Introduction to Post Issuance Compliance and Arbitrage Rebate

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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
Current Events
IRS ITG/TEB FY 2018 Work Plan - Transparency, Efficiency & Effectiveness

Priority Examinations

- Tax-advantaged bonds with guaranteed investment contracts
- Tax-advantaged bonds with qualified hedges
- Tax-advantaged bonds with investments beyond a temporary period
- Acquisition financings – PABs to determine if rehabilitation requirement was satisfied
- Non-qualified use – dispositions of financed facilities and/or excessive private use
- Deep Discount Bonds and Private Activity Bonds with excessive WAMs
- Evidence of noncompliance (referrals)
- History indicates future risk of noncompliance

VCAP – Voluntary Compliance Agreement Program

- Further Streamlining the process to minimize IRS and issuer resources
- Possible streamlined VCAP process for arbitrage violations
IRS Audits / Examinations

- New issuer friendly process adopted April 2017
- Extension requests almost always honored when filed timely
- Unlikely that audits are “random” anymore
  - Data analytics make it more probable that the IRS has identified a problem if an audit is opened
- Survey process
  - Very important to contact bond counsel immediately
  - Do not send any documents to the IRS agent before establishing contact
  - Possible to cancel the audit before it even begins

Goal:
Reduce the burden on issuers and IRS agents, leading to reduced cycle time and quicker resolution
Post Issuance Compliance
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

- 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
Either Way, You Are Obligated to Comply

- You can invest the time to fully develop a system for compliance, or take on that responsibility for identifying, capturing and quantifying each year. Take the hard way or ultimately the easier way.

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**Post-Issuance Compliance**

- Policies
- Procedures: Tax Objectives

**Principles Driven, Process Supported**

- Policies
  - Procedures: Who, What, When?
- Processes
One Size Does Not Fit All

- **Effective** policies and procedures fit your organization
  - Promotes internal awareness throughout your entire organization
  - Helps mitigate risks by identifying potential problems early
  - Offers continuity
  - Policies should flow together

- Be prepared for the IRS

- Gives you significant advantages in dealing with the IRS

- Demonstrates and documents good compliance
Arbitrage Rebate Compliance
How is Arbitrage Measured?

- Arbitrage % = Actual investment earnings yield (−) average borrowing rate (aka, the Arbitrage Yield)

- 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?
Funds Subject to Rebate

PROCEEDS + REPLACEMENT PROCEEDS = GROSS PROCEEDS

- Sale Proceeds / Investment Proceeds
- Cash / Equity / Revenue Funded

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

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

All subject to Rebate

Transferred Proceeds
Any of the above

Exceptions may apply
Arbitrage Rebate – An Example

- Arbitrage is measured 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

<table>
<thead>
<tr>
<th>Project Fund</th>
<th>Cap Int. Fund</th>
<th>Costs of Issuance Fund</th>
<th>Escrow Fund</th>
<th>Debt Service Reserve Fund</th>
<th>Arbitrage Rebate Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>$(100)</td>
<td>($50)</td>
<td>($5)</td>
<td>($50)</td>
<td>$150</td>
<td>($55)</td>
</tr>
</tbody>
</table>
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></td>
<td>✓ 24 months 100% **</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

- **Excess portion subject to arbitrage**
  - I&S Fund - Residual or Interest Reserve
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
## 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>
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*
Yield Restriction Compliance – Strategic Planning

Be aware of yield restriction compliance requirements in a rising interest rate environment

- Project Fund temporary period typically expires in 3 years
  - Yield restriction clock starts at year 3
  - Unspent proceeds become subject to yield restriction, at potentially higher investment rates
  - Negative arbitrage accrued during the first 3 years cannot be blended

- **Strategy – Pre-Issuance Planning**
  - Waive 3-year temporary period
    - Starts yield restriction clock as of the issue date
    - Yield restriction begins immediately (parallel to arbitrage rebate liability)
    - No yield restriction surprise in 3 years
    - Election must be made at time of issuance, typically in the Tax Certificate
    - Consult bond/tax counsel
Impact – Waiving 3-year 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
## 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>
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
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

- UPDATE - 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
Planning is Important

Tax Regulations provide flexibility that may reduce liabilities

- Investment Valuations
- Accounting approach
- Computation Dates, particularly for variable rate bonds
- Various other optional elections
Homework

- Maintain complete inventory of bonds
- Create a file for each bond issue right after the bond closing
- Schedule arbitrage rebate calculations
- Review interest rate provisions of bank loans and private placements
- Create a bond compliance officer
- Complete an annual self-assessment
- Be prepared for an IRS audit
- Ask Questions!