of all the purchase prices and the aggregate future value of all the receipts or the interest that you have earned from that, including the receipt of the constructive sale of the investment. In other words if you had a treasury note and you bought it at a discount and sold it at a premium that you would be including that any gains that you made on those investments. The total of this future value is the rebate amount.

Anne, I just want to interject, this is Carol. From a big picture standpoint we have a mathematical calculation of how to compute arbitrage rebate. What is practically going on here is the federal government through Congress made a determination that for tax-exempt bonds and also for BAB's that state and local governments shouldn't be issuing bonds for the purpose of earning money. There is economically in many markets and the ability for state and local governmental issuer to issue tax exempt bonds that bear a relatively low rate of interest and reinvest that money given that right market given a higher rate of return than the cost of their debt. Congress didn't want state and local governments to be issuing bonds for that reason. So, since 1986 there have been more and more restrictions being placed on tax exempt bonds through either the code or through regulation to prohibit that type of activity. One of the big restrictions is the arbitrage rebate and Anne has done a great job in showing you how we are supposed to unless an exception is available give up to the federal government the excess amount of money that is being earned over the bond yield. In other words, you can't make a profit if you will, from reinvesting your bond proceeds before you actually need them. That is all that's really going on here from an arbitrage rebate standpoint.

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Thank you Carol. I felt you needed to be the voice of reason here.
The next topic is yield reduction payments. You may have heard people say that there are two sets of rules, there's the arbitrage rebate rules and that the yield restriction rules. Simply put, just because you may not have earned any arbitrage rebate that is payable to the government you may have violated a yield restriction regulation meaning that you need to make a yield reduction payment. And what I want to do is go through those examples, and I have three different examples that I have here of what you may have needed to make a yield reduction payment. This concept is similar to arbitrage and that it reduces the amount of investment earnings that an issuer is allowed to keep. The main thing is to remember these are rules in addition to the arbitrage rebate regulations and that payments are required every five years. The regulations allow unrestricted periods of investment during which time earnings in excess of the bond yield are subject to rebate. These periods differ depending on the type of fund. For

instance a construction fund has got a three-year unrestricted period for investment; whereas, a reserve fund never has a restricted period. For investment, an escrow fund must be restricted for the life of that fund etc. What this chart shows in this example is how the yield restriction rules apply to a construction fund. Bond rules allow the construction funds be invested for the first three years above the bond yield. But then after the end of year three you may not invest in anything that is more than .125% above your bond yield. Or you are making a yield reduction payment.

Here in example 1. During the first three year unrestricted period, the construction fund had earned an excess of $10,000. This is not the total interest earnings; this is the interest in excess above the bond yield of $10,000. During years four and five the restricted period they earned an additional $5000. What this means is at the end of the first five-year period. They're making a rebate payment of $10,000 and a yield reduction payment of $5000. Back in the old days, or back in the day as I like to say on television, this used to be a combined single payment of $15,000. Now the new 3038T forms ask you to specifically state what type of payments you are making for yield reduction versus arbitrage rebate.
In example 2 these fund proceeds were invested below the bond yield. During the first three years. Which is probably what you see most often with a construction fund because you've got to keep the funds liquid in order to keep your project moving? Then, during years four and five they did earn above the bond yield perhaps in this case the project got stalled, they knew they were going to be using the money for a while so they put it out there in a longer-term investment, higher yield and ended earning above the bond yield. What might seem fair is being able to net these two, but you are not allowed to once you are outside the first three-year period. Everything you earn and after that above your bond yield on a construction fund is subject to the yield reduction payments. So in this case they are paying a $7000 payment.

In example 3 the bond proceeds were invested above the bond yield for the first three years earning $8000 but years four and five they did reduce the yield on their investments either voluntarily or involuntarily. In the last few years that investment yield reduced on its own and they got a negative arbitrage liability. Because this is negative earnings during a restricted period you are allowed to offset positive earnings during an unrestricted period. So this issuer only ended up making a payment and it was considered a rebate payment of $6000, keeping in mind that the restriction periods are different for construction funds, reserve funds, debt service funds, and escrow funds. I'm going to turn it over to Carol again to just talk about the madness behind these yield reduction payment rules.

Yes, this is an area that is very confusing and one looks now at what we've been left with which is the arbitrage rebate structure and the yield reduction payment structure and wonder how in the world did we get here? Why do we have to have these different things, does it make logical sense? The reason is prior to 1986 we had a situation in which there was no generally no arbitrage rebate for tax-exempt bonds. And so once exempt (remember I talked about the purpose of these rules that the tax exemption is a tax benefit and Congress believes that the tax benefit should be going toward governmental purposes), issuing bonds to make arbitrage which is the difference between what you can get and pay for the tax-exempt market versus the taxable market is not perceived as a governmental purpose, so these rules restrict it, arbitrage rebate came in and applied to most tax-exempt bonds. There are a few exceptions to that which we will discuss. And it is a concept where you pay the excess money to the federal government. Prior to that there was no arbitrage rebate. So the way the restrictions worked is that you were allowed during an initial period, say for a typical new money construction project you were allowed a few years to spend your money and then at that point the IRS said you had to actually yield restrict the money. In other words you are given a grace period that is fairly short to get your project done but after that it is perceived okay if you still have money left over, but we don't want you to be earning this arbitrage. All that made sense before we had arbitrage rebate. It made sense to have these yield restrictions that were in the code and in the treasury regulations, so after arbitrage rebate came in the mid-1980s with the Tax Reform Act in 1986 it appeared to be a little redundant as we had both yield restriction in the code and arbitrage rebate. In other words you were given grace period not to earn rebate and where you would have to pay it over to the federal government and we are left with two parallel systems and at this point excuse me if I'm going to the trouble to calculate the rebate why can't I be just done with the yield restriction also and be deemed to have satisfied the requirement. And the IRS has been listening to those concerns and has taken measures through the treasury regulations to try to align these two parallel systems.

The one that we had before the tax Reform Act of 1986 which basically was discouraging issuers from issuing bonds too early and keeping their money around to make arbitrage and telling them you have to actually earn no higher than the yield on the bonds. That is the yield restriction system and take that system which we still have and the arbitrage rebate system and they kind of merged them a little bit. That is how the government came up with this yield reduction payment. It functions just like the arbitrage rebate it’s a method in the treasury regulations to make the two systems work a little bit better together because frankly it is hard to yield restrict money. Let us talk a little bit about what that means. That means you have to go out and find an investment that is actually yielding when you do your computation blending all of your investments together below or at your bond yield. And you cannot go out and simply pay someone more money to go out and do that. That helps when you have to buy your investments at fair market value. So actually restricting sometimes can be a tough thing to do. So this yield reduction payment which functions like a rebate payment that Anne has just gone through is a very practical way of dealing with the dual systems that we are left with that are provided by the IRS. Carol I agree, I think one of the reasons that the IRS or the federal government finally decided to lighten up a little bit, and allowing people to make the yield reduction payments especially, on escrow funds, came when all of a sudden the federal government decided to start closing the SLGS window. Before when you had escrow fund monies that were sitting in escrow to pay off old bonds that were refunded in order to get a better interest rate you could not earn above that bond yield under no circumstances. Well a lot of those escrow funds were set up to earn quite a bit of interest in those early years so that you could pay off the bonds and roll into zero coupon bonds SLGS. At the end of the escrow period in order to blend down the yield this system worked well until the federal government closed the SLGS window. This was a few years back, however since then, they have decided ok, fine you can make yield reduction payments, on escrow funds. Yes Carol is right part of these regulations evolved because the government does listen to issuers in saying that this is cumbersome and not reasonable given the current economic markets. In addition, there have been proposals made over time and calls for the government to go further in merging the yield restriction system and just having one thing, but there are still some concerns on the governments side about certain types of deals where there might be too much potential for abuse if we completely merge the two systems and just had arbitrage rebate. So I think from a policy standpoint that's why you still see this dual system yield restriction with yield reduction payments and the rebate because there's still some circumstances where the government perceives there is too much of a risk on certain types of deals perhaps in advance refunding, where they do not want to go that next step which would be to do away with the dual system and where it involves code changes which are always difficult. So that is what we are left with and where we are. It's a little bit complicated but that is the practical reason why we've got it here.

One other thing that you need to keep your eyes open about especially if you have issued bonds during the last I would say three years as interest rates have been very low and you have issued below $5 million thinking I met the small issuer exception to rebate and I don't even have to concern myself with this you don't have to consider yourself with rebate but you do have to concern yourself with a real yield restriction yield reduction payment rules. As the interest rates go up and we all know eventually the market is going to turn, you may have a $5 million or $4 million bond that you issued now for 3 ½% that even though your monies left out there earning a small amount is still over the 3 ½% you will be need to make a yield reduction payment. So small issuers beware if you've issued a lot of those small bonds in these last couple of years.

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Let's move on now to the spending exceptions slide. This is one way and probably the primary way that you can exempt your earnings from having to pay arbitrage. There were initially two spending exceptions, the 6 month and the 24 month exception in place, and then with some rule changes a few years back they came in with an 18 month exception. The 24 month exception really applies to construction bonds whereas the 18 month exception will apply to any sort of capital improvement projects, capital bonds. The main thing to remember about these exceptions is that if you are going to say for instance Okay we are looking at the 18 month exception if you are going to say that you are spending 15% at the end of six months that you have spent 75% at the end of 12 months and 100% at the end of 18 months you need to make sure that you've included all the interest that you have earned as well. Have you included your interest earnings? Now under the 24 month exception reserve fund earnings and capitalized interest earnings are included in the computation of your available construction proceeds that amount and the target amount that you are looking to spend. Reserve funds after this construction period, after the 24 months become subject to arbitrage rebates so just because you may have met the 24 month spending exception for your construction money you still have arbitrage concern for the life of the bond as long as the reserve fund is out there. You can elect to exclude you reserve fund earnings for this computation or spending analysis but you need to do that in your tax certificate at issue otherwise it defaults into the interest earnings are included.

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This next slide shows you the actual analysis. In this analysis the issuer met the first two benchmarks it didn't spend enough on proceeds to meet the 18 month expenditure as you can see here the amount exceeding or the amount below when you hit 18 months-they didn't make it. So they were not able to qualify for the two year spending exception even though they had spent everything by the end of 24 months. Carol, you want to go through the why these spending exceptions are out there and explained the purpose behind this?

Yes and there's a real logical reason for why the internal revenue code and the treasury regulations have these exceptions. Remember the purpose I talked about at the very beginning for arbitrage rebate, the yield restriction in the very beginning, the reason is, we should not be issuing tax-exempt bonds with a purpose to earn arbitrage so all of these rules are forcing us were benefited if we issue at the appropriate time and we spend our money in a relatively short period of time for our governmental purpose. If you are able to spend your money fairly quickly certain benefits kick in. So, for example if you spent your money very quickly and went over this first six month exception if you spend your money within six months genuinely you do not have to worry about arbitrage rebate with respect to your project fund. Anne has appropriately described the fact that you might have another fund that's not going to sit there for the life of the deal such as a debt service reserve fund that would be subject to rebate but you get a benefit here and there are certain types of transactions where these types of exceptions work very well. So for example let's say you have a construction project it's going to take you more than six months. Maybe it will take you 18 months or maybe it will take you two years. You have two other alternative exceptions because you are spending your money fairly quickly but if you happen to be able to earn above your bond yield you can keep it, which is to say that the government is giving you a benefit if you will because you are doing what you are supposed to be doing which is you are using tax-exempt financing and issuing at the appropriate time when you are ready to do your project and you are proceeding with speed to get it done so you get a benefit. This type of an exception can work particularly well for example with a variable rate tax exempt financing where you might have relatively in certain markets a low, rate of interest on your financing and you are able to actually, although you do usually have to remain liquid during the construction period. You might be able in the taxable market to be earning above your tax-exempt interest rate. And you might actually be earning arbitrage rebates and here if you spend your money pretty quickly the government says okay you are doing what we wanted you to do and you will be able to keep that arbitrage rebate that you might have earned. So, that is the purpose of these exceptions. They are driving you to be sure that the appropriate time, but too early that's targeting the tax exemption to the appropriate governmental purpose.

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Well put, thank you, Carol. All right the last math concept before we get into some real life examples here I want to discuss a little bit about transferred proceeds. This is a term that you no doubt have heard if you've done a refunding bond. I remember we talked about the arbitrage regulations and the rules are out there for the life of the bond. What happens if you have a bond that you decide to pay it off, it makes sense to get the new bond in place, but the existing bond is called protected beyond 90 days? If you can pay it off within 90 days it is considered a current refunding so all arbitrage liability transfers to the new bond within those 90 days enough said. The old bond is completely paid off and nobody worries about it anymore. But when you've got advanced refunding safeguard bonds are call protected for a couple of years so you need to put the monies aside to pay off those bonds as they come due. What do you do with the arbitrage liability? You've accrued arbitrage rebate payment on the old bonds you are going to accumulate more liability on the funds associated with that old bond. You are also going to be accumulating arbitrage liability on the new bonds. So how do you split it? especially in the case of a reserve fund where you have a reserve out on bond and said okay we are just going to take this reserve and set it into the new bond add new money from it the new bond and that secures the new bond and the IRS eyes a portion of the reserve fund still applies to the old bond for purposes of arbitrage calculation.

So in this example here uses a $25,999,000 bond that was refunded this is what was remaining before any of the refunded bonds have been called now. February 1, 2008, first call is going to happen on this bond. They are going to pay off $545,000 worth of the old bond. So how do you split that rebate liability? The rule says when new monies pay off old bonds that is when rebate liability moves forward. So in this case there was no old money left on the bonds there was perhaps a small reserve fund there was no construction money this is a new bond going to pay off the subsequent bond payments. Usually what happens is when you've got an old bond refunding with the reserve fund the reserve immediately goes to pay off the debt service then you've got the new ones coming in here. So it is just a strict ratio that accumulates over time in this first case 2 .1% of the rebate liability transfers to the new bonds because new bond money paid off the $545,000. That means that 97.9% of their rebate liability stays with the old bond. The next year progresses, $565,000 of the old bonds are paid off now so when you look at the cumulative rebate liability now 4%, 4.3% of the rebate liability is transferring to the new bonds and almost 96% is staying with the old etc, until all of the bonds have transferred 100% of the liability. So it's a rather complex computation if you've got a multipurpose bond and if you've got multiple bonds being called at different dates that calculation can get quite involved but, it it’s cleanest form if you've got new money paying off old bonds you look at the percentage of the money that is paying off the old bonds and you move the rebate liability to the new bond.

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At this point I don't see any questions, so I want to move on and talk about the use of proceeds in the actual which is to say when the rubber hits the road with the rebate computation, because I think the practical math application is important but I think this is something you will get a better take away from. These are life examples that we pulled out of our portfolio that we've got here at Wilidan Financial and we find it very interesting these days as when I started in the business seeing an 7% or 8% bond yield was not that unusual and to have an 8% bond in a positive arbitrage position was not that unusual back in 1994 and now we are seeing fixed-rate bonds at 2 1/2%, 3% that are in a negative arbitrage position so, all I can tell you is you know, we are breaking ground here mathematically speaking with arbitrage but it is going to turn around and things are going to change. Rule of thumb is to know what type of bonds you have issued. In terms of the bond yield this chart shows you the interplay between a variable-rate bond a fixed-rate bond and a variable-rate with a swab. The fixed-rate bond in this case issued in 2006 was about 4.2% straight-line, you can project in fact quite often we do forward-looking rebate calculations based on hypothetical expenditures of bond proceeds hypothetical investment but guaranteed this is what you are going to be paying your bondholders. The fixed-rate with a swap really tracks very close to how the fixed-rate bond tracks that is the purpose of the swap to take out all of the risk out of the variable rates so these next three scenarios are going to talk about. We are not going to talk about the variable with swap. A variable-rate bond has a terrific swing in and when you look at 2006 versus 2010 variable-rate debt has tracked very closely to what taxable and tax-exempt investments have done over the last five years. It crept up and was very close to it the fixed-rate bond yield was back in 2007 but has dramatically declined. Carol, do you want to give a little description of why different types of bonds were issued and let me know and I will move on after that.

Different types of bonds are issued for various purposes for state and local governments. And for purposes of the arbitrage rebate the bond yield is actually computed differently. Issuers often times will want to issue a fixed-rate bond yield when yields are relatively low to lock in that type of rate for relatively long period of time. But often time’s issuers might want to issue a variable-rate bond yield for a portion of their debt just so that they are a little bit more diversified. The variable-rate debt transaction where you might work better also for a bridge time financing where you are going to be anticipating later for whatever reason refinancing that bridge financing in the future. The swap transactions were a type of transaction where you are sort of merging the two together. You are issuing variable-rate debt into the market to take advantage of the market for that kind of debt and your entering into a contract with a third-party where you would actually have a state and local governmental issuer be making fixed payments so that you are locking in a sense your bargaining cost and they in turn would be making the floating rate payments. At various points of time each of these types of debt transactions have been more or less, popular. I think if you were to generalize today because of what's been going on in the economy and to various entities that have been involved in these kinds of transactions I think the fixed-rate transaction is once again the old tried-and-true and becoming more popular.

One other thing to keep in mind in terms of the arbitrage rebate calculation a variable-rate bond is a moving target. Obviously on day one you don't know what you're going to be paying your bondholders therefore you can't really tell if you're going to be earning arbitrage or not. Whereas with a fixed-rate bond it is pretty easy if you issue a 4% bond and put your money in a money market that is paying 1% or less you're probably not going to have arbitrage rebate concerns. A variable-rate bond will track much closer to what money markets are and sometimes they invert and sometimes without warning you end up owing the IRS. The IRS will allow you to aggregate your bond payments or payments to your bond holders for the purpose of computing the variable-rate interest. You can take a first through fifth cumulative approach. You can take a first-year plus a second year plus a fourth-year post it year approach etc. However, there are 15 different iterations in the first five years of being able to calculate the best rate to your advantage based on how you have spent your bond proceeds. That's kind of nice. After the first five years though you are much more limited and how you can calculate the variable rate yield and I think the reason is the IRS goes back to we want you to spend your money after five years you really shouldn't have construction proceeds left and generally variable-rate bonds or not carrying reserves sometimes so after that point they become much more restrictive and now you can calculate the yield. But it is a moving target.

I just want to let the people know that I can see the questions and I will, when Carol takes over here we will take a look at them and make sure we answer them at the end. Thank you so much for submitting them.

Slide # 14 & 15

Use of proceeds scenarios, this is where the rubber hits the road. We've got three different scenarios we will be looking at each of these scenarios we tracked a fixed-rate bond and a variable-rate bonds so that you can see the difference in all of these are bonds that are issued in 2006 – 2007. So the impact of what this current economy or the economy of the past five years has done on arbitrage is rather interesting. In the first scenario where the issuer spent the money quickly but did not meet a spending exception. The second scenario is where the project stalled after three years and they could not get all of their proceeds spent and were stuck and then the third scenario didn't spend their proceeds. Slide 15 shows a construction bond that was issued, both of the bonds was issued in 2007. One was a fixed-rate bond at 4.3% and one was a variable-rate without a swap. On this slide the fixed-rate bond is the red line, the variable-rate bond is the blue line and the investment yield is the green line. You take a look at 2009, where both bonds had approximately 6% of their bond proceeds left. They had spent a lot of money but neither of the issuers met their spending exceptions and during this time as you can see the investment yield, the green line is well above the variable-rate bond yield which is the blue line and above the fixed-rate bond yield which is the red line. So what this means that both of these bonds were earning positive arbitrage between 2007 and the very end of 2009. Now by 2010, all of the bond proceeds had been spent, which even though interest rates went way down there was very little left at the end of 2009 in either of these bonds to invest below the bond yield and earn the negative arbitrage. The fixed-rate bond, the rebate calculation started to go negative at the end of 2009. The variable-rate bonds, the positive arbitrage did not into negative arbitrage until the end of 2010, therefore, leaving very little time to burn off all of this positive arbitrage that it had earned. In both of these cases, these issuers made payments and, it's pretty obvious that in the variable-rate bond there was very little time to burn it off but even the fixed-rate bond although they had more time for the negative liabilities to accrue they didn't have enough of a balance to accrue enough negative liability to burn off what they had earned in this early period. So, the rule of thumb is just because you spend your money quickly and in this case within the first three years each spent about 95% of their bond proceeds and you have nothing left at the end of five years I have a lot of issuers who say it is your five a lot of issuers think that as they have no proceeds left, interest rates way down but you have to remember what happened at the beginning time. It doesn't necessarily mean that you've got no rebate liability. So if you've got a fixed-rate bond or variable-rate construction bond that you issued in 2007, yes you spend your money quickly but did not meet a spending exception. Even though interest rates are low I wouldn't assume that you don't owe an arbitrage rebate payment.

Slide # 16

The next scenario is where the project stalled after year three (and this can happen especially if you have union contracts). We have some clients back East where Amtrak is not being very nice and they've issued these bonds with the intent that Amtrak was going to make improvements to the city and Amtrak has reneged so they started their work and put up the money and now the whole project is stalled this is a construction bond that were both issued in 2007, this was 4.1% variable-rate here is the blue line. It actually, between 2007 and 2011, the variable-rate bond yield has come down and then started to climb back up whereas the fixed-rate bond has stayed steady. Construction was on schedule for the first three years. So they were spending money, spending money until 2010, and then stalled. The investment earnings dropped below the fixed-rate yielded in 2009, so here there were positive earnings on the fixed-rate bond this entire time and they were able to accumulate negative earnings and did not end up having to make a rebate payment. The variable-rate bond had a good deal of time from 2007 almost all the way to 2010, to earn positive arbitrage. Yes, the yield even though the yields were still low, the variable-rate bond yield is starting to climb, this bond is earning negative arbitrage right now is the same situation as before. There is not enough time before the five-year payment is due to earn or burn off that positive arbitrage that has been accumulated.

Slide # 17

The last scenario. Minimal proceeds spent. Here again in this scenario the arbitrage yield for the fixed-rate bond is just slightly over 4%. Variable-rate same sort of curve as before you know you have seen one, you've seen them all, exactly what it did to variable rates between variable between 2007 and 2011, the investment yield is below the bond yields for considerable amount of time they were really only above the bond yields for the first six months in this case and at the end of five years. Few bond proceeds had been spent. So in terms of arbitrage liability both of these bonds are in a negative position. None of these issuers owe the IRS anything for rebate. That said, one of the issuers is under audit for failure to spend their bond proceeds. So the moral to the story is, you need to spend your money. Yes you can be thrilled that you don't owe any rebate payments, but random audits are coming up especially on private activity bonds, on advanced refunding bonds, and construction bonds. The IRS is looking for money anywhere they can find it. In this case yes, they were able to say and able to prove there was no arbitrage liability but then the focus was turned to why didn't you spend your bond monies. At this point I'm going to end and I'm going to go back and read some of these questions I've got. I'm going to pass it on to Carol to talk about the IRS hot topics that deals with what the IRS is looking at with these audits. I know she will talk a little bit about the written procedure requirements that is are out there and she will move on through the documentation and SEC disclosure.

Slide # 18

On this slide we have attempted to list some of the major issues that the IRS looks at when they conduct an audit of a typical tax exempt bond issue. There are very defined things that the SEC are looking at for compliance. It used to be that the idea of having an audit was, there wasn't as much of a risk but recently there have been an addition of IRS agents in this auditing tax bond issues and Build America Bonds area and each agent can process more cases now there are different methods for them to be able to do that, so the likelihood of you actually encountering some form of an IRS audit is actually increased. Having said all that, I have made a list here of issues that they would typically look at.

A) The first one is your actual drawdown schedule. Have you spent your bond proceeds for your typical construction or acquisition bond within three years. This is not just limited to whether or not you have made arbitrage rebate or not and made any sort of profit if you will from the investment. The IRS is actually looking to see that you've spent your money for the governmental purpose. Remember I talked about the governmental purpose way in the beginning. It is very significant because most of the bond issues are structured such that there is an expectation and requirement under the treasury regulations you recently expect to spend your money over the next three years or so when you don't do that, on an audit, expect to have questions about why. And you actually can wind up having a tax issue with your bond issue, even if you didn't earn arbitrage rebate spent your money in accordance with your expectations at the beginning. You will be faced with questions about why is that, why did you not spent your money correctly, unanticipated things that occur might be perfectly fine for this reason, but the moral of the story is try to spend your bond proceeds as quickly as possible and consult with your bond counsel if you have not in fact spend your money in accordance with your expectations.

B) Have you made your rebate payments in a timely manner? This is really significant. There's a federal tax structure that provides making your rebate payments at a minimum every five years and then within a certain short period of time. You get a grace period after you've paid off all of the bonds of the bond issue. So expect on an audit question about whether or not your rebate payments have been made in a timely manner. It behooves issuers to assign somebody within the issuer that is responsible for making sure that this basic post-issuance compliance responsibility is taking place.

C) Are bond proceeds restricted after three years. Once again today's market investment returns are fairly low, but once again if you happen to have had a construction for whatever reason and wind up having bond proceeds left over after three years typically yields will have to restrict and you may need to make sure that the IRS on an audit to see what the investments have been after that period of time.

D) Do the rebate report schedules that you have matched the bond allocation for the purposes? By that typically the IRS is going to ask to see a report about how you spent your money on one project expenditures they will also ask for a report to see how you've invested your money and they will ask for your rebate report. So they are auditing a bond issue that was issued more than five years ago it was your responsibility to have ascertained whether or not you had any arbitrage rebate due unless you had an exception available. For example, if you are a small issuer and if your rebate report shows a schedule of expenditures that does that match the project cost that you are telling the IRS about what the projects were you spend your money on, you have to make sure you're keeping good accurate records and they are consistent.

E) Have you complied with IRS safe harbors for guaranteed investment contracts for bidding open markets securities for a refunding escrow? Okay what am I talking about? Remember in the beginning I talked about how yield restriction was a difficult concept from a practical standpoint? It's hard to go out and find an investment that yields exactly how you wanted too and you must make sure you are yielding at or below the yield. Maybe not in today's market with everything yielding so low but in a lot of different markets that we've had it might be difficult. You are supposed to be buying investments at the market value what you do with them and with a guaranteed investment contract that is a negotiation with a private party for a specific return. Wait a second. How do we know that one is at fair market value? You're not supposed to be paying extra money above market so that you get the right yield. So the IRS put out safe harbors requiring bidding for those kinds of investments. If you are audited and you have a guaranteed investment contracts for which you have invested your bonds proceeds you need to make sure you've complied with the IRS safe harbors, and you need to be keeping records of the bidding. The record should be maintained with all of your other records with respect to the tax and bond issue.

Slide # 19

Now I'm going to move on to the next area which is documentation and disclosure. Now, what happens if there is a tax issue with respect to your bond issue?

A) Are you supposed to disclose it? If it is a material issue you are supposed to disclose it. And there have been lots of questions about what do you do. Obviously if the tax issue is coming up in the beginning and the structure it is an area where the bond counsel must look at it and make sure they given an unqualified opinion that typically the bonds are tax exempt if something is material to an investor it must be disclosed. The trend is for more disclosure to make things transparent, and so what you are seeing typically in tax matters disclosure is that there is more of a discussion now about the various components of a tax exempt bond issue. In the past the tax matters discussion was relatively short. That's because bond counsel will typically give an unqualified opinion, the interest on the bond was tax-exempt. And there should be no tax issue associated with that opinion.

B) Today there has been a move to disclose more than that typically whether the tax treatment a premium on the bond and discount and certain secondary market tax issues. You will not typically find a disclosure paragraph regarding a particular tax issue because bond counsel is supposed to be reaching the conclusion that there is not one of those tax issues present. You do hit certain issues that what is subsequent to after you issue the bond, in an audit for example, you are in the middle of an audit and the IRS are raising a tax issue, and there are various benchmarks that need to be discussed here very carefully with bond counsel if you are in an audit, and the IRS is raising questions there are certain points in time when the IRS may send a letter saying that they believe there is an issue at that point in time and that may very well raise a disclosure issue and you may come to the conclusion that one is now made aware to you after closing and the IRS isn't even involved and it may be appropriate for you to disclose it.

Finally, what written procedures do I need? First and foremost you need to have a person or group of people within the state and local governmental issuer that is responsible for your post-issuance compliance for your tax exempt bond issues. You need to have a person that has taken on that responsibility. They need to be charged with keeping accurate records, knowing who is responsible for keeping records and what the content of those records needs to be. They need to be charged with hiring and charged with being an arbitrage rebate consultant and should make sure that the reports are coming in and appropriate actions are being taken. These things need to be documented somewhere because the

IRS in both their information reporting and their connection with various compliance procedures that they are sending out is asking the question of issuers, do you have written procedures? Why are they doing this? They are encouraging you to set up your house so that you will be in compliance. That it will be simple for you. That these rules will not become too burdensome after the fact. It is helpful to be thinking about this type of written procedures as you are doing your bond issue. Often times you can put those types of complaints procedures within your tax certificate and take care of it there. Or you may decide that you want to adopt a separate resolution and take care of the post-issuance compliance procedure in a separate way. But, this is a trend. This is where it is going at first and foremost to make sure that you have somebody charged with the responsibility of watching over the tax restrictions contained in your bond documents for your bond issue. Q & A

Carol that is a great lead into one of the questions that we got here has to do with recommendations for frequency of computation more importantly, what they are doing is they have someone internally tasked with keeping up with the arbitrage yield restriction and they do use a consultant to calculate each bonds timetable by which they mean I think each installment date they have a consultant to a full-blown report. But they are doing calculation for arbitrage and yield restriction internally. So the question is: Is there any quick and audit defensible templates that we recommend?

There are two sides to this, for arbitrage rebate the Internal Revenue Code requires computations at a minimum every five years. And then when the bonds are actually are paid off. And for yield restriction you should at least be on that kind of a schedule and probably before that to make sure you are in compliance. But your bond documents may require far more frequent schedules even though the code and the regulations may not require that and the reason for that is to not let things get too much out of control. It may be more difficult, time-consuming, more difficult to find the records if you wait too long. So oftentimes bond counsel will want you to do a more frequent type of calculation, perhaps every year. And if you have a more complex bond issues it may behoove you also to do the calculation more frequently. We worry as bond counsel sometimes that issuers if they are earning arbitrage rebate and not doing their calculations very frequently that they might inadvertently spend the extra arbitrage rebate and maybe they will spend it on a governmental project that they were supposed to but that they don't have the money and they owe it to the federal government.
The only thing that I would add to that in terms of an audit defensible position the best thing you can do is have these internal written procedures in place so that you name the position within your organization that is responsible for annual update of arbitrage rebate and you define how that person or persons is keeping up with the continuing education especially in this market is also important. Things are changing rapidly twice a year. It seems like whenever the NABL conference meets you've got new interpretations of the tax law, so if you are doing this annual computations internally you need to make sure that you not only have got mechanical procedures in place for how you are going to collect and retain your bond documents and how you are training your staff on existing regulations, how you are keeping up with those regulations as well. The other thing is if you are doing your computations in house and you're having a rebate calculator do it every five years just make sure you've got a rebate fund like Carol said, they're also the worst thing could be that you really did spend the money where you needed to, you just earn more than you were allowed to keep but you spent it.

Carol if you've got some are quick questions or sage words of advice they would like to give everyone, I know that Linda asked that you name a few refer resources, reference resources for people to use. I know that here we use the ABCs of arbitrage, we use the G FOA and we use NABL as our three main resources for ongoing education as well as the IRS themselves and the SEC. In any other resources would like to recommend?

Those are good, and obviously our forums such as this are a great resource. I would encourage everybody to continue to take advantage of these types of programs that are put on to increase education. And I also would say at the end of the day if an issue comes up such as so my goodness, I went back and suddenly realized I have a lot of bond proceeds left over and I'm now in year six or year seven, what do I do? Take advantage of your bond counsel. Don't wait for the IRS audit. Call the bond counsel and go back and see what can be done with respect to your bond issue and what your legal status is at this point it's always better to have the information. Just as we are being encouraged to be more transparent with disclosure, if you having the knowledge base is always a good thing. And it is a good thing in today's environment for you to keep in contact post-issuance with your bond counsel.

I think, Carol makes a very good point about staying educated in the IRS has actually put their money where their mouth is for the first time ever. They have said that if you are keeping up with your arbitrage rebate, say you're a new finance director coming into a new city you know all about arbitrage and the first thing interested to get where your tax exempt bonds are in terms of compliance and you realize oh, there is a problem. If in fact the city has maintained adequate written procedures for how they are going to handle this internally you can go to the IRS under the voluntary compliance program and say to them we just discovered a mistake and the IRS will calculate the penalty if there is one from the date of discovery as opposed to the date of occurrence. That could mean lots of money, tens of thousands of dollars, the IRS is charging 4-5% underpayment interest rate credit for issuers that are earning about 1% on their investments. So, having the wherewithal to know that it's important, to know where to go for the information and to make sure that there's good long-term procedures in place can end up saving you some money in the long run.

Well, thank you. Think we've got all of the questions and some of them I have them answered online. If I missed any I do apologize. I do recommend like I say the ABCs of arbitrage, CDIAC and the GFOA Website. If you've got any questions having to do with mechanics or the reason behind the madness Carol and I are both more than happy to have you contact us directly. Thank you very much to Linda and to Mark for hosting this event. It helps us out tremendously when issuers are educated on the topic of compliance. So thank you so much.

I want to thank Carol & Anne, and for their presentation again I urge anyone to contact them directly or to use CDIAC for a conduit. Also take a moment to recognize our upcoming webinars November 30th from 10 to 11:15am we will focus on swaps and December 7th on the investment side of the house we are going to address agency securities, GSE's, supranational, Farmer Mac and a green the bond investing.

Again, thank you Carol & Anne and we appreciate the participation of those involved online today.