Advanced Bond Topics

Ohio GFOA Annual Conference

September 2024

Joe Violand, Lona Valentine & Brenda Wehmer

OHIO GFOA

REDTREE INVESTMENT GROUP

Dinsmore

Advanced Bond Topics

- Paying cash vs borrowing for a Project
- Arbitrage sensitive investment strategies
- Arbitrage details & other IRS rules
- Capitalized Interest limitations
- How Revenue sources affect structure

Investing Debt Proceeds and Arbitrage

Paying Cash vs Borrowing

The age-old question…

Highlighted Approaches:

- Philosophical
- Mathematical

Two Considerations:

- Investment returns
- Borrowing Costs

REDTREE INVESTMENT GROUP

Investing Proceeds

How it's the Same

- Investment options are same as other operating funds*
- Investing in a manner to follow cash flow needs
- Interest tracking details

How it's Different

- *Arbitrage Considerations
  - Tax-exempt municipal bonds
  - State and Local Government Securities "SLGs"
    - Pronounced as "Slugs"
    - Specifically: Demand Deposit SLGs
- Separate Investment Accounts

REDTREE INVESTMENT GROUP

Investing Proceeds in Arbitrage Environment

Background

- 2020 – Present
  - Debt issues in this time frame need to pay special attention
  - Interest costs/arbitrage yields lower than investment rates

Fluid Investment Strategies

- Goal is to minimize arbitrage liability and maximize retained earnings
- Be prepared to make adjustments
- Know legal guidelines

REDTREE INVESTMENT GROUP

Investing Proceeds in Arbitrage Environment

How to manage arbitrage liabilities?

- Invest funds upon receiving debt proceeds
- Example
  - Arbitrage Yield – 4.10%
  - Invested proceeds in 5%+ environment
- Actual spending dictates allowable interest earnings
  - Spending schedules change
  - Markets change

REDTREE INVESTMENT GROUP

Investing Proceeds in Arbitrage Environment

How to manage arbitrage liabilities?

- Regular checkups called interim computations
  - Could indicate a need for strategy change
- Example
  - 1 year anniversary date of issuance
  - $300,000 arbitrage liability
  - Check spending schedule remaining
  - Assess investment market conditions

REDTREE INVESTMENT GROUP

Investing Proceeds in Arbitrage Environment

How to manage arbitrage liabilities?

- Tax-exempt municipal bonds
  - Interest earned is arbitrage exempt
  - ORC limitations generally apply
    - Limited to 20% allocation
- SLGs
  - Demand deposit option
    - Interest earned is arbitrage exempt
    - Cannot move from a lower yielding investment to higher yielding SLGs, if applicable
    - Rates reset daily
    - Some barriers to entry
    - More difficult to manage

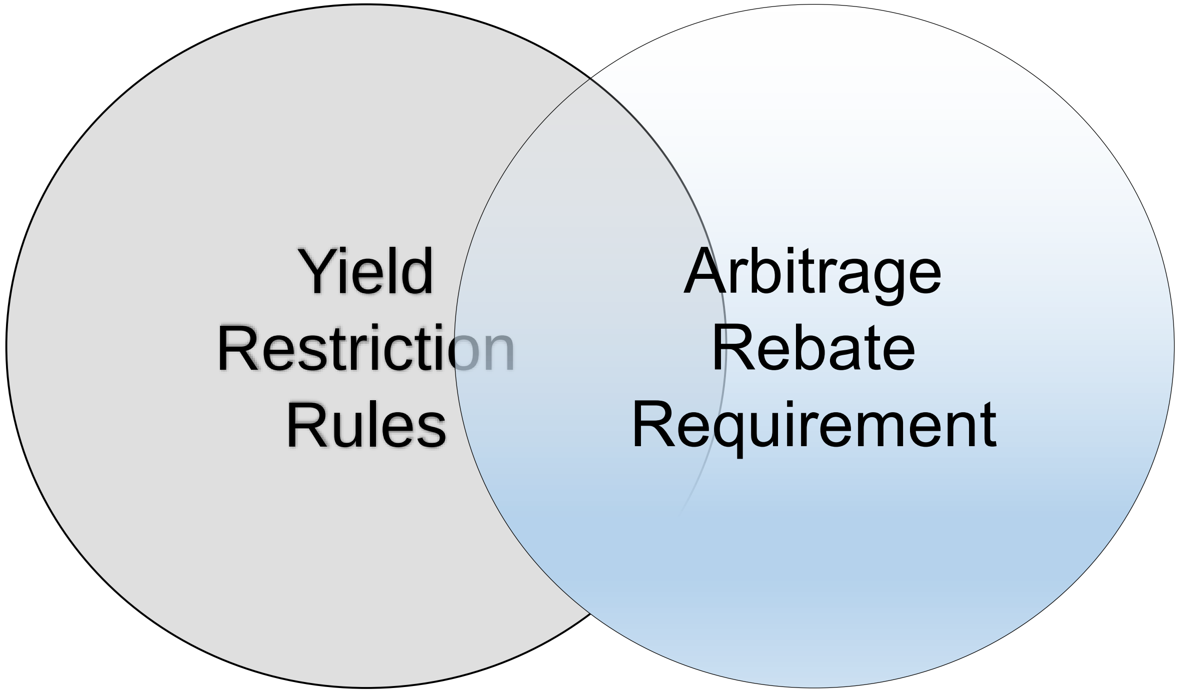
REDTREE INVESTMENT GROUP

Arbitrage Details & Other IRS Rules

Yield Restriction versus Arbitrage Rebate

Yield Restriction – IRC Section 148(a): Governs when you may legally earn arbitrage from Investing bond proceeds.

Federal/IRS Rules - IRC Section 148(f): Mandates when you must rebate arbitrage earned to the federal government.



Prior to 1986, only yield restrictions were applied. After 1986, both rules apply.

Yield Restriction

In general, “gross proceeds” of an issue may never be invested at a yield that is materially higher than the yield on the Bonds.

Yield Restriction

Materially higher defined as	Above Bond Yield
General Restriction	1/8th of 1% (.0012 or .125%)
Advance refunding escrows	1/1000th of 1% (.00001 or .001%)
Replacement Proceeds	1/1000th of 1% (.00001 or .001%)
Non-AMT tax-exempt obligations	No yield limitation

- Certain exceptions to this rule are available during "temporary periods."
- **If you don't invest it at all, IRS could impute FMV rate.**

Dinsmore

What is Rebate?

"Tax" measured by the difference between what is actually earned on the investment of the proceeds in the Nonpurpose Investments and what would have been earned if invested at bond yield, less annual computation credits.

Yield Restriction versus Arbitrage Rebate

Yield Restriction

- Tax Reform Act of 1969
- 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
- Bond Yield
- Issue Date
- Certain Exceptions (Spending, BFDSF, Small Issuer)
- Rebate Payments
- Computation Credits

Dinsmore

Yield Restriction versus Arbitrage Rebate

- Compliance with both arbitrage systems is essential for maintaining the tax-exempt status of a bond issue
- Arbitrage bonds result from earnings that exceed the allowable investment yield under either materially higher limit in yield restriction or the bond yield in arbitrage rebate
- Arbitrage earnings must be remitted to the U.S. Treasury through a yield reduction payment (if permitted) and/or a rebate payment

Rebate Exceptions

Exception To The Rebate Requirement: Small Issuer

- Government with general taxing power
- Bonds must be for use of issuer
- Does not expect to issue > $5 million of new money (and in the past, advance refunding bonds when they were permitted) (up to $10 million more if school construction) during calendar year.

Exception To The Rebate Requirement: Spending Exceptions

- 6-month Exception
- 18-month Capital Expenditure Exception
- 2-year Construction Exception (only for governmental and 501(c)(3) bonds)
- Completely Optional

6 Month Exception

- All proceeds spent within 6 months
- Excludes 4R Fund

18-Month Capital Expenditure Exception

- For non-construction issue
- Often utilized in connection with land acquisition
- 15% in 6-months
- 60% in 12-months
- 100% in 18-months

Construction Expenditure Exception

- At least 10% of Available Construction Proceeds spent in the 1st 6 months
- 45% spent 1st year
- 75% spent at 18 months
- 100% in 24 months (only for governmental and 501(c)(3) bonds)
- Can be combined with 6 months rule

How Does The 2-Year Exception to Rebate Work With The 3-Year Temporary Period?

Doesn't – they are independent, and are there for different reasons

- The 3-year temporary period determines if you can have arbitrage in the first place (based on reasonable expectations)
- The 2-year and 18-month spending exceptions determine if you can keep arbitrage (based on actual facts)

Exceptions To The Rebate Requirement: Debt Service Fund

No rebate if:

- No more than $100,000 in earning; or
- No more than $2.5 million in average annual debt service, or
- For governmental bonds, if the bonds meet the 2-year construction expenditure rule.

Exceptions To The Rebate Requirement: Certain Investments

No rebate if:

- Non-AMT tax-exempt obligations;
- Demand-deposit SLGs (not typical time-deposit)

Calculation and Payment

Required Calculation Dates

Installment Calculation Dates (Every 5 Years):

- 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
- Installments of at least 90% of cumulative rebate is due

Final Calculation Date:

- Date all bonds of an issue have been retired
- Cash defeasance or refunding may accelerate final computation date
- Final Payment due within 60 days
- 100% of remaining arbitrage rebate is due

Payment

- **File IRS Form 8038-T**
- **If not timely:**
  - Late interest plus late explanation letter:
    - If innocent failure and paid within 180 days of discovery late interest and penalty (see below) may be waived. No waiver if bonds are under audit.
    - If innocent failure and not paid within 180 days of discovery, late interest plus a penalty of 50% of amount due for governmental and 501(c)(3) Bonds (100% penalty amount for other types of bonds).
    - If IRS Commissioner determined that failure to pay timely was due to willful neglect, bonds may be declared taxable arbitrage bonds.

Arbitrage Rebate Reports

- As stated in the previous slides, determining the yield on the investments, the yield on the tax-exempt bonds whether the appending exceptions have been satisfied is complex
- Because of this, issuers and borrowers engage firms like Dinsmore to prepare Arbitrage Rebate Reports
  - These reports determine whether the tax-exempt bonds have been spent correctly and whether the State or political subdivision has to pay the IRS excess yield in order to keep interest on the bonds tax-exempt and in the case of Dinsmore, offers a legal opinion with respect to those matters
  - These reports are required to be done at least every five years until the bonds are refunded or mature. Critical to do them in a timely manner because interest and penalties accrue on amount owed and can exceed amount originally owed

Capitalized Interest

Ohio State Law

- ORC 133.16 General Obligation Bonds
  - Generally 24 months
- Revenue Bonds
  - Until receipt of revenues
  - Construction period
- Special Assessment
  - Until receipt of assessments
  - Construction period plus 1 year or 3 years

Dinsmôre

Capitalized Interest

- Add to Bond Amount
- Generated by Premium

Example:

Add Capitalized Interest to Bond Amount

Project Amount	$5,000,000
2 years CAP I @ 4.50%	450,000
Par amount of Bonds	$5,450,000 principal amount to be repaid
Sell Bonds at Par	100%
Bond Proceeds	$5,450,000
Interest rate	4.50%
Yield	4.50%

Example:

Use Premium to pay Capitalized Interest

Project Amount	$5,000,000
Par amount of Bonds	$5,000,000
Sell Bonds at Premium 109%	$450,000 – Premium
Bond Proceeds	$5,450,000
Interest Rate	5.25%
Yield	4.46%
2 years interest	$520,000

Capitalized Interest

Debt Limits can impact ability to increase Bond amount

Direct Debt Limits – Principal Amount

Indirect Debt Limits – Debt Service

Capitalized Interest

- State Law prohibits putting premium into Project Fund
- Premium must go into Bond Retirement Fund
- Used to pay Cost of Issuance or Interest on Bonds

Capitalized Interest

IRS Rules for Tax Exempt Bonds

Borrow or use premium for up to 3 years of interest payments

- 3 years from issue date
- 1 year from placed in service date
- IRS does not distinguish between use of Bond amount or premium for capitalized interest

Dinsmore

Capitalized Interest

IRS Rules

Tax Exempt Bonds

- Premium can be used for Project to pay interest on Bonds

Dinsmore

Capitalized Interest

- Reconcile State law and IRS Rules
- Premium goes into Bond Retirement Fund
- Premium used for Cost of Issuance and Interest on Bonds

Capitalized Interest

Taxable Bonds

- No IRS limits or Rules on Capitalized Interest
- State law still applies

Debt Service Structure

General Obligation ORC 133.21

Structure

- Level principal
- Level total debt service
- 3 times test

First principal payment

- Semi Annual
  - 1st day 2nd February following 15th of July after Legislation
- Annual
  - 1st day 3rd August following 15th of July after Legislation

Debt Service Structure

Structure Rules

Not applicable to Revenue Bonds

- Not generally applicable to refunding securities
    - GO → GO
    - GO → Revenue

Structure Rules are applicable

- Notes → Bonds
- And refunding Revenue to General Obligation

Dinsmore

Thank you!

Questions?

Joe Violand
joe@redtreeinv.com
513-834-6708

Lona Valentine
Lona.valentine@dinsmore.com
513-639-9238

Brenda Wehmer
brenda.wehmer@dinsmore.com
513-639-9217