



Arbitrage – It’s Baaack!

Now what?!

A PRIMER ON ARBITRAGE
REBATE COMPLIANCE

BINGHAM

ARBITRAGE
REBATE
SERVICES



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Arbitrage Compliance in Tax-Exempt Debt Issues

NCLGIA Summer Conference Panel

- ❖ G. Thomas (Tom) Lee, Partner – Womble Bond Dickinson
- ❖ Jon Mize, Partner – Womble Bond Dickinson
- ❖ Caroline Xiong, Financial Services Director – Moore County NC
- ❖ Jeff Moore CPA CGMA, Business Development/Client Support – Bingham Arbitrage Rebates Services Inc.

Learning Objectives

At the conclusion of this session, participants will gain knowledge that:

1. There are tax rules associated with tax-exempt debt, and not complying with the rules can jeopardize the tax status of your tax-exempt debt.
2. If you comply with the rules, there may be some money to be legally made that can be used for your project.
3. You are not alone - there are consultants that are available to assist you in complying.



The Legal Team

ROLES & RESPONSIBILITIES



“Bond Counsel”

- North Carolina Law on Local Government Debt
- Draft Legal Documents
- Knows and Can Explain Various Financing Options, Techniques and Financial Products.
- Federal Securities Lawyer
- Tax Lawyer
 - Federal Tax Restrictions when Tax-Exempt Debt is Incurred.
 - Private Activity Issues
 - Arbitrage Issues



What is “Arbitrage”?

- Issuer Borrows \$25 million at tax-exempt interest rate of 4%.
- Issuer invests at investment rate of 5%.
- In Year 1, Issuer earns \$250,000 above its cost of funds.
- Uncle Sam does not like this.

General Rule

Issuer has to pay earnings above its cost of Funds to US Treasury – “Rebate.”

Exception No. 1 “Six Month Exception”

If all Bond Proceeds and earnings are expended in 6 months, there is no rebate required.

Exception No. 2

“Two-Year Construction Exception”

- Applies Only to a “Construction Issue”
 - Issuer must expect that 75% of the issue will be spent on “construction expenditures.”
 - “Construction expenditures” generally do not include land acquisitions.
 - “Constructed Personal Property” (e.g. customized fire truck)
- Expenditure Requirements
 - 10 % within 6 months
 - 45% within 12 months
 - 75% within 18 months
 - 100% within 24 months
 - For 6, 12 and 18 months, issuers estimate of investment earnings may be used.
 - Special rule for retainages

“Bi-Furcation” of Construction Issue

- Issuer Treats the Issue as 2 issues – one for construction and one for non-construction.
- Election to divide the issue between construction and non-construction must be made by the Issue Date.
- All construction expenditures must be included in the allocated “construction issue.”

Exception No. 3 “18 Month Exception”

- Not limited to Construction Issues
- 15% within 6 months
- 60% within 12 months
- 100% within 18 months
- Cannot be Used with the 2-year exception

Exception No. 4 “Penalty In Lieu of Rebate”



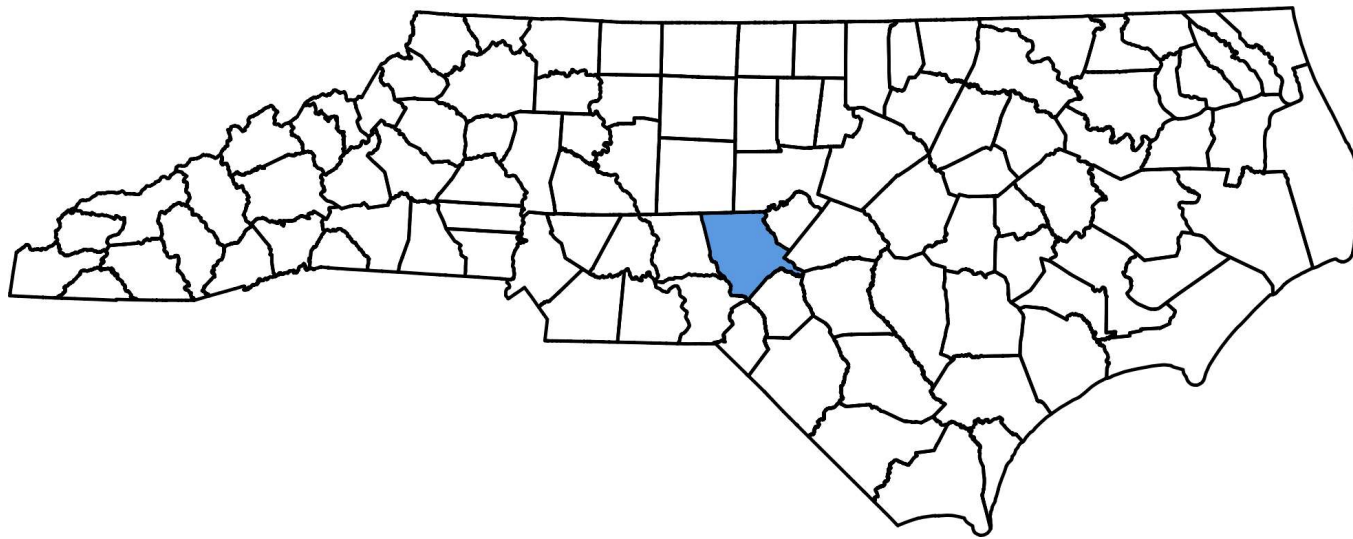


County of Moore
— North Carolina —

Moore County

Arbitrage Compliance

Moore County Profile



Moore County Profile (continued)



Moore County Profile (continued)

- Population of 99,727 according to the 2020 Census
- Located in the Sandhills region of North Carolina (Southern Pines, Pinehurst and Aberdeen)
- County of Moore (# of FTE): 726 employees (FY2023)
- General Fund Budget in FY2023: \$135,133,899
- General Fund Budget in FY2024: \$144,711,448

Moore County Profile (continued)

A penny on the County Property (Fund 100, \$.33/\$100) & ALS (Fund 200, \$.0375/\$100) Tax rate is anticipated to generate \$2,163,174 in revenue.
 A penny on the Fire Service Property (Fund 215, \$.0875/\$100) Tax rate is anticipated to generate \$639,375 in revenue.

Per Board of Commissioner action, Moore County performs a Revaluation every 4 years

Tax Rate Comparisons of Current, Revenue Neutral, and Proposed			
Fund Description	FY23 Tax Rates	FY24 Revenue Neutral	FY24
General Fund (100)	\$0.4850	\$0.3512	\$0.3300
Advanced Life Support (200)	\$0.0400	\$0.0290	\$0.0375
Rural Fire Protection (215)	\$0.1050	\$0.0871	\$0.0875
Cummulative (100, 200, 215)	\$0.6300	\$0.4673	\$0.4550

Moore County - Arbitrage Compliance History

- On June 30, 2002, Arbitrage Rebate Payable was \$207,526. The arbitrage rebate was paid off to the IRS in fiscal year 2002-2003.
- This was our last arbitrage rebate paid to the IRS based on our financial reports.
- From 1992 to 2001, our notes payable had an interest rate range from 4.36% (Airport Facility in 1992) to 7.5% (DSS facility in 2001).

Outstanding Debt Summary

Legal Debt Margin Calculation for Fiscal Year 2021-2022:

Appraised valuation on June 30, 2022	<u>\$ 14,635,522,557</u>
Debt limit - eight percent (8%) of appraised valuation	<u>1,170,841,805</u>
<u>Gross Debt</u>	
Total bonded debt	147,720,000
Revenue Bond	1,371,000
Limited obligation bonds	78,307,000
Federal/State revolving loan	1,236,766
Notes payable	38,474,187
Capital lease	<u>163,816</u>
Gross debt	<u>267,272,769</u>
<u>Statutory Deductions</u>	<u>(37,635,752)</u>
Net debt	<u>229,637,017</u>
Legal debt margin	<u>\$ 941,204,788</u>

General Fund: General Obligation	Interest Rates	Date Issued	Date Series Matures	Amount of Original Issue	Balance Outstanding on June 30, 2022
Schools GO Debt Series 2018 AB	3.125-5.0%	2018	12/1/2038	\$31,000,000	\$26,350,000
Schools GO Debt Series 2019A SP	2.875-5.0%	2019	1/15/2039	\$34,000,000	\$28,900,000
Schools GO Debt Series 2019B PH	2.0-5.0%	2019	7/15/2039	\$38,000,000	\$34,200,000
College/Schools Refund. Debt Series 2016	2.0-5.0%	2016	6/1/2029	\$42,380,000	\$29,080,000
College GO Debt Series 2021	1.0-4.0%	2021	1/15/2041	\$20,000,000	\$19,000,000
Total General Fund General Obligation (GO)					\$137,530,000
Total Enterprise Fund General Obligation					
GO Refunding Series 2016 EMWD USDA	2.0-5.0%	2016	6/1/2046	\$8,750,000	\$7,525,000
GO Refunding Series 2021-EMWD 2011 USDA GO	2.0-5.0%	2021	6/1/2049	\$2,725,000	\$2,665,000
Total Enterprise Fund General Obligation					\$10,190,000
General Fund/Enterprise: Limited Obligation Bonds					
LOB Public Safety Complex 2010 LOB 2016 Refunding	2.05%	2016	6/1/2031	\$14,481,000	\$10,128,000
Pinehurst Area Utility Project LOB 2016 Refunding 2010	2.05%	2016	6/1/2031	\$6,448,000	\$5,019,000
LOB EMWD Refunding Bond LOB Series 2016 (for Utilities)	2.0-5.0%	2016	6/1/2046	\$8,750,000	\$7,525,000
Courthouse LOB Series 2021	2.0-5.0%	2021	6/1/2041	\$45,665,000	\$43,380,000
WPCP (2013 SRF Loan), Series 2021	4.0-5.0%	2021	6/1/2033	\$9,795,000	\$9,050,000
PU (2014 SRF Loan), Series 2021	4.0-5.0%	2021	6/1/2034	\$580,000	\$540,000
PU (EMWD 2011 USDA GO), Series 2021	2.0-5.0%	2021	6/1/2049	\$2,725,000	\$2,665,000
Total Limited Obligation Bonds					\$78,307,000
Enterprise: Revenue Bond Anticipation Note					
EMWD Revenue Bond Anticipation Note	1.35%	2020	11/3/2021	\$1,395,000	\$1,371,000
Total Revenue Bond Anticipation Note					\$1,371,000
General Fund/Direct Bank Loans					
North Moore High School	3.04%	2019	1/15/2039	\$15,812,000	\$13,440,000
Dozer 2020	1.95%	2020	9/23/2025	\$244,000	\$195,200
Area I WP Elementary School - LOB 2018	2.95%	2018	10/1/2037	\$31,000,000	\$24,800,000
Total Direct Bank Loans					\$38,435,200
Total Bonds (LOB and GO and Revenue) and Direct Bank Loans					\$265,833,200

Enterprise Fund: Installment Purchase	Interest Rates	Date Issued	Date Series Matures	Amount of Original Issue	Principal Balance Outstanding on June 30, 2022
Trucks 2016	1.48%	2016	10/21/2022	\$520,184	\$38,987
Total: Installment Purchase					\$38,987

Federal/State Revolving Loans:

Enterprise Fund: Revolving Loans	Interest Rates	Date Issued	Date Series Matures	Amount of Original Issue	Principal Balance Outstanding on June 30, 2022
ARRA Clean Water Revolving Loan, E-SRF-T-09-0208, Sewer	0.00%	2010	5/1/2030	\$1,462,425	\$583,300
Interceptor Sewer Rehab Emergency Revolving Loan, E-SEL-T-12-0044, Sewer	0.00%	2014	5/1/2034	\$1,089,109	\$653,465
Total Enterprise: Revolving Loans					\$1,236,765

Capital Leases:

Governmental Funds: Capital Leases	Interest Rates	Date Issued	Date Series Matures	Amount of Original Issue	Principal Balance Outstanding on June 30, 2022
Stretchers 2018	6.29%	2018	12/5/2023	\$223,200	\$93,654
Stretchers 2020	6.29%	2020	4/21/2025	\$114,655	\$70,162
Total Governmental Funds: Capital Leases					\$163,816

Recent Tax-Exempt Issues Experiences

- On February 17, 2021, the County issued **\$20 million general obligation bonds** for Sandhills Community College to build a Nursing & Health Sciences facility, due in annual principal installments of \$1,000,000 through January 15, 2041, plus interest at 1.0% to 4.0%
- On June 17th, 2021, the County issued **\$45,665,000 of the Limited Obligation Bonds, Series 2021** (2021 Bonds) for the purpose of providing funds to pay the costs related to the acquisition, construction and equipping of a **new County courthouse**, County office and parking and other support facilities. EMWD issued its **General Obligation Bonds, Series, 2021** (EMWD Refunding Bond) for the amount of **\$2,725,000 to pay off the 2011 USDA G.O. Water Bonds** (EMWD). The County then purchased the EMWD Refunding Bond with the proceeds of the 2021 Bonds. The total amount of **\$10,375,000 of the Limited Obligation Bonds, Series 2021** was to refinance certain State Revolving Fund (SRF) loans from the State of North Carolina by **paying off the 2013 SRF Loan and 2014 SRF Loan.**

Investing Tax-exempt Debt Proceeds

- Money Market Accounts with First Bank (Matching NCCMT interest rate)
- North Carolina Capital Management Trust (NCCMT)
 - 30-Day Net Yield in January: 4.22%
 - 30-Day Net Yield in February: 4.46%
 - 30-Day Net Yield in March: 4.57%
 - 30-Day Net Yield in April: 4.73%
 - 30-Day Net Yield in May: 4.97%

Negative Arbitrage Calculations Shifting to Accumulate Arbitrage Liabilities “Year 3”



\$34,000,000
County of Moore, North Carolina
General Obligation School Bonds,
Series 2019A

Bond Year Three
Arbitrage Rebate Compliance Report
Evaluation Date: March 28, 2022

Negative Arbitrage Calculations Shifting to Accumulate Arbitrage Liabilities “Year 3” (continued)

ARBITRAGE REBATE CALCULATION

<u>PROJECT</u>	<u>BOND YIELD</u>	<u>AMOUNT TO BE REBATED</u>
County of Moore, NC GO School Bonds, Series 2019A	2.6152317%	
Arbitrage Rebate Calculation, Ending March 28, 2022		<u>\$ - 535,436.63</u>
Total Arbitrage Rebate Liability Accruing:		<u><u>\$ 0.00</u></u>

The County of Moore, North Carolina (the “County”) is not accruing an arbitrage rebate or yield reduction liability as of March 28, 2022 with regards to the above referenced bond issue. This amount applies through the third annual computation (cumulative from the date of issue) and does not represent the amount, which may be due at the first installment evaluation date, March 28, 2024.

Negative Arbitrage Calculations Shifting to Accumulate Arbitrage Liabilities “Year 4”

Summary of Calculations

Bond Year Four Evaluation Date: March 28, 2023
(March 28, 2019 to March 28, 2023)

Bond Yield: 2.6152317%

Arbitrage Rebate Calculation

<u>Fund</u>	<u>Arbitrage Rebate Liability</u>
Computation Credits	(\$7,615.79)
Project Fund (Term)	(\$378,975.92)
Project Fund	(\$165,986.96)
	<hr/>
Total Arbitrage Rebate Liability (100%):	(\$552,578.67)
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Total Arbitrage Rebate Liability Accruing:	\$0.00
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Negative Arbitrage Calculations Shifting to Accumulate Arbitrage Liabilities “Year 4” (continued)

Excess Investment Yield Calculation

End of Temporary Period - Capital Projects	March 28, 2022
Bond Yield + .125%:	2.7402317%
<u>Fund</u>	<u>Yield Reduction Liability</u>
Project Fund	<u>(\$6,876.20)</u>
Total Excess Investment Yield Liability:	<u><u>(\$6,876.20)</u></u>
Total Yield Reduction Liability Accruing:	<u><u>\$0.00</u></u>

Negative Arbitrage Calculations Shifting to Accumulate Arbitrage Liabilities “Year 4” (continued)

- Beginning on March 28, 2022, the Series 2019A Bonds were subject to the excess investment yield/yield reduction calculation (applies when proceeds are outstanding after 3-years). As you will see on the attached, the results of this calculation are only **(\$6,876.20)**. Due to the increasing interest rate environment, it is very possible that the County will owe a yield reduction payment to the IRS next year. Given the amount of proceeds left outstanding in the Series 2019A Project Fund, the County could use some of these proceeds (ie excess interest earnings) to cover this potential liability.

Now What?

- Reach out to “Partners” for questions and clarification
 - Bond Counsel
 - Financial Advisors
 - Arbitrage rebate consultants
- Start conversations
 - With Management, “updates”
 - With banks, “eligible expenditures”
 - With Moore County Schools, “challenges, timeline for unspent proceeds”



Arbitrage Rebate Compliance

STRATEGIES IN A RISING
RATE ENVIRONMENT

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What Kind of Debt Requires Arbitrage Rebate and Yield Restriction Calculations?

**Applies to every tax-exempt borrowing
and some taxable subsidy obligations**

Examples include:

- Bonds: General Obligation, Revenue, Limited Obligation
- BANs and Short-term Variable Notes
- Notes, Leases, Commercial Paper
- Installment Financing Contracts / Agreements
- BABs, QZABs, QSCBs

(Filing any type of IRS Form 8038 means post-issuance compliance for arbitrage rebate and / or yield restriction is required.)

Two Sets of Rules and Two Separate Calculations

Arbitrage Rebate & Yield Restriction – It's the Law

Arbitrage Rebate Rules:

Compliance due at least every 5 years while gross proceeds remain outstanding, and

Yield Restriction Rules:

If project proceeds are held > 3 years, outstanding project proceeds are to be yield restricted and earn limited income. The yield restriction calculation becomes a factor for compliance purposes.

Definitions

Arbitrage

The difference between the interest paid on tax-exempt bonds and the interest earned by investing the proceeds of the tax-exempt bonds in taxable higher yielding securities. Federal income tax laws generally restrict the ability to earn arbitrage in connection with tax-exempt bonds or other federally tax-advantaged bonds.

Arbitrage Rebate

Investment earnings on your bond proceeds in excess of the declared tax-exempt bond yield must be rebated to the Federal Government.

What is Subject to Post-Issuance Compliance?

- Project / Construction Fund
- Cost of Issuance Fund
- Capitalized Interest Fund
- Debt Service Reserve Fund
- Escrow Fund
- Sinking Funds
- Interest Earnings

- Pledged Funds

- Transferred Proceeds

Myth Busters

- ❖ “I need to spend all my Construction Proceeds within three years, or I’ll lose my tax-exempt status” – **FALSE**
- ❖ “I should keep my gross proceeds in cash, so I’ll avoid arbitrage earnings” – **FALSE**
- ❖ “If I spend all of my Construction Proceeds within two years, I’ve met the 2-Year Spending Exception” – *Maybe*

Exceptions

- ❖ Small Issuer Exception
- ❖ Spending Exceptions
 - 6-month spending exception
 - 18-month spending exception
 - Two-Year spending exception
- ❖ “Bona Fide” Debt Service Fund

Spending Exceptions

Six-Month Exception:

- 100% at 6 Months

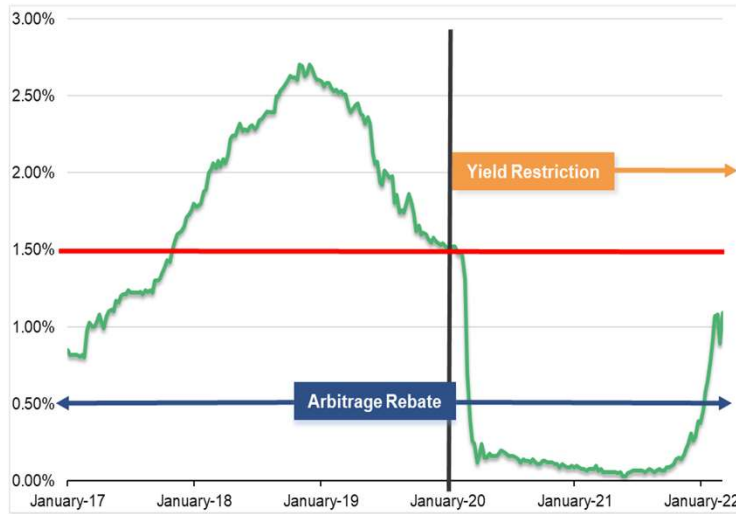
Eighteen-Month Exception:

- 15% at 6 Months
- 60% at 12 Months
- 100% at 18 Months (5% reasonable retainage)

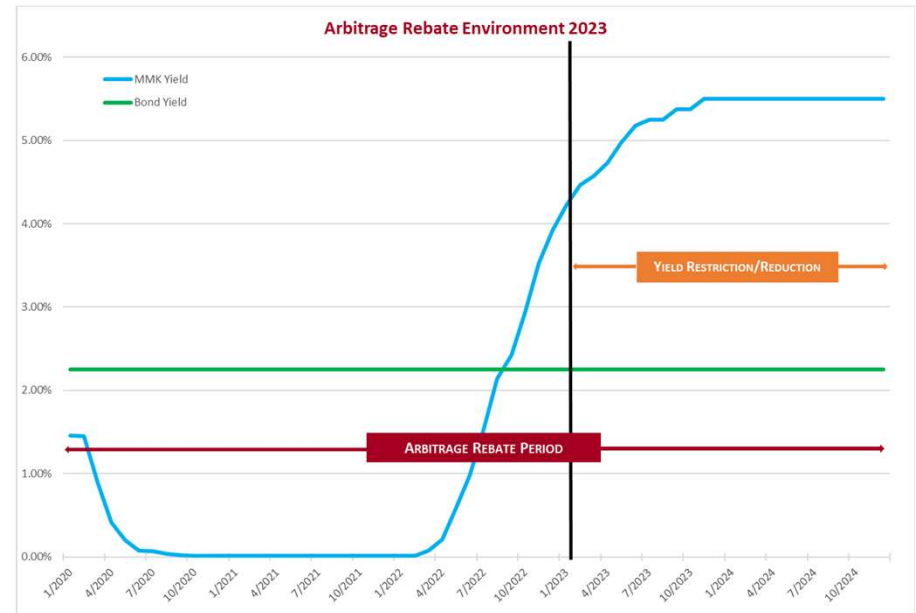
Two-Year Construction Exception:

- 10% at 6 Months
- 45% at 12 Months
- 75% at 18 Months
- 100% at 24 Months (5% reasonable retainage)

Why all this chatter about Arbitrage Liabilities?



← 5-year period starting in 2017...

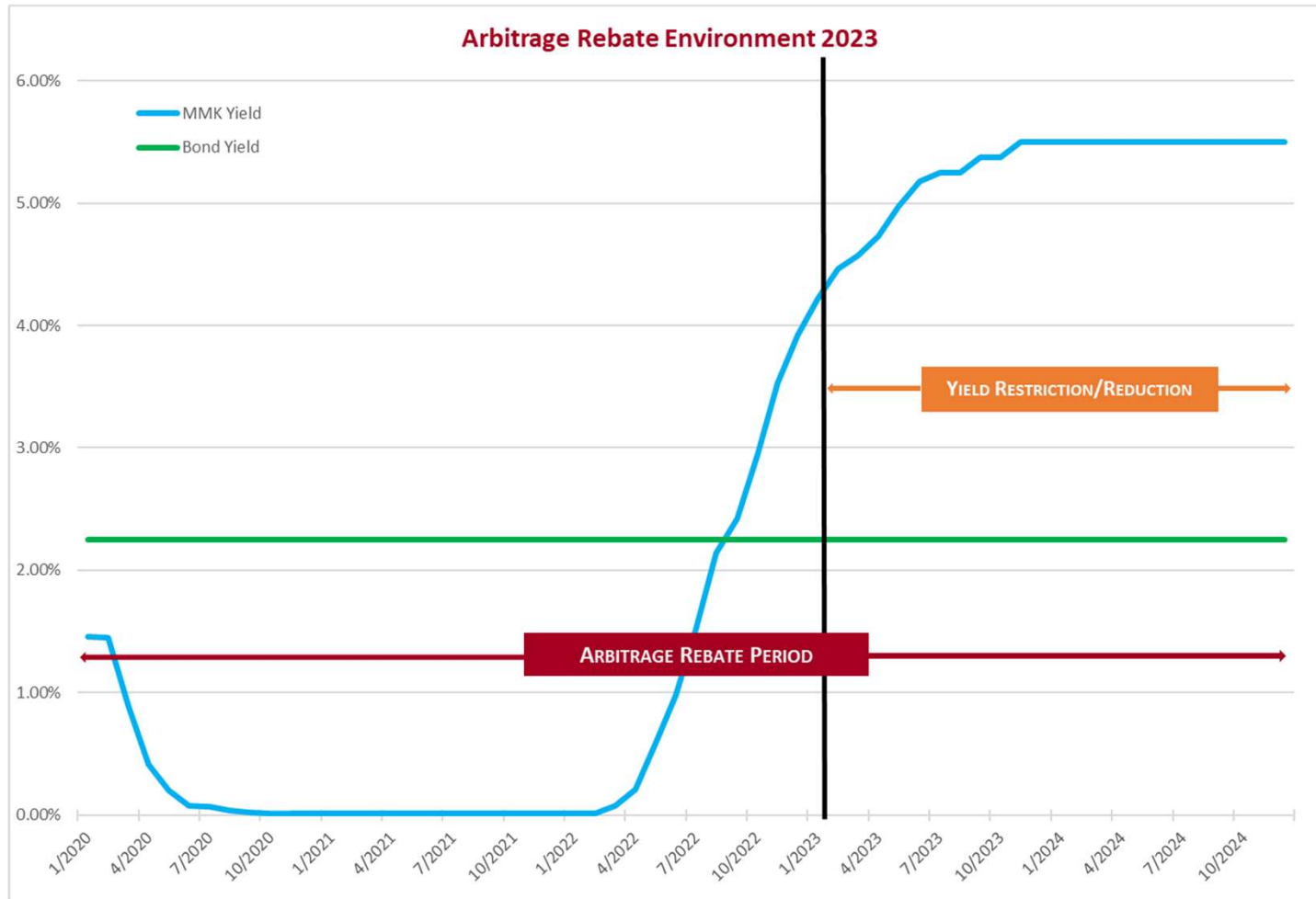


Very different from 5-year period starting in 2020...



Arbitrage Rebate versus Yield Restriction

Rising Investment Rates Create *Natural* Arbitrage



Arbitrage Rebate versus Yield Restriction

Comparison

ARBITRAGE REBATE

Example:

First Installment Period

(Years 1 - 5)

Investment Yield:	1.90%
<u>Bond Yield:</u>	<u>2.25%</u>
Arbitrage:	-0.35%

No Rebate payment due

YIELD RESTRICTION

Example:

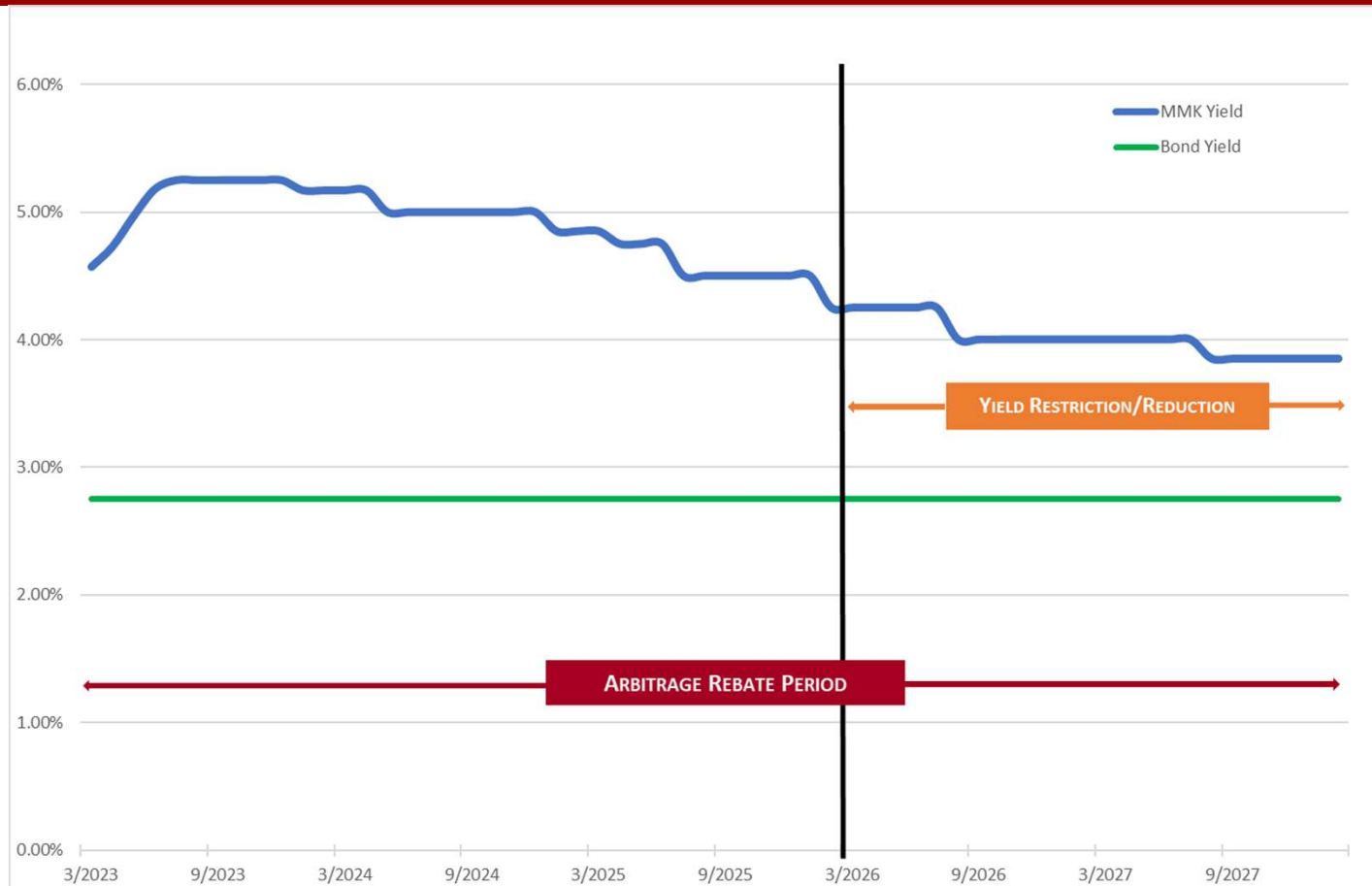
First Installment Period

(Years 4 – 5)

Investment Yield:	4.000%
<u>Bond Yield + .125%:</u>	<u>2.375%</u>
Earnings over Bond Yield:	1.625%

Yield Reduction payment due

Series 2023 - Natural Arbitrage



For illustrative purposes only.

Best Practices for Arbitrage Rebate Compliance

- ❖ Check with bond counsel regarding reimbursement resolutions.
- ❖ Have compliance reports completed annually versus waiting until the fifth-year/installment period.

Best Practices for Arbitrage Rebate Compliance

- ❖ Inform your arbitrage rebate firm of changes to an issue, such as being refunded. Evaluation dates change.
- ❖ Maintain good records by keeping:
 - Bank/Investment/Trust Statements
 - Bond Transcript
 - Past Arbitrage Rebate Reports

IRS requirement: Keep all records for tax-exempt issues at least 3 – 6 years after bonds paid in full.

Written Procedures for Arbitrage Rebate Compliance

What is the IRS looking for in Written Procedures?

1. Documentation
2. Who is in charge of overseeing compliance?
3. Who is responsible for making sure calculations/reports are completed?
4. Will your department complete calculations in house? Or will an outside firm be hired?
5. Use of Proceeds / Change in use
6. Education and Training
7. Record Keeping

Arbitrage Rebate Compliance and Follow Up

- You can complete the arbitrage rebate report yourself or outsource it.
- If you find you are going to owe rebate, and it isn't the final computation date, you must pay at least 90%. The final payment can be deferred until the end of the calculation period.
- If you are late with your payment, you have to write an "innocent failure" letter to explain (Revenue procedure 2005-40 and 2005-28).
- Nonpayment of arbitrage rebate can result in a loss of tax-exemption for your bonds.
- Have a policy and process in place, mark your calendars!

**Arbitrage
earnings CAN be
a GOOD thing!**

- You earned the most bang for your buck!
- Your investment return was good.
- Being prepared when the installment date arrives, no one is caught off guard and everyone is ready when the payment is due.

Thank You
for Your
Attention!

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