What Every Issuer Needs to Know About Arbitrage Rebate

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Arbitrage Rebate & Yield Restriction – It's the Law

- 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
  - **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 **<u>every</u>** tax-exempt borrowing and some taxable subsidy obligations

Tax Considerations Timeline

- Arbitrage rebate requirements apply to **every** tax-exempt borrowing and certain taxable subsidy obligations
- Compliance begins with pre-issuance planning and continues with post-issuance policies and procedures (does it ever end…)

Pre-Issuance

- Timing
- Project Draw Schedule
- Evaluate available exceptions and elections
- Identify investment options

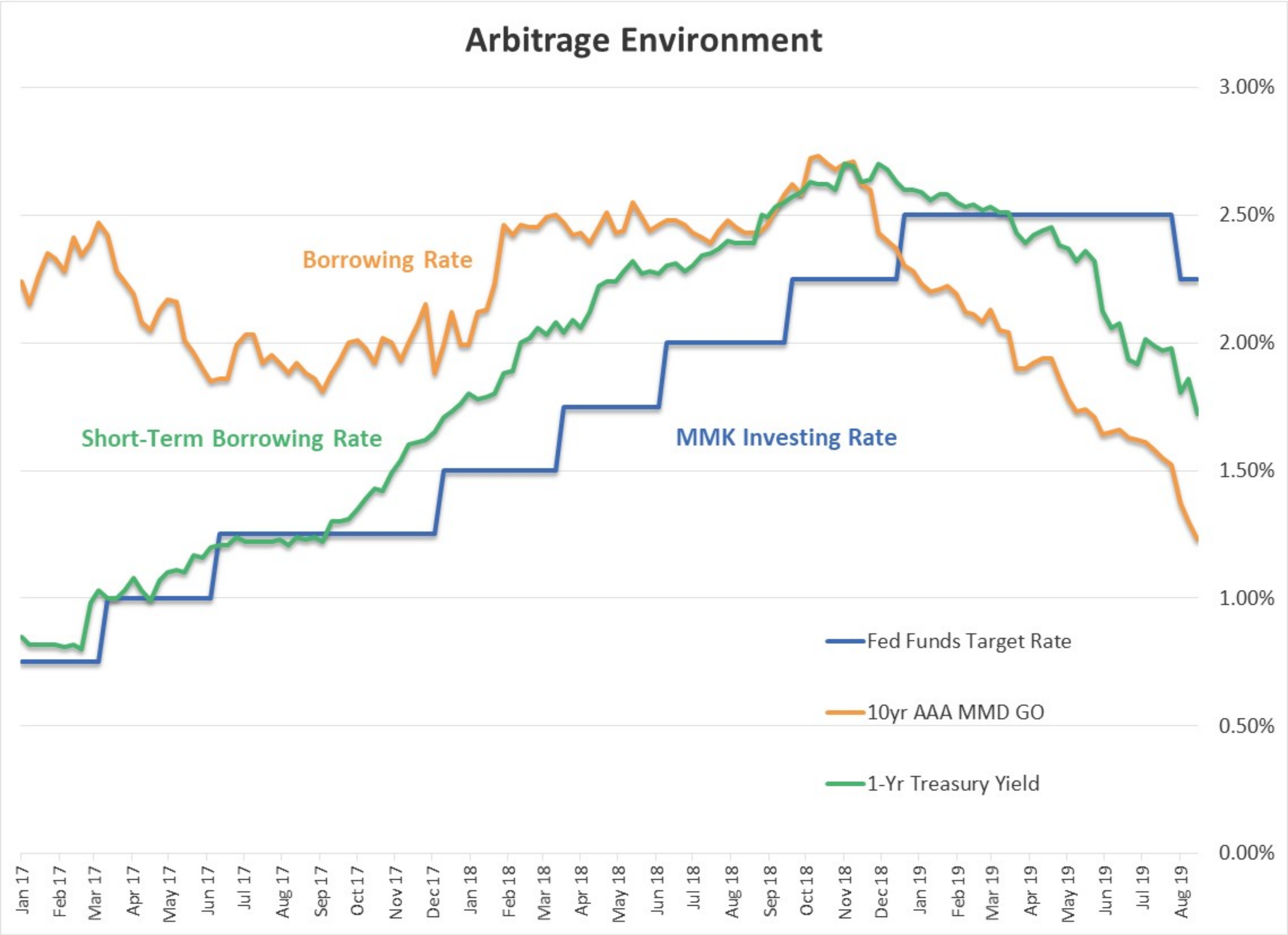
Issuance

- Invest bond proceeds
- Purchase securities, establish FMV
- Revise draw schedule
- Make elections in Tax Certificate

Post-Issuance

- Arbitrage reporting
- Monitor draw schedule
- Monitor investments
- Record retention

Positive Arbitrage – It’s Back



Sources: Bloomberg, Thomson Reuters. See important disclosures at the end of this presentation.

Arbitrage & Yield Restriction – The Basics

- 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
- Cumulative from the issue date

Funds Subject to Rebate

PROCEEDS	+	REPLACEMENT PROCEEDS	=	GROSS PROCEEDS
Sale Proceeds / Investment Proceeds		Cash / Equity / Revenue Funded		
• Project / Construction Funds • Capitalized Interest Funds • Debt Service Reserve Funds • Escrow Funds • Costs of Issuance Funds • Interest earnings		• Debt Service Funds • Debt Service Reserve Funds • Any “Pledged” Fund		All subject to Rebate Exceptions may apply
Transferred Proceeds Any of the above				

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 (eliminating the “arbitrage”)

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

Spending Exceptions – Can Be Internally Monitored

- "Reward" for spending bond proceeds quickly
- Allowed to keep positive arbitrage
- Optional to apply & a simple way to establish compliance
- Must meet each benchmark, no catch-up allowed

* Exceptions for 5% of the proceeds of the issue if spent within one year

** De minimis (lesser of 3% or $250K) and reasonable retainage (5% spent in 12 months) exceptions may apply for last benchmark

6-Month	
All gross proceeds	
✓ 6 months	100% *

18-Month	
All new money	
✓ 6 months	15%
✓ 12 months	60%
✓ 18 months	100% **

2-Year (ACP)	
Construction issues	
✓ 6 months	10%
✓ 12 months	45%
✓ 18 months	75%
✓ 24 months	100% **

Yield Restriction Compliance

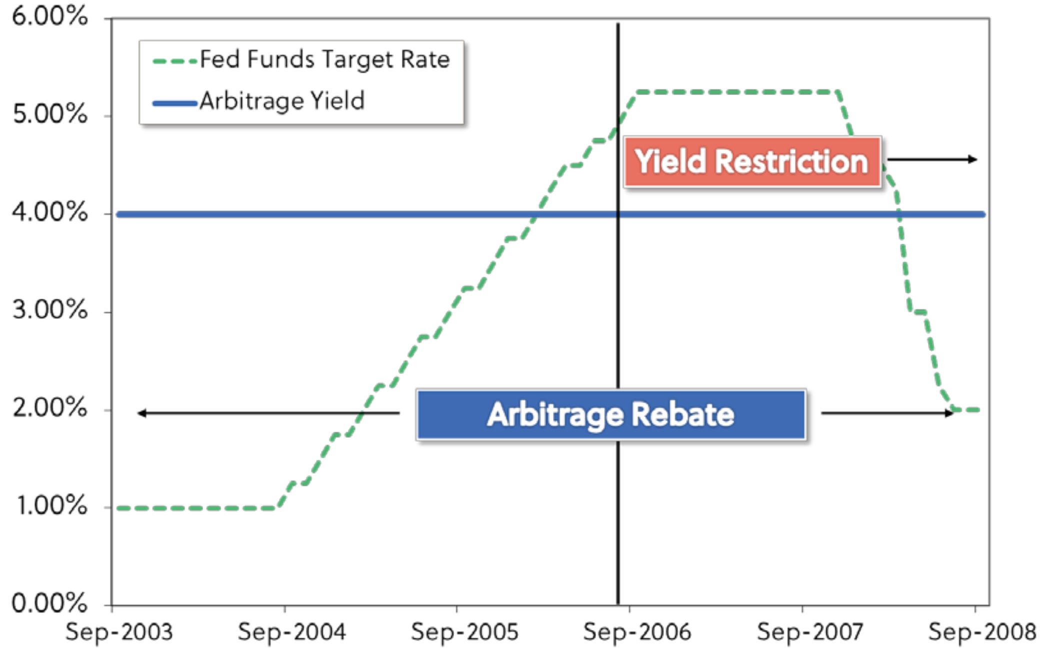
What is Yield Restriction?

- 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

Arbitrage Rebate vs. Yield Restriction

- Arbitrage Rebate and Yield Restriction are separate calculations
- Yield Restriction only applies to proceeds that are subject to yield restriction
- Cannot blend positive arbitrage of yield restricted proceeds with negative arbitrage of unrestricted proceeds
- Exceptions apply
  - Exception for "Reasonably Required" Reserve Fund
  - Minor Portion
  - Temporary periods

Could the next 5 years produce a similar interest rate environment?



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

Calculation Requirements & Timing

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

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 PLUS 60 days.
  - 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

Record Retention

- 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

DO NOT DESTROY:

- ✓ 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 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 an eye on spending exceptions
  - Allows you to plan for a future liability
- Ask Questions!

Let’s see what you’ve learned…

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