

# What Every Issuer Needs to Know About Arbitrage Rebate

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# What is Arbitrage Rebate?

## Arbitrage

- ▶ When the yield on taxable investments exceeds the tax-exempt restricted rate

## Rebate

- ▶ Essentially a 100% tax
- ▶ Issuer's "rebate" or pay excess earnings to the IRS

## Arbitrage Rebate

- ▶ Financial disincentive to violate the rules
- ▶ Non-compliance could result in taxable bonds



To **prevent abuses**, the tax code limits the permitted uses of tax-exempt bonds

Applies to **every** tax-exempt borrowing and some taxable subsidy obligations

Tax law and regulations create financial disincentives to **prevent** issuance of tax-exempt debt for profit-driven reasons

Prevents:

- Issuance of more bonds than are necessary
  - Issuance of bonds earlier than is necessary
  - Bonds from being 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.
- 
- Measured on an issue-by-issue basis
  - Arbitrate Rebate begins on the issue date
  - Yield Restriction begins at the expiration of a temporary period
- 
- Yield restriction – IRC Section 148(b)
  - Arbitrage rebate – IRC Section 148(f)
  - Overlapping requirements – “Belt & Suspenders”



# Tax Considerations Timeline

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

## Pre-Issuance

- Timing (how financing schedule affects investment rates)
- Project draw schedule
- Evaluate available exceptions and elections
- Identify investment options



## Issuance

- Invest bond proceeds
- Purchase securities, establish fair market value
- Revise draw schedule
- Make elections in tax certificate



## Post-Issuance

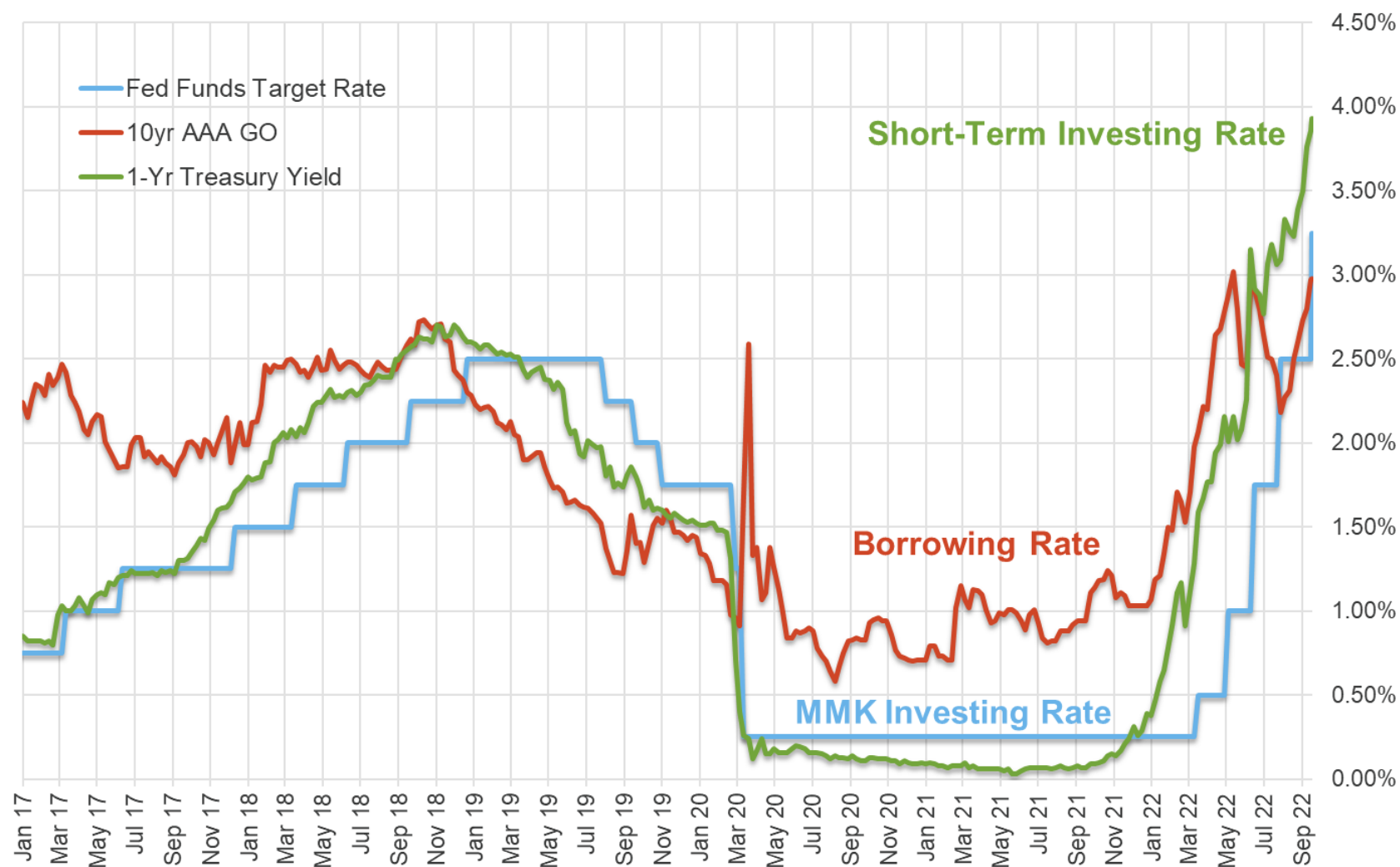
- Arbitrage reporting
- Monitor draw schedule
- Monitor investments
- Record retention



# Positive Arbitrage – It's Back



# Arbitrage Environment



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

# Positive and Negative Arbitrage

$$\begin{aligned} & \text{Actual investment earnings yield} \\ & - \text{Average borrowing rate (aka, the } \textit{arbitrage yield}) \\ & \hline & = \text{Arbitrage \%} \end{aligned}$$

- ▶ **“Positive Arbitrage”** = Actual earnings > Earnings @ arbitrage yield (positive earnings yield spread)
- ▶ **“Negative Arbitrage”** = Actual earnings < Earnings @ arbitrage yield (negative earnings yield spread)
- ▶ Arbitrage Rebate Liability =
  - ▶ Earnings of bond proceeds invested in taxable securities less (-)
  - ▶ Earnings of bond proceeds invested at the arbitrage yield
    - Future value methodology
    - Measured on an issue-by-issue basis
    - Cumulative from the issue date



# Funds Subject to Rebate

PROCEEDS	+	REPLACEMENT PROCEEDS	=	GROSS PROCEEDS
<div>Sale Proceeds / Investment Proceeds</div> <div><ul style="list-style-type: none"><li>• Project / Construction Funds</li><li>• Capitalized Interest Funds</li><li>• Debt Service Reserve Funds</li><li>• Escrow Funds</li><li>• Costs of Issuance Funds</li><li>• Interest earnings</li></ul></div> <div>Transferred Proceeds</div> <div>Any of the above</div>		<div>Cash / Equity / Revenue Funded</div> <div><ul style="list-style-type: none"><li>• Debt Service Funds</li><li>• Debt Service Reserve Funds</li><li>• Any “Pledged” Fund</li></ul></div>		<div>All subject to Rebate</div> <div>Exceptions may apply</div>





# Exceptions to Arbitrage Rebate

- ▶ Small Issuer Exception
- ▶ Spending Exceptions
  - ▶ 6-month
  - ▶ 18-month
  - ▶ 2-year
- ▶ “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”)



# Exceptions to Arbitrage Rebate

## Small Issuer Exception

Exception to  
Arbitrage Rebate  
Only

- ▶ 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



# Exceptions to Arbitrage Rebate

## Spending Exceptions (Can Be Internally Monitored)

- ▶ **“Reward”** for spending bond proceeds quickly
- ▶ Allowed to keep positive arbitrage
- ▶ Simple way to establish compliance (no future value, no yields)
- ▶ Must meet each benchmark, no catch-up allowed

Exception to  
Arbitrage Rebate  
Only

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%**

\* 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



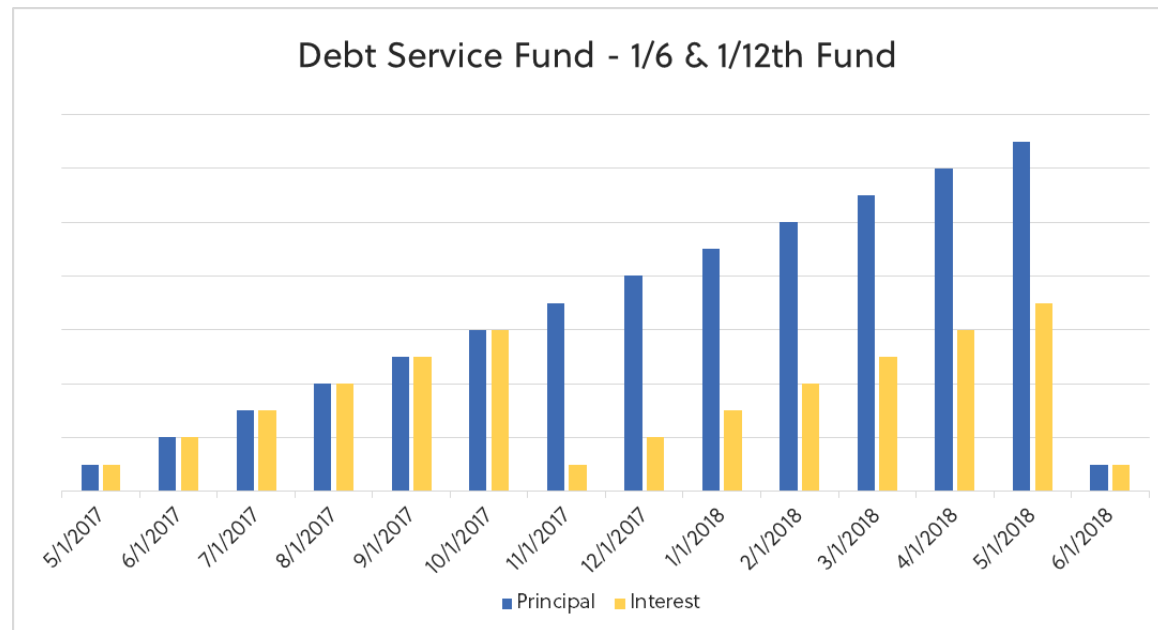
# Exceptions to Arbitrage Rebate

## “Bona Fide” Debt Service Fund Exception

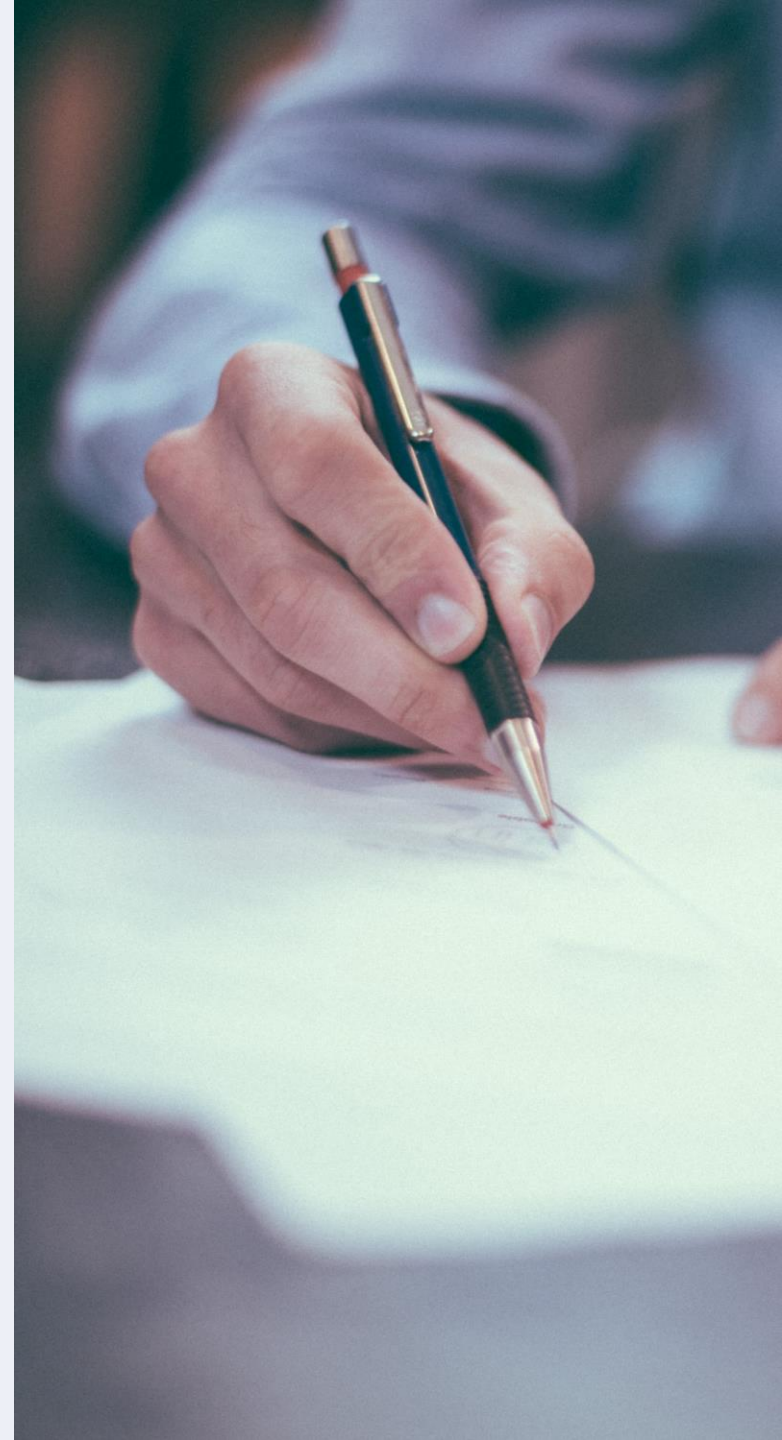
- ▶ Depleted at least annually except for greater of:
  - ▶ Previous year’s earnings in the fund, or
  - ▶ 1/12th of previous year’s principal and interest payment
  - ▶ Additional earnings test for Private Activity Bonds

Exception to  
Arbitrage Rebate

Exception to  
Yield Restriction



# Yield Restriction Compliance



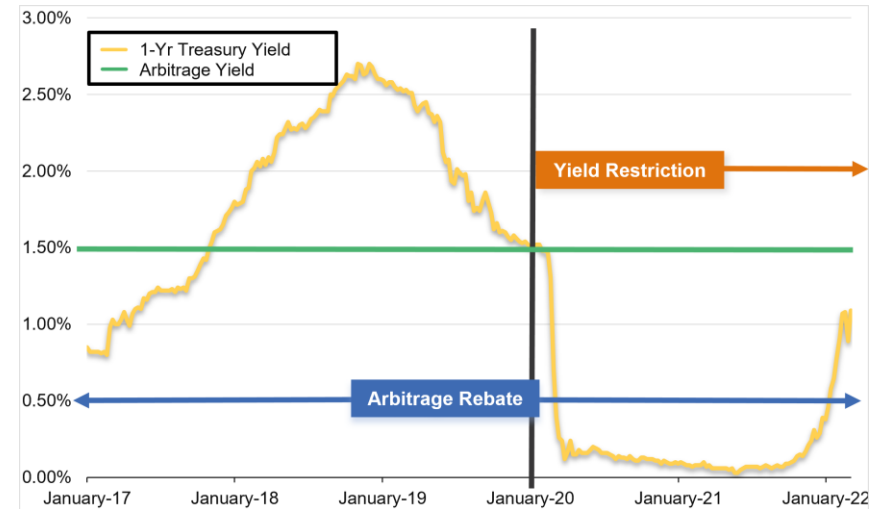
# What is Yield Restriction?

- 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



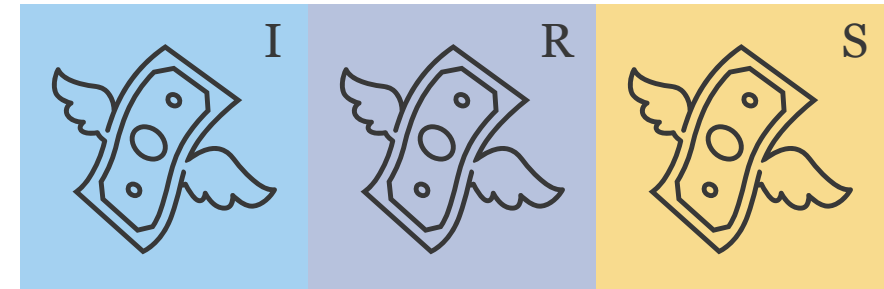


# Calculation Requirement



# Calculation and Filing Requirement

- ▶ Payment due no later than 60 days after the computation date
  - ▶ No later than 5-years after the issue date
  - ▶ 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”



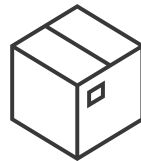
# Refunds

- ▶ 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



# Can I Earn Positive Arbitrage?

- ▶ **EARNING** positive arbitrage may be allowed in certain circumstances, but prohibited in other circumstances.

Proceeds	Able to Earn Positive Arbitrage?
Current Refunding	YES
Tax-Exempt Advance Refunding	NO
Defeasance Escrow	NO
Project Funds	YES
Reserve Funds	YES



# Dual Requirements of Arbitrage

Arbitrage Rebate	Gross Proceeds	Yield Restriction
<ul style="list-style-type: none"> <li>Subject to rebate from issue date, <i>unless</i>:</li> <li>Exempt if a spending exception is met (6-month, 18-month, or 2-year)</li> <li>Exempt if the issue qualifies under “small issuer”</li> </ul>	<b>Project Fund and Capitalized Interest</b>	<ul style="list-style-type: none"> <li>Generally, a 3-year temporary period applies (5-years with certification for a longer period necessary)</li> <li>Temporary period can be waived</li> <li>Yield restricted at the bond yield + 0.125% after temporary period expires</li> </ul>
<ul style="list-style-type: none"> <li>Subject to rebate from issue date, <i>unless</i>:</li> <li>Exempt if the issue qualifies under “small issuer”</li> </ul>	<b>Reserve Fund</b>	<ul style="list-style-type: none"> <li>Exempt from yield restriction if qualified as a reasonably required reserve or replacement fund in size</li> <li>If failed in size, yield restricted at the bond yield + 0.001%</li> </ul>
<ul style="list-style-type: none"> <li>Subject to rebate from issue date. <i>unless</i>:</li> <li>Exempt if the issue qualifies under “small issuer”</li> <li>Exempt if the 6-month spending exception is met</li> </ul>	<b>Escrow Fund</b>	<ul style="list-style-type: none"> <li>Yield restricted at the bond yield + 0.001% after the end of the applicable temporary period: <ul style="list-style-type: none"> <li>Advance Refunding: 30 days</li> <li>Current Refunding: 90 days</li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>Exempt from rebate if qualified as a bona fide debt service fund (generally depleted annually)</li> <li>If failed in compliance, subject to rebate</li> </ul>	<b>Debt Service Fund</b>	<ul style="list-style-type: none"> <li>Exempt from yield restriction if qualified as a bona fide debt service fund (generally depleted annually)</li> <li>If failed in compliance, yield restricted at the bond yield + 0.001%</li> </ul>
<ul style="list-style-type: none"> <li>Subject to rebate from issue date, <i>unless</i>:</li> <li>Exempt if the issue qualifies under “small issuer”</li> <li>Exempt if a spending exception is met</li> </ul>	<b>Cost of Issuance</b>	<ul style="list-style-type: none"> <li>For new money issues, a 3-year temporary period applies</li> <li>For refunding issues, a 13-month temporary applies</li> </ul>



# Case Study

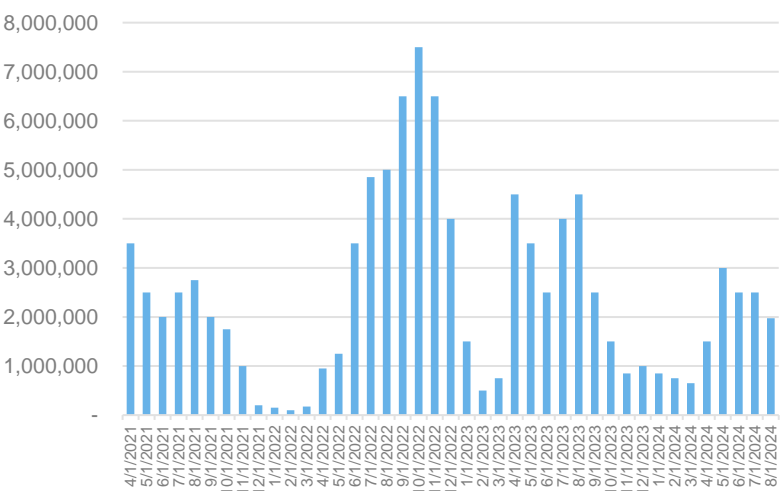
The Situation: The Authority of We Need To Raise Tolls To Repair All These Potholes (the “Authority”) is selling Series 2022A new money revenue bonds with the following characteristics:

Par Amount	\$110,000,000
Construction Fund Deposit	\$100,000,000
Reserve Fund Deposit	\$10,000,000
Estimated Draw Schedule	~40 mos
Arbitrage Yield	2.50%
Current Investment Yield	3.00%

## Questions to consider:

1. How confident is the Authority in the draw schedule?
2. Does the Authority expect to meet a spending exception? Should the spending exception be applied?
3. Does the Authority expect to earn positive arbitrage?
4. Is waiving the 3-year temporary period an option?

Authority Draw Schedule - Series 2022A





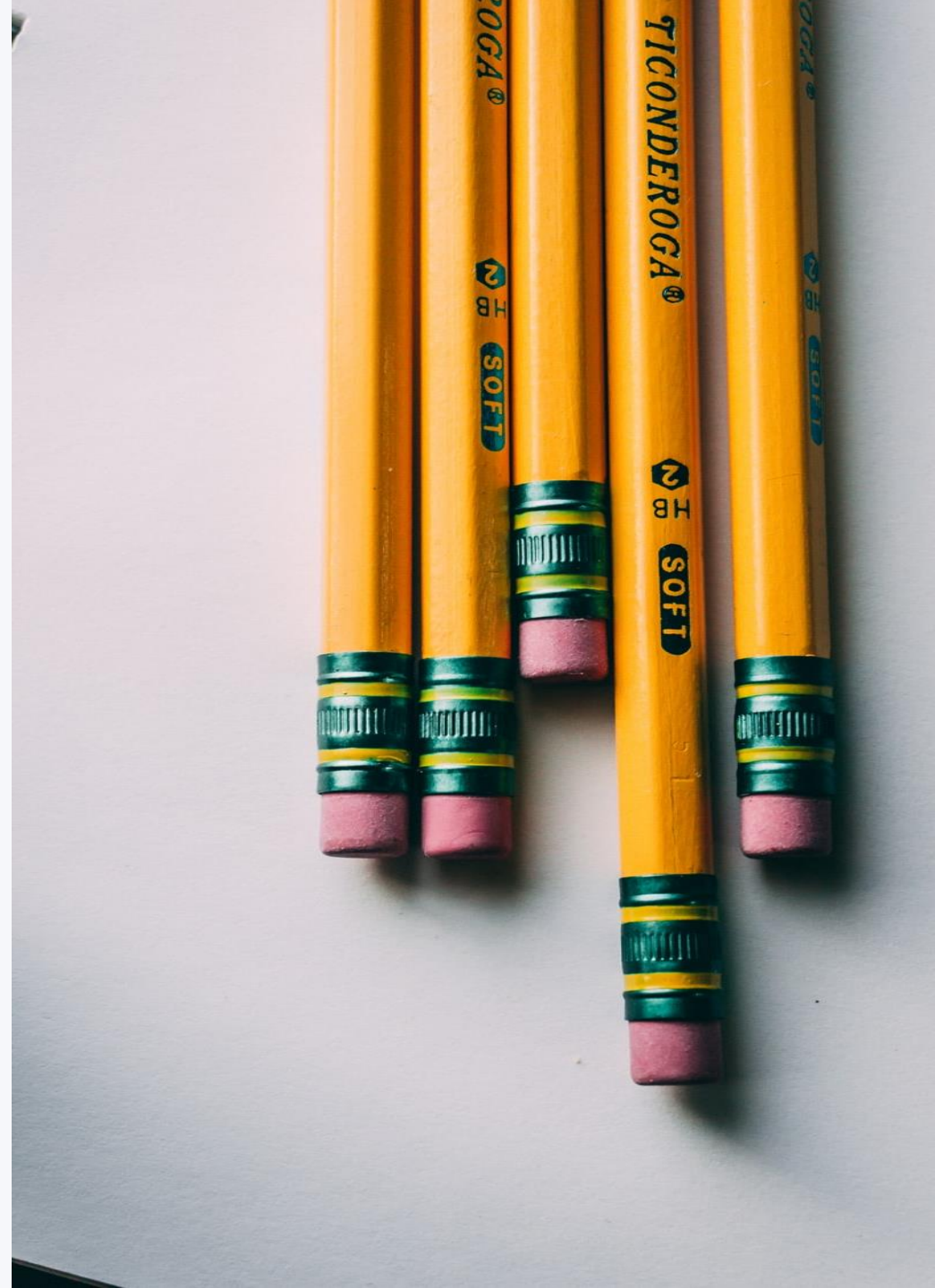
# Tips for a Smooth Process

Exception to  
Arbitrage Rebate  
Only

- ▶ Be familiar with the tax or non-arbitrage certificate
- ▶ Create an organized file system
  - ▶ Avoids having to find records from 5-years ago
  - ▶ Consider hiring a consultant when the bonds are issued
- ▶ Schedule your calculation at least 60 days or more in advance
- ▶ Know the exceptions
  - ▶ If eligible, find out which one, and what that means for the issue
- ▶ Consider having calculations prepared more frequently
  - ▶ 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...





# **What Every Issuer Needs to Know About Arbitrage Rebate**

Get ready to compete!

**With respect to the Arbitrage Rebate  
and Yield Restriction Regulations,  
what is the Federal Government trying  
to prevent related to tax exempt  
bonds?**

# **With respect to the Arbitrage Rebate and Yield Restriction Regulations, what is the Federal Government trying to prevent related to tax exempt bonds?**

Issuing more bonds than necessary

Issuing bonds sooner than necessary

Leaving bonds outstanding longer than necessary

All of the above

# **With respect to the Arbitrage Rebate and Yield Restriction Regulations, what is the Federal Government trying to prevent related to tax exempt bonds?**

Issuing more bonds then necessary

Issuing bonds sooner than necessary

Leaving bonds outstanding longer than necessary

All of the above

# Leaderboard



**Which of the following issues is not subject to the Arbitrage Rebate and Yield Restriction Regulations?**

# Which of the following issues is not subject to the Arbitrage Rebate and Yield Restriction Regulations?

\$30,000,000 Taxable Build America Bonds, Series 2010A

\$15,000,000 General Obligation Bonds, Series 2015  
(Tax-exempt)

Master Lease dated July 15, 2017 privately placed with  
US Bank

Pension Obligation Bonds (Taxable) Series 2011

# Which of the following issues is not subject to the Arbitrage Rebate and Yield Restriction Regulations?

\$30,000,000 Taxable Build  
America Bonds, Series 2010A

\$15,000,000 General Obligation  
Bonds, Series 2015 (Tax-exempt)

Master Lease dated July 15, 2017  
privately placed with US Bank

Pension Obligation Bonds  
(Taxable) Series 2011

# Leaderboard

## **Which are exceptions from Yield Restriction?**

# Which are exceptions from Yield Restriction?

Small Issuer Exception, 2-year Spending Exception

Minor Portion, Temporary Period

18-Month Spending Exception, Minor Portion

Bona Fide Debt Service Fund Exception,  
Temporary Period

# Which are exceptions from Yield Restriction?

Small Issuer Exception,  
2-year Spending Exception

Minor Portion, Temporary  
Period

18-Month Spending  
Exception, Minor Portion

Bona Fide Debt Service Fund  
Exception, Temporary Period

# Leaderboard



**How long are you federally required to retain records related to your tax-exempt bonds?**

# How long are you federally required to retain records related to your tax-exempt bonds?

6 Years

Life of the Bonds +3

7 Years

Life of the Bonds +6

# How long are you federally required to retain records related to your tax-exempt bonds?

6 Years

Life of the Bonds +3

7 Years

Life of the Bonds +6

# Leaderboard

**True or False. Only the proceeds I receive from selling my Bonds are subject to the arbitrage rebate and yield restriction requirements.**

**True or False. Only the proceeds I receive from selling my Bonds are subject to the arbitrage rebate and yield restriction requirements.**

True

False

**True or False. Only the proceeds I receive from selling my Bonds are subject to the arbitrage rebate and yield restriction requirements.**

True

False

# Leaderboard



**True or False. I can take negative  
arbitrage from my Series 2011 Bonds  
and use it to offset positive arbitrage  
on my 2019 Bonds.**

**True or False. I can take negative arbitrage from my Series 2011 Bonds and use it to offset positive arbitrage on my 2019 Bonds.**

True

False

**True or False. I can take negative arbitrage from my Series 2011 Bonds and use it to offset positive arbitrage on my 2019 Bonds.**

True

False

# Leaderboard

**True or False. My reporting requirements end once I have fully expended my project fund monies.**

**True or False. My reporting requirements end once I have fully expended my project fund monies.**

True

False

**True or False. My reporting requirements end once I have fully expended my project fund monies.**

True

False

# Leaderboard



# **Which form is used to make an Arbitrage Rebate or Yield Reduction Payment?**

# Which form is used to make an Arbitrage Rebate or Yield Reduction Payment?

8038-G

8038-CP

8038-T

8038-R

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8038-G

8038-CP

8038-T

8038-R

# Leaderboard

**The School District issued Bonds to fund the construction of a new high-school. Which spending exceptions are available for this issue?**

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6-month spending exception

18-month spending exception

2-year spending exception

All of the above

# **The School District issued Bonds to fund the construction of a new high-school. Which spending exceptions are available for this issue?**

6-month spending exception

18-month spending exception

2-year spending exception

All of the above

# Leaderboard



**The County issued 30 year Bonds on  
May 5, 2019 with principal payable on  
August 1 beginning on August 1, 2019.  
The first required calculation date is:**

**The County issued 30 year Bonds on May 5, 2019 with principal payable on August 1 beginning on August 1, 2019. The first required calculation date is:**

May 5, 2020

August 1, 2020

May 5, 2024

August 1, 2024

**The County issued 30 year Bonds on May 5, 2019 with principal payable on August 1 beginning on August 1, 2019. The first required calculation date is:**

May 5, 2020

August 1, 2020

May 5, 2024

August 1, 2024

# Leaderboard

**Bonus: True or False. Having positive arbitrage with respect to my issue is a bad thing.**

**Bonus: True or False. Having positive arbitrage with respect to my issue is a bad thing.**

True

False

**Bonus: True or False. Having positive  
arbitrage with respect to my issue is a bad  
thing.**

True

False

# Leaderboard



# Thank You!



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