

Maryland GFOA Winter 2019 Conference

January 25, 2019

**Arbitrage Rebate and
Post-Issuance Compliance**

BINGHAM
Arbitrage
Rebate ~
Services
Incorporated

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Two Sets of Rules

**Arbitrage Rebate Rules
and
Yield Restriction Rules**

What are the General Rules?

- **IRS allows borrowing at tax exempt rates**
- **IRS expects borrower to spend loan or bond proceeds promptly**
- **If project proceeds are held > 3 years, outstanding project proceeds are to be yield restricted and earn limited income. The yield restriction calculation becomes a factor for compliance purposes.**

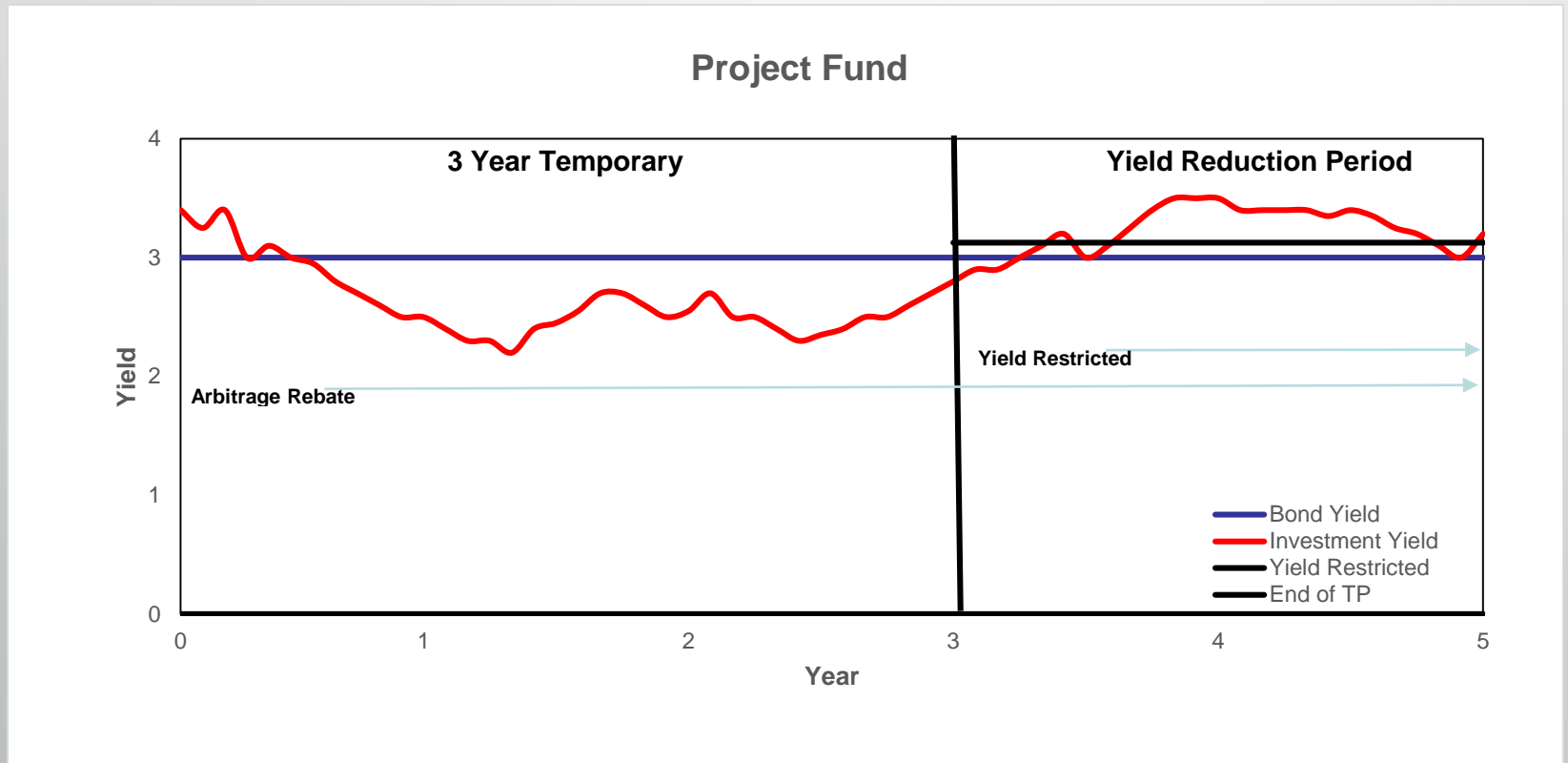
What is Arbitrage Rebate?

- **Taxable investment earnings in excess of the declared tax-exempt bond yield (“arbitrage”) must be rebated to the Federal Government.**
- **Arbitrage Rebate Calculations should be performed, at the latest, every 5 years over the life of the Issue.**
- **Failure to comply with the rebate requirements could ultimately result in the loss of tax-exempt status on the issue, and financial penalties.**

What is Yield Restriction?

- **Temporary Period for Capital Projects is three years**
- **As of three-year expiration, project proceeds are yield restricted to bond yield + .125%**
- **If project proceeds are yielding above the bond yield + .125%, a yield reduction payment is due**

Arbitrage Rebate and Excess Yield Calculations



Bond Yield to Investment Yield Comparison

Sample of Bond Yields

Series 2015 GO: 2.4489%

Series 2016 Revenue: 3.2082%

Series 2017 GO: 2.0881%

Series 2017 Revenue: 2.5787%

Series 2018 Revenue: 2.5136%

Series 2018 GO: 2.8773%

Investment Yields

December 2016: 0.37% - 0.750%

June 2017: 0.73% - 1.290%

December 2017: 1.07% - 1.450%

June 2018: 1.71% - 2.210%

December 2018: 2.16% - 2.503%

Comparison

Arbitrage Rebate?

Example:

First Installment Period
Years 1 – 5

Investment Yield: 1.75%

Bond Yield: 2.088%

Arbitrage: - .33%

No rebate payment due.

Yield Restriction Calculation?

Example:

First Installment Period
Years 4 - 5

Investment Yield: 2.50%

Bond Yield + .125%: 2.213%

Earnings over

Bond Yield: 0.287%

Yield Reduction payment due.

Arbitrage Rebate Payment and Yield Reduction Payment?

What if there is an arbitrage rebate payment and a yield reduction payment due?

You do not owe two payments. Only one payment is due, but the higher amount is due.

Issues Subject to Compliance

Any Tax-Exempt Financing including:

- **Bond Anticipation Notes**
- **Installment Financings / Bank Loans**
- **General Obligation Bonds**
- **Revenue Bonds**
- **Pooled Financings**
- **Refunding Bonds**
- **Direct Pay / Tax Credit Bonds including
Build America Bonds (BABs)**

Required Information for Compliance Review?

Bond Documents:

- **Official Statement**
- **Non-Arbitrage Certificate**
- **IRS Form 8038-G**
- **Verification Report, if applicable**

Gross Proceeds Investment Activity:

- **Investment Activity**
 - **Construction Funds/Project Funds**
 - **Debt Service Reserve Funds**
 - **Cost of Issuance Funds**
 - **Escrow Funds**

Which Funds are Subject to Arbitrage Rebate Compliance?

- **Cost of Issuance Fund**
- **Construction Fund / Project Fund**
- **Escrow Fund**
- **Debt Service Reserve Fund**

Small Issuer Exception

Criteria for meeting Exception:

- Government Entity with general taxing powers
- Not a Private Activity Issue
- 95% of the proceeds were used for local government purposes
- \$5MM or less in issuance per calendar year, non school (K-12) issues
- \$15MM for K -12 after 2001, increased\$10MM

IMPORTANT NOTE: Small Issuer still subject to Excess Yield Calculation.

Spending Exceptions

6 Month, 18 Month, and 2 Year Exception

Six Month Exception:

100% @ 6 months

Eighteen Month Exception:

15% @ 6 months

60% @ 12 months

100% @ 18 months

Two Year Construction Exception:

10% @ 6 months

45% @ 12 months

75% @ 18 months

100% @ 24 months

Effects of Refunding Bond Issues

- **Transferred Proceeds, Unspent Proceeds**
- **Parity Reserve Fund Re-Allocations**
- **Refunding Issue may also require Arbitrage Rebate Compliance**
- **Earlier evaluation dates for Refunded Bonds**
- **Taxable Refunding creates Replacement Proceeds**

Be sure to notify your Arbitrage Rebate Firm when Issues are refunded.

Payments to the IRS - Rebate or Yield Reduction

Due Dates

- **Installment payments are typically made at least every five years.**
- **Each installment payment equals at least 90%.**
- **Final payment equals the remaining 10% due.**
- **Installment payments paid within 60 days of the evaluation date.**
- **Final payment paid within 60 days of the final redemption date.**

Payments to the IRS - Rebate or Yield Reduction

If Late...

- **If a payment is late, Underpayment Rate applies which is based on Federal Short Term Rate.**
- **Penalty in lieu of loss of tax exemption.**
 - 50% - Government Issuer**
 - 100% - Private Activity excludes 501(c)(3)'s**
- **Innocent failure letter: Revenue Procedure 2005-40, 2005-28**

Written Procedures for Rebate Compliance

- **IRS Form 8038-G Line 44:**
“If the Issuer has established written procedures to monitor the requirements of Section 148, check the box.”
- **Educate staff**
- **Put procedures in place to follow**
- **Assign who is responsible**
- **Document & Record Retention**
- **Plan for succession**

Best Practices for Arbitrage Rebate Compliance

- **Inform your Arbitrage Rebate firm of changes to Issue, such as Refunding issues. Evaluation Dates are effected.**
- **Maintain good records by keeping: Investment records, trust statements for bond related accounts (Reserve Funds, Debt Service Funds), bond transcript, past Arbitrage Rebate Calculations.**
- **IRS requirement: Keep all records for tax-exempt issues at least 3 – 6 years after bonds paid in full.**

Best Practices for Arbitrage Rebate Compliance

Annual arbitrage compliance reviews.

- **Right before or right after annual audit**
- **Part of overall organization compliance**

Benefits:

- **Implement changes quickly**
- **Book liability if needed**
- **Less costly to make changes**
- **Records accessible**
- **Minimal disruption to staff.**

IRS Updates

Build America Bonds (BABs) Issued in December 2010. The IRS has been auditing BABs.

BABs: taxable to the Investor, but treated as tax-exempt to the Issuer due to the tax credits. Arbitrage Rebate Compliance is required on BABs. BABs Expired 12/31/2010.

**2,354 BAB issues sold in 2009 & 2010
for \$181.5 billion**

IRS

<https://www.irs.gov/tax-exempt-bonds>

Within this website, links include:

- **TE/GE FY 2019 Program Letter**
- **Tax Exempt Bonds Voluntary Compliance**
- **TEB Newsletter**



Questions?

