



Beginners Guide to Arbitrage Rebate & Yield Restriction

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Then & Now



Old News

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



New News

THE BOND BUYER

Taxation

Bond Documents Being Revised for Issue Price Rules

March 9, 2017

THE BOND BUYER

Taxation

Final Issue Price Rules Make Allowances for Competitive Sales

December 8, 2016

THE BOND BUYER

Taxation

IRS Reorganizing Tax Exempt Bond Group in May

March 10, 2017

THE BOND BUYER

Taxation

What's in Treasury's Newly Released Final Arbitrage Rules

July 15, 2016



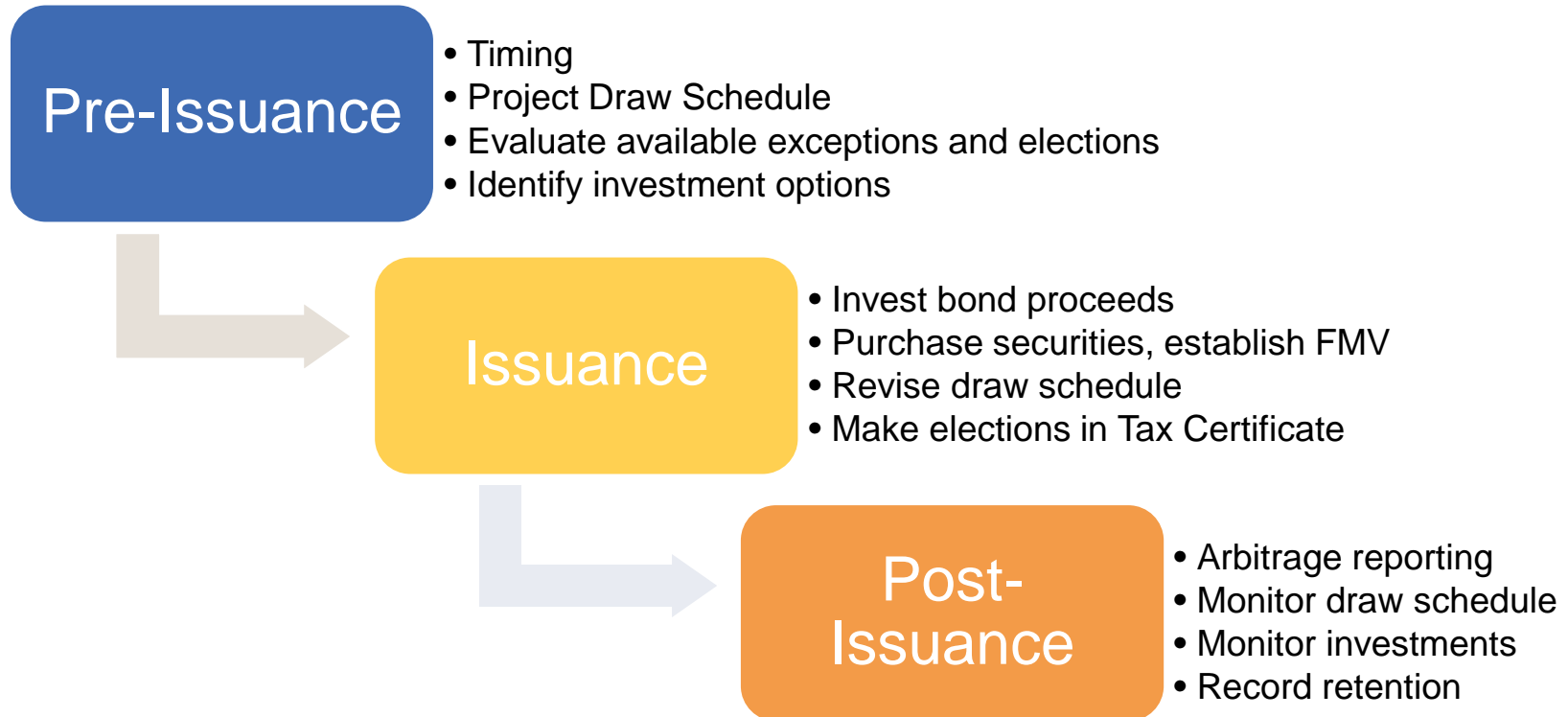
History: Why we have Arbitrage Rebate

- 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 (1-time only)
 - **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 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...)





Arbitrage Rebate



How is Arbitrage Measured?

- 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

+ REPLACEMENT PROCEEDS =

**GROSS
PROCEEDS**

Sale Proceeds /
Investment Proceeds

- Project / Construction Funds
- Capitalized Interest Funds
- Debt Service Reserve Funds
- Escrow Funds
- Costs of Issuance Funds
- Interest earnings

Cash / Equity /
Revenue Funded

- Debt Service Funds
- Debt Service Reserve Funds
- Any “Pledged” Fund

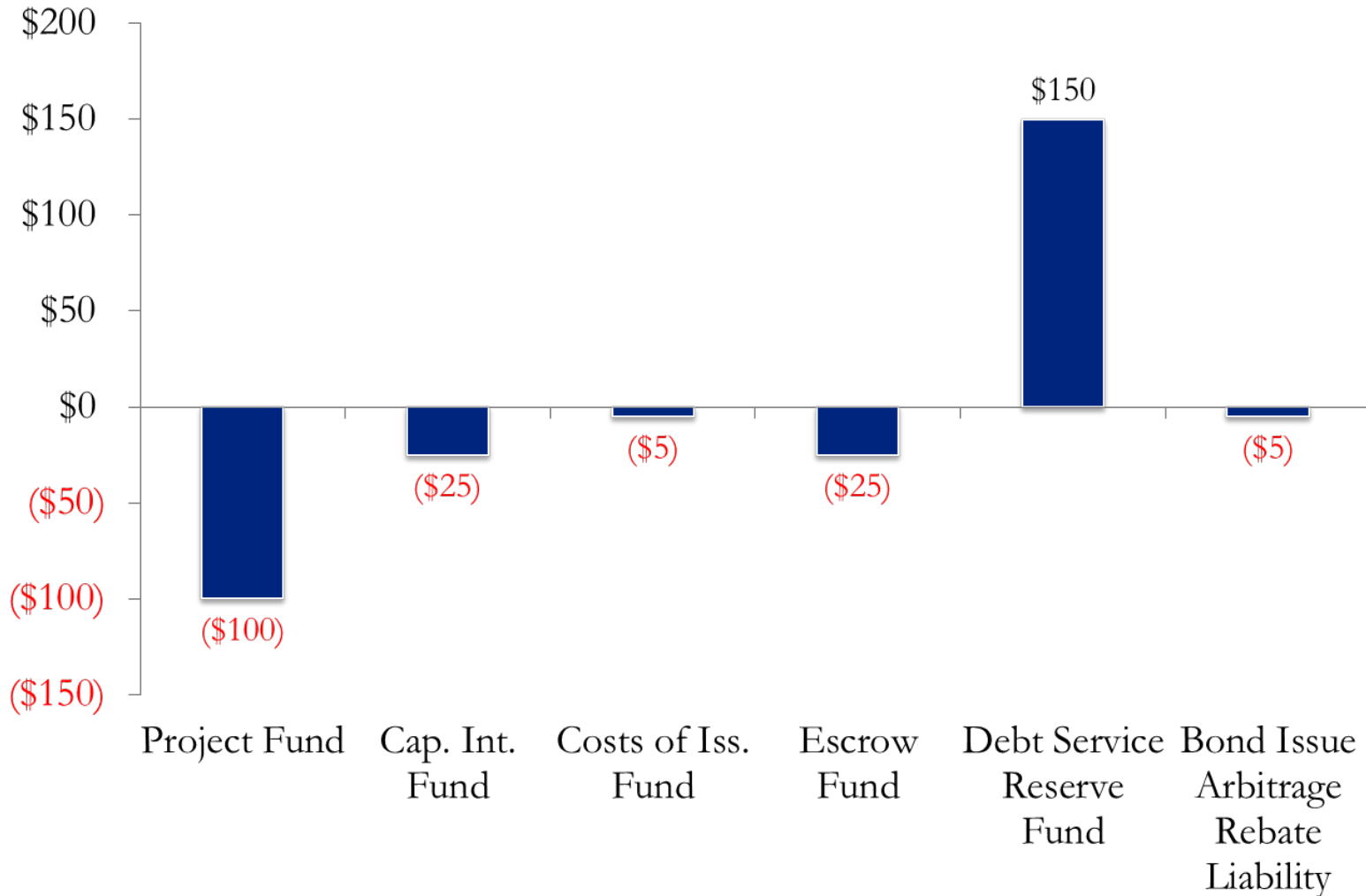
All subject to
Rebate

Exceptions
may apply

Transferred Proceeds
Any of the above



Blend Funds within an Issue, but Measure Issue by Issue





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
- Simple way to establish compliance (no FV, no yields)
- Must meet each benchmark, no catch-up allowed

* De minimis exceptions generally apply for the last benchmark

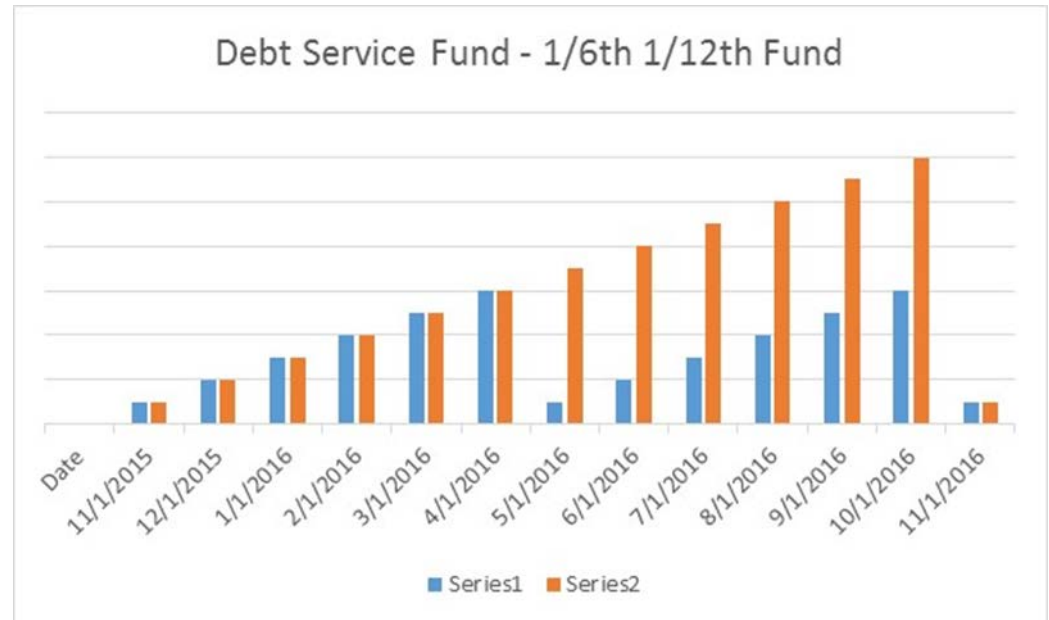
** De minimis and reasonable retainage exceptions may apply for last benchmark

| 6-Month | 18-Month | 2-Year (ACP) |
|--------------------|--------------------|---------------------|
| All gross proceeds | All new money | Construction issues |
| ✓ 6 months 100% * | ✓ 6 months 15% | ✓ 6 months 10% |
| | ✓ 12 months 60% | ✓ 12 months 45% |
| | ✓ 18 months 100% * | ✓ 18 months 75% |
| | | ✓ 24 months 100% ** |



“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





Yield Restriction



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



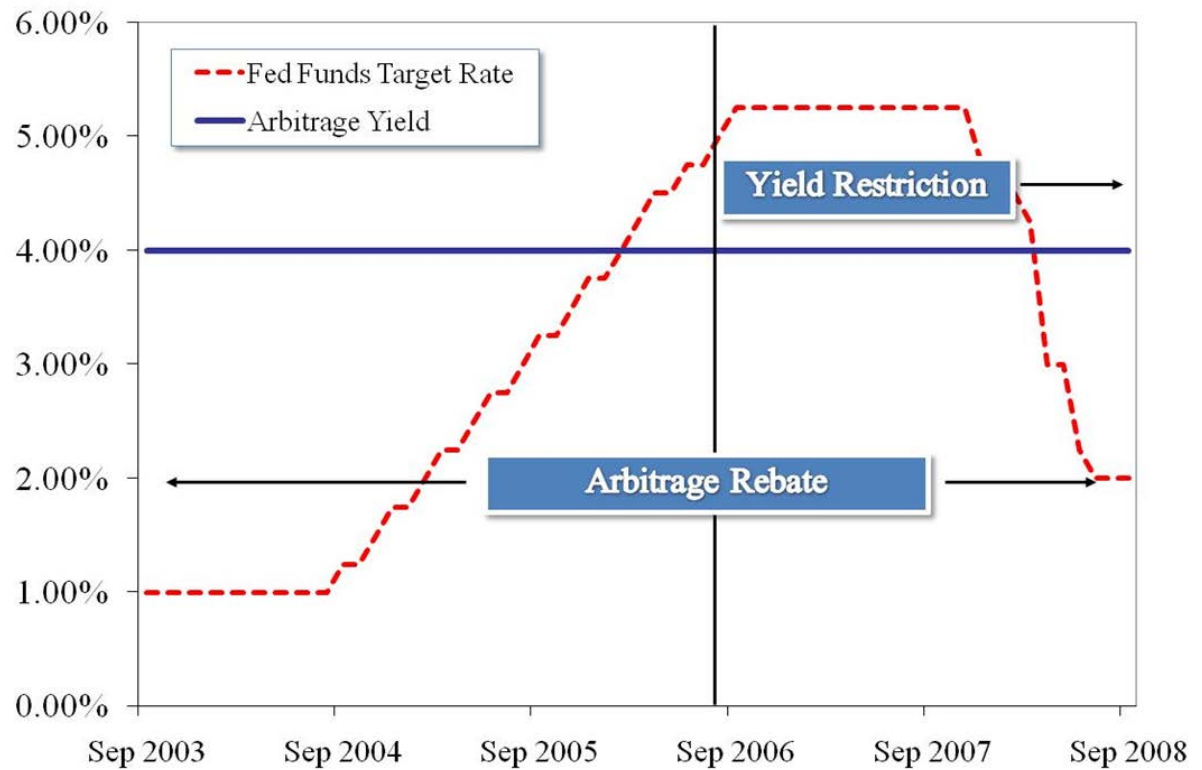
Temporary Periods

| 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)





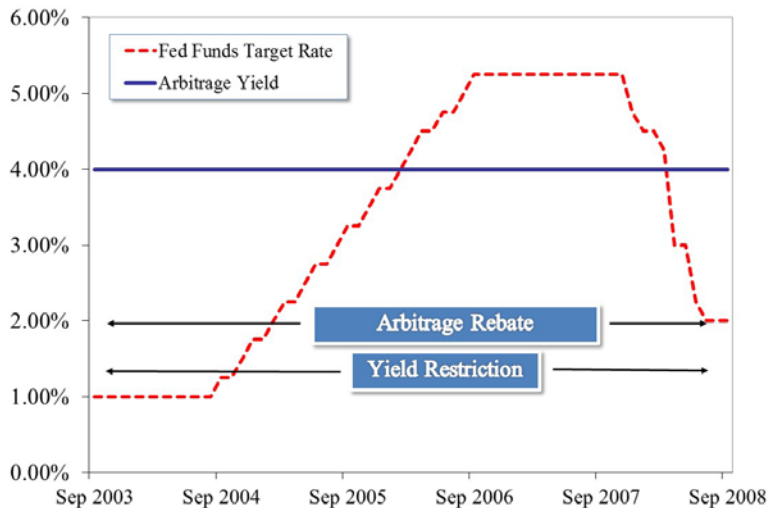
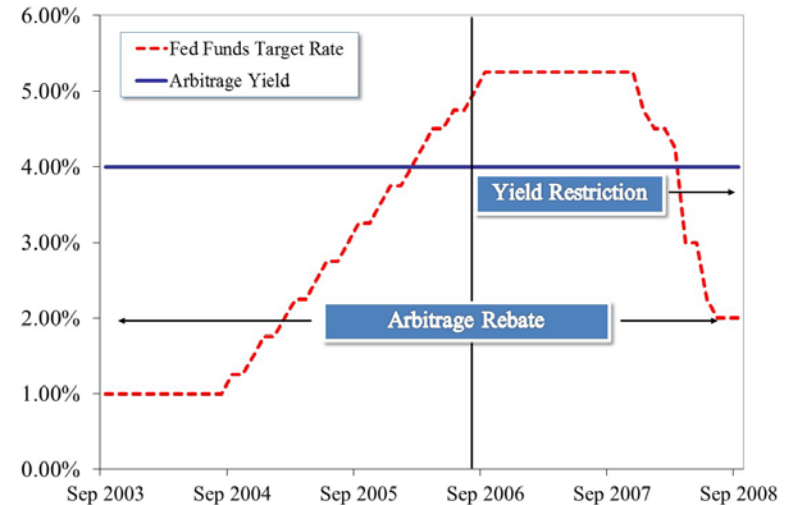
Yield Restriction Compliance Methods

- 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**



Waiving the Temporary Period

- No waiver of temporary period =
 - No rebate liability at year 5
 - **Yield Restriction Liability at year 5**
 - **Pay IRS excess interest earned in years 4 and 5**



- Waiver of temporary period =
 - No rebate liability at year 5
 - No yield restriction liability at year 5
 - Keep excess interest earned in years 4 and 5
- **Must make affirmative election in Tax Certificate at closing**



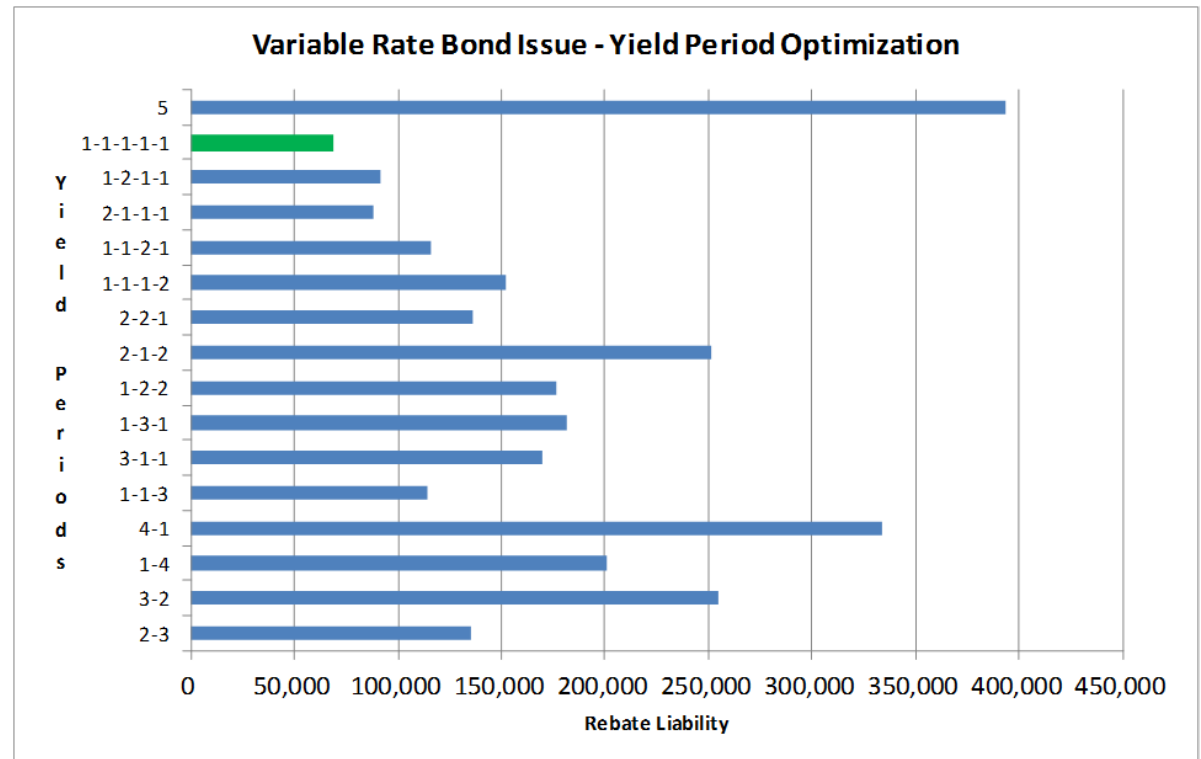
Other Tax Strategies

| What | Why |
|---|---|
| Waive the temporary period in a current refunding escrow | Bank negative arbitrage to blend with other yield restricted investments |
| Waive the right to invest Reserve Fund in higher yielding investments | Blend negative arbitrage with other yield restricted investments |
| Extend the 3-year temporary period | If longer project period is warranted and can be documented |
| Computation date selection | 5-years is longest permissible computation period, but shorter periods may benefit the client |
| Waive (do not apply) spending exceptions | Spending exceptions are optional, no real value in negative arbitrage environment |



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





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





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) _____

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) <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:
 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 | | |
| 28 Is the issue a variable rate issue? | 28 | Yes | No |
| 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: <input type="checkbox"/> Issuer <input type="checkbox"/> 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 <input type="checkbox"/> if self-employed | PTIN _____ |
| Firm's name <input type="checkbox"/> _____ | Firm's EIN <input type="checkbox"/> _____ | | | |
| Firm's address <input type="checkbox"/> _____ | 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



Refunding Impacts

- May accelerate final maturity of the issue and [final rebate calculation](#)
- 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



Current Events



Final IRS Regulations

- Effective 10/16/2016
- Intended to finalize proposed regs from 2007 and 2013 (excluded Issue Price Definition)

| | |
|------------------------------------|--|
| Working Capital | Valuation of Investments |
| Computation Date Credits | Yield Reduction Payments |
| Premium Callable Bonds | FMV of U.S. Treasury Obligations |
| Joint Bond Yield Authority | External Commingled Investment Funds |
| Integration of Hedges | Small Issuer Exception – Pooled Bonds |
| Recovery of Overpayments (Refunds) | FMV of Guaranteed Investment Contracts (GIC) |

- Issue Price Regulations finalized on December 9, 2016
 - Effective June 7, 2017



Final IRS Regulations – Issue Price

A. General rule:

- First price at which 10% of the bonds are sold to the public

B. Special rule for use of initial public offering price (IOP):

- Issue price is the IOP, subject to a modified “hold-the-price” anti-abuse rule
- Underwriters agree to hold the price for five business days after the sale date (or, if earlier, until 10% of the bonds have been sold at no greater than the IOP)

C. Special rule for competitive sales:

- Issue price is the reasonably expected IOP, subject to a three-bid requirement (with no hold-the-price rule)
- If three bids not received, revert to A or B
- A, B and C can be measured maturity by maturity
- Private placement with no underwriter:
 - Issue price is the price paid by the buyer

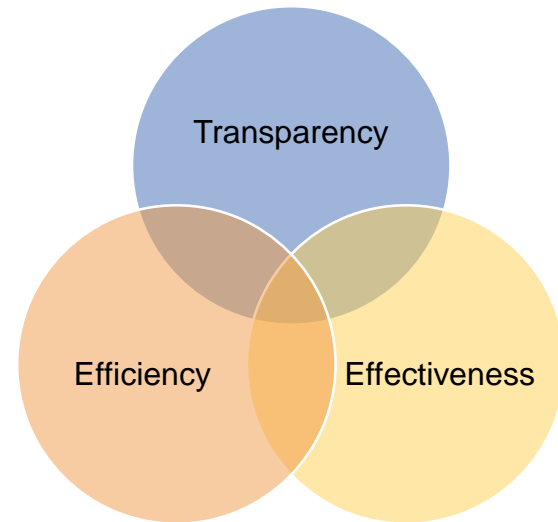
June 2017

| Sun | Mon | Tue | Wed | Thu | Fri | Sat |
|-----|-----|-----|-----|-----|-----|-----|
| | | | | 1 | 2 | 3 |
| 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| 11 | 12 | 13 | 14 | 15 | 16 | 17 |
| 18 | 19 | 20 | 21 | 22 | 23 | 24 |
| 25 | 26 | 27 | 28 | 29 | 30 | |
| | | | | | | |



IRS TEB FY 2017 Work Plan

- **Education Outreach**
 - Publications and webinars/webcasts
 - Direct pay bond refund process
 - Interactive Form 8038-CP
- **Priority Examinations**
 - Evidence of noncompliance (referrals)
 - History indicates future risk of noncompliance
- **VCAP – Voluntary Compliance Agreement Program**
 - Reduction in number of VCAP requests
 - Streamlining the process to minimize IRS and issuer resources
 - Possible streamlined VCAP process for arbitrage violations





IRS Audits – 2016-2017 Priority Examination Areas

- Referrals, whistleblower, refunds
 - Refund claims for arbitrage overpayments and direct-pay bonds
 - 80% of refund claims paid
- History indicates future noncompliance
 - Specifically identified small issuer bonds and prison financings
- Data analytics to identify trends and noncompliance indicators
- Market segmentation
 - Variable rate advance refunding issues
 - Advance refundings with open market security escrows
 - Solid waste financings that include manufacturing processes



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.
- **PFM Golden Rule: Develop processes, procedures and internal controls to assure timely compliance and avoid problems**





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



Final Takeaways

- 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!

THANK YOU!



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