California Debt and Investment Advisory Commission

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Understanding Arbitrage

Presented by

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Background: Why we have Arbitrage Rebate

- To prevent abuses, the tax code limits the permitted uses of tax-exempt bonds
  - Prevents issuance of more bonds than are necessary
  - Prevents issuance of bonds earlier than is necessary
  - Prevents bonds from remaining outstanding longer than is necessary
  - Limitations on advance refunding
  - In other words, borrow what you need, when you need it, for an appropriate duration based on what is being financed.

- Tax law and Regulations create financial disincentives (i.e., arbitrage rebate) to prevent issuance of tax-exempt debt for profit-driven reasons
  - Yield restriction – IRC Section 148(b)
  - Arbitrage rebate – IRC Section 148(f)
  - Overlapping requirements – “Belt & Suspenders”

- Applies to every tax-exempt/tax-advantaged borrowing

How is Arbitrage Measured?

- Arbitrage % = Actual investment earnings yield (–) average borrowing rate (aka, the Arbitrage Yield)
- Arbitrage rebate liability =
  - Earnings of bond proceeds invested in taxable securities less (-)
  - Earnings of bond proceeds invested at the Arbitrage Yield
    - "Positive Arbitrage" = Actual Earnings > Earnings @ arbitrage yield (positive earnings yield spread)
    - "Negative Arbitrage" = Actual Earnings < Earnings @ arbitrage yield (negative earnings yield spread)
- Future value methodology
- Measured on an issue-by-issue basis
  - Within an issue, aggregated among funds

What is an Issue?

- Under the Regulations (1.150-1), an issue means 2 or more bonds that meet all of the following requirements:
  - Sold substantially at the same time – not less than 15 days apart
  - Sold pursuant to common plan of finance – bonds to finance the same or similar projects.
  - Payable from same source of funds

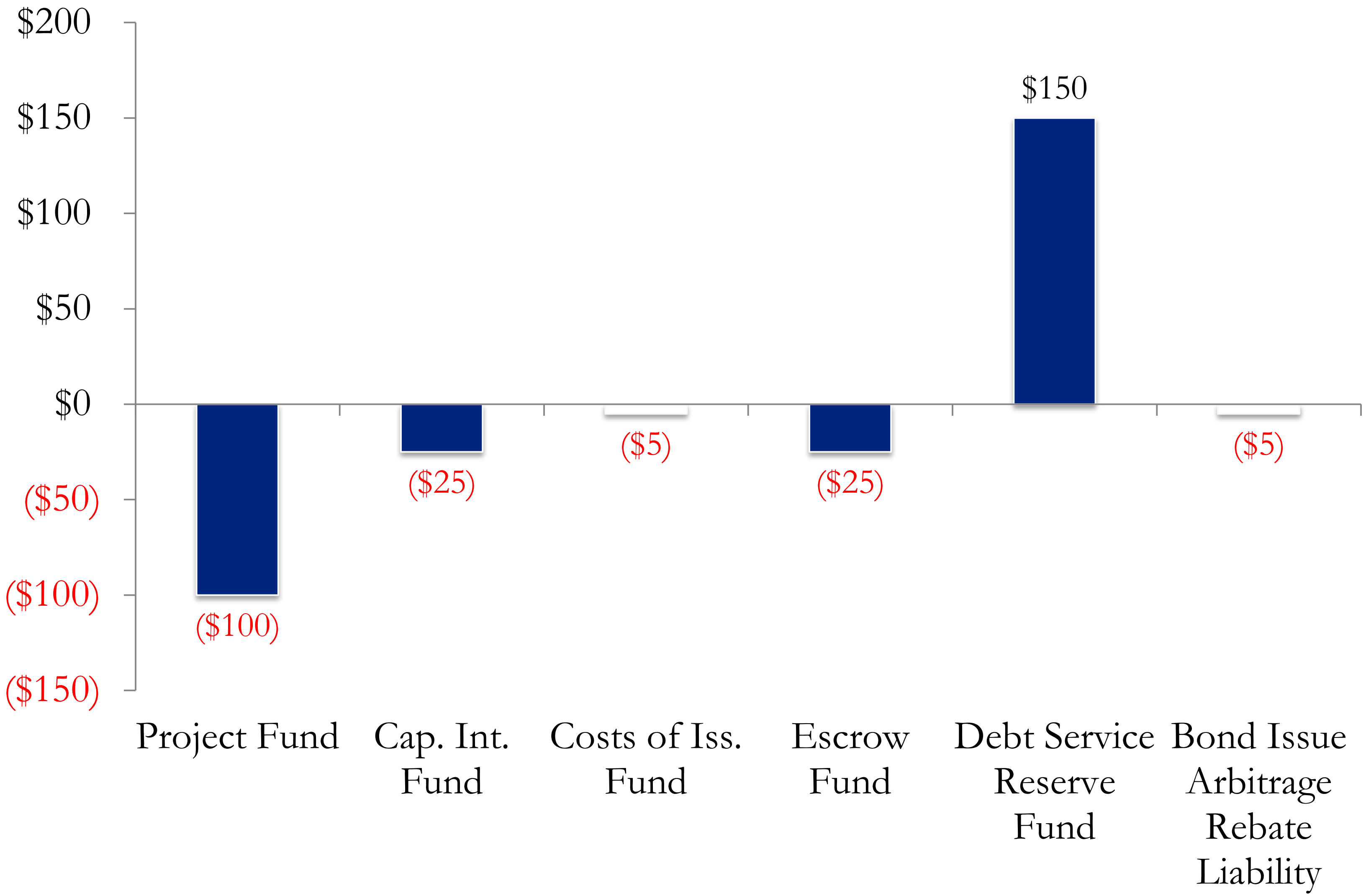
- Combined issues require a combined arbitrage yield calculation and an aggregate arbitrage rebate calculation

Funds Subject to Rebate

Proceeds Category	Funds
Sale Proceeds / Investment Proceeds (“Proceeds”)	Project / Construction Funds Capitalized Interest Funds Debt Service Reserve Funds Escrow Funds Costs of Issuance Funds
Transferred Proceeds (“Proceeds”)	Any of the above
Cash / Revenue Funded (“Replacement Proceeds”)	Debt Service Funds Debt Service Reserve Funds Any “Pledged” Fund

Proceeds + Replacement Proceeds = Gross Proceeds

Arbitrage Rebate – An Example



Exceptions to Arbitrage Rebate

- The Small Issuer Exception
- The Spending Exceptions
  - 6-month spending exception
  - 18-month spending exception
  - 2-year spending exception
- “Bona Fide” Debt Service Fund exception
- Electing to pay the 1.5% penalty in lieu of rebate
- Investing in tax-exempt obligations

Small Issuer Exception

- Calendar year exception
  - $5 million of governmental bonds for municipalities
  - $15 million per year for public school construction
- Requirements
  - General taxing powers
  - Governmental bonds (not private activity bonds)
  - At least 95% of the proceeds must be used for local governmental activities
- Exclusion of current refunding issue in certain circumstances

6-Month Spending Exception

- Spend 100% of Gross Proceeds within 6 months

✓	6 months	100%**

- **Except for 5% of the proceeds of the issue if spent within one year – not available for private activity bonds (other than qualified 501(c)(3) bonds) or TRANs

18-Month Spending Exception

- Gross Proceeds spent as follows:

✓	6 months	15%
✓	12 months	60%
✓	18 months	100%**

- **Except for reasonable retainage (5% spent in 12 months) or de minimis amount (lesser of 3% or $250K, spent with due diligence)

2-Year Spending Exception

- Available Construction Proceeds (ACP) spent as follows:

✓	6 months	10%
✓	12 months	45%
✓	18 months	75%
✓	24 months	100%**

- **Except for reasonable retainage (5% spent in 12 months) or de minimis amount (lesser of 3% or $250K, spent with due diligence)

Proceeds Included in Spending Exceptions

Gross Proceeds (6- and 18- Month Tests)

- All proceeds except:
  - "Bona fide" debt service fund
  - Reserve or replacement fund
  - Not expected at closing, but proceeds after 6-months
  - Repayments of grants financed by the issue

Available Construction Proceeds (ACP) (2-Year Test)

- Includes:
  - Proceeds used to pay for the project, including earnings
  - Capitalized Interest Fund deposit plus earnings
  - Earnings on sale proceeds used to pay costs of issuance, <u>but not sale proceeds used to pay costs of issuance</u>
  - Earnings on DSRF unless issuer elects to exclude from ACP

“Bona Fide” Debt Service Fund Exception

- Depleted at least annually except for greater of:
  - Previous year’s earnings in the fund, or
  - 1/12th of previous year’s principal and interest payments

- Private Activity Bonds
  - Fund has annual earnings of less than $100,000, or
  - Average annual debt service does not exceed $2.5 million

What is Yield Restriction?

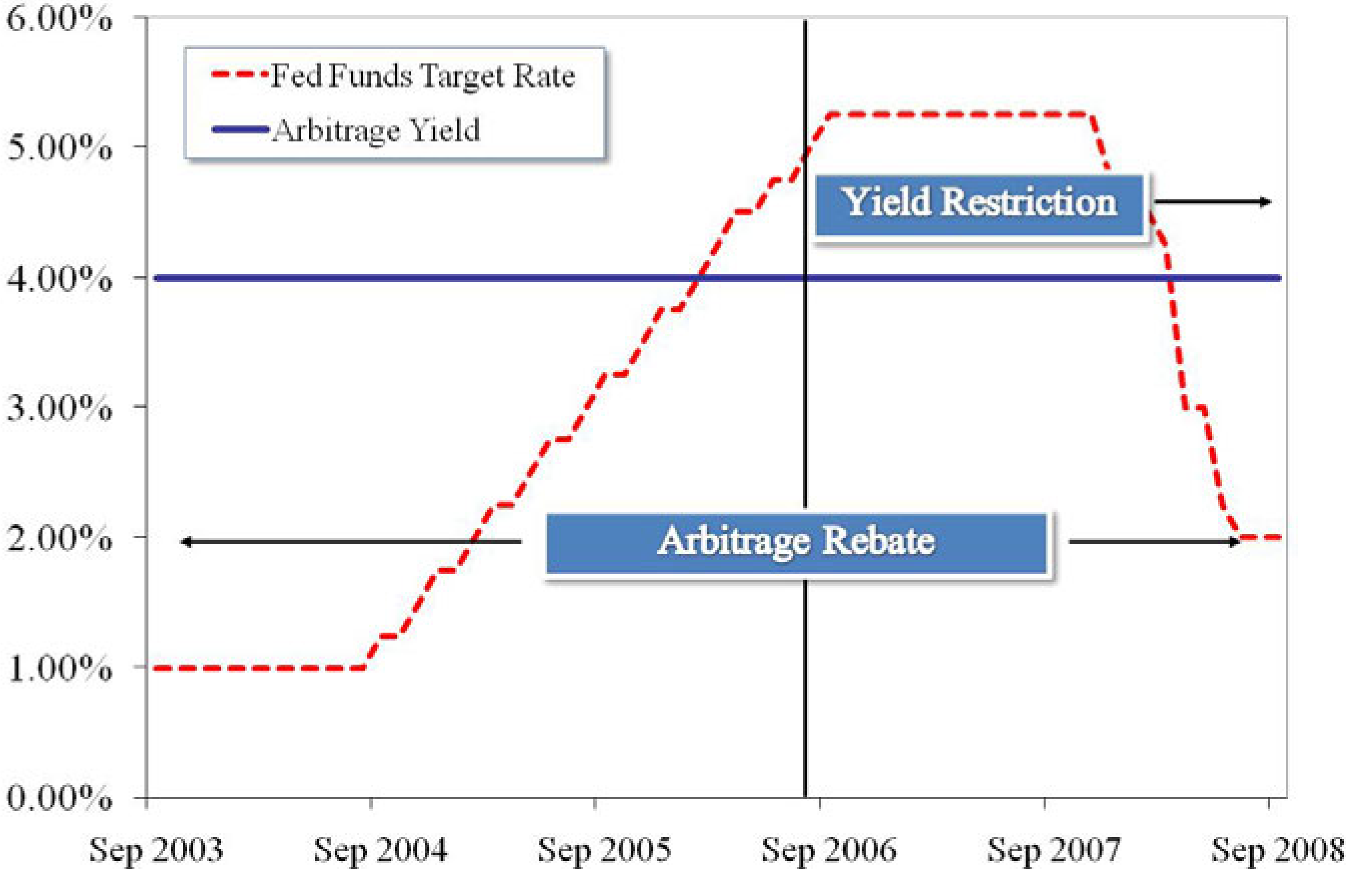
- Like rebate, restriction against investing above the arbitrage yield
- Only applies to proceeds that are subject to yield restriction
- Exceptions apply
  - Temporary periods
  - Exception for “Reasonably Required” Reserve Fund
  - Minor Portion

Temporary Periods

Fund Type	Temporary Period
Construction Fund	Typically 3-Years, 5-years with certification
Bona Fide Debt Service Funds	13-Months
Advance Refunding Proceeds	30-Days
Current Refunding Proceeds	90-Days
Investment Proceeds	1-year from date of receipt

Yield Restriction Impact – Unspent Proceeds

- Yield restriction liability calculation
  - <u>cannot</u> blend negative arbitrage on unrestricted proceeds with positive arbitrage on restricted proceeds (can blend for rebate liability calculation)

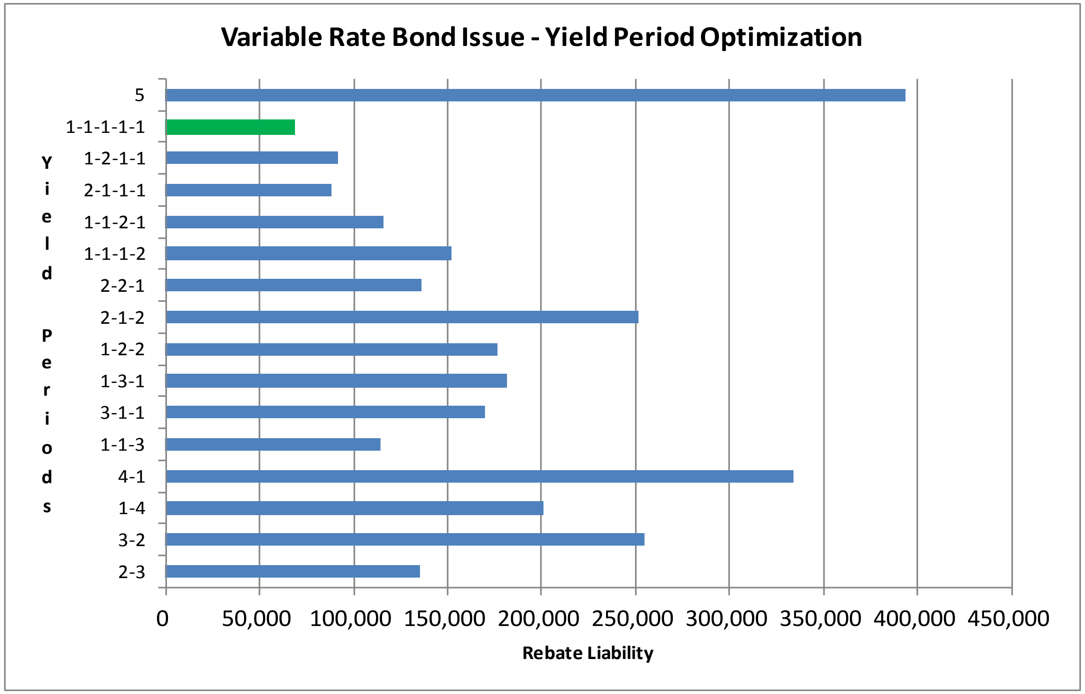


Yield Restriction Compliance Methods

- Active Yield Restriction
  - Investments must be purchased at fair market value
- Yield Reduction Payments
  - Rebate like payments
  - Limited availability for advance refunding issues
- Other Options
  - Longer construction fund temporary period (5-years vs. 3-years)
  - Waiver of temporary period at issuance

One Size Does Not Fit All

- Tax Regulations provide flexibility that may reduce liabilities
  - Investment Valuations
  - Accounting approach
  - Computation Dates, particularly for variable rate bonds
  - Various other optional elections



Accounting For Bond Proceeds

- Significant factor in determining arbitrage rebate and yield restriction liabilities
- Permitted to use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue
- Expenditure reallocations are permitted, however there are time limits
  - Expenditure allocations must be made no later than 18-months after the later of the expenditure date or the date the project is placed in service
  - Must be made no later than 60 days after five-year anniversary/final maturity date
- Proceeds of working capital financings (e.g., TANS, TRANs) subject to “proceeds-spent-last” requirement

Refunding Impacts

- May accelerate final maturity of the issue.
- Possible loss of temporary period on the bonds being refunded.
- Escrow yield cannot exceed the bond yield by more than 1/1000th of 1%
- May create Transferred Proceeds – when proceeds of the prior issue or issues become proceeds of the Refunding Bonds

Calculation & Filing Requirements

- Payment due no later than 60 days after the computation date
  - No later than 5-years after the issue date, and every 5-years thereafter until the final maturity date
  - At least 90% of the liability
  - As of final maturity date, 100% of the liability
- Submit check & IRS Form 8038-T
- Do not submit calculations
- No filing required if no payment is due

IRS Form 8038-T

Form **8038-T** (Rev. April 2011) Department of the Treasury Internal Revenue Service

Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate
► Under Sections 143(g)(3) and 148(f) and Section 103(c)(6)(D) of the Internal Revenue Code of 1954

OMB No. 1545-1219

Part I Reporting Authority — Check box if Amended Return ► ☐

1 Issuer's name		2 Issuer's employer identification number (EIN)	
3 Number and street (or P.O. box no. if mail is not delivered to street address)	Room/suite	4 Report number (For IRS Use Only) 7	
5 City, town, or post office, state, and ZIP code		6 Date of issue	
7 Name of issue		8 CUSIP number	
9 Name and title of officer of the issuer or other person whom the IRS may call for more information		10 Telephone number of officer or other person	

11 Type of issue ► Issue price ► 11

Part II Arbitrage Rebate and Yield Reduction Payments — Amount

12	Computation date to which this payment relates (MM/DD/YYYY)		
13	Arbitrage rebate payment (see instructions) ☐ check box if less than 100% of rebate amount	13	
14	Yield reduction payment (see instructions) ☐ check box if less than 100% of yield reduction amount	14	
15	Rebate payment from Qualified Zone Academy Bond (QZAB) defeasance escrow (see instructions)	15	

Part III Penalty in Lieu of Arbitrage Rebate

16	Number of months since date of issue: ☐ 6 mos ☐ 12 mos ☐ 18 mos ☐ 24 mos ☐ Other. No. of mos ►		
17	Penalty in lieu of rebate	17	
18	Date of termination election (MM/DD/YYYY)		
19	Penalty upon termination	19	

Part IV Late Payments

20	Does failure to pay timely qualify for waiver of penalty (see instructions) Yes ☐ No ☐		
21	Penalty for failure to pay on time (see instructions)	21	
22	Interest on underpayment (see instructions)	22	

Part V Total Payment

23	Total payment. Add lines 13, 14, 15, 17, 19, 21, and 22. Enter total here	23	

Part VI Miscellaneous

24	Unspent proceeds as of this computation date	24	
25	Proceeds used to redeem bonds	25	
26	Gross proceeds used for qualified administrative costs for guaranteed investment contracts (GICs) and defeasance escrows	26	
27	Fees paid for a qualified guarantee	27	

			Yes	No
28	Is the issue a variable rate issue?	28		
29	Did the issuer enter into a hedge? Name of provider ____ Term of hedge ____	29		
30	Were gross proceeds invested in a GIC? Name of provider ____ Term of GIC ____	30		
31	Were any gross proceeds invested beyond an available temporary period?	31		
32	Calculations for filing of this form prepared by: ☐ Issuer ☐ Preparer:			

Signature and Consent

Under penalties of perjury, I declare that I have examined this return, and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. I further declare that I consent to the IRS's disclosure of the issuer's return information, as necessary to process this return, to the person that I have authorized above.

Signature of issuer's authorized representative | Date | Type or print name and title

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ►			Firm's EIN ►	
Firm's address ►			Phone no.	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11545Y Form **8038-T** (Rev. 4-2011)

Late Payments

- Governmental bonds (including qualified 501(c)(3) bonds)
  - 50% of rebate amount, plus interest
- Private activity bonds
  - 100% of rebate amount, plus interest
- Interest computed @ underpayment rate (reset quarterly)
- Late payment explanation required
- Penalty (excluding interest) is typically waived if:
  - Liability plus interest is paid within 180 days after the date the failure was discovered
  - Bonds not under audit
  - Late payment not caused by “willful neglect”

Refunds

- Bond issues may be eligible for a refund
  - Rebate payment made after first 5-year period, offsetting negative arbitrage thereafter
  - Computational error
- Request must be filed no later than 2 years after the final computation date
  - Issues w/final computation dates prior to 6/24/2008 had until 7/1/2010 to file a Refund Request
  - File a Form 8038-R
    - Prior 8038-T (proof of prior payment)
    - Calculation related to payment
    - Additional documents generally requested by the IRS
- May want to consider potential audit risk before filing
- IRS will not pay interest on prior payment

Caution: New Proposed Regulations

- Proposed- Not final
- Elect in whole, not in part (elect with caution!)
- Summary of proposals-
  - Price for bond yield moves from expected based on 10% sale to 25%
  - Simplifies variable rate bond yield calculations involving deemed terminations of swap; Eliminates lots of math but no expected big impact;
  - For Transferred Proceeds, makes transfer of yield restricted investments to a taxable refunding consistent with treatment for tax exempt refundings;
  - Puts into regulation current utilized 2 year statute of limitations after bond redemption to file a refund claim

Extra, Extra, Read all about it!

THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

IRS Plans Full Audits of Advanced Refundings, Other Debt

Tuesday, September 27, 2011

THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

IRS: Governments Lacking in Post-Issuance Compliance Procedures

Thursday, July 14, 2011

THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

IRS Asking 300 About Advance Refundings, Post-Issuance Compliance

Thursday, May 26, 2011

THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

ENFORCEMENT

IRS Begins BAB Audits, Asks Issuers About Their Buyers

Monday, October 25, 2010

A Change In IRS Focus

- Prior focus on pre-issuance type compliance problems
  - Is the project financeable with tax-exempt bond proceeds?
  - Less focus on post-issuance compliance, such as arbitrage rebate
- Beginning in 2007, shift in focus to post-issuance compliance
  - “Soft contact” surveys sent to 501(c)(3) organizations and governmental entities to assess post-issuance compliance
  - Significant increase in IRS audits
  - Emphasis on <u>written</u> policies and procedures to manage post-issuance compliance
  - Change in IRS Forms to include acknowledgement of written procedures
- **Arbitrage rebate** is a significant part of post-issuance compliance
  - Also includes private business use compliance and related requirements

2013 IRS Focus Areas

- Examinations of filed IRS Form 8038-T’s
  - Payment Verifications
  - Unspent Proceeds
- Examinations of Small Issuers
- VCAP – Voluntary compliance
- Released the Publication “Avoiding Troubled Tax-Advantaged Bonds – A Study of Issuer Compliance Considerations”
- Continued Emphasis on formal written procedures for post issuance compliance
- Announced sending another round of compliance check questionnaires to Governmental issuers
- New proposed Regulations

IRS – Best Practices – Written Procedures

- Due diligence review at regular intervals;
- Identifying the official or employee responsible for review;
- Training of the responsible official/employee;
- Retention of adequate records to substantiate compliance;
- Procedures reasonably expected to timely identify noncompliance; and
- Procedures ensuring that the issuer will take steps to timely correct noncompliance.

Record Retention Requirements

- Requirements are burdensome and may not be consistent with document destruction policies
  - Life of the Bonds + 3 years
  - If the Bonds are refunded, life of refunding bonds + 3 years
- Consider separate document collection, storage and destruction policies for bond related records
- Consider electronic storage systems

Examples – Records to Retain

- Board minutes, resolutions
- Appraisals
- Bond transcripts
- Newspaper ads, misc. correspondence
- Investment records
- Expenditure histories
- Invoices
- IRS Filings
- Records related to acquisition of investment agreements and interest rate swaps
- Payments for credit facilities
- Arbitrage rebate and yield restriction compliance reports

Tips for a Smooth Calculation Process

- Be familiar with your documents – especially the tax or non-arbitrage certificate located in the bond transcript.
- Create a file to retain information needed for the calculation right after the bond closing.
  - Avoids having to find records from 5-years ago
  - Consider hiring a consultant when the bonds are issued
- Schedule your calculation – 60 days after the calculation date is not a lot of time, we suggest starting the process at least 60 days in advance of the calculation date.
- Know the exceptions – if your bond counsel indicates you are eligible for an exception, find out which one, and what that means for the issue.
- Keep your calculations current – consider having calculations prepared more frequently then at the 5-year date.
  - Can help in keeping and eye on spending exceptions
  - Allows you to plan for a future liability
- Ask Questions!

THANK YOU!