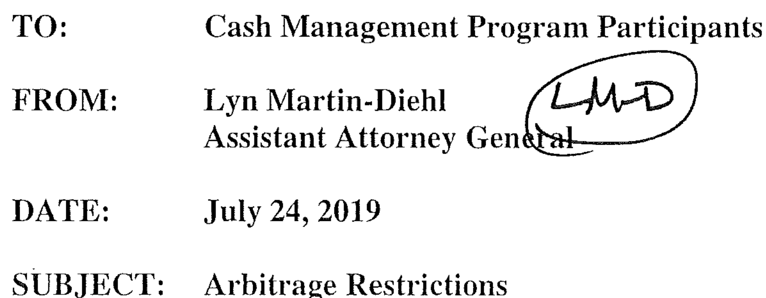
MEMORANDUM



TO: **Cash Management Program Participants**

FROM: **Lyn Martin-Diehl**
Assistant Attorney General

DATE: **July 24, 2019**

SUBJECT: **Arbitrage Restrictions**

This memorandum is intended to identify, describe and explain in general terms the federal tax restrictions applicable to the issuance of certificates of indebtedness by Oklahoma school districts and counties. The memorandum is not intended to address specific transactions, nor is it intended as a substitute for guidance by competent bond counsel.

GENERAL BACKGROUND

Oklahoma law permits school districts and counties to issue short-term financial obligations in the form of certificates of indebtedness. 70 O.S. Supp. 2014, § 5-136.1; 19 O.S. 2011, § 347. These certificates are issued to obtain proceeds used to pay the current expenses of the district or county pending receipt of ad valorem or other revenues. The Oklahoma Commission on School and County Funds Management approves suitable requests from qualified entities to participate in short-term cash management programs.

The Internal Revenue Code of 1986, as amended (the "Code" or the "IRC") provides that an obligation of a state, or a political subdivision of a state, is a "state or local bond." IRC § 103(c). The term "bond" is generic and includes bonds, notes or other evidences of obligation. Because Oklahoma school districts and counties are political subdivisions of the state, the certificates of indebtedness issued by these entities are, for federal tax purposes, "bonds." *Id.*

Interest on state or local bonds is ordinarily excluded from gross income. Thus, state or local obligations are known as tax-exempt bonds. IRC § 103(a). Tax-exempt bonds generally bear a lower rate of interest than other taxable investments and effectively reduce the cost of borrowing to governmental entities, such as school districts and counties.

The fact that tax-exempt bonds bear a lower rate of interest than taxable investments, also

gives rise to the potential for tax arbitrage. Tax arbitrage occurs when the proceeds of tax-exempt bonds are invested in taxable investments which bear a yield higher than the bonds issued. Bonds issued by state or local governments which are deemed to be arbitrage bonds are *not* tax-exempt. IRC § 103(b)(2).

ARBITRAGE BONDS

An obligation is an arbitrage bond if--at the time the obligation is issued--the issuer reasonably expects i.) to use the proceeds to acquire investments which have a higher yield, or ii.) to replace funds which were used to acquire investments which have a higher yield.[1] IRC § 148(a). In addition, an obligation may be *treated* as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue to acquire higher yielding investments. IRC § 148(a).

An obligation will not be treated as an arbitrage bond "even though the proceeds are invested in instruments that have a higher yield than the obligation" if the proceeds are so invested for only a reasonable temporary period until the funds are needed for the purpose for which the obligation was issued. IRC § 148(c)(1).[2]

To illustrate the operation of these rules, assume that a school district issues a certificate of indebtedness. If at the time of issuance the district *intends* to use the proceeds of the certificate to buy and hold investments which have a higher yield than the certificate, then the certificate will likely be deemed to be an arbitrage bond and denied tax-exempt status. However, if the district expects to use the proceeds of the certificate to pay the legitimate expenses of the district, and invests the funds for only a temporary period until they were actually needed, then the certificate will likely not be treated as an arbitrage bond. School districts and counties generally wish to avoid having the certificates they issue treated as arbitrage bonds.

The investment of amounts that are part of a reasonably required reserve or a replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds. The

1 Treas. Reg. §§ 1.148-1, 1.148-11(m) affect the issue price of bonds—a primary factor used in yield calculations relating to arbitrage. Underwriters have significant responsibilities under the regulations in documenting issue price. Underwriters participating in the Oklahoma Commission on School and County Cash Management Program must comply with said regulations and properly document issue price for calculation of arbitrage investment restrictions applicable to tax exempt bonds issued pursuant to the school and county funds management program.

2 On April 9, 2019, the IRS issued Treas. Reg. § 1.148-1(e)(4). The provision clarifies that the definition of "investment-type property" in which bond proceeds may be invested with regard to arbitrage determinations, does *not* include real or personal property acquired with bond proceeds for reasons other than investments. The amendment is applicable to bonds sold on or after July 8, 2019. Issuers may, however, elect to apply the provision to bonds sold before July 8, 2019. Districts and counties should consult with qualified bond counsel as to the application of the rule and its application to the facts of particular transactions when contemplating bond issuance.

amount of gross proceeds of an issue that qualifies as a reasonable required reserve or replacement fund may not exceed an amount equal to the least of i.) 10% of the stated principal amount of the issue, the maximum annual principal and interest requirement on the issue, or ii.) 125% of the average annual principal and interest requirements on the issue. The determination of whether an issue consists of arbitrage bonds under Section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of this issue. Treas. Reg. § 1.148-2(b). An issuer may establish its reasonable expectations through certification.

To establish such expectations, an officer of the issuer responsible for issuing bonds should, in good faith, certify the issuer's expectations as of the issue date. The certification must state the facts and estimates that form the basis of the issuer's expectations. While certification is *evidence* of the issuer's expectations, it does not establish conclusions of law regarding the issuer's *actual* expectations. Treas. Reg. § 1.148-2(b)(2).

The regulations also contain an anti-abuse provision which prohibits an issuer from employing "an abusive arbitrage device" in connection with the issuance. An abusive device is defined as an action having the effect of enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage and overburdening the tax-exempt bond market. Treas. Reg. § 1.148-10(a)(2). An action overburdens the tax-exempt bond market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purpose of the bonds, based on all the facts and circumstances. Factors evidencing an over issuance include i.) the issuance of a bond, the proceeds of which, are reasonably expected to exceed by a more than a minor portion of the amount necessary to accomplish the governmental purpose of the issue, or ii.) an issue, the proceeds of which are, in fact, substantially in excess of the amount of the sale proceeds allocated to expenditures for the governmental purpose of the issue. Treas. Reg. § 1.148-10(a)(4).

THE REBATE REQUIREMENT

The Code generally requires issuers, including school districts and counties, to return or "rebate" any arbitrage earnings to the United States. IRC § 148(f). The amount of rebate payable is the amount earned from investing the proceeds of the issue, minus the amount which would have been earned if such proceeds had been invested at a rate equal to the yield on the issue. IRC § 148(f).[3] Where a governmental issuer fails to comply with the rebate requirement, its obligations

3 New issue price regulations went into effect on December 9, 2016, and apply to bonds issued on or after June 7, 2017. Treas. Reg. §§ 1.148-1, 1.148-11(m). These changes affect the issue price factor used in yield calculations relating to arbitrage and made significant changes to Underwriter responsibilities in documenting issue price. The

may be treated as arbitrage bonds. IRC § 148(f).[4]

EXEMPTIONS FROM THE REBATE REQUIREMENT

The Code provides a number of exemptions from the rebate requirement. An issuer *need not rebate arbitrage earnings* on an issue which falls within one of these exemptions. Conversely, an issuer *must pay rebate* on any issue which does not come within any exemption. Two exemptions are most pertinent: the spend-out exemption and the small issuer exemption.

1. The Spend-Out Exemption

An obligation will be exempt from rebate if the governmental entity which issued the certificate expends the proceeds on legitimate governmental expenses within six months of the date of issuance. IRC § 148(f)(4)(B). The Code creates a special "safe harbor" rule for determining whether the proceeds of tax-anticipation notes, such as certificates of indebtedness, are expended within six months. Under this rule, a certificate of indebtedness will not be subject to rebate if at some point within six months after the issuance of the certificate, the "cumulative cash-flow deficit" of the school district or county exceeds 90% of the proceeds of the issue. IRC § 148(f)(4)(B).

The "cumulative cash-flow deficit" of a school district or county is the amount by which the actual expenses that ordinarily would be paid out of tax or other revenues exceeds the amount of funds available--other than the proceeds of the issue, but including the funds earned from investing the proceeds--during the period for payment of expenses. IRC § 148(f)(4)(B).

Because the six month spend-out exemption is based on the issuer's actual cash-flow deficit, it essentially creates a "look-back" test. That is, to determine whether a district or county is in compliance, the entity must look back over its actual cumulative cash-flow deficit to see if it

Commission requires that Underwriters participating in the Oklahoma Commission on School and County Cash Management Program comply with said regulations and properly document issue price for calculation of arbitrage investment restrictions applicable to tax exempt bonds.

4 The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 (the "Tax Cuts and Jobs Act" or "PL 115-97"), repealed and amended various provisions of the American Recovery and Reinvestment Act of 2009 (the "Stimulus Act") which previously supplemented Code Section 148 and other Code sections relating to arbitrage. To determine the effects of the Tax Cuts and Jobs Act with relation to removal of provisions of the Stimulus Act of 2009 under which the district may previously have received grants, financial assistance and or issued bonds permitted specifically under the Stimulus Act, e.g., qualified school construction bonds, requires complex factual analysis. School districts and counties should consult with qualified bond counsel to analyze the impact of PL 115-97 with regard to the issuer's circumstances.

totals 90% or more of the amount of the proceeds of the certificate. If within six months of the date of the issue the cumulative deficit is 90% or more of the proceeds, then the school district or county will not be required to pay rebate; otherwise, the issue will be subject to the usual rebate requirement.

2. The Small Issuer Exemption

The Code also creates an exemption for small issuers. Under this provision, a certificate issued by a school district or county[5] which will not issue more than $5,000,000 in tax-exempt obligations during the relevant calendar year is not subject to rebate if at least 95% of the proceeds of the certificate are to be used to pay the expenses of the school district or county. IRC § 148(f)(4)(D). Under limited circumstances, obligations for new school construction may be as much as $15,000,000 and still come under the exception. IRC § 148(f)(4)(D)(vii).

Unlike the spend-out exemption, the small issuer exemption creates a prospective or "look-forward" test. This test requires that a school district or county intend, at the time of the issue, to spend at least 95% of the proceeds of the certificate on its legitimate governmental expenses. If this intention does not exist or cannot be justified by reasonable projections, then the school district or county must pay rebate.

POTENTIAL CONSEQUENCES OF NONCOMPLIANCE

There are a number of consequences which may arise in the event a school district or county fails to comply with the federal and state restrictions pertaining to the issuance of tax-exempt certificates of indebtedness. Consequences fall generally into three categories.

First, there are potential federal consequences. Certificates that fail to comply may be deemed to be arbitrage bonds within Section 103 of the Code and denied tax-exempt status. A school district or county would then also be required to pay rebate to the United States on past arbitrage earnings.

Potential state law consequences also exist. Title 60, Section 177.3 makes participating in a cash management program without obtaining Commission approval a criminal offense. Section 177.3 also makes the submission of false or misleading documents to the Commission a criminal offense. A violation is a misdemeanor punishable by a fine of not less than one thousand dollars and/or imprisonment for up to one year in the county jail. Any official convicted of this

5 Counties which are beneficiaries of public trusts that issue tax exempt bonds should consider the aggregation rule set forth in Section 148(f)(4)(D) of the Code in determining whether they meet the exemption's $5,000,000 ceiling.

offense may be removed from office and any professional license issued to the official may be revoked. *Id.*

Finally, there are other collateral consequences to consider in the event a school district or county fails to comply with the applicable arbitrage regulations and a certificate issued by the school district or county is, therefore, deemed to be an arbitrage bond. These include the potential adverse effect on the credit rating of the entity and the increased cost or potential inability of the entity to obtain credit enhancement in the future. Moreover, there is a substantial likelihood of additional liability on the part of the school district or county, and perhaps the individual officers, as a result of any breach of the covenants contained in any contract or arbitrage certificate executed in connection with the issuance of the certificate of indebtedness.

THE ROLE OF THE COMMISSION

The Commission is directed by state law to oversee the participation of school districts and counties in short-term cash management programs. In carrying out this mandate, the Commission has used its best efforts to prepare forms which will enable school districts and counties to comply with all applicable regulations. Observing the guidelines imposed by state law and the requirements established by the Commission, however, does not necessarily equate with compliance with the federal regulations.

The Commission cannot assure school districts and counties that they are in compliance with federal tax law. Rather, the ultimate responsibility for compliance with federal arbitrage restrictions falls upon the local school district and county officials who direct that a district or county participate in the program, and who place their signatures on the authorizing documents.

This informal memorandum represents the views of the author and does not constitute an official opinion of the Attorney General.