Introduction to Post Issuance Compliance and Arbitrage Rebate

Katia M. Frock, Director
frockk@pfm.com

PFM Asset
Management LLC

213 Market Street
Harrisburg, PA 17101

Phone: 717.232.2723
Fax: 717.233.6073
www.pfm.com

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

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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

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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

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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

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Record Retention

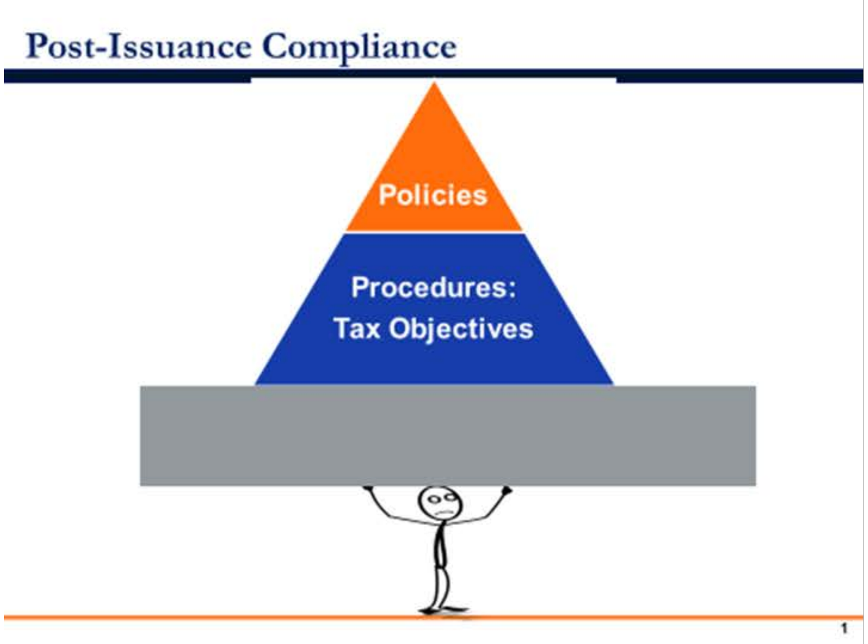
- Life of the Bonds + 3 years
- If the Bonds are refunded, life of refunding bonds + 3 years
- Consider separate document collection, storage and destruction policies for bond related records
- Consider electronic storage systems

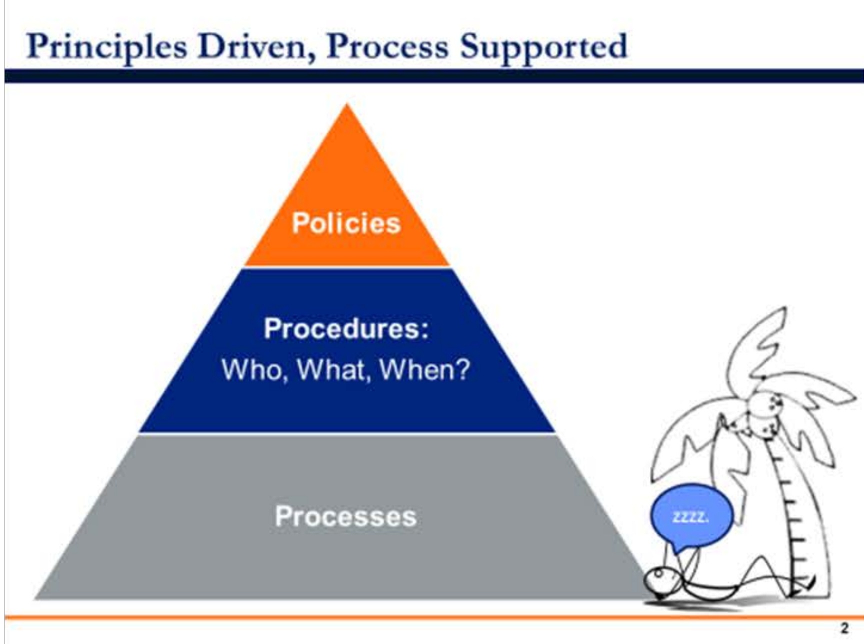
DO NOT DESTROY:

- ✓ 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.





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?

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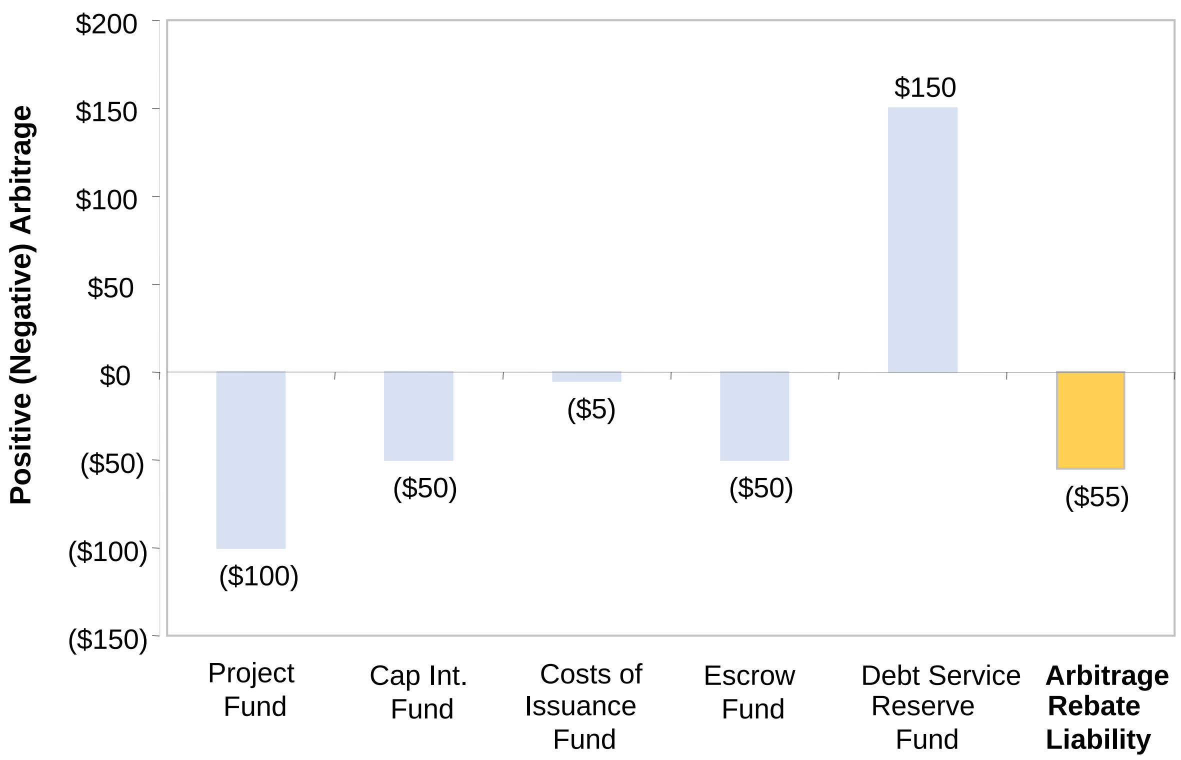
Funds Subject to Rebate

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 Exceptions may apply
Transferred Proceeds Any of the above				

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



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

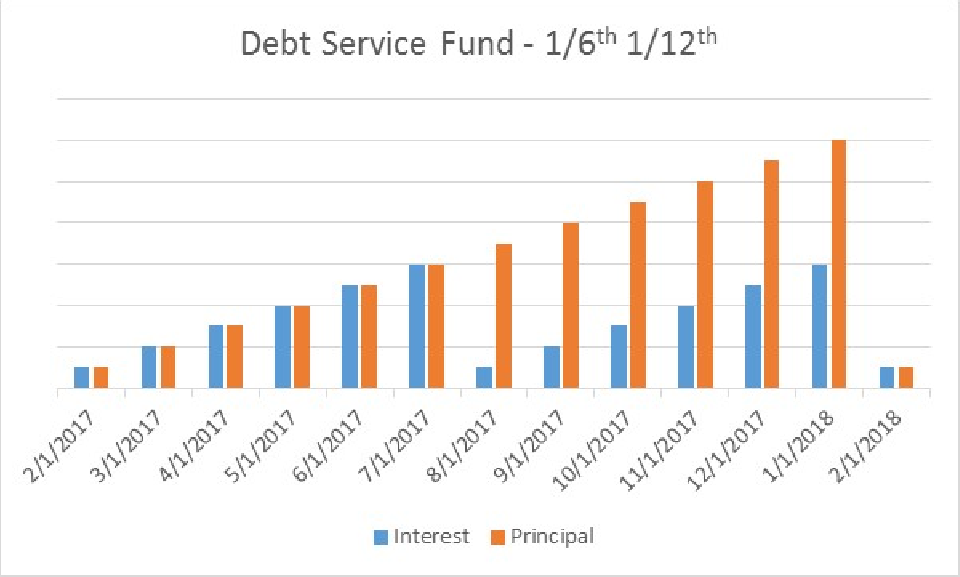
* De minimis exceptions generally apply for the last benchmark

** 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

- 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

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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

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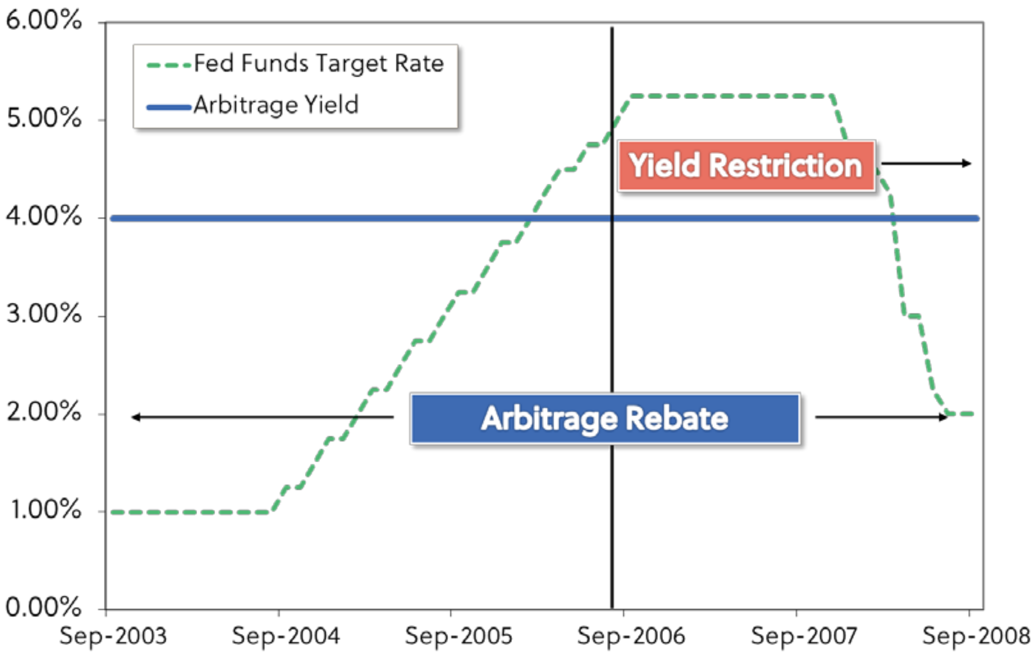
Arbitrage Rebate vs. Yield Restriction

- 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**

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Yield Restriction Compliance – Strategic Planning

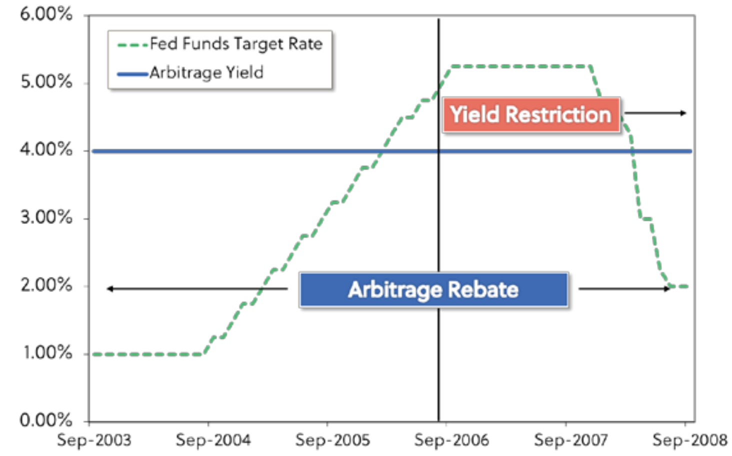
- Be aware of yield restriction compliance requirements in a **rising interest rate environment**

  - 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

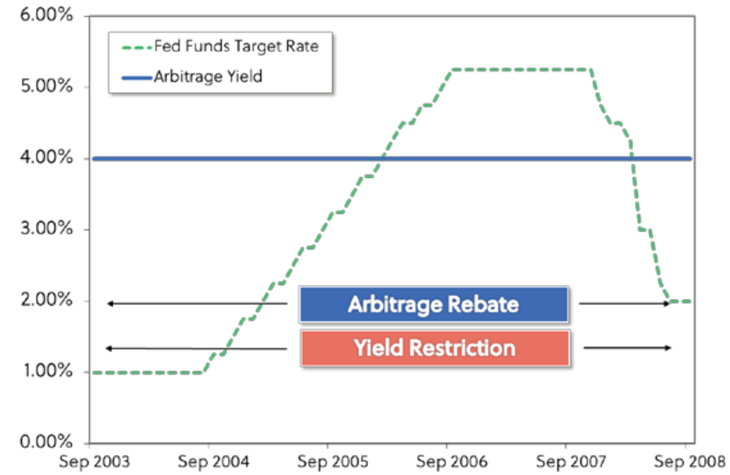
  - **Strategy – Pre-Issuance Planning**
    - Waive 3-year temporary period
      - Starts yield restriction clock as of the issue date
      - Yield restriction begins immediately (parallel to arbitrage rebate liability)
      - No yield restriction surprise in 3 years
      - Election must be made at 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

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

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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”

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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

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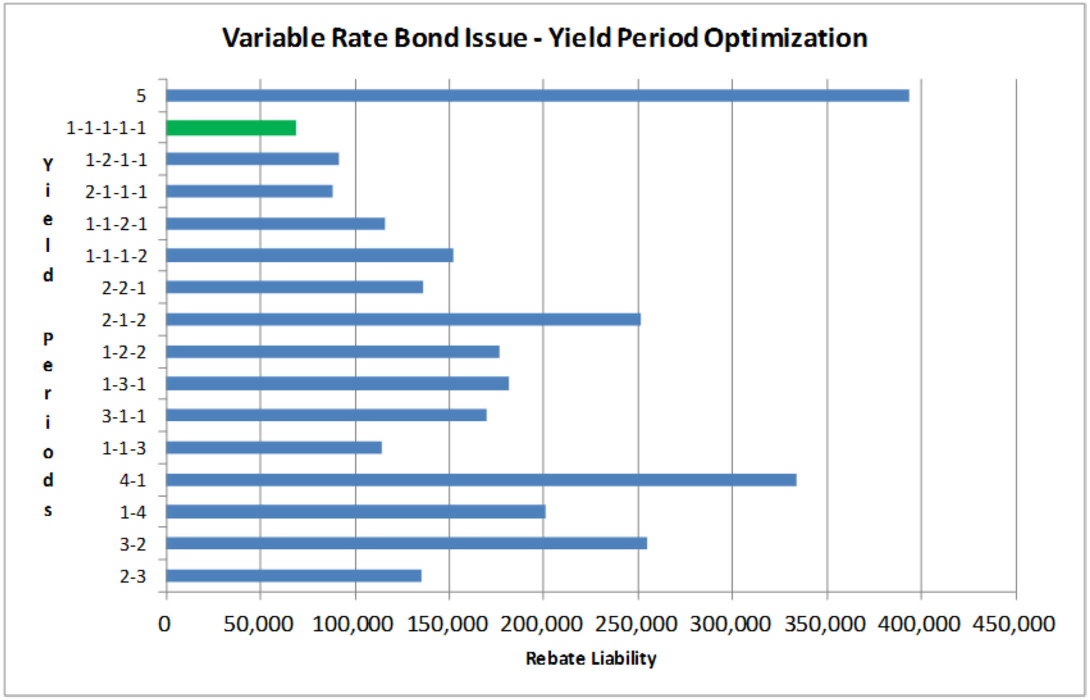
Planning is Important

- 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!

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