



BOARD OF SCHOOL TRUSTEES

KELLER INDEPENDENT SCHOOL DISTRICT

4B. Preview

Date: January 10, 2005

SUBJECT: CONTRACT FOR ARBITRAGE SERVICES

BOARD GOAL: Budget and Finance

FISCAL NOTE: Contract costs and any arbitrage rebate due would be payable from interest earned on bonds

**ANTICIPATED
DATE FOR ACTION: January 24, 2005**

Background Information:

- The arbitrage rebate requirements have been in effect since 1986 and apply to any issuer of tax-exempt bonds. Prior to 1986, issuers could issue tax-exempt bonds at interest rates of 7%, invest the proceeds of those bonds at 9 or 10%, and make significant profits. In many cases, there were no projects associated with the bonds and issuers were simply issuing bonds in order to make these profits. Congress imposed the arbitrage rebate requirements in 1986 to stop these types of abuses.
- The current law states that if an issuer issues bonds with a borrowing cost, or yield of 4%, for example, and invests those proceeds at 5%, thus earning a 1% spread, that 1% spread must be remitted to the IRS in the form of an arbitrage rebate payment.
- These payments are required to be made every five years from the date the bonds are issued and on the final maturity date of the issue.
- Failure to comply with the rebate requirements could result in significant penalties.

It is time for arbitrage to be calculated on the 2000 bond issue. Interest rates have been extremely low over the last few years and it would seem that the District would not owe an arbitrage rebate. However, there are other factors included in the calculation of arbitrage, which could result in a rebate, such as any reserve funds in the debt service fund, refundings and yield restrictions. Because of these issues and because of the complexity of the calculations, management has concerns as to whether arbitrage has been calculated correctly in the past, as no documentation of prior arbitrage calculations for the District can be found.

Administrative Considerations:

First Southwest Company, the District's financial advisors, performs arbitrage rebate compliance services, including:

- Rebatable arbitrage computations every 5 years and on final maturity date
- Completion of the IRS Form 8038-T
- An opinion letter verifying that the rebate calculation results are accurate and consistent with the rebate requirements
- Computation of the correction amount and penalties required by the regulations
- Determination of a spending exception under the rebate requirements

A sample contract with fee schedule is attached. In any year that debt is issued, the District's arbitrage calculation fees will be covered by the normal financial advisor fees of First Southwest. In years when no debt is issued, fees will only be assessed for issues for which a calculation is deemed necessary, as issues meeting certain requirements may be exempt from calculation. The arbitrage rebate payment would be payable from interest revenue earned on the particular bond issue. Fees for the calculation of arbitrage would be payable from either bond interest or bond proceeds.

JPMorgan Chase Bank has contacted the District for a Treasury Rebate Report (arbitrage report) on the 1994 Certificates of Participation. Once an entity has been contacted for this report, there is a 180-day good faith period in which no penalties will be assessed if the report is provided within that time frame. The District must have arbitrage calculated on this issue and, for the purposes of due diligence, should have calculations performed on other appropriate issues to determine any liability to the IRS.

The sample contract has been sent to legal counsel for review.

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Respectfully submitted,

Kent Morrison
Assistant Supt. of Finance