Arbitrage Compliance Procedures: Timing and Use of Proceeds

Oklahoma Capitol Improvement Authority

Office of Management and Enterprise Services, Central Accounting and Reporting

ADOPTED: November 15, 2013

This document is designed to inform Oklahoma government recipient entities of the proper procedures for the use of proceeds from bonds issued by the Oklahoma Capitol Improvement Authority (OCIA). The following processes will assure compliance with state law, IRS Code, GASB and GAAP.

The State of Oklahoma's ability to issue tax-advantaged bonds is dependent upon proper bond issuance, appropriate expenditure of proceeds and prudent debt service administration. The proper issuance of bonds requires that OCIA issue bonds only when funds are required and when proceeds from each issuance are enough to fund the identified project or projects (and no more). Additionally, proceeds must be spent with due diligence.

Capital projects funded by bond proceeds must comply with approved use requirements and be completed in a timely fashion to avoid monetary penalties and potential IRS restrictions on the state's ability to issue tax-advantaged bonds.

Subsequent to the proper issuance and deposit of bond proceeds into a construction account, agencies must follow specific procedures. These procedures require agencies to develop and submit certain documents to OCIA and, when required, the Office of Management and Enterprise Services division of Construction and Properties (CAP). Required documentation must be submitted during the construction phase and in some cases, prior to bond issuance. Agencies are also required to submit regular updates as requested.

Key Terms:

Spend Plan – This is the recipient agency's plan to expend bond proceeds with due diligence. This plan should anticipate construction completion and full expenditure within the three-year temporary period. More abbreviated spend plans provide the opportunity for agencies to utilize all interest earnings, up to and including any positive arbitrage.

Temporary Period – This is a three-year temporary period directly following bond issuance. This is the period in which at least 85% of bond proceeds should be spent and construction completed. Additionally, this is the period in which arbitrage, both positive and negative amounts, are tracked by the arbitrage consultant and any payments from the appropriate bond funds are made to the IRS.

Non-Construction Issue – A non-construction issue is a bond issue in which less than 75% of the debt issuance is for construction. Generally, a non-construction issue is used to primarily purchase land and/or equipment (greater than 25% of proceeds).

Private Use – Government-bond constructed facilities must not transfer the benefits of tax-exempt financing to non-governmental entities. Exceeding the IRS limitation on private use can result in a conversion of tax-advantaged bonds to private use bonds and place the ability of the state to further issue tax-advantaged bonds in jeopardy.

Completion Certificate – A completion certificate must be provided by the recipient agency once construction has been completed. This signifies that project funds are no longer required and prompts OCIA to utilize them as directed by the bond transcript. This certificate should be submitted no later than three years after issuance or as soon as possible thereafter.

Arbitrage – This term refers to interest earnings generated when gross proceeds of a bond issue are used to acquire investments that earn a yield materially greater than the yield on the bonds issued. This calculation is made during the three-year temporary period following the issuance of the bonds. Special attention should be paid to spending exceptions that allow recipient agencies to retain some or all excess earnings when projects are completed within certain time periods. Be aware that positive arbitrage calculations may result in payments to the IRS from remaining construction funds or other available funds.

Yield Restriction – Similar to arbitrage, the IRS disallows investment yields in excess of bond yields after the temporary period. There are no exceptions to this rule.

Refunding – Refunding refers to newly issued OCIA bonds with lower interest rates or for budgetary purposes to reduce the current or long-term debt service requirements of the state.

Responsible Party	**Action**	**Time Frame**
OCIA Staff	Provide instructions to state agencies regarding Internal Revenue Code (IRS) requirements for the timing and use of bond proceeds. [**Municipal Bonds 101** & **IRS Compliance Guide**] Generally, bond proceeds are for capital expenditures and not working capital expenditures, i.e., current operations expenses.	Prior to bond sale and ongoing
OCIA Staff	Provide guidance to state agencies setting forth current IRC spending requirements to qualify for the *temporary period spending exemption* pursuant to section 1.148-2(e)(2)	Prior to bond sale and ongoing
OCIA Staff	Provide guidance to state agencies on IRC rebate spending exceptions which allow the state to retain earnings on invested proceeds above calculated arbitrage yields for Project/Construction funds and for the Cost of Issuance. Calculations are made by individual bond series.	Pre-bond sale and ongoing

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State Agencies / Grantees	State agencies/grantees must affirm to OCIA that the *Temporary Period* exception timeline is met. State agencies/grantees should certify via their spend plan in the Interagency Agreement that the *Temporary Period* is satisfied in order for the state to issue the bonds tax-exempt. At the time the bonds are issued, the state agency/grantee must reasonably expect to: • Spend, or have a binding commitment to an unrelated third party to spend, at least 5% of the net sale proceeds of the issue within 6 months after the issue date; • Spend at least 85% of the net sale proceeds of the issue within three years after the issue date; and • Proceed with spending the proceeds of the issue on eligible expenditures with due diligence.	Pre-bond sale and ongoing Charge agencies for additional rebate reports and administrative expenses required beyond three-year temporary period
State Agencies/ Grantees	Provide a spend plan that shows the spending exception to arbitrage rebate for *construction issues* of at least 75% of available proceeds spent on *construction expenditures* as defined in the tax certificate for the issue as follows: <u>Elapsed Time After Issuance</u> <u>Required Spending</u> 6 months 10% 12 months 45% 18 months 75% 24 months 100%	Pre-bond sale and ongoing
State Agencies/ Grantees	Provide a spend plan that shows the spending exception to arbitrage rebate for *non-construction issues* as follows: <u>Elapsed Time After Issuance</u> <u>Required Spending</u> 6 months 15% 12 months 60% 18 months 100% Example: when more than 25% of the proceeds of a new borrowing issue are spent on a combination of land and equipment (other than specially made equipment) that issue is eligible only for the 18 month exception in this section.	Pre-bond sale and ongoing
State agencies/ Grantees	Prepare formal *Agency Requests to Reimburse* letter. Identify any expenditure to be reimbursed from bond proceeds. Submit letter to OCIA for review and approval prior to bond issue date. Intent to reimburse must be made within 60 days of original expenditure.	Pre-bond sale and ongoing

Responsible Party	Action	Time Frame
OCIA Staff/State Bond Advisor	Review state agency requests to borrow debt service costs (capitalized interest) to ensure period for which debt is borrowed. This precedes the date assets are placed in service as provided by state agencies in the *Completion Certificate*.	Pre-bond sale
OCIA Staff	Provide guidance and requirements on operational readiness to state agencies/grantees new to bond issues.	Pre-bond sale
OCIA Staff	Include the requirement in interagency agreement that 85% of bond proceeds be spent within three years of issuance to ensure compliance with rules on excessive borrowing. 100% of the bond proceeds should be spent within the first five years after issuance. Additional restrictions on available funds and investment yield may be required beyond the three-year temporary period. Recipient agency /grantee may incur additional OCIA charges.	During pre-bond sale communication
OCIA Staff/State Agency/Bond Counsel	Evaluate potential *private use* of financed assets, including use by such entities as the federal government, and private research at universities or local governments. Determine appropriate action for proposed private use, including removing the item from the financing or selling taxable bonds to finance the asset.	Prior to bond sale
OCIA Staff	Review and approve state agency requests to incur costs prior to date of bond sale to ensure compliance with all necessary components of *Agency Request to Reimburse* letter. Prepare formal OCIA *Declaration of Official Intent to Reimburse Capital Costs*.	Intent to Reimburse Declaration completed **before expenditure is incurred**
State Agencies	For bond proceeds that will be granted to unrelated parties, you must enter into written contractual agreement with the unrelated party. Include in contractual agreement that obligations of the grant are **limited solely** to conditions required to ensure and confirm expenditures are made in accordance with the purpose of the grant and granted funds will only be used for capital expenditures unless the use of granted funds for working capital is discussed with bond counsel prior to the bond sale in accordance with tax code. Provide a copy of agreement to OCIA for approval.	Agreement is completed before expenditure is incurred

Responsible Party	Action	Time Frame
OCIA Staff	Compare actual cash draws and expenditures to spend plans through review of the Office of the State Treasurer statements. If necessary, evaluate alternative uses of funds, e.g., permit use by other qualifying projects, to maintain compliance with IRC spending requirements.	Semi-annually
OCIA Staff	At the time that annual arbitrage rebate liability communications and surveys are conducted with state agencies, request affirmative confirmation that assets acquired with bond proceeds continue to be used for eligible purposes.	Annually in July/August
State Agencies	Report on the status of assets acquired with tax-exempt bond proceeds. If necessary, work with OCIA on remedial action up to and including defeasance of outstanding bonds.	Annually in July/August
State Agencies	Submit *Completion Certificate* when bond project has been completed as required in the *Bond Resolution*.	At the time asset is ready for its intended use
OCIA Staff	After receipt of *Completion Certificate*, analyze balance of the project/construction fund. In consultation with counsel, determine appropriate course of action regarding investment/use of remaining proceeds, including potential requirement to yield-restrict investments. OCIA will follow the specific bond resolution with regard to the disposition of excess construction funds. They may be used for another qualifying asset if permitted.	At receipt of the *Completion Certificate*
State Agencies/ Grantees OCIA Staff/Bond Counsel	In the rare event a state agency/grantee abandons a project that it originally expected to undertake as a capital project: • Pre-Issuance Abandonment: If the state agency/ grantee has made expenditures for a capital project that it intended to reimburse with tax-exempt bond proceeds of a future issue, and the project is abandoned prior to the issue, the state agency/grantee will not seek to reimburse such expenditures with tax-exempt bonds. • Post-Issuance Abandonment: If the state agency/grantee abandons a capital project after	At project abandonment

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	expenditures on such project have been repaid with tax-exempt bond proceeds, the state agency/grantee will notify OCIA staff. OCIA will consult with bond counsel to determine if the state agency/grantee may reallocate the tax-exempt bonds originally allocated to the project to another capital project or other applicable remedies provided under tax code.	
State Agencies/ Grantees	To the extent that all proceeds from a bond issue have not been spent within three years, state agencies/grantees will provide a written explanation from project management to OCIA describing what circumstances changed after the bonds were issued such that all of the proceeds could not be spent within three years. State agencies/grantees shall provide an amended spend plan with a revised *date certain* completion date. If a positive rebate liability exists at the end of the temporary three-year period, OCIA staff may retain sufficient construction proceeds to satisfy potential IRS rebate payments.	Third anniversary of bond issue Notice shall be given as soon as the recipient agency is aware that bond construction proceeds will not be spent prior to the three-year anniversary
OCIA Staff	If bond proceeds remain unexpended after three years, work with counsel to determine if such proceeds should be placed only in *yield-restricted* investments, pursuant to the following regulations: • The project proceeds of tax-exempt borrowings for capital projects can be invested at an unrestricted yield for a temporary period of three years per Treasury Reg. Sec. 1.148-2(e)(2). • After the third anniversary date, any unspent project proceeds are yield restricted to the bond yield plus 1/8% per Treasury Reg. Sec. 1.148-2(d)(2)(i). • However, the regulations permit issuers to make yield reduction payments to satisfy the yield restriction rule per Treasury Reg. Sec. 1.148-5(c)(3)(i)(A). • The yield reduction payments need to be calculated at the same time and in the same manner as rebate payments per Treasury Reg. Sec. 1.148-5(c)(2)(i). ▪ Although the calculation of yield reduction payments and rebate payments are made at the same time and in the same manner, the calculation of yield reduction payments is a separate calculation and so the amount of rebate owed would not generally equal the	Three years after bond sale date

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	amount of yield reduction payments owed at a computation date. Example: It took five years to spend all project proceeds of an issue. For the first two and a half years there was negative arbitrage, but for the second two and a half years there was positive arbitrage. It is possible that over the five year rebate computation period, the state did not earn net positive arbitrage on the project fund and would not owe rebate. However, if the state did earn positive arbitrage after the temporary period ended at year three (between year three and five), the state would owe yield reduction payments in an amount necessary to bring the post year three yield down to the bond yield plus 0.125%. The state could owe yield reduction payments but not rebate.	