Beginners Guide to Arbitrage Rebate & Yield Restriction

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Then & Now
Old News

The Bond Buyer

IRS Plans Full Audits of Advanced Refundings, Other Debt
Tuesday, September 27, 2011

The Bond Buyer

IRS: Governments Lacking in Post-Issuance Compliance Procedures
Thursday, July 14, 2011

The Bond Buyer

IRS Asking 300 About Advance Refundings, Post-Issuance Compliance
Thursday, May 26, 2011

The Bond Buyer

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…?)

**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
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

<table>
<thead>
<tr>
<th>PROCCEEDS</th>
<th>+</th>
<th>REPLACEMENT PROCCEEDS</th>
<th>=</th>
<th>GROSS PROCCEEDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Proceeds / Investment Proceeds</td>
<td>Cash / Equity / Revenue Funded</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Project / Construction Funds</td>
<td>• Debt Service Funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Capitalized Interest Funds</td>
<td>• Debt Service Reserve Funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Debt Service Reserve Funds</td>
<td>• Any “Pledged” Fund</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Escrow Funds</td>
<td>Any of the above</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Costs of Issuance Funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Interest earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

All subject to Rebate

Exceptions may apply
Blend Funds within an Issue, but Measure Issue by Issue

- Project Fund: ($100)
- Cap. Int. Fund: ($25)
- Costs of Iss. Fund: ($5)
- Escrow Fund: ($25)
- Debt Service Reserve Fund: $150
- Bond Issue Arbitrage Rebate Liability: ($5)
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

<table>
<thead>
<tr>
<th>6-Month</th>
<th>18-Month</th>
<th>2-Year (ACP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All gross proceeds</td>
<td>All new money</td>
<td>Construction issues</td>
</tr>
<tr>
<td>✓ 6 months 100% *</td>
<td>✓ 6 months 15%</td>
<td>✓ 6 months 10%</td>
</tr>
<tr>
<td></td>
<td>✓ 12 months 60%</td>
<td>✓ 12 months 45%</td>
</tr>
<tr>
<td></td>
<td>✓ 18 months 100% *</td>
<td>✓ 18 months 75%</td>
</tr>
<tr>
<td></td>
<td>✓ 24 months 100% **</td>
<td></td>
</tr>
</tbody>
</table>
“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

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Temporary Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction Fund</td>
<td>Typically 3-Years, 5-years with certification</td>
</tr>
<tr>
<td>Bona Fide Debt Service Funds</td>
<td>13-Months</td>
</tr>
<tr>
<td>Advance Refunding Proceeds</td>
<td>30-Days</td>
</tr>
<tr>
<td>Current Refunding Proceeds</td>
<td>90-Days</td>
</tr>
<tr>
<td>Investment Proceeds</td>
<td>1-year from date of receipt</td>
</tr>
</tbody>
</table>
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

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

**Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate**

### Part I - Reporting Authority

1. Issuer's name or other identifying information.
2. Issuer's employer identification number (EIN).
3. Number and street (P.O. box no., if used) to which mail is not delivered to address.
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. Other.
9. Name and title of officer of the issuer or other person who the IRS may call for more information.
10. Telephone number of officer or other person.

### Part II - Arbitrage Rebate and Yield Reduction Payments

- **Computation date to which this payment relates (MM/DD/YYYY).**
- **Arbitrage rebate payment (see instructions).**
- **Yield reduction payment (see instructions).**
- **Penalty in Lieu of Arbitrage Rebate.**
- **Date of termination decision (MM/DD/YYYY).**
- **Penalty upon termination.**

### Part IV - Late Payments

- **Does failure to pay timely qualify for waiver of penalty (see instructions).**
- **Penalty for failure to pay on time (see instructions).**
- **Interest on underpayment (see instructions).**

### Part V - Total Payment

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

### Part VI - Miscellaneous

- **Unpaid proceeds as of this computation date.**
- **Proceeds used to redeem bonds.**
- **Gross proceeds used for qualified administrative costs for guaranteed investment contracts (GICs) and defeasance escrows.**
- **Fees paid for a qualified guarantee.**
- **Is the issue a variable rate issue?**
- **Did the issuer enter into a hedge?**
- **Were gross proceeds invested in a GIC?**
- **Were any gross proceeds invested beyond an available temporary period?**

### Signature and Consent

Signature of issuer's authorized representative.

### Paid Preparer Use Only

Preparer's name and date.

For Paperwork Reduction Act Notice, see the separate instructions.

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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)

<table>
<thead>
<tr>
<th>Working Capital</th>
<th>Valuation of Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computation Date Credits</td>
<td>Yield Reduction Payments</td>
</tr>
<tr>
<td>Premium Callable Bonds</td>
<td>FMV of U.S. Treasury Obligations</td>
</tr>
<tr>
<td>Joint Bond Yield Authority</td>
<td>External Commingled Investment Funds</td>
</tr>
<tr>
<td>Integration of Hedges</td>
<td>Small Issuer Exception – Pooled Bonds</td>
</tr>
<tr>
<td>Recovery of Overpayments (Refunds)</td>
<td>FMV of Guaranteed Investment Contracts (GIC)</td>
</tr>
</tbody>
</table>

• 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
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 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!