

Arbitrage & Post Issuance Compliance



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Rationale for Legislation – *Why are we here?*

- Arbitrage rules were written into the Internal Revenue Code of 1986 and multiple versions of Regulations so borrowers would not:
 - Borrow more funds than needed
 - Borrow funds earlier than needed
 - Borrow funds for a longer term than needed
- Borrowing tax-exempt is a subsidy from the federal government
- The government does not want its generosity abused

Non-Compliance Penalty

- Revoke Tax-Exempt Status
- Enter into IRS Settlement Agreement to pay taxpayer exposure or other amount.

Arbitrage Rules Scope – *What do the rules apply to?*

Arbitrage rules apply to **all tax-exempt and tax-advantaged debt**, including, but not limited to:

- Bonds
- Notes
- BANs, RANs, TANs
- Bank Loans
- Certificates of Participation
- Capital Leases
- Taxable issues receiving subsidies (for example, Build America Bonds)

What is Arbitrage Rebate?

- A. A fee paid to keep the IRS “happy”
- B. The payment borrowers owe when tax-exempt bond proceeds earn above the permitted yield
- C. A voluntary compliance practice recommended by Bond Counsel
- D. I have no idea!

Arbitrage – *What is the focus of the rules?*

- Arbitrage is the spread between the tax-exempt borrowing rate and taxable earnings rate. When taxable investments generate a yield in excess of tax-exempt borrowing rate, the dollar value of the difference is paid back to the IRS as a Rebate.
- Taxable investments are captured for many types of “gross proceeds”, as described later, for the life of the issue.



Illustration of Arbitrage Excess Proceeds *Concept*

(Concept only – this does not represent the methodology in the Tax Code)

For \$1,000,000 proceeds
outstanding for 1 year:

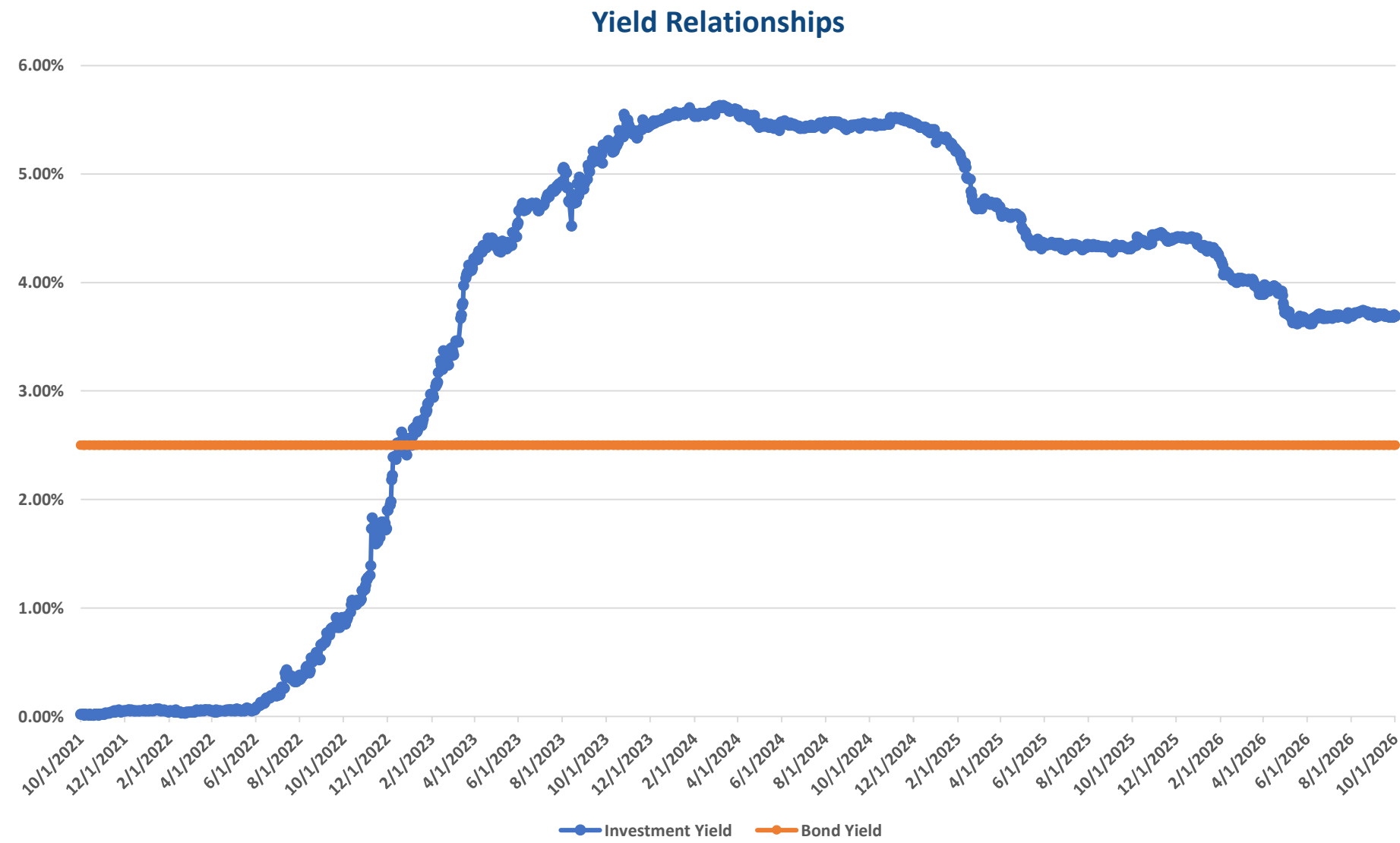
Arbitrage/excess earnings are affected by:

- 1) Amount of proceeds included
- 2) Length of time proceeds included
- 3) Magnitude of spread between
Investment Return and Bond/Arbitrage
Yield

	Yield	Earnings
Bonds	2.5%	\$25,000
Investments	3.5%	\$35,000
	Excess Earnings	\$10,000

Arbitrage Illustrated

5-Year Lookback – 3 Mo Treasury Returns



How and When Do I Prove Compliance?

Calculation required at least **every 5 bond years** and **at maturity**; recommended annually [Note: Bond Year might be selected in documents]

Form 8038-T must be filed within **60 days of 5th bond year end** if a payment is due.

Note: If bonds are refinanced, an IRS filing calculation is needed as of the final redemption to confirm compliance of the refinanced issue.

Computation Credits annually offset Rebate Payments = \$2,170 for calendar year 2026 (adjusts for CPI)

Calendaring Computation Periods:

Bonds Issued 4/25/2021, due 10/1/2040

Installment Comp Date (1 st Bond Year* + 5 Years)	Payment Date (Computation Date + 60 Days)
4/25/2026	6/24/2026
4/25/2031	6/24/2031
4/25/2036	6/24/2036
10/1/2040	11/30/2040

Types of Proceeds

What do I need to know to confirm I am compliant?

1. Bond Yield
2. What happened to Proceeds →

Sale Proceeds	Amounts Borrowed - Project Fund, Capitalized Interest, Reserve Fund, Refunding Escrow, Costs of Issuance
Investment Proceeds	Earnings on Proceeds
Transferred Proceeds	Unspent amounts of a refunded issue - Reserve/Project Funds
Replacement Proceeds	Funds not borrowed, but that have a direct nexus to the issue
	Pledged amounts in Debt Service, Reserve, Residual Funds
Disposition Proceeds	Proceeds from sale of bond-financed assets

Sample Rebate Computation

		Rate of				Future Value 5/15/26
Date	Project Fund	Return	Interest	Running Balance	FV Factor	at 3.00% Bond Yield
5/15/2021	50,000,000.00			50,000,000.00	1.1605408	(58,027,041.25)
4/28/2022	(15,000,000.00)	2.50%	1,191,780.82	36,191,780.82	1.1280777	16,921,165.72
5/30/2023	(12,000,000.00)	3.00%	1,180,942.77	25,372,723.59	1.0920875	13,105,049.41
5/15/2024	(12,500,000.00)	3.50%	853,983.31	13,726,706.90	1.0613636	13,267,044.38
3/18/2025	(8,500,000.00)	4.50%	519,546.45	5,746,253.36	1.0350937	8,798,296.43
5/15/2026	(6,079,221.19)	5.00%	332,967.83	-	1.0000000	6,079,221.19
			4,079,221.19			143,735.88
	Computation		5/15/2022	(1,830.00)	1.1264926	(2,061.48)
	Credits:		5/15/2023	(1,960.00)	1.0934433	(2,143.15)
			5/15/2024	(2,070.00)	1.0613636	(2,197.02)
			5/15/2025	(2,120.00)	1.0302250	(2,184.08)
			5/15/2026	(2,170.00)	1.0000000	(2,170.00)
						(10,755.73)
					Total Rebate	132,980.15

Arbitrage Exceptions

How can I minimize payments?

- Exempt Issues
- Exempt Accounts
- Exempt Investments

How can I minimize payments?

Arbitrage Exceptions - Issue

- **Small Issuer Exception (Governmental Issues only)**
 - Aggregate face amount of all tax-exempt bonds (excluding private activity bonds) issued during the calendar year will not exceed \$5,000,000 (exception to **rebate**, not yield restriction)

BENEFIT OF MEETING ANY EXCEPTIONS

- By meeting an exception to rebate, any **positive Rebate Amount** accrued **will be retained** by the Issuer/Borrower.

How can I minimize payments?

Arbitrage Exceptions - Issue

Spending Exceptions - *Planning Opportunity*

	6 Month Exception	18 Month Exception	2 Year Exception (Construction Issues)
6 MONTHS	100%	15%	10%
12 MONTHS		60%	45%
18 MONTHS		100%	75%
2 YEARS			100%

NOTES:

- If all parameters are met, excess earnings may be retained by the borrower
- If not met, funds are subject to rebate starting at the issue date
- May be applied optionally – *not beneficial in negative arbitrage environment*

How can I minimize payments?

Arbitrage Exceptions – Debt Service Fund

Bona-fide Debt Service Funds (Section 1.148-1(b) of the Regulations)

A bona-fide debt service fund is defined as a fund, which may include proceeds of an issue that –

- Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and
- Is depleting at least once each bond year; except for a reasonable carryover amount not to exceed the greater of:
 - The earnings on the fund for the immediately preceding bond year; or
 - One-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Arbitrage Exceptions – Investments

- **Non-AMT Tax-Exempt Securities**
- **Demand Deposit State and Local Government Securities (SLGS)**
 - U.S . Treasury Securities
 - Purchased through subscription process using SLGSafe system
 - Fully liquid (but allow a few days for transfers of funds)
 - Daily reset of rate of return based on adjustment to yield on 13-week T-Bills (Rate 5/30/2025 = 3.36%)

Expenditure of Proceeds – Current Outlay of Cash

- Expenditure of Proceeds requires a “**current outlay of cash**” for the governmental purpose of the issue (i.e., the Project).
- Alignment of investment records with expenditure records is crucial.

Expenditure of Proceeds – Allocation

- **Allocation of Proceeds** to expenditures must occur not later than 18 months after the date the expenditure is paid or the project is placed in service, but in no case later than 60 days after the 5th anniversary date of the issue.
- Multiple sources of funds for the Project requires a reasonable accounting method to allocate Proceeds to Expenditures –
 1. **Specific Tracing**
 2. **Gross Proceeds Spent First**
 3. **First-In, First-Out**
 4. **Ratable Allocation**

Expenditure of Proceeds - Reimbursement

Arbitrage regulations dictate the extent to which amounts spent prior to closing can be deemed paid from Bond Proceeds

- **“Preliminary Expenditures” up to 20% of the Issue Price**

- Architectural and engineering costs, survey costs, soil testing and other costs prior to start of construction but not land acquisition or site preparation

- **Official Intent Resolution**

- Capital Expenditures contemplated in an Official Intent Resolution dating no earlier than 60 days prior to the Resolution AND the reimbursement is made not later than 18 months after the original expenditure.

Yield Restriction

Similar but different requirement than Rebate –
Key Differences are - ***Timing & Amounts***

- Arbitrage from non-restricted proceeds cannot be blended with arbitrage from restricted proceeds
- Restricted/Non-Restricted vary by issue and are laid out in the Tax Documents

Non-Yield Restricted	Yield Restricted
Project Fund during Temporary Period	Project Fund after Temporary Period
Reasonably Required Reserve Funds	Overfunded Reserve Funds
Current Refunding Escrow	Advance Refunding Escrow
Minor Portion (generally \$100,000)	Replacement Proceeds including Non-Bona Fide Debt Service Funds

Sample Yield Restriction Computation

		Rate of				Future Value 5/15/23
Date	Project Fund *	Return	Interest	Running Balance	FV Factor	at 4.00% Bond Yield
5/15/2018	50,000,000.00			50,000,000.00	1.2189944	(60,949,721.00)
4/28/2019	(15,000,000.00)	3.25%	1,549,315.07	36,549,315.07	1.1738527	17,607,790.88
5/30/2020	(12,000,000.00)	3.00%	1,195,613.21	25,744,928.28	1.1243055	13,491,666.45
5/15/2021	(12,500,000.00)	3.50%	864,042.11	14,108,970.39	1.0824322	13,530,402.00
3/18/2022	(8,500,000.00)	4.50%	534,014.87	6,142,985.26	1.0469447	8,899,029.72
5/15/2023	(6,498,941.80)	5.00%	355,956.54	0.00	1.0000000	6,498,941.80
			4,498,941.80			(921,890.16)
						Future Value 5/15/23
						at 4.125% **
Date	Project Fund *	Rate of Return	Interest	Running Balance	FV Factor	Allowable Yield
5/15/2021	14,108,970.39			14,108,970.39	1.0850876	(15,309,469.09)
3/18/2022	(8,500,000.00)	4.50%	534,014.87	6,142,985.26	1.0484314	8,911,667.22
5/15/2023	(6,498,941.80)	5.00%	355,956.54	0.00	1.0000000	6,498,941.80
			889,971.41		Total YRP	101,139.92
* 3 year temporary period						
** Bond Yield + 0.125% per IRC Section 148						

Positive Arbitrage
is **POSITIVE**.

A. True

B. False

Positive Arbitrage is Positive!

	Rebate Calculation 4.00% Bond Yield, Various Investment Returns and Deposits/Withdrawals	Rebate Calculation with consistent 4.5% Interest Return
Sale Proceeds	\$50,000,000.00	\$50,000,000.00
Investment Proceeds (Earnings)	4,498,941.80	6,125,959.55
<i>Rebate Amount</i>	<i>(921,890.16)</i>	<i>705,127.59</i>
<i>Computation Credits</i>	<i>(9,799.68)</i>	<i>(9,799.68)</i>
Rebate Payment	<u>0.00</u>	<u>(695,327.91)</u>
Proceeds Available for Project	\$54,498,941.80	\$55,430,631.64

Net proceeds for project after Rebate Payment exceed proceeds in negative arb environment by \$931,689.84

Record Retention Requirements

- SIGNIFICANT requirements - All pertinent records from date of issue through final maturity plus 3 years (if issue is refinanced, records for original issue must be kept until 3 years after maturity of refunding)
 - Bond transcript
 - Bank records
 - Expenditure records (copies of invoices, bills, cancelled checks ideally)
 - Investment records or sub-ledgers
 - Debt service records (principal, interest, bond insurance/letter of credit fees (if any), swap payments (if any))
 - Asset lists, monitoring of usage/change in use

Key Takeaways

- **Positive Arbitrage** is **NOT BAD**, as long as you are aware of it and prepared.
- ***The importance of annual calculations***
 - Catch any problems early
 - Examples – overfunded debt service funds, failure to transfer monies out of project funds, paying off bonds early and not having calculations done in a timely manner.
 - Helps track expenditure of Proceeds correctly.
 - Prepare for rebate or yield reduction payment so there are no surprises.
- Calculations are **cost neutral** in a **positive arbitrage environment**.

Questions?

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