

Introduction to Arbitrage Rebate

California Debt and Investment Advisory Commission
Municipal Debt Essentials: Debt Administration Day Three
March 15, 2012

The logo for PFM Asset Management LLC, featuring the letters 'PFM' in a bold, sans-serif font. To the left of the letters are several horizontal lines of varying lengths, creating a stylized graphic element.

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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

- Post-issuance tax compliance begins with the debt issuance process and provides for a continuing focus on the investment of bond proceeds and the use of bond-financed property.
- Elements of an Effective Post-Issuance Tax Compliance Program include:
 - Written policies and procedures
 - A Team assigned to manage the compliance process
 - Record Retention
 - **Arbitrage Rebate and Yield Restriction Compliance**
 - Private business use Compliance
 - Periodic review of the process
 - Staff training and education
- The Advisory Committee on Tax-Exempt and Governmental Entities published a report on this issue titled: *After the Bonds are Issued Then What?*

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 have been sent to 501(c)(3) organizations and governmental entities to assess post-issuance compliance
 - Significant increase in IRS audits
 - Emphasis on written 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

What is Arbitrage Rebate?



- Federal tax law requirement - Section 148 of Internal Revenue Code
 - Arbitrage Rebate & Yield Restriction Compliance
 - Overlapping requirements – “Belt & Suspenders”
- Tax law and related regulations are intended limit use of tax-exempt bonds
 - Prevent issuance of more bonds than are necessary
 - Prevent issuance of bonds earlier than is necessary (hedge bonds)
 - Prevent 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 abuses
- Applicable to **every** tax-exempt borrowing unless exceptions apply

How is Arbitrage Measured?



- Based on reinvestment of bond proceeds in taxable securities
- Actual investment earnings on bond proceeds (-) Earnings at Arbitrage Yield
 - **“Positive Arbitrage”** = Actual Earnings > Earnings @ arbitrage yield
 - **“Negative Arbitrage”** = Actual Earnings < Earnings @ arbitrage yield
- Measured on an issue-by-issue basis
 - Within an issue, aggregated among funds

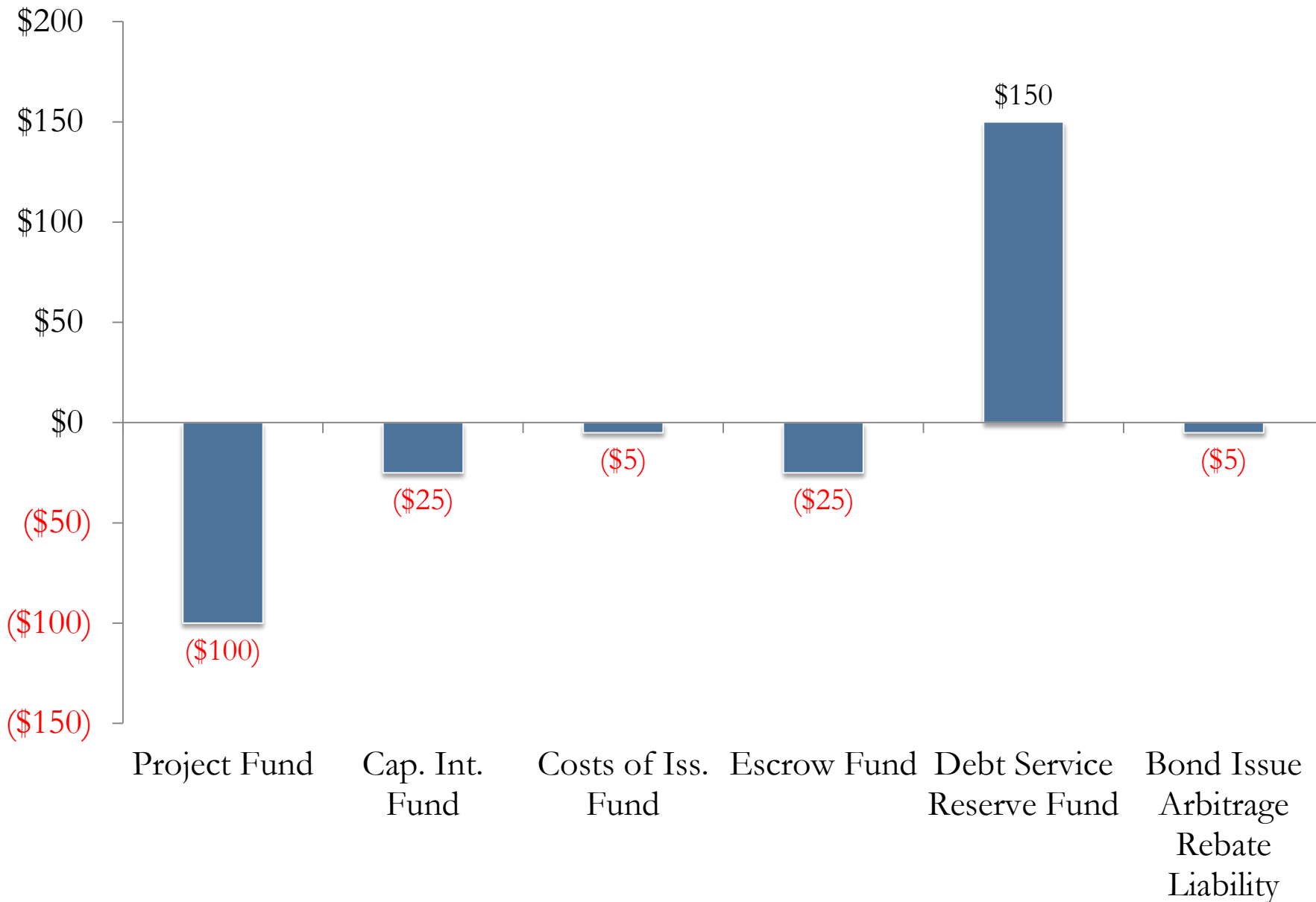
Funds Subject to Rebate



| 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



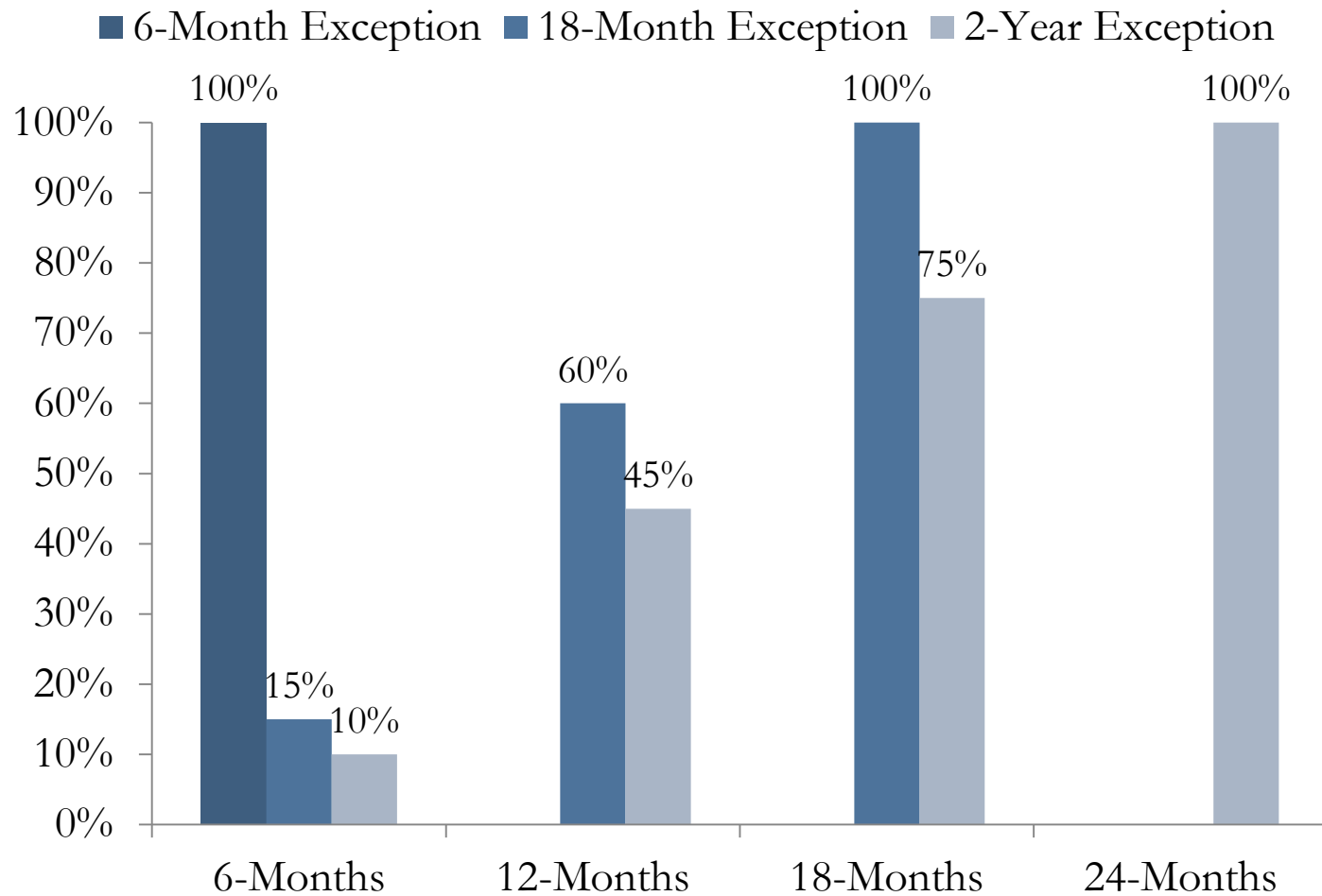
- The Small Issuer Exception
- The Spending Exceptions
 - 6-month spending exception
 - 18-month spending exception
 - 2-year spending exception
- “Bona Fide” Debt Service Fund exception
- Electing to pay the 1.5% penalty in lieu of rebate
- Investing in tax-exempt obligations

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

Spending Exceptions



- Small balance & retainage exceptions may apply at the end of the spending period

“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

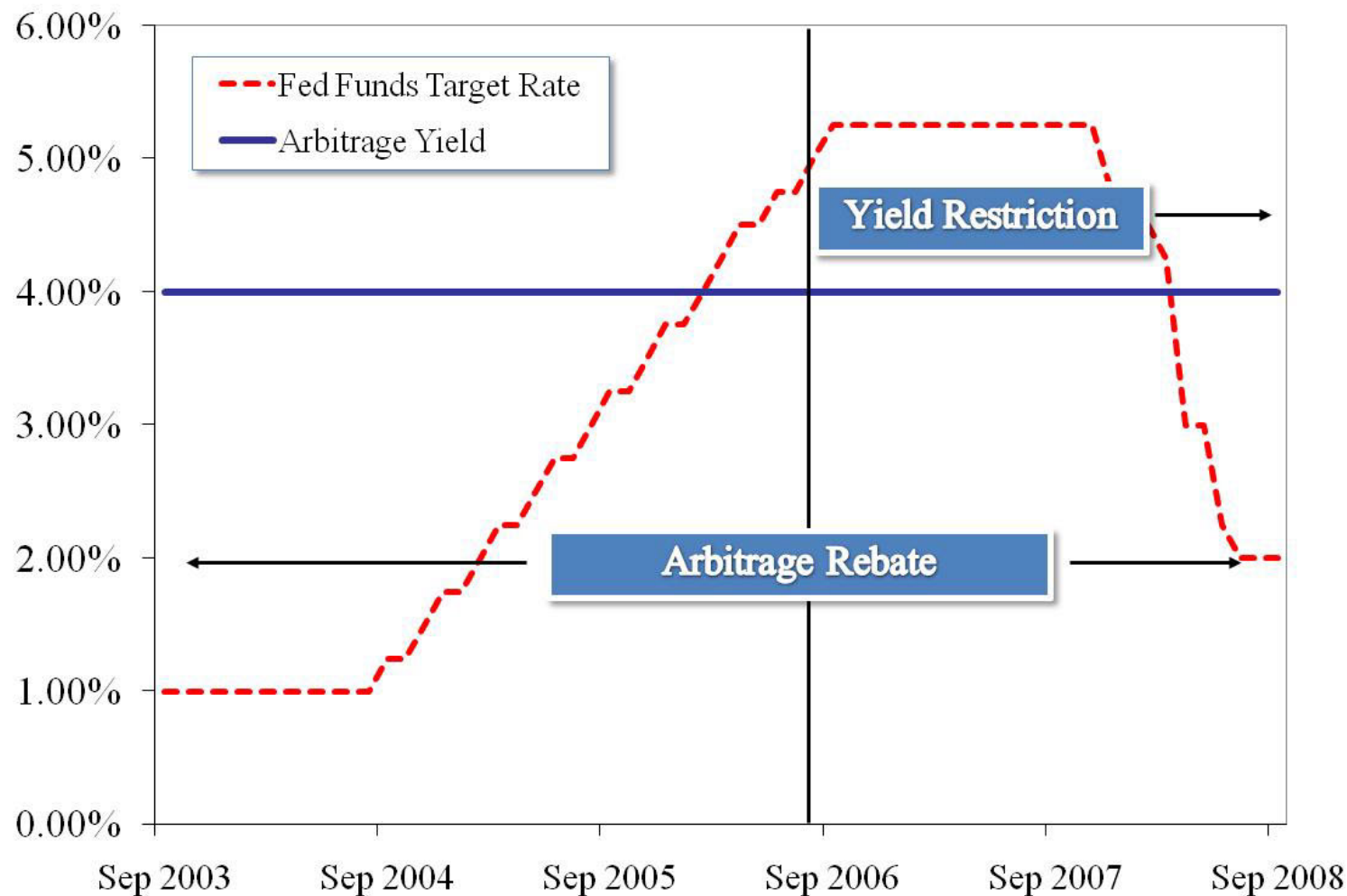


| Fund Type | Temporary Period |
|------------------------------|---|
| Construction Fund | Typically 3-Years, 5-years with certification |
| Bona Fide Debt Service Funds | 13-Months |
| Advance Refunding Proceeds | 30-Days |
| Current Refunding Proceeds | 90-Days |
| Investment Proceeds | 1-year from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

Yield Restriction Impact – Unspent Proceeds



- Yield restriction liability calculation
 - cannot 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

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 <input type="checkbox"/> | |
|----------------------------|--|------------|--|--|
| 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) | |
| 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 | |

| Part II Arbitrage Rebate and Yield Reduction Payments | | Amount |
|---|---|--------|
| 11 | Type of issue <input type="checkbox"/> Issue price <input type="checkbox"/> | 11 |
| 12 | Computation date to which this payment relates (MM/DD/YYYY) | |
| 13 | Arbitrage rebate payment (see instructions) <input type="checkbox"/> check box if less than 100% of rebate amount | 13 |
| 14 | Yield reduction payment (see instructions) <input type="checkbox"/> 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: <input type="checkbox"/> 6 mos <input type="checkbox"/> 12 mos <input type="checkbox"/> 18 mos <input type="checkbox"/> 24 mos <input type="checkbox"/> Other. No. of mos <input type="text"/> | |
| 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 <input type="checkbox"/> No <input type="checkbox"/> | |
| 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? | | |
| 29 | Did the issuer enter into a hedge? Name of provider _____ Term of hedge _____ | | |
| 30 | Were gross proceeds invested in a GIC? Name of provider _____ Term of GIC _____ | | |
| 31 | Were any gross proceeds invested beyond an available temporary period? | | |
| 32 | Calculations for filing of this form prepared by: <input type="checkbox"/> Issuer <input type="checkbox"/> Preparer: | | |

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 and Consent | Signature of issuer's authorized representative _____ Date _____ | | Type or print name and title _____ | |
| | Print/Type preparer's name | Preparer's signature | Date | Check <input type="checkbox"/> if self-employed PTN |
| Paid Preparer Use Only | 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)

- 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”

- 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

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
 - Examples: FIFO, direct tracing, ratable allocation, gross proceeds spent first
 - Proceeds are allocated to an issue until they are spent (**actual cash outlay**)
- 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

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

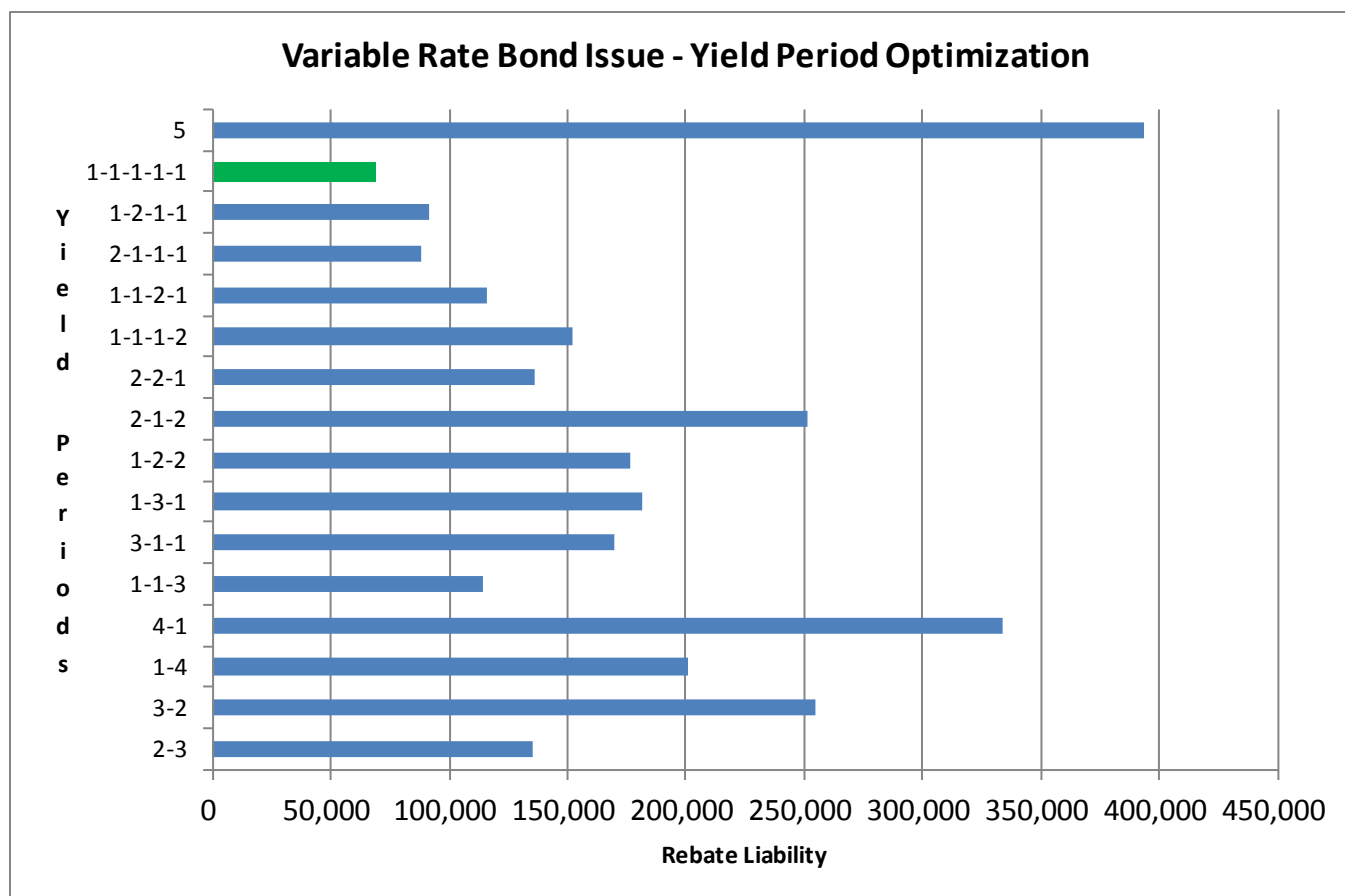


- Board minutes, resolutions
- Appraisals
- Bond transcripts
- Newspaper ads, misc. correspondence
- Investment records
- Expenditure histories
- IRS Filings
- Records related to acquisition of investment agreements and interest rate swaps
- Payments for credit facilities
- Arbitrage rebate and yield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

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



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 than at the 5-year date
 - Can help in keeping an eye on spending exceptions
 - Allows you to plan for a future liability
- Ask Questions!

Final Thoughts & Considerations



- The IRS is focused on post-issuance compliance
 - Attempting to influence issuers to create/adopt/implement written post-issuance compliance procedures
 - Audits, “soft-contact” surveys
 - Changes to 8038 series forms
- Arbitrage rebate and yield restriction compliance is an integral part of post-issuance compliance
 - Keeping good records, making timely allocations, and proactively monitoring arbitrage rebate and yield restriction liabilities will mitigate audit risk
 - Arbitrage rebate & yield restriction compliance can be very complicated and costly if liability reduction strategies are not considered
 - Regulations provide methodological flexibility
 - Evaluate permissible alternative approaches before cutting a check to the IRS

THANK YOU!