Arbitrage Rebate 101

The Basics Every Issuer Should Know

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Arbitrage is earned when the proceeds of a tax-exempt or tax-advantaged bond issue are used to acquire investments that earn a yield in excess of the bond yield (or arbitrage yield), the average yield issuers pay to their bondholders. Liabilities are measured by computing the excess amount earned on investments over the amount that would have been earned if proceeds were invested at the bond yield. Unless the issuer can apply an exception or exemption to the arbitrage rebate and yield restriction requirements, excess earnings must be rebated to the Internal Revenue Service (IRS).

The History

The arbitrage rebate and yield restriction rules are deeply rooted in the Internal Revenue Code and U.S. Treasury Regulations. Originally addressed in the Internal Revenue Code of 1954, the rules exist to curb abuses and to provide financial disincentives meant to prevent the issuance of "arbitrage bonds." Violations of the rules could cause bonds to be treated as arbitrage bonds — meaning they could be treated as taxable bonds which would be bad news.

The Dual Requirements

The dual-focused requirements of arbitrage rebate and yield restriction present a challenge for issuers because, while the requirements are conceptually similar, the liability calculations are completely distinct and cannot offset each other.

What are Proceeds and Gross Proceeds?

Gross Proceeds =

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	Replacement Proceeds	• **Replacement Proceeds:** Amounts that have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for such purpose.

Proceeds are the **sale proceeds** of an issue plus **transferred proceeds** related to unspent proceeds from refunded issues, plus interest earned on both amounts. **Replacement proceeds** are amounts derived from available cash or revenues that are pledged or have a nexus to an issue, like debt service funds and cash-funded reserve funds. **Gross proceeds** equals proceeds plus replacement proceeds.

All gross proceeds of an issue are subject to the arbitrage rebate requirements and may also be subject to yield restriction. The table below details the different funds that constitute gross proceeds and how they may be subject to arbitrage rebate, yield restriction, or both.

Arbitrage Rebate	Gross Proceeds	Yield Restriction
Subject to rebate from issue date, *unless:* • Exempt if a spending exception is met (6-month, 18-month, or 2-year) • Exempt if the issue qualifies as "small issuer"	**Project Fund and Capitalized Interest**	• Generally, a 3-year temporary period applies (5-years with certification for a longer period if necessary) • Temporary period can be waived • Yield restricted at the bond yield + 0.125% after temporary period expires
Subject to rebate from issue date, *unless:* • Exempt if the issue qualifies as "small issuer"	**Reserve Fund**	• Exempt from yield restriction if qualified as a reasonably required reserve or replacement fund in size • If failed in size, yield restricted at the bond yield + 0.001%

Subject to rebate from issue date, *unless:*
• Exempt if the issue qualifies as "small issuer"
• Exempt if the 6-month spending exception is met (for Escrow funded with sale proceeds)
	Escrow or Defeasance Fund	• Yield restricted at the bond yield + 0.001% after the end of the applicable temporary period (can be waived):
		  • Advance Refunding: 30 days
		  • Current Refunding: 90 days

Subject to rebate from issue date, *unless:* • Exempt if the issue qualifies as "small issuer" • Exempt if a spending exception is met	**Cost of Issuance**	• For new money issues, a 3-year temporary period applies • For refunding issues, a 13-month temporary period applies
Subject to rebate, *unless:* • Exempt from rebate if qualified as a bona fide debt service fund (generally depleted annually) • If not bona fide, subject to rebate	**Bond Fund/ Debt Service Fund**	• Exempt from yield restriction if qualified as a bona fide debt service fund (generally depleted annually) • If not bona fide, yield restricted at the bond yield + 0.001%
Subject to rebate from date of deposit, *unless:* • Exempt if the issue qualifies as "small issuer"	**Other Pledged Fund**	• Yield restricted at the bond yield + 0.001% • 30-day temporary period for replacement proceeds may apply; otherwise subject to yield restriction from date of deposit

Arbitrage Rebate Exceptions

There are two major exceptions to arbitrage rebate: size-based and time-based. Generally, an issue is exempt from arbitrage rebate under the **small issuer exception** if the issuer has governmental taxing powers and reasonably expects to issue no more than $5,000,000 face amount of tax-exempt bonds during the calendar year that the bonds are issued. The calendar year "small issuer" threshold is increased to $15,000,000 for public school construction issues.

Additionally, there are the 6-month, 18-month, and 2-year **spending exceptions** to arbitrage rebate. The 6-month spending exception is available to any bond issue including refunding issues. The 18-month spending exception is available to all new money bond issues, while the 2-year spending exception is available only to "construction" issues (75% or more of proceeds will be spent on actual construction costs). To meet a spending exception, proceeds must be spent in accordance with the IRS prescribed benchmarks (see table on page 3). It is important to note that all benchmarks must be met as there is no "catch-up" provision. At the final benchmark, there may be allowances for minimal unspent proceeds.

Spending Exception	6 Months	12 Months	18 Months	24 Months
6-Month | All Gross Proceeds	100%			
18-Month | All New Money	15%	60%	100%	
24-Month | Construction Issues	10%	45%	75%	100%

If the proceeds of an issue are invested above the arbitrage yield and a spending exception is met, the issuer is permitted to keep all interest earnings. Additionally, a multi-purpose bond issue may be bifurcated into separate issues for the purpose of spending exception compliance. For example, the 6-month spending exception could be applied to the current refunding portion and the 2-year spending exception could be applied to the new money portion. The spending exceptions could then be tested for each portion separately.

An issuer could elect to pay a "penalty-in-lieu-of-rebate." With this election, the issuer chooses to pay the IRS 1.5% of the benchmark shortfall amount. Since failure would require a payment to the IRS, it would not be recommended unless the issuer has near complete confidence in the draw schedule.

While the spending exceptions to arbitrage rebate have hard and fast benchmarks for expenditures, they are optional to apply. If proceeds are not spent quickly enough to meet all required benchmarks, the proceeds are subject to the arbitrage rebate requirements.

Yield Restriction Exceptions

Temporary periods to yield restriction allow proceeds of an issue to be invested at an unrestricted yield for a defined period of time. For example, capital projects typically qualify for a three-year temporary period, provided that the issuer can demonstrate certain expectations including timely spending and reasonably expecting to spend the proceeds with due diligence. During the temporary period, investment earnings above the allowable yield may be retained by the issuer; however, once the temporary period has expired, excess earnings must be rebated to the IRS.

An exception to the yield restriction requirements with no time limit applies to **reasonably required reserve** or replacement funds. If a reserve fund is "reasonably required" by a three-part size test, it is not subject to the yield restriction requirements. Nonetheless, reserve funds are still subject to the arbitrage rebate requirements regardless of size unless the small issuer exception applies.

The IRS allows for a "minor portion" that can be treated as exempt from yield restriction with no time limit. A minor portion is defined as an amount of proceeds not exceeding the greater of $100,000 or 5% of sale proceeds and can be treated as exempt from yield restriction.

Bona Fide Debt Service Funds

Gross proceeds used to pay debt service on the bonds are not subject to the arbitrage rebate or yield restriction requirements if the debt service fund is "bona fide." A **bona fide debt service fund** matches revenues with principal and interest obligations, depleting at least once each bond year to no more than a reasonable carryover amount. Earnings in the bona fide debt service fund cannot exceed $100,000 per bond year, unless it is a fixed-rate governmental issue with an average maturity of five years or more. Debt service funds should be monitored every bond year to ensure depletion and bona fide exception status.

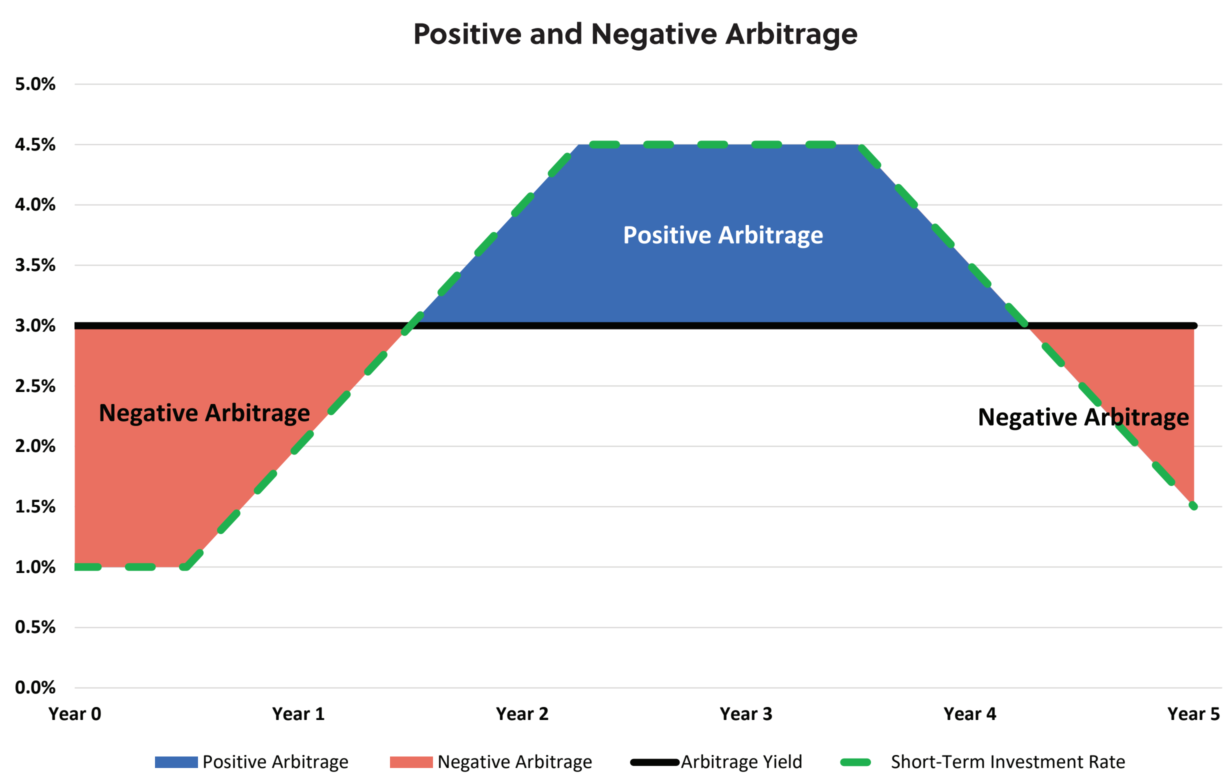
Unspent Proceeds

With the exception of select tax-credit bonds, there are no deadlines for an issuer to spend proceeds. At closing, the issuer certifies reasonable expectations regarding the expenditure of proceeds – but there is no requirement to test for compliance based on actual facts. One implicit danger of not spending capital project proceeds within three years is the additional yield restriction requirements that apply at the end of the temporary period.

Issuers should account for unspent proceeds prior to the end of temporary periods or after completion of the financed projects. If unspent proceeds remain, issuers should identify additional qualified expenditures and move forward with due diligence. This may include allocating proceeds to pay debt service interest only on the bonds.

Positive Arbitrage vs. Negative Arbitrage

Positive arbitrage accrues and is earned when proceeds are invested and interest is earned at an average rate above the arbitrage yield. Negative arbitrage accrues when proceeds are invested and interest is earned at an average rate below the arbitrage yield. As depicted in the chart below, different interest rate environments provide varying opportunities to earn positive or negative arbitrage. When proceeds are invested at interest rates above the arbitrage yield (area shaded in blue), the proceeds are earning positive arbitrage; when proceeds are invested at interest rates below the arbitrage yield (area shaded in red), the proceeds are earning negative arbitrage. Over a five-year period, positive arbitrage in higher interest rate periods can be blended with negative arbitrage in lower interest rate periods to determine the **aggregate arbitrage position** for each bond issue.



What reporting is required?

At a minimum, the arbitrage rebate and yield restriction liabilities on an issue must be computed **at least every five years** and on the final redemption or maturity date. If an issue has accrued a liability, the issuer has 60 days from the computation date to remit payment to the IRS. Issuers are required to pay at least 90% of the liability as of each installment computation. At the final computation date, 100% of any remaining liability must be paid. Payments are made using the IRS Form 8038-T.

Fortunately, an issuer may request a refund if it is determined that an overpayment was made. This may be the case if a mathematical or legal error occurred in determining the payment amount or if the payment made exceeds the cumulative liability for the issue as of the most recent computation date. The request is made using the IRS Form 8038-R, which can be filed at any time for refund requests greater than $5,000. For refund requests less than $5,000, overpayment may not be recovered until the final computation date. In any event, refund requests must be filed no later than two years plus 60 days after the final computation date.

What if I missed a payment?

If a payment is late or missed, the IRS may impose a 50% penalty for governmental bonds, and a 100% penalty for private activity bonds. In addition, late payment interest is calculated at the IRS underpayment rate, an above-market interest rate, and is based on the amount that should have been rebated. The penalty may be waived if the amount due plus late interest, is paid within 180 days after discovery of the failure to pay on time. However, the IRS will not permit a waiver if the issue is under audit, or it finds the failure to be due to "willful neglect."

IRS Audits and Record Retention

The statute of limitations for the IRS to audit an issue does not expire until three years after the final maturity date, or if refunded, the final maturity of the refunding bonds. All records related to an issue should be retained for the audit life of an issue. This includes the bond documents and closing transcript, and all investment and expenditure records. While summary level data may be acceptable, issuers should be prepared to provide detailed records related to all bond proceeds investments and expenditures.

Best Practices

- Establish internal policies and procedures to monitor the compliance status of your debt portfolio.
- Maintain a complete inventory of tax-exempt and tax-advantaged bond issues that may be subject to the arbitrage rebate requirements.
- Create a file for each bond issue right after closing and keep all relevant documents.
- Consult with your financial advisor and bond counsel and make sure you understand the compliance status of each tax-exempt and tax-advantaged bond issue.
- Be aware of available spending exceptions and spend bond proceeds with due diligence.
- Review for Small Issuer Exempt Bonds – set a reminder to review any unspent balances prior to the three-year anniversary date. If unspent proceeds remain after three years, schedule yield restriction liability calculations.

- Other Bonds Subject to Arbitrage Rebate – schedule arbitrage rebate and yield restriction liability calculations. Fifth-year reporting is a must; annual reporting is better to prevent surprises.
- Implement a record retention policy.
- Be prepared for an IRS audit.

The arbitrage rebate rules are complex and can be cumbersome. This summary is meant to provide the basics that all issuers should be familiar with and understand. Consult your financial advisor, bond counsel or arbitrage rebate consultant for more information.

To learn more or discuss in greater detail, please contact us:

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