Council of Development Finance Agencies

Advanced Bond Finance Course

ARBITRAGE AND REBATE

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January 30, 2009

Introduction

1. December 2003 - IRS announces it will work on arbitrage issues to a great extent.
2. Arbitrage - Under section 148, an "arbitrage bond" is not tax-exempt.
3. An arbitrage bond is "any bond issue whose proceeds are invested, over the term of the bond issue, at a rate of return that is materially higher that the interest rate on the bonds."
4. Rebate - The IRS requires the arbitrage profits be rebated unless there is a rebate exception applicable to the issue.
5. No economic benefit - The Borrower does not get the economic benefit for investing bond proceeds above the bond yield unless the issue qualifies for a rebate exception.

Higher Yielding Investments

1. Definition - Depends whether the investment property is a "purpose" or "non-purpose" investment.
2. "Purpose investment“ - An investment that is acquired to carry out the governmental purpose of an issue such as building a new library, courthouse, fire station etc.
3. "Non-purpose investment“ - An investment property that is NOT a purpose investment (it may include the debt service reserve fund).
4. Definition of Investment property
   - any Security (165 g-2-a);
   - any obligation; or
   - any annuity contract

   It also includes property principally held as a passive vehicle for the production of income.

Higher Yielding Investments, cont.

5. Materially higher yielding (thus an arbitrage bond) - if the yield on the investments exceeds the yield on the bond issue of which they are proceeds by more than .125 percent (this is one-eighth of one percent above the bond yield). However, purpose investments involving loans to organizations described in Section 501(c)(3) of the Code or loans to substantial number of persons representing the general public by more than 1.5 percent.
6. Qualified costs - for a purpose investment are included if paid by the borrower (costs to sell the investment, costs of issuing or repaying the issue, cost to sell or retire the investment, costs of issuance and underwriter's discount).

Higher Yielding Investments, cont.

7. Qualified costs - for a non-purpose investment, these include qualified administrative costs that are "reasonable" direct administrative costs, other carrying costs, brokerage commissions but not legal and accounting fees, record keeping or similar costs. This does not include overhead.
8. Reasonable costs - if the administrative costs are comparable to the administrative costs that would be charged for the same investment, or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax exempt bond.

Three to Five Year Temporary Periods

1. Unexpended Proceeds - may be invested without restrictions to yield during an initial temporary period but will still be subject to rebate, unless there is a spending exception to rebate.
2. Temp period of three years - From the date of issue of the bonds if the conduit borrower incurs within 6 months of the date of the issuance of the bonds a substantial obligation to a third party to expend at least 5 percent of the new sale proceeds of the issue on the capital projects. (Not binding if it is subject to contingencies within the control of the borrower.)
3. 85% net sale proceeds must be allocated - for expenditures on capital projects by the end of the 3 year temporary period.
4. Reasonable required reserve or replacement fund - May be invested without restriction as to yield, although the investment earnings will be subject to rebate, whether or not funded from bond proceeds, if the size limitation imposed on this type of fund is satisfied.

Three to Five Year Temporary Periods, cont.

5. The reserve may not exceed the lesser of 1) 10 percent of the principle amount of the bonds, or 2) the maximum annual principal and interest requirements on the issue or 125 percent of the average annual principal and interest requirements on the issue.
6. 13 month temporary period - amounts in the bona fide debt service fund.
7. Minor portion - Lesser of 5 percent of the proceeds of the issue or $100,000 may be invested without restriction as to yield but will be subject to rebate.

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YIELD

1. Not equivalent to the interest rate.
2. Also depends on the purchase or issue price paid (premium, discount, or par and the term of the bond issue).
3. Need to know the issue price - first price at which a substantial number of bonds (more than 10%) are sold to the public.
4. Yield must be calculated to at least 4 decimal places.

Exceptions to Arbitrage Rebate

1. Small Issuer ($5,000,000) exception - Not available for private activity bonds, only governmental bonds.
2. Bona Fide Debt Service Funds - Investment earnings on a bona fide debt service fund to the extent such earnings are less than $100,0000 during such bond year (deemed met if the average annual debt service in respect of an issue does not exceed $2.5 million).

Exceptions to Arbitrage Rebate, cont.

3. 6-month exception to Rebate - Rebate need not be paid to the federal government if all the proceeds of the bonds are spent within 6 months following the issue date of the bonds.

4. 18-month exception to Rebate - If the bond proceeds are spent in accordance with the following spend schedule:
   - At least 15 percent within 6 months,
   - At least 60 percent within 12 months, and
   - 100 percent within 18 months.

Bonds & Office Condos

January 30, 2009

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Advantages of Bond Financing

1. Interest on Bonds is exempt from federal income tax as well as from state and local taxes within the state of issuance.

2. Generally, interest rates are one to two percentage points below conventional market rates.

- **What are examples of the types of 501(c)(3) financings that can be done?**

- **What is new in this area?**

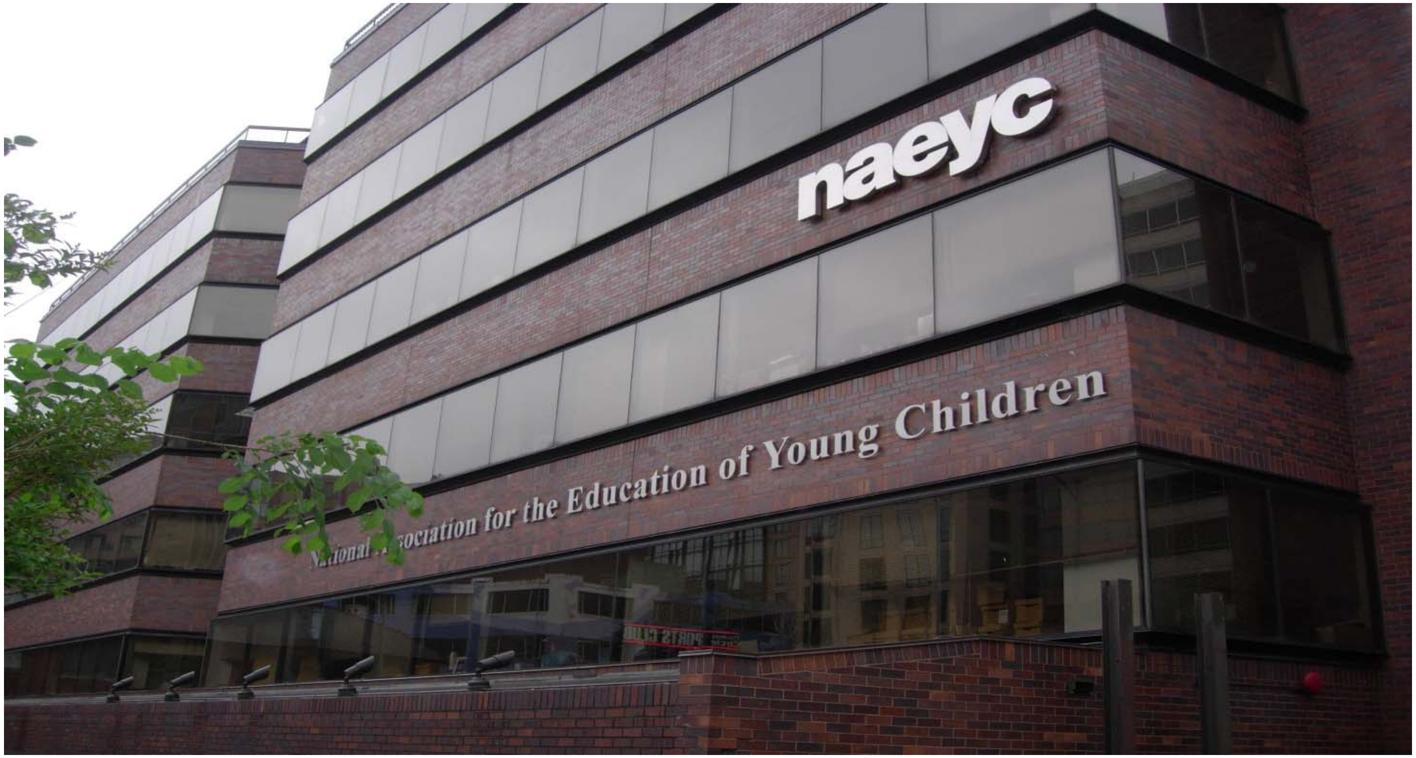
Examples:

Associations – 501(c)(3) organizations

Tax Exempt Bonds

1. **Purchase a building – may use less than all of the building**
2. **Renovate a building – may use less than all of the building**
3. **New Construction – may purchase a floor in an office condo**

National Association for the Education of Young Children



Building Acquisition with Tax Exempt Bonds

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Center for Community Change

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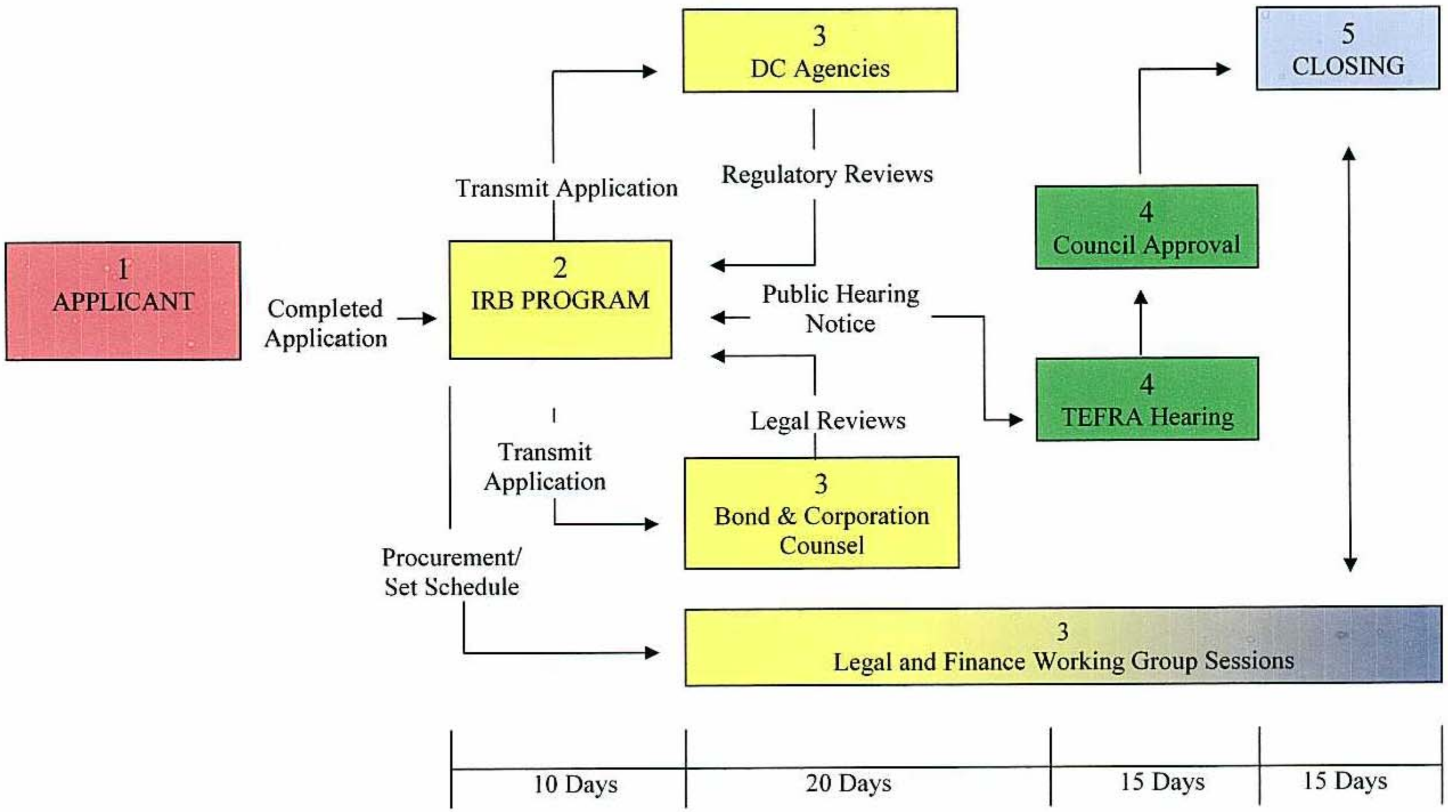
District of Columbia
Office of the Deputy Mayor for Planning and Economic Development
Revenue Bond Program
General Timeline



The Pew Charitable Trusts

- **Non Profit Village**
  - **901 E. Street, NW**

- **200 Million Dollars of Tax Exempt Bonds**

901 E Street, NW

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The Washington Post

Monday, June 16, 2008

BUSINESS

Pew's Mission to Lower Nonprofits' Office Rent

By Christopher Twarowski
Washington Post Staff Writer

Call it a nonprofit lifeline.

Pew Charitable Trusts, one of the largest nonprofit organizations in the nation, has acquired the 10-story office building at 901 E St. NW, just across the street from the J. Edgar Hoover Building. The 265,000 square-foot space will serve as the group's new Washington headquarters with a twist: Pew plans to lease 90 percent of the building to other nonprofit groups, at 10 to 15 percent below market rates.

"We plan to make this our home for a long, long time," says Rebecca W. Rimel, Pew Charitable Trusts' president and chief executive. "We are hoping to find nonprofits who want to make this their home for a long time."

Philadelphia-based Pew will combine its two downtown D.C. offices into the building on E Street NW. The organization has a staff in the area of about 150, which it expects to double over the next three years. Pew's increased presence in the District is fueled by a stronger emphasis on policy work and greater support from outside donors, Rimel said.

Pew's plan comes as other nonprofits have been leaving the District because of higher rents, said Sean Madigan, spokesman for the D.C. deputy mayor's office. Neil O. Albert, deputy mayor for planning and economic development, last year created a task force designed to keep nonprofit groups in the city as well as attract new ones.

"It's a real problem," Rimel said. "Many nonprofits want to be in the District for all of the reasons that we do: access to talent, access to colleagues and other nonprofits, access to policymakers. And at these rental rates, it's very, very hard to not only find the resources, but to justify the investment."

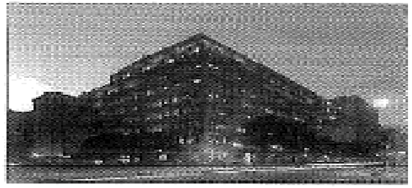
The going rate for comparable commercial space in the area is from the mid-$50s to the mid-$60s per square foot, said Matt Feeney, a managing partner at tenant-advisory firm CresaPartners who worked with Pew to find an office.

After two years of looking, Pew closed on its new digs in February for $155 million. Funding came from $200 million in bonds, $180 million of them tax-exempt, made possible with the help of the task force. The bonds were issued by the D.C. revenue bond program and financed by PNC Bank. The District has no obligation.

"It's a win-win for everybody," says Olivia Shay Byrne, chair of the nonprofit task force and a partner in the law firm Reed Smith, which has an office on K Street. Shay-Byrne worked closely with Pew, acting as the borrower's counsel. "It's a win for the District. It's a win for the tenants. It's great for Pew because it's part of their mission to do this."

A 2007 report by the Nonprofit Roundtable of Greater Washington found that about 7,600 local, national and international nonprofit organizations served the greater Washington area. According to the report, sponsored by the World Bank, those nonprofits combined provided about 218,000 jobs and $9.6 billion in annual wages and taxes.

Pew is renovating the building, implementing a number of environmentally responsible construction practices and designs in the hope of achieving LEED (Leadership in Energy and Environmental Design) certification for the overall building and the higher LEED gold certification for its space. Pew will move into the top four floors beginning in December. The building is available immediately for new tenants.



PEW CHARITABLE TRUSTS

Pew Charitable Trusts is reducing rent for nonprofits at its new D.C. location.

Rimel said Pew is negotiating with potential tenants but would not disclose names. To sweeten the pot, nonprofits that move in will have use of the building's 1,750-square-foot conference room and meeting space, along with its fitness center.

One nonprofit besides Pew will definitely be there: the American Cancer Society, which has had an office on the fifth floor since 2001. It has three years left on its lease, after which it can renegotiate with Pew.

"We're pleased to be a part of an effort to strengthen the nonprofit presence in Washington," said Steven Weiss, the society's senior director of media advocacy. "So much of the culture of Washington, D.C., is found in the nonprofit community, and we consider that a vital part of what makes the city as vibrant as it is."

501(c)(4) or (6)

Trade Associations

Enterprise Zone Bonds

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National Association of Realtors

Purchase and Lease of Balance of the Building

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Office Condos

- Tax exempt bonds can be used to buy a floor in an office condo.
- Acquisition and Renovation Cost
- 2% costs of issuance
- Examples

The New York Times

Wednesday, October 10, 2007

Office Condos Present Nonprofits With New Alternatives For Purchases In The District

Square Feet

The New York Times

Fleeing Rents in Capital, Nonprofits Buy Condos

By EUGENE L. MEYER

WASHINGTON, Oct. 5 — Buffeted by steadily rising rents and a shortage of space for midsize offices here, a number of nonprofit organizations in the nation's capital have hit upon a solution to their needs: They are going condo.

Since July, several nonprofit groups have agreed to buy space in new and renovated office buildings in prime downtown Washington locations; more office condos are on the horizon.

"From what I've seen, there's absolutely a pent-up demand for ownership of quality modern office space, which is very hard to find," said Eugene J. Kenney, a vice president of Akridge, a Washington real estate firm that has renovated one downtown building to create office condos and is looking to do more.

The trend has been abetted by a Washington revenue bond program that allows nonprofits to obtain low-rate financing, typically 2 percentage points below market rates. Interest on these government bonds is tax-exempt, making them attractive to investors.

"It's a fairly new piece of the puzzle," said William Liggins, director of Washington's revenue bond program.

Rents have risen so sharply that some tenants find them prohibitive; this makes office condos increasingly attractive. "The leasing market is on a 12-year roll, especially the last three years," said Geoffrey Kieffer, a broker of leasing services with Woodmark Real Estate Services, a commercial real estate firm. Some buildings have been "breaking the $70 to 80 per square foot rental barrier" in terms of annual rent, he said.

What is more, blocks of space suitable for small and midsize companies are in short supply. "There have been no options for 50,000 square feet or smaller," Mr. Kieffer said.

But now there are. So far this year, five properties in Washington have been converted into office condos or are being transformed. The owners are marketing these spaces heavily to nonprofits, which are a major employer in this city of national associations and lobbying groups.

"They typically cannot afford at these prices to buy a whole office building in D.C. but are able to buy maybe a floor or two," said Olivia Shay-Byrne, a lawyer who has worked with several nonprofits seeking to buy condos.

She said that the city has 1,904 associations, occupying 14.8 million square feet, and that 1,148 of them are in Washington's central business district.

Leasing costs were up 6 percent in the second quarter this year from last year, and the average annual rental was $49.77 a square foot, the highest in the Washington metropolitan region, according to a survey by Grubb & Ellis, a national real estate firm.

Washington officials worry that nonprofits may move to the suburbs, where, according to Neil O. Albert, deputy mayor for planning and economic development, "rents are cheaper and real estate taxes are not that high."

Traditionally, many of these organizations have occupied late 19th-century and early 20th-century brownstones, formerly private mansions, in the Capitol Hill and Dupont Circle neighborhoods. But the impressive staircases of those buildings and other touches redolent of the Gilded Age are not an ideal configuration for a professional office.

The opportunity to buy an office condo has "allowed these people to come out of their town house and consolidate onto one floor, with tremendous efficiencies," said Aaron Pomerantz, a Washington-based senior vice president of Grub & Ellis.

The American Educational Research Association has done just that. Two months ago, the 25,000-member association, formed in 1916, bought the top two floors of 1430 K Street NW, a new glass-faced 12-story building. It was the first building to go all-condo in the heart of downtown.

From the penthouse deck, the association's deputy director, Phoebe H. Stevenson, can look west along K Street, the fabled street of lobbyists. Facing north, she can see the National Cathedral in the distance.

The group has had its headquarters since the early 1960s in two adjoining brownstones it owns off Dupont Circle, Ms. Stevenson said. "As staff size continued to grow, the charm of historical brownstones no longer met our needs for size and functionality," she said.

Now, the association owns nearly 13,000 square feet of Class A office space. There is plenty of room for its staff of 28, and it is even subleasing 1,100 square feet.

The research group paid $6.8 million for its new offices and spent $1.1 million in preparing the space for occupancy. The group is asking $4.5 million for its two brownstones and is financing its current purchase in full through tax-exempt bonds at a variable rate 1.2 percent below market. "In the long run, this is tremendous savings for a nonprofit," she said.

Ms. Stevenson shared the good news with her former employer, the 14,600-member American Sociological Association, which is now buying two floors in the same building. The association, founded in 1905, was nearing the end of its lease in an older building and was interested in buying space to house its staff of 30, but not a whole building.

"We didn't have any indication one way or another the rents were going up — it just looked attractive to purchase," said Les Briggs, director for finance. "We weren't interested in really being landlords. Nor did we have money to afford to purchase a whole building. The notion of condos is very attractive because it allows you to buy and own just what you need."

Using Washington's bond financing, the association is putting down $2.3 million and borrowing $7.7 million, to cover the purchase price of $8.2 million for 13,016 square feet — about $630 a square foot — and three parking spaces, along with additional build-out costs. The group hopes to close the sale in November and to move into its condo office next February or March.

Akridge, which bought and renovated 1016 16th Street NW for office condos, has sold out all but the sixth floor, for which it is asking $2.95 million, or $673 a square foot for 4,384 square feet. The Jesuit Conference is the largest purchaser in the building, having acquired 17,500 square feet on four floors for itself and two related organizations at an undisclosed cost.

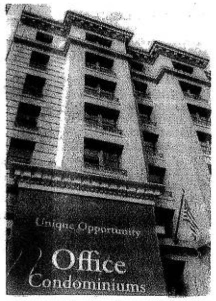
A few blocks west, the National Football League Players Association sold its building at 2021 L Street NW in June for $23.4 million to investors who plan to increase its size to 79,000 square feet, from 54,000, by adding two floors and extending its rear footprint. There are also plans to convert the former United Press International building at 1510 H Street NW into condo offices.

Other plans are afoot to construct an 11-story all-condo office building at 111 K Street NE, formerly a triangular 7,000-square-foot parking lot near Union Station.

Even before ground is broken there, letters of intent have been signed for 90 percent of the building, all from nonprofits, which will be paying up to $650 a square foot, according to Bruce Pascal, the broker for the building.

"This would be first successful preselling of an office condo that hasn't even broken ground yet," he said.

But, he predicted, not the last. "If you could buy less than a full building and still get ownership benefits, the market would respond to that."



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1430 K Street, NW

- **American Education Research Association Tax Exempt Bonds**
- **American Sociological Association Tax Exempt Bonds**

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1016 16th Street

- **The Fordham Foundation Tax Exempt Bonds**

- **The Jesuit Conference, Inc. Tax Exempt Bonds**

111 K Street, NW

New Eleven-Story

Class A Office Condominiums

(90,000 square feet)

J Street Development

- **NOMA District**
- **Roof-top terrace**

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The End