

What Every Issuer Needs to Know About Arbitrage Rebate

FGFOA 2025 School of Government Finance

October 30, 2025

Mike Steinbrook
Director

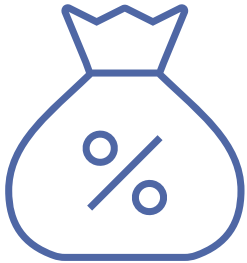
Disclosures

To ensure compliance with U.S. Treasury Regulations governing tax practice, we inform you that any U.S. federal tax advice contained in this communication, including any attachments, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any penalties under U.S. federal tax law, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. PFM Asset Management, a division of U.S. Bancorp Asset Management, Inc., cannot provide legal advice, and appropriate professionals should be consulted if such issues are involved.

U.S. Bancorp Asset Management, Inc. is registered with the SEC under the Investment Advisers Act of 1940. A copy of our Form ADV, Parts 2A & 2B is available upon request.



Understanding Arbitrage Rebate



Within a local government investment program, it is important to recognize the tax implications associated with the investment of tax-exempt bond proceeds. This session will cover basic arbitrage rebate and yield restriction compliance concepts and apply them to investment strategies for project, debt service, and other bond proceeds accounts in order to maximize your retainable investment income and implement strategies to enhance your investment program.

When you complete this session, you should be able to:

- Identify and apply the rules for spending exceptions to arbitrage rebate
- List the two types of IRS regulations that apply to tax-exempt borrowings
- Recognize the similar but different rules related to arbitrage rebate and yield restriction



Meet the Presenters



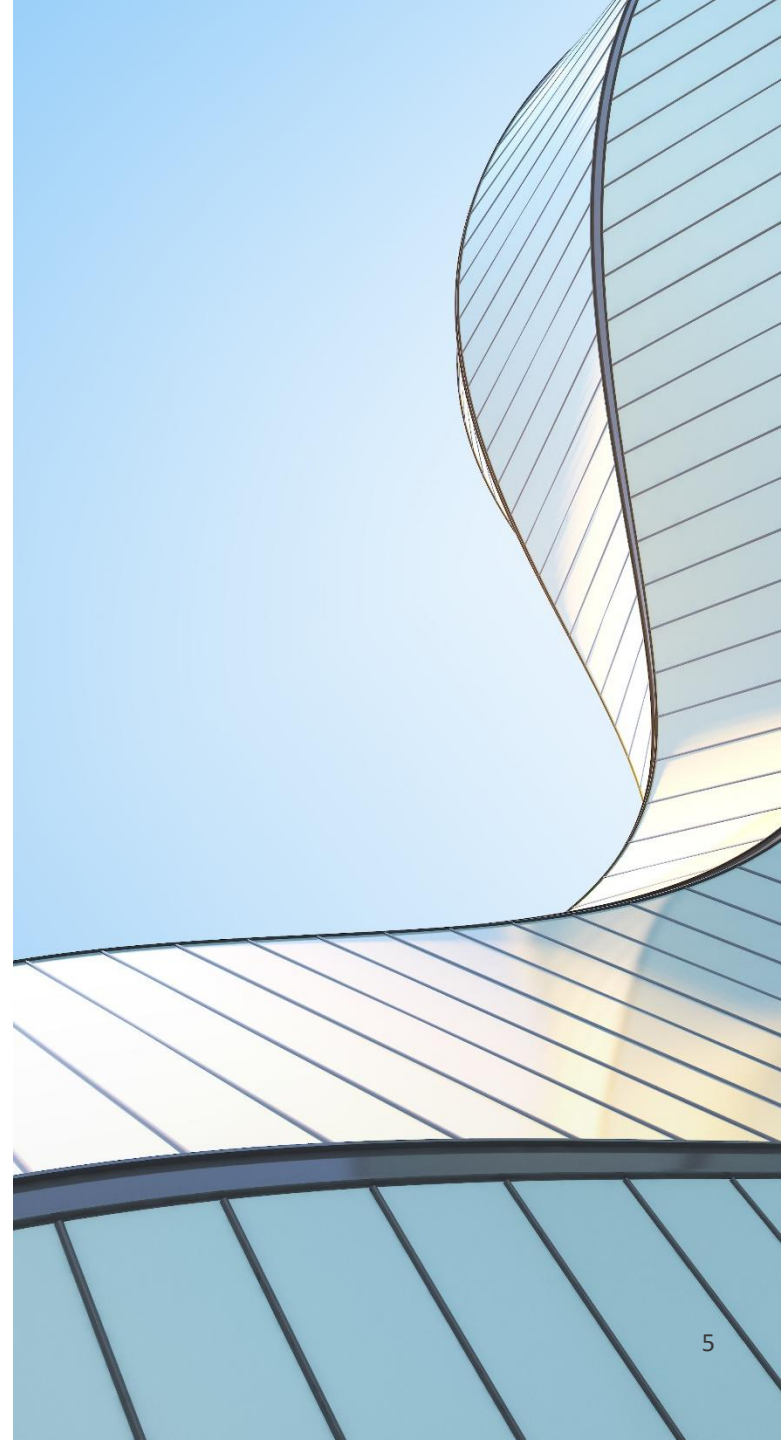
Mike Steinbrook

Director, Arbitrage Rebate

steinbrookm@pfmam.com



What is Arbitrage Rebate?



Poll Question #1

You just received a letter from the IRS notifying you that a bond issue is under audit. What do you do next?

- A. Put in for that extra long vacation
- B. Place the letter at the very bottom of the To-Do pile
- C. Log onto LinkedIn and research what kind of other jobs are available
- D. Read the letter, gather your internal post issuance compliance team, identify the IRS point of contact, and get in touch with bond counsel
- E. Ask me again at the end of this training



Understanding Arbitrage Rebate

Arbitrage

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

Rebate

Issuer's "rebate" or pay excess earnings to the IRS

Purpose

Financial disincentive to violate the rules
Prevent issuance of tax-exempt debt for profit-driven reasons



Tax Considerations Timeline

- Arbitrage rebate requirements apply to every tax-exempt borrowing and certain subsidy obligations (unless an exception applies)
- 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 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
- Continuing disclosure
- Monitor private business use

Positive and Negative Arbitrage

$$\frac{\text{Actual investment earnings yield} - \text{Average borrowing rate or "arbitrage yield"}}{1} = \text{Arbitrage \%}$$

"Positive Arbitrage" =

Actual earnings > Earnings @ arbitrage yield
(*positive earnings yield spread*)

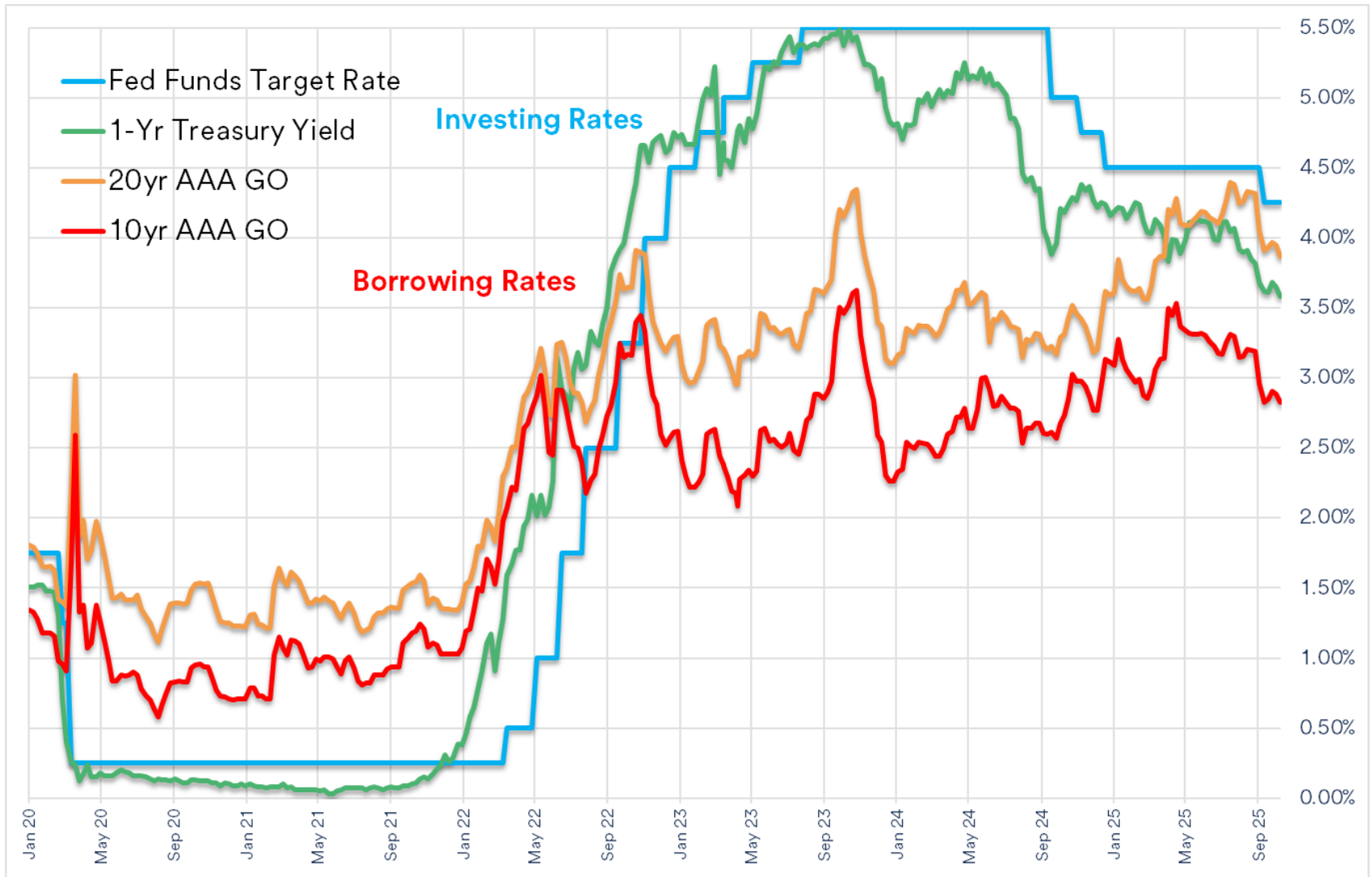
"Negative Arbitrage" =

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

Arbitrage Environment



For illustrative purposes only.
Sources: Bloomberg, EMMA. Rates as of October 15, 2025.

Arbitrage Rebate and Yield Restriction

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

- Rules provide a deterrence from:
 - 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.



Arbitrage Rebate and Yield Restriction

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

- Measured on an issue-by-issue basis
- Non-compliance could result in taxable bonds
- Overlapping requirements – “Belt & Suspenders”
 1. **Arbitrage Rebate – IRC Section 148(f):**
Arbitrage Rebate begins on the issue date
 2. **Yield Restriction – IRC Section 148(b):**
Yield Restriction begins at the expiration of a temporary period



Dual Requirements

Key differences are timing and amounts restricted

Separate requirements require separate calculations

- Cannot blend Arbitrage Rebate and Yield Restriction liabilities
- Common situation to end up with negative arbitrage rebate but positive yield restriction or vice versa

	Construction Funds	
	Arbitrage Rebate	Yield Restriction
Requirement Begins	Issue Date	Typically, after a 3-year Temporary Period (may be waived or extended to 5-years)
Amounts Restricted	Sale Proceeds	Unspent Proceeds

Arbitrage Rebate and Yield Restriction

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

- G.O. Bonds
- Tax Credit Bonds
 - Build America (BAB)
 - Qualified School Construction (QSCB)
 - Qualified Zone Academy (QZAB)
- Notes
 - State Aid Notes (SAN)
 - Tax Anticipation Notes (TAN)
- Lines of Credit



What Funds Are Restricted?

PROCEEDS

Sale Proceeds/ Investment Proceeds

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

Transferred Proceeds

Any of the above

+

REPLACEMENT PROCEEDS

Cash/Equity/ Revenue Funded

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

=

GROSS PROCEEDS

All Subject to Rebate and Yield Restriction

Unless an
exception applies



Poll Question #2

I can take negative arbitrage from my Series 2021 Bonds and use it to offset positive arbitrage on my Series 2025 Bonds.

A. Yes

B. No



Requirement #1

Arbitrage Rebate



Exceptions to Arbitrage Rebate

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

**Exception to
Arbitrage Rebate
Only**



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

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 only

✓ 6 months 10%
✓ 12 months 45%
✓ 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.

Spending Benchmarks

2-Year Test Example

- 2025 Bonds must be a “Construction” issue, meaning at least 75% of the project is construction.
- Must meet each benchmark, no catch-up allowed
- Available Construction Proceeds (ACP)
= Project Fund + Expected Earnings

2025 Project Fund	\$25,000,000
Expected Earnings*	\$1,000,000
ACP – Denominator	\$26,000,000

Benchmark Date		% Required Expenditures	\$ Required Expenditures	\$ Actual Expenditures	Met Benchmark?
Issue Date	10/30/2025				
6 months	4/30/2026	10%	\$2,600,000	?	Yes / No
12 months	10/30/2026	45%	\$11,700,000	?	Yes / No
18 months	4/30/2027	75%	\$19,500,000	?	Yes / No
24 months	10/30/2027	100%**	\$26,000,000	?	Yes / No

* Based on reasonable expectations as of the issue date.

** De minimis (lesser of 3% or \$250K) and reasonable retainage (5% spent in 12 months) exceptions may apply for last benchmark.

Other Exceptions to Arbitrage Rebate

- **Investing in Tax-Exempt Obligations**

- This eliminates the “arbitrage”
- Issuers retain earnings above the bond yield
- Subject to market availability and credit considerations
- U.S. Treasury offers Demand Deposit State and Local Government Series (“SLGS”)

- **Electing to pay the 1.5% Penalty in Lieu of Rebate**

- Available for “construction” issues
- Agree to pay a penalty on any shortfalls relative to the 2-year spending benchmarks
- Continues beyond 2-year benchmark if proceeds remain unspent
- Penalty is agnostic to positive/negative arbitrage
- Payment must be made even if earnings are below the bond yield



Exceptions to Arbitrage Rebate and Yield Restriction

“Bona Fide” Debt Service Fund Exception

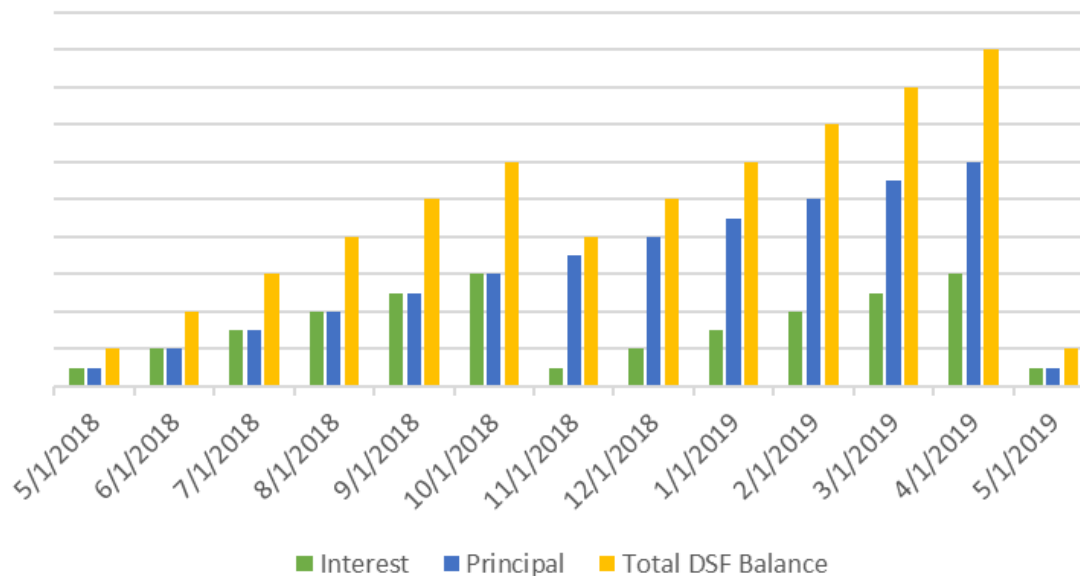
Depleted at least annually except for greater of:

- 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**

Debt Service Fund - 1/6th 1/12th



Poll Question #3

The City issued Bonds to fund the construction of a new administration building. Which spending exceptions are available for this issue?

A. 6-month spending exception

B. 18-month spending exception

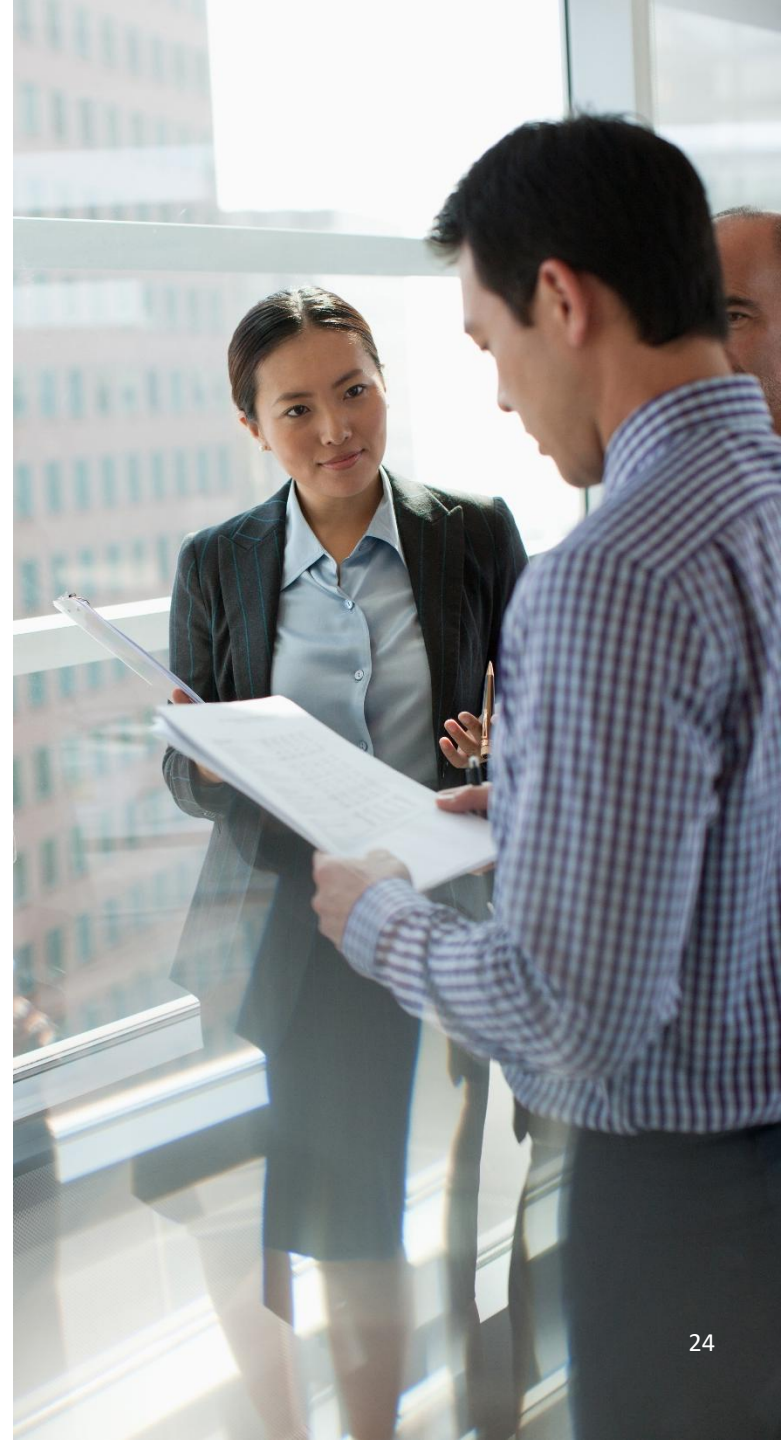
C. 2-year spending exception

D. All of the above



Requirement #2

Yield Restriction



What is Yield Restriction?

- Separate and distinct from the Arbitrage Rebate requirement
 - Like Rebate, it is a restriction against investing above the arbitrage yield
 - Key differences are:
 - Timing
 - Amounts Restricted
- Cannot blend Arbitrage Rebate and Yield Restriction liabilities
 - Separate calculations required
 - Common situation to end up with negative arbitrage rebate but positive yield restriction or vice versa

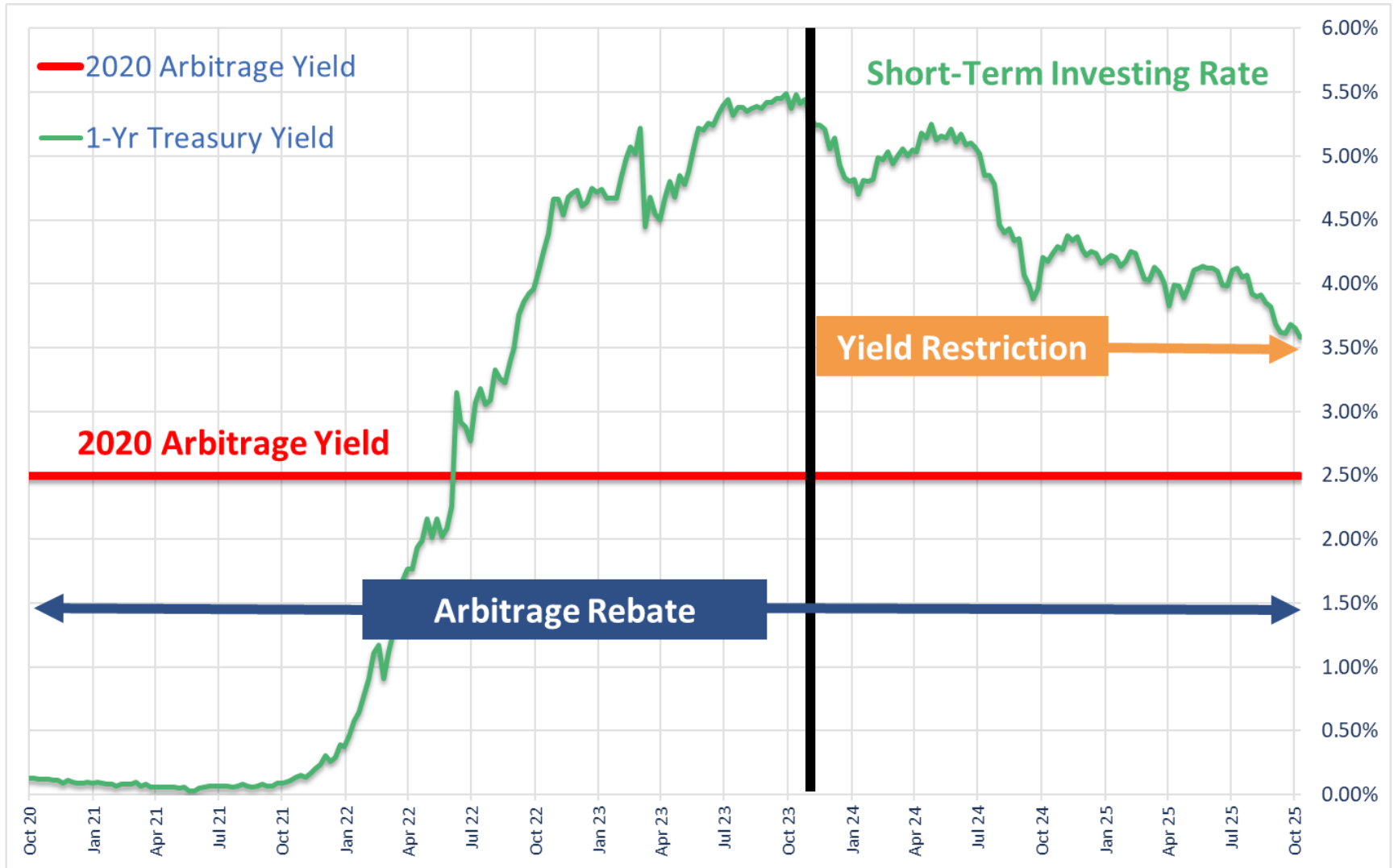


Exceptions to Yield Restriction

- “Temporary Period”
 - Generally, 3-years for construction proceeds.
 - Can be extended to 5-years with certification (must be done before closing)
 - Can also be waived entirely
- Reasonably Required Reserve or Replacement Funds
 - Based on size tests
- Minor Portion
 - Generally, less than \$100,000.
- Investing in tax-exempt obligations (eliminating the “arbitrage”)



Arbitrage Rebate vs. Yield Restriction



For illustrative purposes only.
Sources: Bloomberg, EMMA. Rates as of October 15, 2025.

Yield Restriction Compliance Methods



Active Yield Restriction

- Investments must be purchased at fair market value
- Tax exempt investments



Yield Reduction Payments

- Rebate-like payments
- Limited availability for advance refunding issues and defeasance escrows



Other Options

- Longer construction fund temporary period (5-years vs. 3-years)
- Waiver of temporary period at issuance



Poll Question #4

A bank offers an investment option with a yield equal to my new bond's arbitrage yield. It's much lower than the yield on the other options. It sounds like an easy way to comply with the arbitrage rules. Should I be concerned?

A. Yes

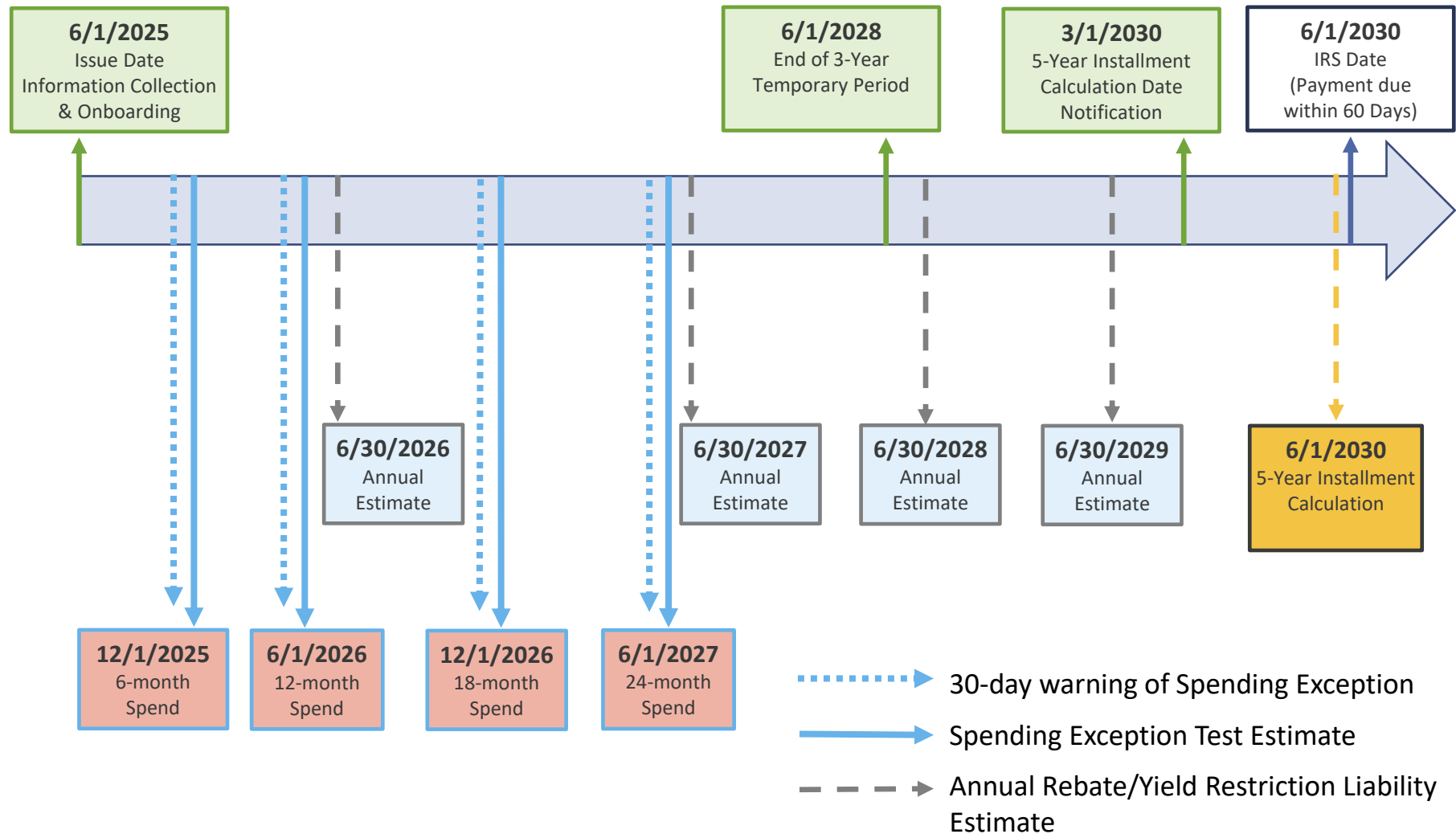
B. No



Calculation Requirement



Arbitrage Rebate – Potential Calculation Touchpoints



Hypothetical – City A

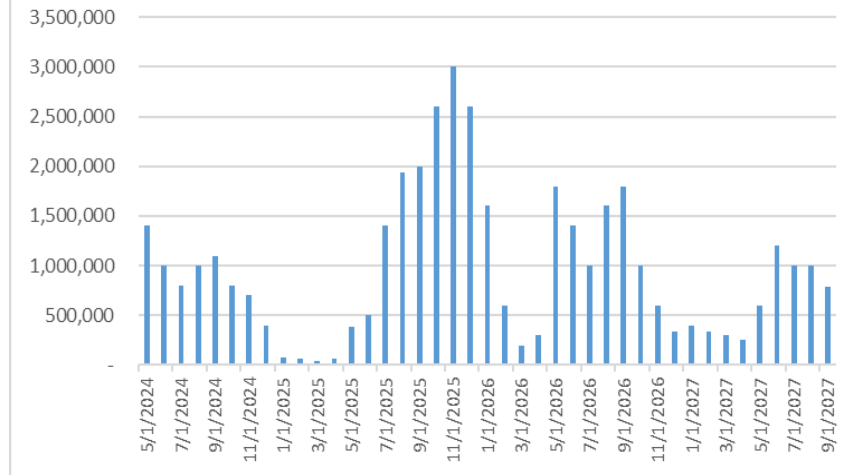
The Situation: City A is selling Series 2024A Building Bonds with the following characteristics:

Par Amount	\$40,000,000
Construction Fund Deposit	\$40,000,000
Estimated Draw Schedule	~40 mos
Arbitrage Yield	3.50%
Current Investment Yield	4.50%

Questions to consider:

- 1) Does City A expect to meet a spending exception? Should the spending exception be applied?
- 2) Does City A expect to earn positive arbitrage?
- 3) Does City A expect to be subject to yield restriction?

Draw Schedule - Series 2024A



Expected Gross Earnings	\$3,500,000
Expected Positive Arbitrage	\$850,000
Expected Net Earnings	\$2,650,000

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 and IRS Form 8038-T
- Do not submit calculations
- No filing required if no payment is due
- Late Payments
 - Require explanation and payment of late interest
 - May also require payment of a penalty (50%)
- Overpayment
 - Refunds can be requested if liability reverses
 - IRS will not pay interest on overpayment



Late Payments and Refunds

Late Payments

- Governmental bonds [including qualified 501(c)(3) bonds]
 - 50% 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

Poll Question #5

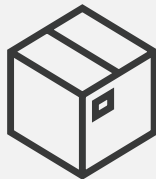
When must Arbitrage Rebate or Yield Reduction Payments be mailed to the IRS?

- A. Before the auditors complete the annual field work
- B. Prior to the expiration of the 90-day temporary period
- C. No later than 60 days after the installment computation date
- D. Within 180 days of the fiscal year end date (along with annual financial disclosures)



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

Tips for a Smooth Process

- **Be familiar with rules and make sure project team is aware.**
 - Discuss the unique requirements early on to avoid surprises later.
- **Understand available exceptions and monitor compliance.**
 - Do what you can to spend funds quickly before spending exception benchmarks.
- **Calculate any liability on a periodic basis if no exceptions apply.**
 - If a liability is accruing, annual calculations are appropriate.
 - Don't forget about dual requirements.
 - Be aware of yield restriction on unspent proceeds.
- **Set aside excess earnings before funds are completely spent.**
 - Fund can be moved to a separate "Rebate Fund" to help with payment planning.
- **Create an organized file system.**
 - Be prepared to provide the IRS with relevant documents



Poll Question #6

Earning positive arbitrage is a good thing.

A. Yes

B. No

C. Sounds like a trick question



Questions?



**Thank you for
joining us!**

Disclosures

The views expressed within this material constitute the perspective and judgment of U.S. Bancorp Asset Management, Inc. at the time of distribution and are subject to change. Any forecast, projection, or prediction of the market, the economy, economic trends, and equity or fixed-income markets are based upon current opinion as of the date of issue and are also subject to change. Opinions and data presented are not necessarily indicative of future events or expected performance. Information contained herein is based on data obtained from recognized statistical services, issuer reports or communications, or other sources, believed to be reliable. No representation is made as to its accuracy or completeness.

PFM Asset Management serves clients in the public sector and is a division of U.S. Bancorp Asset Management, Inc., which is the legal entity providing investment advisory services. U.S. Bancorp Asset Management, Inc. is a registered investment adviser, a direct subsidiary of U.S. Bank N.A. and an indirect subsidiary of U.S. Bancorp. U.S. Bank N.A. is not responsible for and does not guarantee the products, services, or performance of U.S. Bancorp Asset Management, Inc.

NOT FDIC INSURED : NO BANK GUARANTEE : MAY LOSE VALUE

