FIRST SOUTHWEST COMPANY

Arbitrage Rebate Training

Texas Public Finance Authority

December 6, 2002

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Arbitrage Rebate Training

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- Arbitrage Terminology
- General Arbitrage Rebate Requirements
- Exceptions to the Rebate Requirements

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- Accounting and Allocation Rule
- Calculating the Rebate Amount
- IRS Enforcement
- TPFA's Role in Maintaining Arbitrage Requirements

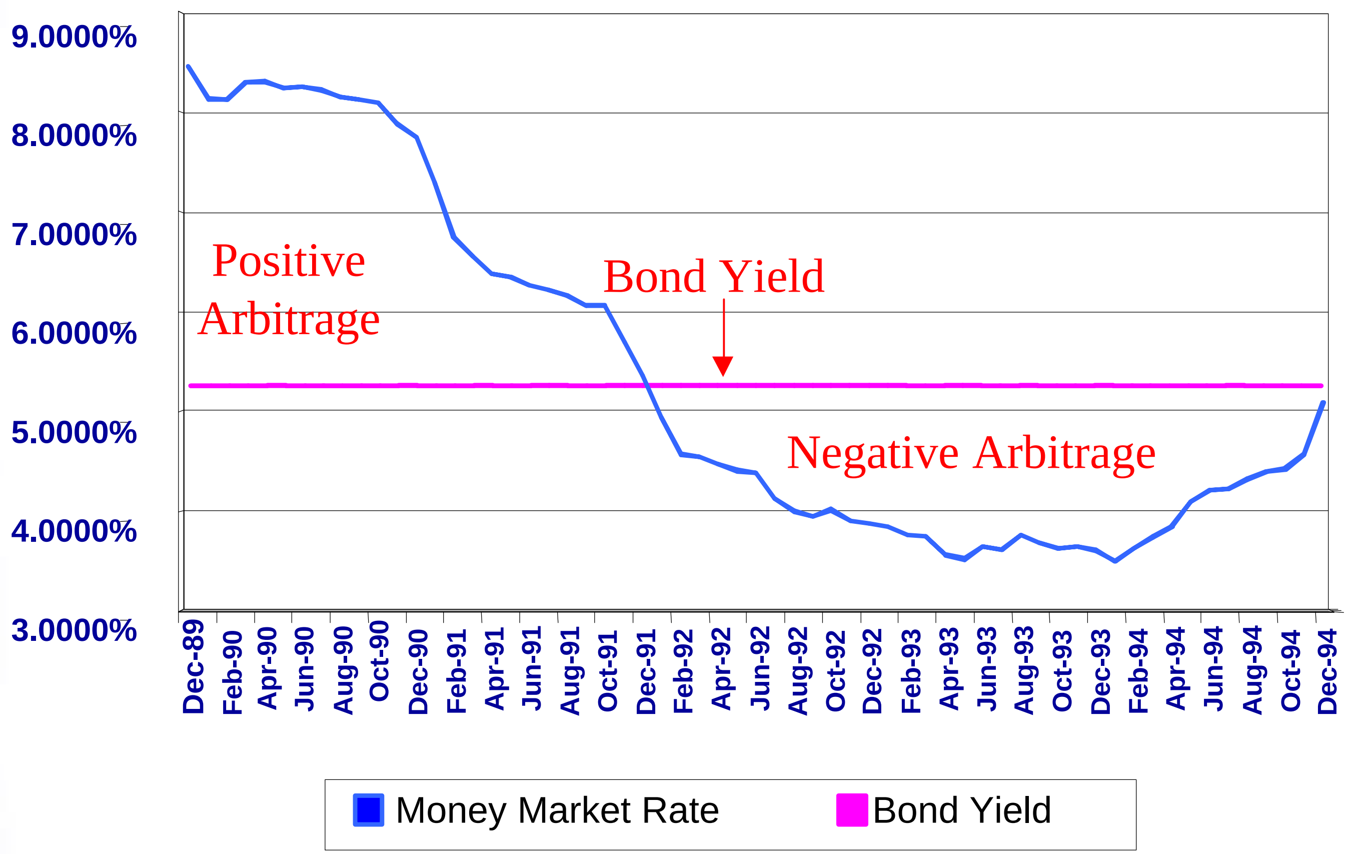
Basics of Arbitrage Compliance for Tax-Exempt Bond Proceeds

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.

In a Nutshell

- Your job? Spend the proceeds!
- TPFA’s job? Maximize interest earnings
- Rebate – not a “bad” tax
- Earn as much as you can – up to the bond yield and spend proceeds as quickly as possible

Net Funding

- TPFA projects interest earnings based on the estimated expenditure schedule
- Size of the bond issue is reduced by the amount of the estimated interest earnings
- Deviations in timing, amount of expenditures or in interest rates will cause variances in project funds

Net Funding Example

Date	Deposit	Interest @ 3%	Scheduled Draws
12/1/02	9,837,984.42	-	1,000,000.00
3/1/03	-	66,038.16	2,000,000.00
6/1/03	-	51,587.44	3,000,000.00
9/1/03	-	29,556.65	2,000,000.00
12/1/03	-	14,833.33	2,000,000.00
Total	9,837,984.42	62,015.58	10,000,000.00

Required IRS Reporting Dates

2/24/94	2/24/99	2/24/2004	2/24/2009	2/15/2014
Delivery Date	Installment Calculation Date	Installment Calculation Date	Installment Calculation Date	Final Calculation Date

Required Payment Amounts

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

Required Payment Amounts

- TPFA performs rebate calculation estimates annually, but makes payments as required every 5 years.
- Computation of Rebate Amount is a future value calculation – not simple math.

Penalties for Noncompliance of Arbitrage Regulations

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

General Anti-Abuse Rule

Bonds are arbitrage bonds (taxable) if abusive arbitrage device is used.

- Abusive arbitrage device:
  – Enables the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and
  – Overburdens the tax-exempt market.

Overburdening the Tax-Exempt Market

- A transaction overburdens the market if it results in:
  - issuing more bonds,
  - **issuing bonds earlier**, or
  - allowing bonds to remain outstanding longer than necessary to accomplish governmental purpose.

Consequences of Overburdening the Market

- Investments are restricted to a yield not greater than 1/1000th of 1% above the yield on the bonds.
- Issue not eligible for yield reduction payment.
- Proceeds must be spent on a “bond-proceeds-spent-last” basis.

Exceptions to the Rebate Requirements

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.

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 (including reasonably expected earnings).

18-Month Spending Exception

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

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 %

Sample 24-Month Spending Requirements

	Issue Price	$10,043,800.30
Less:	Cost of Issuance	<43,800.30>
	Reserve Fund (funded with bond proceeds)	<1,000,000.00>
Plus:	Estimated Earnings **During 24-Month Period**	950,000.00
	Available Construction Proceeds (ACP)	9,950,000.00
	Actual Earnings During 24-Month Period:	875,000.00

Required Cumulative Expenditures:

6 Months	10%	=	995,000.00
12 Months	45%	=	4,477,500.00
18 Months	75%	=	7,462,500.00
24 Months	100%	=	9,875,000.00 (a)

(a) (proceeds plus actual interest earned)

Final Spending Period Exceptions

- Proceeds deemed spent if following occurs:
  - – Reasonable Retainage rule (less than 5% net sales proceeds)
  - – De Minimis Amount rule (lesser of 3% of issue price or $250,000)

Construction Issue

- At least **75%** of the available construction proceeds will be used to finance construction expenditures.

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.

Items to Consider About the 24-Month Exception

- Unexpected delay.
- Must include projected interest earnings.
- Negative arbitrage position.

Accounting and Allocation Rules

An allocation of gross proceeds to expenditures:

- Requires current outlay of cash
- Proceeds used to make grants considered spent on date of grant
- Proceeds to conduit borrower not spent until spent by borrower
- Proceeds of "reimbursement bonds" considered spent on date of reimbursement allocation

Timing Rule

An allocation of proceeds to expenditures must occur no later than 18 months after the later of:

- Date expenditure is paid
- Date project is placed in service

In any event, allocation must occur by 60 days after 5 year anniversary

Allocation of Gross Proceeds to an Issue

- Reasonable, consistently applied accounting methods.
- Consistently applied uniformly within a fiscal period and between fiscal periods.
- Bona fide deviations permitted.

Tracking Investments

- Rebate liability computed separately for each bond issue
- Investment activity must be tracked separately for each issue
- Commingled funds create unique problems

Allocation of Gross Proceeds to Expenditures

- Reasonable, consistently applied accounting method used:
  - Specific tracing method;
  - gross proceeds spent first method;
  - first-in, first out method; and
  - ratable allocation method.
- 5-Day cash outlay requirement for expenditure posting.

Commingled Fund Definition

- A "commingled fund" contains:
  - – proceeds of the issue, and,
  - – more than $25,000 of other funds.
- Must be invested without regard to their source.

Commingled Fund Allocations

- Commingled funds must use special allocation rules.
- Must allocate to investors at least every three months (daily, weekly, monthly or quarterly).
- Ratable allocation must be used (average daily balance or average monthly balance).

Let’s See What You’ve Learned!

List two of the four reasonable accounting methods, considered to be safe harbors for IRS purposes, in allocating expenditures within a commingled fund.

Bond Yield

- Benchmark for Computing Rebate Amount

- Two types of Issues
  - Fixed Rate
  - Variable Rate

Fixed Rate Issue

- We know principal, interest, coupon rates and yields at delivery for life of issue.
- In general, compute one overall yield to maturity to be used for all rebate calculations.
- Yield is a weighted average yield of all debt service payments.

Yield on a Variable Yield Issue

- Computed separately for each computation period.
  - Normally, 5 year yield periods
  - Alternatively, one year yield periods
- After first installment, must consistently apply one of the previous methods.

Variable Yield Issue Sample

- Computed separately:

– Year 1	3.25%
– Year 2	4.05%
– Year 3	4.50%
– Year 4	4.87%
– Year 5	5.12%

- Composite 5 year yield:

– Blended years 1-5	4.62%

Commercial Paper

- In general, each drawdown is treated as a separate bond issue for rebate.
- Therefore, CP program results in many issues and many bond yield calculations.
- Must trace rollovers.

IRS Enforcement Program

IRS Enforcement Program

- Tax-exempt bond enforcement program started in June 1993 in response to GAO criticisms.
- IRS coordinates its efforts with SEC.
- Organization structure revamped effective October 1, 1999.

Government Entities Sector

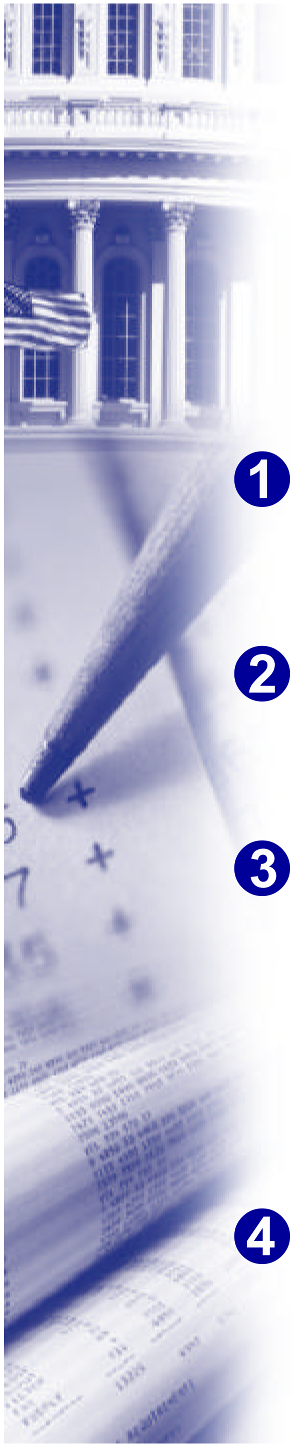
- Two functions:
  - Outreach, planning and review
  - Field operations and review

Outreach, Planning & Review (OPR)

- Voluntary Compliance Program
  - Settled about 20 cases in 2001
- IRS Website
  - www.irs.gov/bonds
- Publish CPE Texts
- Forms
  - 8038-R

Field Operations

- Currently about 300 exams/claims pending
- Processed about 290 cases/claims in 2001
- Correspondence Examination
- Yield Burning Examination



IRS Enforcement Program

❶ Random audits

❷ Issues identified by third parties

❸ Issues with possible abuses (GICs, Escrows, etc.)

❹ Issuer refund requests

Results of 2000 Compliance Survey

- 89 surveys mailed to private activity issuers
- Issued between 1992 and 1993
- Selected based upon 8038s filed at issuance
- 5 issuers failed to do any rebate calculations
- 22 issuers did calculations improperly

2001 Correspondence Examination

- 95 surveys mailed to fixed rate bonds issued in 1995
- Randomly selected issuers in 32 states
- Average size of issues - $50 million
- Surveys mailed in December 2001
- See sample survey letter - Tab 7 of your binder

Results of 2001 Correspondence Examination

- 57 – complied with rebate requirements
- 25 – IRS had questions/concerns
- 13 – have not yet responded
- May lead to full-fledged field audits

Areas of Interest in 2002

- Tax Revenue Anticipation Notes
- Solid Waste Issues
- Housing - Single Family and Multi Family
- 3rd Correspondence Examination - Private Activity Bonds Sold in 1995
- Document Retention Program w/ GFOA

Voluntary Closing Agreemen Program (VCAP)

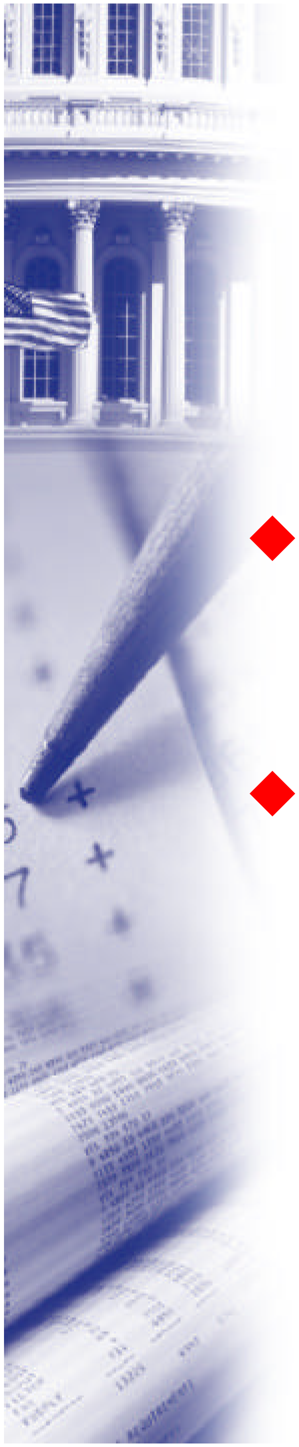
Allows issuers to approach the IRS to settle tax law problems with their bonds

- Announced October 1, 2001
- Results in smaller amount paid than if audited
- Issuers permitted to initiate discussions anonymously
- IRS is requesting comments about the program from the public

Voluntary Closing Agreement Program (VCAP)

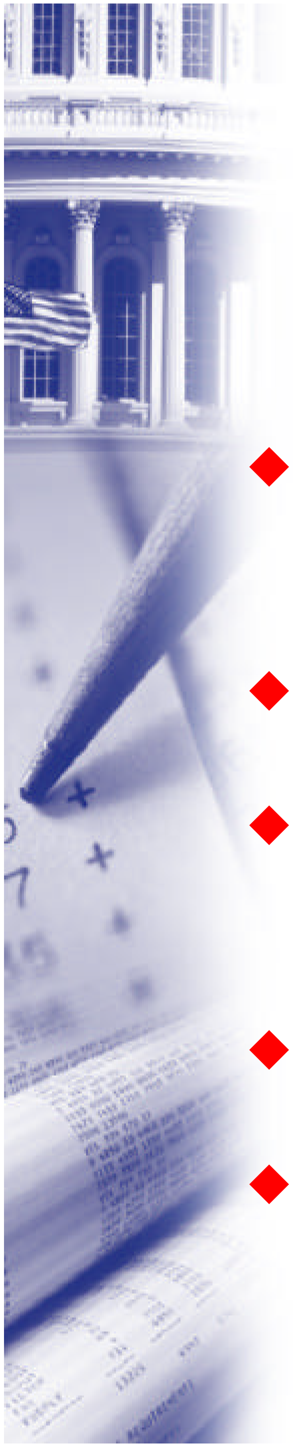
VCAP not available when:

- Issue currently under examination
- Violation can be remedied by existing remedial actions
- Tax-exempt status of bonds is at issue in court
- IRS determines that violation was due to willful neglect



IRS Enforcement Program

- 3-Year statute of limitations on ability for IRS to tax most bondholders.
- Record retention of certain information required for up to 6 years after bond issue has been retired.



TPFA's Role in Maintaining Arbitrage Rebate Requirements

- Establishes and tracks separate funds (not CP program)
- Tracks spending benchmarks
- Provides information to FSC to compute annual rebate estimate
- Establishes and updates rebate fund liability
- Remits all necessary payments to the IRS

Reporting to TPFA

- Monthly Status Reports
- Draw Requests
- Change in Project budget, scope, or expenditures (lesser of 10% or $1 million)

Reporting to Legislature

- Legislative oversight of bond funded projects
- Project Description
- Project Budget
- Project Status
- Project Cost (bonds vs. other sources)

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