

**THREE YEAR NOTES
(A TALE OF TOO MANY CITIES)**

by
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1. Introduction

In the early days of the Tax-exempt Bond Program, the Service examined a number of transactions that involved issuance of short-term bonds (usually three-year notes) (referred to herein as the “Notes”) purportedly to finance construction of public school buildings. The issuers of the Notes were school districts located in small towns and cities. The examinations revealed that a number of the transactions were abusive arbitrage devices. In fact, certain participants were convicted and incarcerated. It was assumed that such transactions were part of history and the Service would not encounter such abusive transactions again.

Unfortunately, the Service has recently come across presentations made by investment banking firms to school districts located in small towns, cities and counties that sound similar to the prior Notes transaction. Attached as an Exhibit to this Article is a print out of a power point presentation made by an investment banking firm to a number of school districts. Such presentations raise concerns at the Service that arbitrage driven transactions continue to be promoted and done. The purpose of this Article is to raise awareness of small issuers (including, but not limited to, school districts) and to avoid pitfalls found in similar abusive arbitrage transactions.

2. Recent Examinations

The attached presentation is misleading in that it focuses solely on how an issuer can earn arbitrage without regard to meeting the spending requirements for bond proceeds under section 148 of the Code and the regulations thereunder. The presentation does not clearly state that for an issuer to be permitted to earn arbitrage profits during the initial temporary period, the issuer must reasonably expect to meet the spending requirements set forth in Treas. Reg. § 1.148-2(e)(2). Additionally, the presentation fails to state that in order to keep the arbitrage profits, the issuer must meet one of the exceptions to the rebate requirement.

The Service has examined certain Notes purportedly issued to finance capital projects and, in a number of these cases, preliminary adverse letters have been issued. As a result of the examinations, the Service has concluded that a number of issuers, on the date of issue, did not reasonably expect to spend the proceeds of the Notes on the governmental purpose for which the Notes were

issued. Listed below are some of the facts that have lead the Service to come to this conclusion.

- 1) Exposure to market risk was not consistent with stated draw down needs.
- 2) Normal preplanning for school projects like feasibility studies, architectural and site planning are not started when the notes are issued.
- 3) Voters and/or school boards have not officially approved a project.
- 4) School board officials have bragged publicly about arbitrage earnings to local reporters.
- 5) Bond proceeds were used to purchase securities at marked up prices.
- 6) Personal relationships between school board members and the underwriters.
- 7) Actual capital budget plans did not show planned spending within the 3-year period.
- 8) Some towns were closing down schools and had no planned construction.
- 9) State planning records are inconsistent with expectations to spend within three years.
- 10) There was immediate redemption of the notes upon receipt of audit letters.

3. Spending Requirements

Although interest earned on any State or local bond is excluded from gross income of a bondholder, this exclusion does not apply to an arbitrage bond, as defined under section 148 of the Code.

Under section 148 of the Code and regulations, an arbitrage bond is a state or local bond all or a portion of the proceeds of which are reasonably expected to be used to acquire investments that have a materially higher yield than the yield on the bonds. Generally, yield on an investment is materially higher if such yield is one-eighth of one percent over the yield of the bonds. The regulations provide a

number of exceptions to this general rule, one of which is that proceeds of bonds issued to finance a capital project may be invested without regard to the yield restriction rule for an initial three year temporary period. See section 1.148-2(e)(2) of the regulations.

To qualify under this exception, an issuer must demonstrate that, on the date of issue, it reasonably expected the proceeds to be allocated to expenditures for capital projects. Specifically, an issuer must reasonably expect to (1) satisfy the expenditure test by allocating 85 percent of the net sale proceeds to expenditures on capital projects by the end of the 3-year period; (2) satisfy the time test by incurring within six months an obligation to a third-party to spend 5 percent of the net sale proceeds; and (3) satisfy the due diligence test by proceeding with due diligence to complete capital projects funded by the issue.

4. Rebate Exception

Even if an issuer satisfies the spending requirements discussed above it must rebate any arbitrage earned during the initial temporary period unless it falls within a specific exception. One of the exceptions to rebate generally utilized by the school districts is provided in section 148(f)(4)(D). This is referred to as the “small issuer exception.”

The small issuer exception to paying rebate is available to an issuer if the aggregate amount of all tax-exempt bonds issued by the issuer in the calendar year does not exceed \$5 million. Under section 148(f)(4)(D)(vii), the \$5 Million is increased to the lesser of \$15 million or the amount of bonds attributable to financing the construction of public school facilities¹.

Generally, if the following requirements of section 148(f)(4)(D)(i) are satisfied an issuer will qualify for the small issuer exception:

- 1) A governmental unit with general taxing powers issues the issue;
- 2) No bond which is part of an issue can be a private activity bond;
- 3) 95 percent or more of the net proceeds of such issue are to be used for local government activities of the issuer; and

¹ Although a question remains whether the expenditure requirement under section 148(f)(4)(D)(vii) must be actually met (rather than a reasonable expectation to spend) for the issuer to qualify for the rebate exception under such section.

- 4) The aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by this governmental unit is not reasonably expected to exceed \$5 million (\$15 million for school boards) during the calendar year.

5. Conclusion

The Service recommends that a small issuer presented with the possibility of a transaction pursuant to which it can earn “free” money, should contact bond and tax counsel and proceed cautiously. The maxim “if it is true good to be true, it probably is,” also applies to issuance and sale of municipal obligations. The Service has an active outreach and education program and the issuer should feel free to contact the Service if it has any questions regarding the proposed transaction. Additionally, personnel in the Tax Exempt Bonds, Outreach, Planning and Review function (“OPR”) are available to discuss requirements to be met for interest on the bonds to be excludible from gross income. Contact OPR at (202) 283-2999 (not a toll free number). The Service also encourages issuers to visit its website at www.irs.gov/bonds to obtain additional educational publications and materials.

Exhibit

***Little Town School District
Short-term Arbitrage
Financing***

***\$10,000,000
Three Year Note Issue***

Background

- ◆ ***Current Tax Regulations permit School Boards to prefund projects up to three years.***
- ◆ ***School Boards are allowed to borrow up to \$10 Million in every calendar year and keep any positive investments earnings (interest earned above what is being paid on notes) gained on the money.***
- ◆ ***In current market conditions, School Boards have and are borrowing money in advance of projects - just to invest the proceeds for three years and legally keep the positive investment earnings.***

Example:

1. ***A School Board borrows \$10 Million for 3 years on a tax-exempt basis and pays an annual interest rate of 5.2%.***
2. ***The School Board then invests the money in government securities over the same 3 year period and receives an annual interest rate of 7.05%.***
3. ***With this situation, the School Board earns 1.85% in excess interest to what it is paying on the Notes. This is referred to as positive arbitrage.***

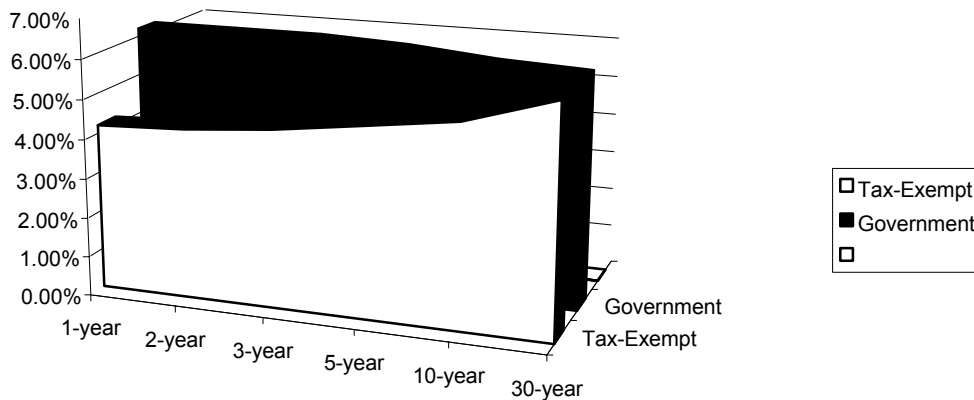
Current Investment Conditions

- ◆ ***Short-term government investments are presently yielding more than long-term government investments, resulting in an inverted yield curve.***

Example:

As of 5/23/00, a 3-year U.S. Treasury yielded 6.67%, compared to a 30 year U.S. Treasury which yielded 6.17%.

- ◆ ***On the other hand, short-term tax-exempt issues were yielding less than the long-term tax-exempt issues, resulting in a positive sloping yield curve.***
- ◆ ***This market creates a spread of anywhere between 1.4% and 1.8%. Usually this spread averages between 1.2% and 1.35%.***



Conditions for Borrowers

- ◆ *The School Board must have reasonable expectations to spend this \$10 Million on capital projects over the next three calendar years (in certain situations this 3-year period can be extended to 5 years).*

- ◆ *The School Board must make a commitment or an attempt to spend 5% (\$500,000) of the proceeds within the first 6 months. This can include money spent on feasibility studies or architectural contract. Any money spent 60 days prior to the issue can also be applied against this 5%.*

- ◆ *The School Board must not have issued any tax-exempt debt prior to the Note Issue. This includes bond refundings and tax-exempt leases. Any amount that is borrowed before the note offering would reduce the amount of the issue for the arbitrage note.*

Example of Cashflow

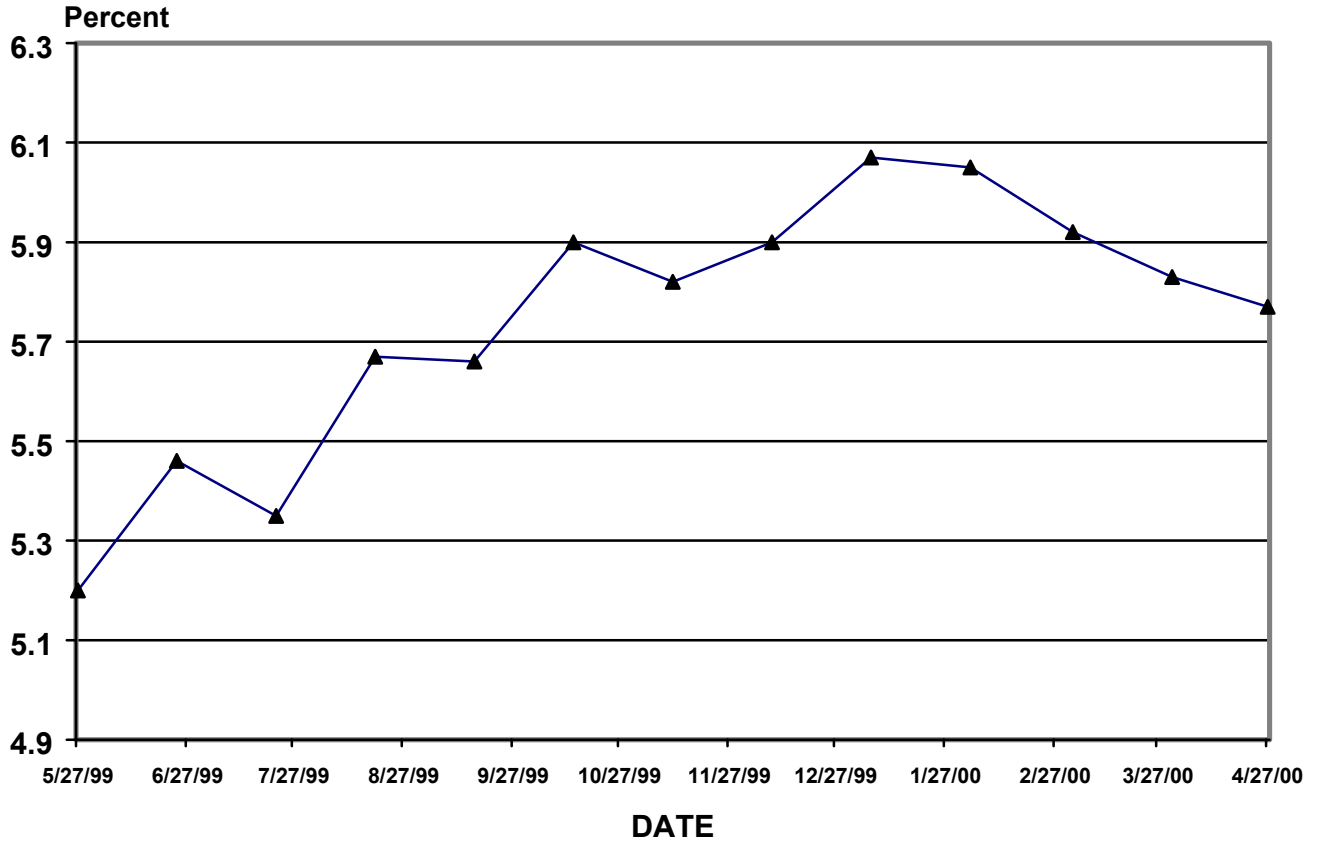
In today's market, the Board could achieve an investment rate of 1.85% higher than they will pay on the bonds. This would earn the Board, on average, \$15,277 per month, until the money is drawn down.

Assuming the money is spent on the last day of the notes, the Board could earn \$549,972 in positive arbitrage and legally keep the money.

Bond Buyer 20 Bond Index

Twelve Month History

As of May 19, 2000



**The Index is representative of General Obligation Bonds maturing
in 20 years.**