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Inverted Yield Curve and Single Family Convertible Option Bonds

As the inverted yield curve continues, and even widens at times (effectively for the first time in almost 20 years), there is renewed interest in the use of Convertible Option Bonds ("COBs") to maximize investment earnings in the short term, primarily for single family mortgage revenue bonds. But the use of COBs raises some complex federal tax issues. Below is a summary of the applicable tax issues, and how to deal with them for a typical single family COB issue.

Typical Structure

- Convertible option bonds (COBs) are nominal long-term bonds (e.g., 30 years), typically with a one-year mandatory put/remarketing.
- COB proceeds are escrowed for the initial one-year period and invested at a rate of interest in excess of the initial rate of the COBs.
- After the initial one-year period, COBs are tendered at par and subject to remarketing or redemption.
  - **This COB structure is used in lieu of a short-term bond (e.g., one year) with no remarketing provision. This is intended to avoid an argument from the IRS that the COB is being issued too early and for no applicable governmental purpose.**
- The intention is to refund the COBs on the mandatory tender date, but remarketing is an option.
- If remarketed, the structure of the remarketed COBs is set forth in the original COB authorizing indenture/resolution (to avoid reissuance concerns). Expenditure of the COB proceeds is not expected/permitted until the mandatory tender date.
- Generally, the COBs are issued along with another series of typical long-term bonds (the "Long Bonds") the proceeds of which will be immediately available to purchase/make loans (collectively, the "Composite Issue").
  - **We highly recommend this Composite Issue structure to avoid an argument by the IRS that the COBs were issued too early and therefore represent an arbitrage device.**

By issuing the Long Bonds with immediately drawable funds, along with COBs with delayed availability of funds, the issuer is providing an orderly use of proceeds of the Composite Issue over time. There may be circumstances in which the COB could be issued without companion Long Bonds. However, that would create a less defensible tax structure and would require issuer representations regarding expected use of funds and incurring commitments during the escrow period for the use of the proceeds.

Arbitrage

- Temporary period
  - If the HFA reasonably expects to spend at least 85% of the proceeds of the Composite Issue within three years, has binding commitments to expend at least 5% of the proceeds of the Composite Issue within six months, and proceeds with due diligence to purchase/make loans, the proceeds of the Composite Issue can be invested without regard to yield restriction.
    - **Note that, if the COB were issued by itself and not part of the Composite Issue, the satisfaction of the diligence requirement is harder to defend.**

- Arbitrage rebate
  - As a general rule, investment of the proceeds of the Composite Issue at a yield in excess of the yield of the Composite Issue will give rise to a rebate liability on the part of the Issuer of the Composite Issue.

  - Rebate exceptions
    - If all of the proceeds of the Composite Issue are spent within six months of the date of issuance of the Composite Issue, there will be no rebate liability.
      - Note that, by freezing the proceeds of the COB (e.g., no expenditures for one year), this rebate exception is impossible to satisfy.

    - If the following percentages of the proceeds of the Composite Issue are spent within the times designated, no arbitrage rebate will be required:
      - 15% of the proceeds of the Composite Issue spent within six months of the date of issuance of the Composite Issue; 60% of the proceeds of the Composite Issue spent within 12 months of the date of issuance of the Composite Issue; and 100% of the proceeds of the Composite Issue spent within 18 months of the date of issuance of the Composite Issue.
      - **Note that the ability to satisfy these spending requirements within the times stated will depend heavily upon the relative sizes of the COB and the Long Bonds as well as the period of time that the COB proceeds investments are not expected to be used/frozen.**

Housing Finance Agency Group

John Wagner
Omaha
(402) 231-8811
john.wagner@kutakrock.com

Michelle Adams
Atlanta
(404) 222-4646
michelle.adams@kutakrock.com

Kevin Barney
Chicago
(312) 602-4117
kevin.barney@kutakrock.com

Jeffrey Blumenfeld
Philadelphia/Chicago
(215) 299-4317
jeffrey.blumenfeld@kutakrock.com

Mitchell Bragin
Washington, D.C.
(202) 828-8450
mitchell.bragin@kutakrock.com

Sisera Daniel
Washington, D.C.
(202) 828-2327
sisera.daniel@kutakrock.com

Jim Hathaway
Little Rock
(501) 975-3137
jim.hathaway@kutakrock.com

Karilyn Kober
Omaha
(402) 231-8770
karilyn.kober@kutakrock.com

Steve Likes
Omaha/Minneapolis
(402) 661-8648
steve.likes@kutakrock.com

Erika Lynch
Omaha
(402) 231-8722
erika.lynch@kutakrock.com

Fred Marienthal
Denver
(303) 292-7817
frederic.marienthal@kutakrock.com

John McGill
Omaha
(402) 231-8974
johnk.mcgill@kutakrock.com

Drew Page
Omaha
(402) 661-8631
drew.page@kutakrock.com

Patti Peterson
Omaha
(402) 231-8785
patricia.peterson@kutakrock.com

Leslie Powell
Atlanta
(404) 222-4639
leslie.powell@kutakrock.com

Dawn Roth
Omaha
(402) 231-8772
dawn.roth@kutakrock.com

- **If the COB is refunded instead of remarketed, the transferred COB proceeds are treated as if they remained proceeds of the Composite Issue for purposes of determining whether the proceeds of the Composite Issue satisfied the 18-month expenditure test to avoid arbitrage rebate.**

- Bond yield
  - The Composite Issue is a variable yield bond issue because of the remarketing provision, and it converts to fixed yield when the COB is either remarketed or redeemed. Section 1.148-4(d) of the Income Tax Regulations provides that, if a variable yield bond issue (like the COB component of the Composite Issue) is later converted to a fixed yield bond issue, the yield of the Composite Issue is computed as if the Composite Issue were outstanding for no more than five years (the first rebate computation date). As of that date, the yield of the Composite Issue is recalculated for the remaining term of the Composite Issue.
    - **This five-year initial computation applies only for purposes of determining whether the investment of proceeds of the Composite Issue in non-purpose investments will give rise to any arbitrage rebate liability. Thus, satisfying the 18-month spending exception to rebate becomes more important. By cutting off the bond yield computation at the five-year anniversary, the COB long-term rate after conversion and on the Long Bonds gives much less weight to the Composite Issue bond yield calculation than a yield to maturity calculation.**
    - **For purposes of determining whether the yield of single-family mortgage loans is no more than 112.5 basis points above the yield of the Composite Issue, yield to maturity of the Composite Issue (with 100% FHA prepayment assumptions) applies, not the five-year computation.**

If you have questions about this summary, or variations of the typical COB structure used in the summary, please feel free to contact any member of Kutak Rock's Housing Finance Agency Practice Group. You may also visit us at www.KutakRock.com.