Arbitrage Rebate Compliance Basics

Current Environment & Important Reminders

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Agenda

Learning Objectives

- Learn the basics of arbitrage rebate calculations and compliance
- Understand the difference between arbitrage rebate and yield restriction
- Understand strategies to mitigate compliance issues
- Assess existing policies and procedures and be prepared for an IRS audit

Discussion Topics

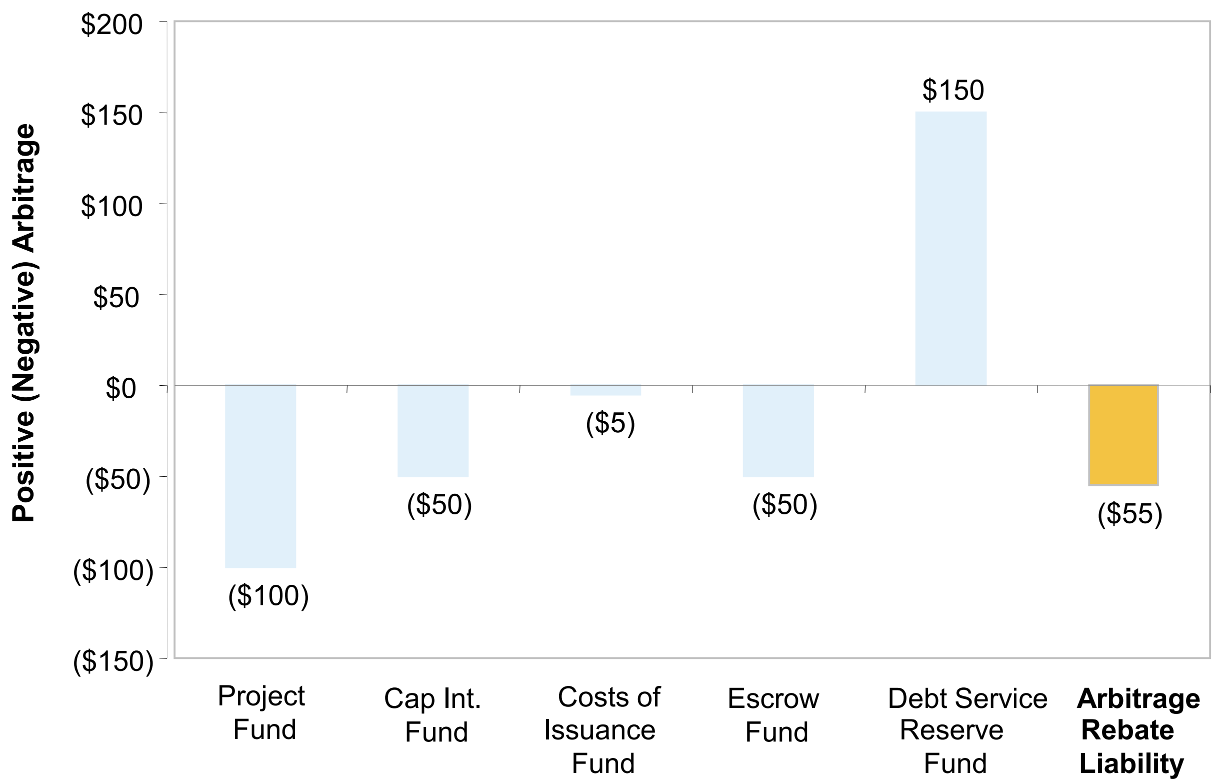
- Arbitrage rebate calculations basics
- Tax Considerations before, during & after issuance
- Compliance Strategies
- Post Issuance Compliance – Best Practices

Arbitrage Rebate & Yield Restriction – The Basics

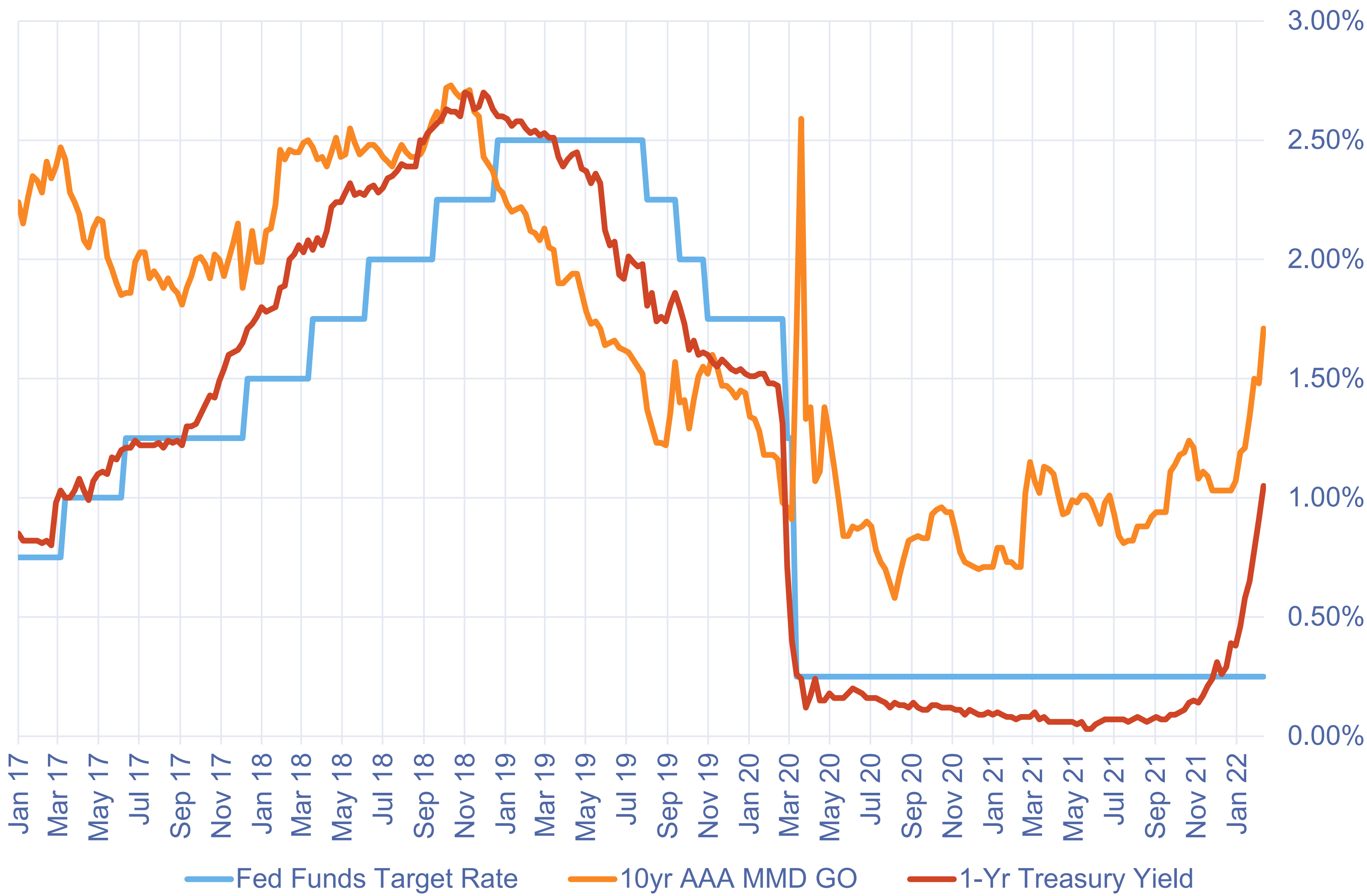
- Primary Objective: Prevent Abuses
  - Prohibits issuing more bonds then necessary
  - Prohibits issuing bonds earlier than necessary
  - Prohibits bonds from remaining outstanding longer than necessary
- Applies to **<u>every</u>** tax-exempt and some taxable subsidy obligations
- **Arbitrage Rebate** begins on the issue date
- **Yield Restriction** begins at the expiration of a temporary period

Arbitrage Liability Example

- Arbitrage is measured <u>issue-by-issue</u> in aggregate and over time
- For each bond issue, all funds subject to arbitrage are blended together
- Negative arbitrage in a fund can be used to offset positive arbitrage in other funds



Arbitrage Environment



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

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

Bond Proceeds Compliance Strategies: Arbitrage Rebate

Funds Subject to Rebate

PROCEEDS	+	REPLACEMENT PROCEEDS	=	GROSS PROCEEDS

Sale Proceeds or Investment Proceeds

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

Transferred Proceeds

Any of the above

Cash/Equity/Revenue Funded

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

All Subject to Rebate

- Exceptions may apply

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

These are exceptions to Arbitrage Rebate *Not* Yield Restriction

Small Issuer Exception

- **Calendar Year Exception**
  - $5 million of governmental bonds for municipalities
  - $15 million 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 issues** in certain circumstances

Still subject to Yield Restriction Requirements

Spending Exceptions

Exception to Arbitrage Rebate Only

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
- **Optional** to apply

** 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% **

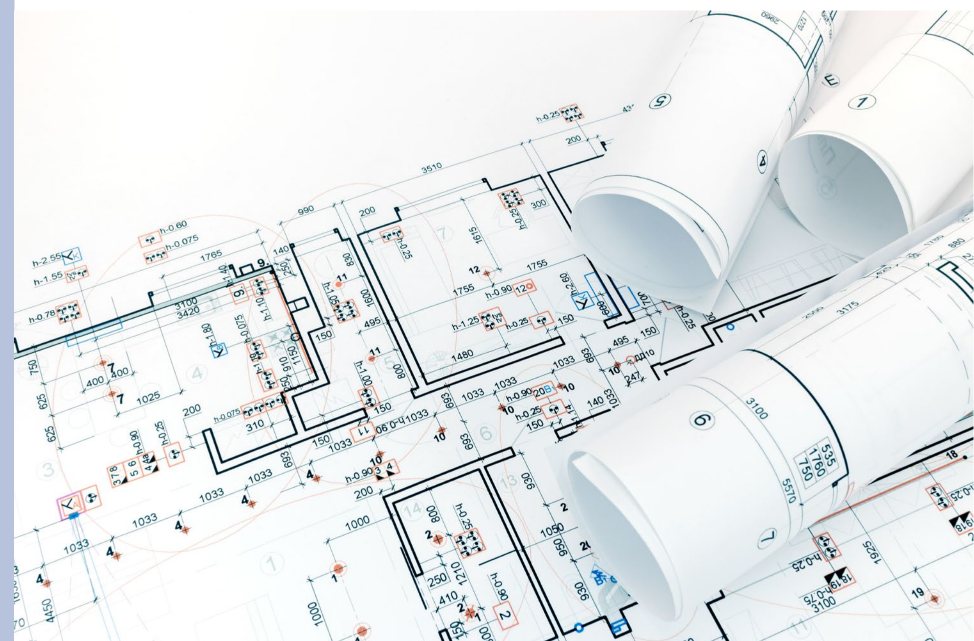
2-Year (ACP)	
Construction issues	
✓ 6 months	10%
✓ 12 months	45%
✓ 18 months	75%
✓ 24 months	100% **

Bond Proceeds Compliance Strategies: Yield Restriction

Exceptions to Yield Restriction

- "Temporary Period"
  - Generally 3-years for construction proceeds
  - Can be extended to 5-years with certification
  - Can also be waived entirely
- Reasonably Required Reserve or Replacement Funds
- Minor Portion
  - Generally less than $100,000
- Investing in tax-exempt obligations

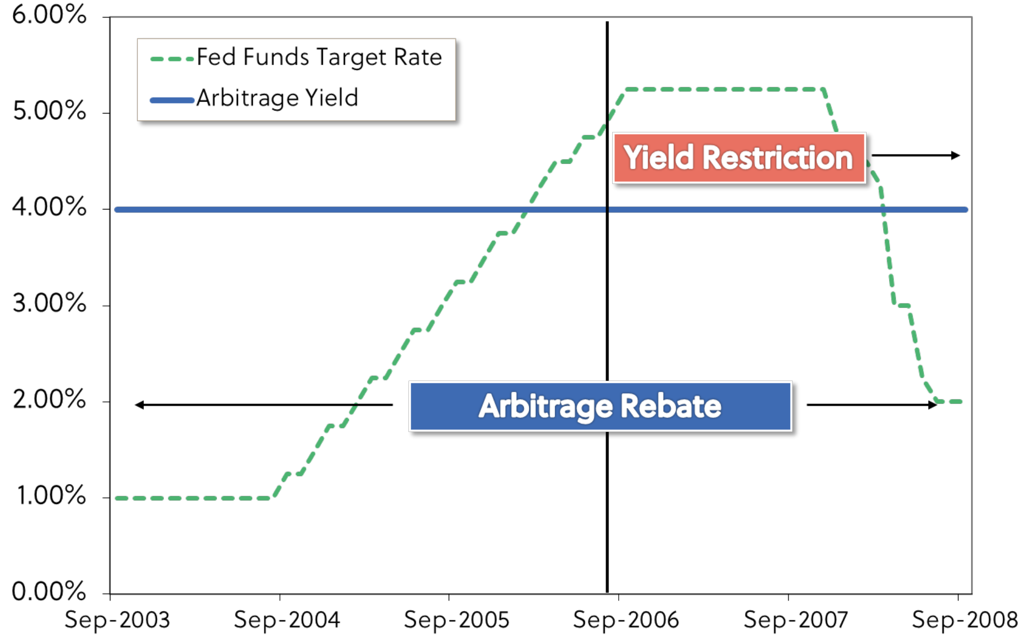
These are exceptions to Yield Restriction *Not* Arbitrage Rebate



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
- Yield restricted proceeds cannot earn above the “Materially Higher Yield” (arbitrage yield + .125%)
- Cannot blend positive arbitrage of yield restricted proceeds with negative arbitrage of unrestricted proceeds

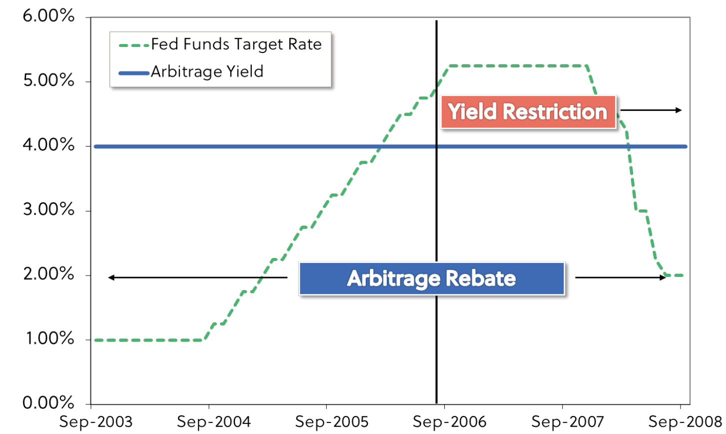
Could the next 5 years produce a similar interest rate environment?



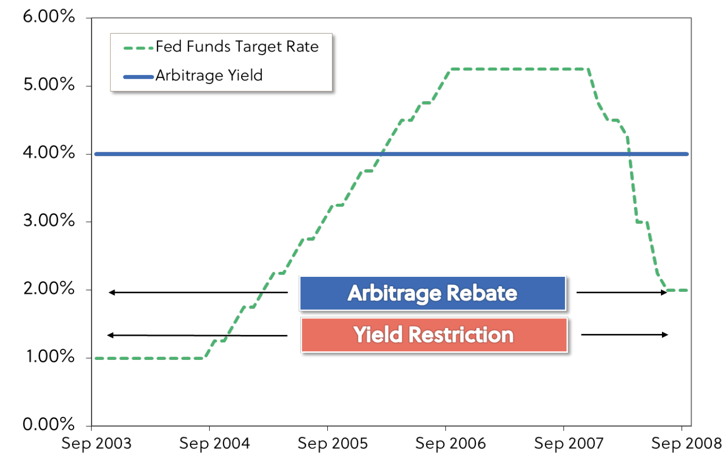
Yield Restriction Impact

Waiving a 3-year Temporary Period

- Situational Awareness – preparing for potential higher interest rates in the future



- 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

To Waive or Not To Waive

- Even in today's uncertain interest rate environment – this may still make sense
- Consider the following:

DRAW SCHEDULE	ARBITRAGE YIELD		
	Low	Mid	High
Short (<18 mos.)	NO	NO	MAYBE
Medium (18-24 mos.)	NO	MAYBE	YES
Long (>24 mos.)	MAYBE	YES	YES

- **Each bond issue should be examined separately with your advisors and bond counsel. Representation above is based on current market conditions and current expectations of borrowing rates and investment rates for bond proceeds.**
- Tax election to waive the temporary period must be made by the issuer in writing at settlement – no ability to change election after the bonds are issued.

Each Bond Issue is Unique

Questions to Consider

How confident are you in the draw schedule?

Do you expect to meet a spending exception? Should it be applied?

Is waiving the 3-year temporary period an option?

Do you expect to earn positive arbitrage?

Additional Considerations – Often Overlooked

"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

Exception to Arbitrage Rebate

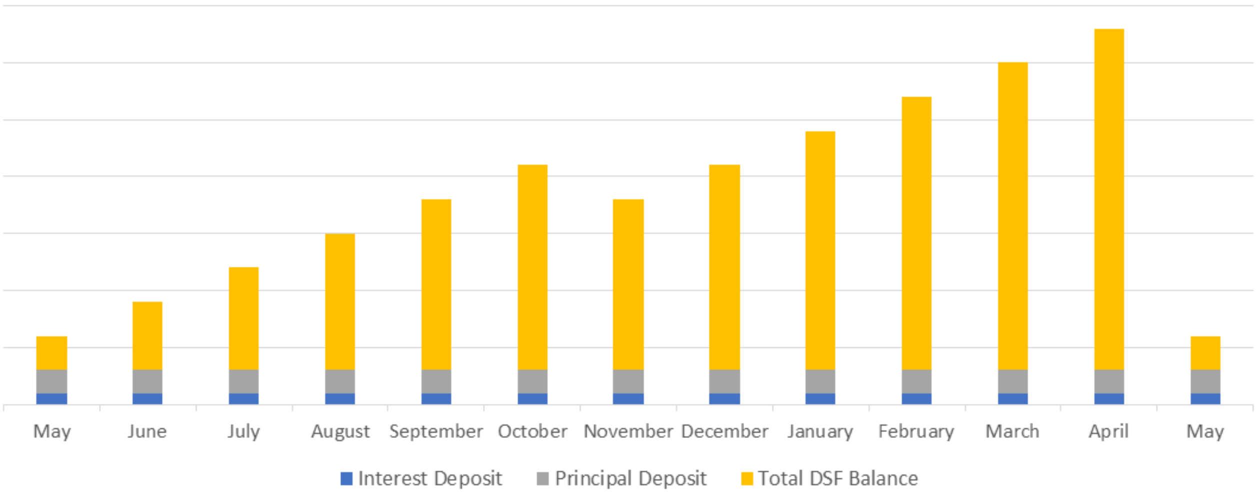
Exception to Yield Restriction

Excess portion of DSF is subject to both Arbitrage Rebate & Yield Restriction

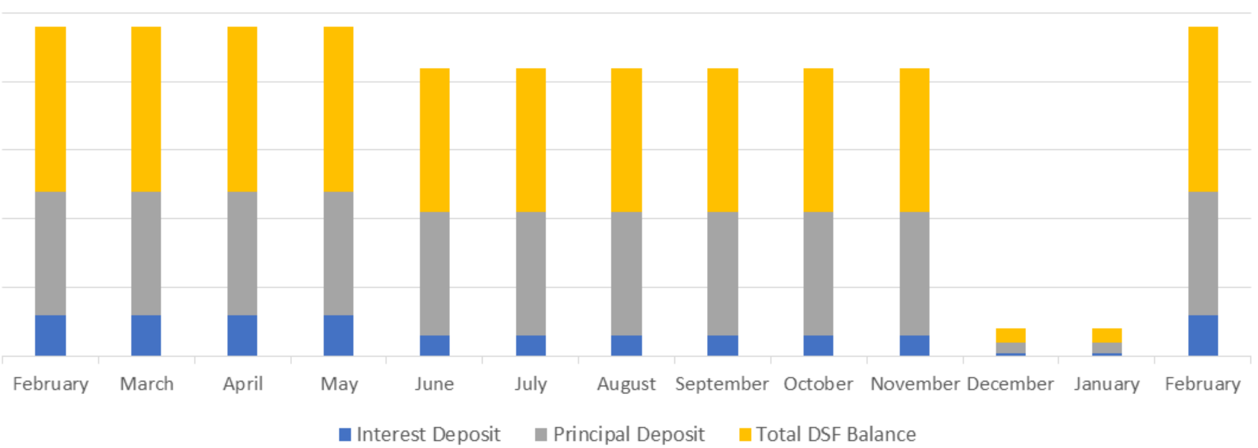
- Residual, Interest Reserve or Reserve Portion
- How to allocate?

Debt Service Funds

Monthly Deposits: 1/6th of semi-annual interest payment and 1/12th of principal payment

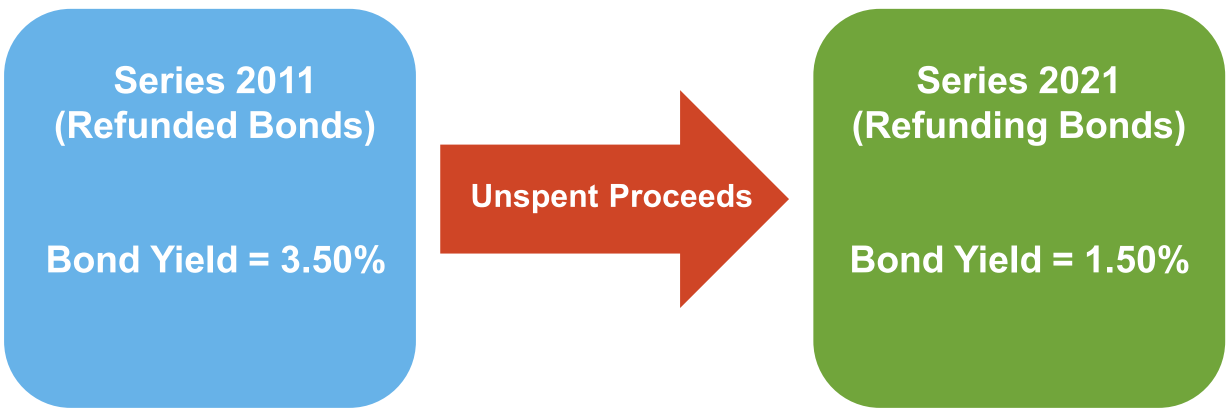


Single or large deposits: Tax revenues received early in the calendar year deposited to meet budgeted debt service



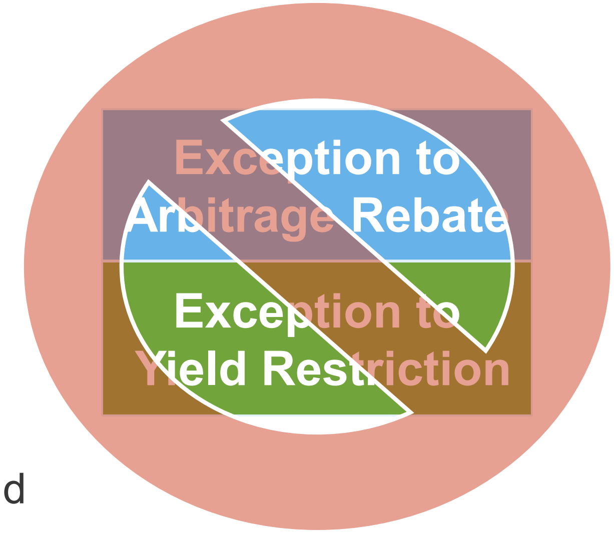
Be Aware of Refunding Impacts

- May accelerate final maturity of the issue
- 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
- Universal Cap Issue related to Taxable Advance Refunding Escrows



Unspent Proceeds

- Generally no spending deadline for proceeds
- Neglecting unspent proceeds opens the door for **unforeseen liabilities**
  - Cost of Issuance Fund outstanding longer than 6 months
  - Project Fund proceeds remaining after the 3-year temporary period
  - Reasonably Required Reserve or Replacement Fund exceeding the size limitation
  - Overfunded Debt Service Funds
- Proceeds should continue to be spent with due diligence
  - Identify additional qualified expenditures
  - Allocate to interest payments on the Bonds



Post Issuance Compliance: Requirements & Best Practices

Calculation & Filing Requirements

- Payment due no later than 60 days after the computation date
  - At least every 5 years
  - 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
- Refund Requests

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.

Many issuers and bond lawyers acknowledge that simply having something in writing to "check the box" is not enough

Record Retention

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

- 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
- Banks and other third parties may destroy records after 7 years

IRS TE/GE FY Work Plan

FY 2021 Program Letter

General Information

- Examine organizations and entities using referrals and data analytics to focus on high-risk issues
- Expand e-filing of Forms 990 and 8038-CP

Audit / Examination Focus Areas

- Public Safety Bonds – Private Business Use
- Sinking Fund over-funding
- Variable rate bonds
- Claims for payments on Direct Pay Bonds – Build America Bond subsidy payments
- Arbitrage violations – Bond proceeds invested beyond allowable temporary period

FY 2022 Program Letter

General Information

- Increase in the TE/GE workforce with most new hires assigned to enforcement duties
- Expand outreach activities –creating educational videos, increasing service to underserved communities, and launching new e-forms and services

Fiscal Year 2022 Priorities

- Strengthen Compliance Activities
- Leverage Technology and Data Analytics
- Develop Workforce
- Improve Operational Efficiencies
- Ensure Awareness and Collective Understanding

Final Thoughts

Tips for Navigating Arbitrage Rebate

- ✓ Determine the yield for arbitrage purposes – understand the arbitrage environment
- ✓ Compile and maintain a list of bond issues in need of rebate and yield restriction calculations
- ✓ Know the exceptions, consult with bond counsel and arbitrage compliance resources
- ✓ Perform calculations no later than 5-year anniversary dates and final maturity or final bond redemption dates (may be earlier than 5-years). Annual reporting is better for planning purposes and helps to eliminate surprises.
- ✓ Make payments no later than 60 days after computation date
- ✓ Retain copies of compliance calculations and all documents in the event of an audit
- ✓ Ask Questions!

Thank you!

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