NEW ENGLAND STATES
GOVERNMENT FINANCE OFFICERS ASSOCIATION

Riding the Return Wave: Arbitrage Compliance in a Higher Rate Environment

AMTEC
Since 1990
American Municipal Tax-Exempt Compliance

April 17, 2024

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What is Arbitrage?

- With respect to the issuance of municipal securities, the excess profit from the investment of tax-exempt bond proceeds in higher-yielding taxable securities.

- Positive Arbitrage - Generated when the overall investment yield is above the bond yield.

- Negative Arbitrage - Generated when the overall investment yield is below the bond yield.

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Do you get to keep the difference?

- General rule: No. It must be remitted to the U.S. Treasury.

- The payment to the U.S. Treasury represents the amount of arbitrage earnings on bond proceeds and certain other related funds, except for earnings that are not required to be rebated under certain exceptions provided under the Internal Revenue Code.

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What is a Federal Tax Certificate?

Serves as checklist for tax due diligence:

- Road map to arbitrage
- Identification of relevant facts of bonds, project, issuer, etc.
- Legal restrictions on use of project, bond proceeds, calculation of yield and other bond-related numbers
- Yield restriction and rebate limitations (and exceptions)

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Spending Exceptions

- Review and determine any possible exceptions to apply.

SIX-MONTH EXCEPTION - Issuer must spend 95% of proceeds, including interest earned, within 6 Months.

EIGHTEEN-MONTH EXCEPTION - Issuer must spend 100% of proceeds, including interest earned, and meet each of the following interim spending requirements:

6 Months: 15%	**12 Months: 60%**	**18 Months: 100%**

TWO-YEAR EXCEPTION - Issuer must spend 100% of proceeds, including interest earned, and meet each of the following interim spending requirements:

6 Months: 10%	**12 Months: 45%**	**18 Months: 75%**	**24 Months: 100%**

Wait, there are more exceptions?!

SMALL ISSUER EXCEPTION - Bond proceeds are not subject to rebate during the Temporary Period if the aggregate face amount of all tax-exempt bonds issued by a governmental unit during a calendar year does not exceed $5 million or $15 million (school construction). Following the Temporary Period, unspent proceeds are subject to **Yield Restriction**.

BONA FIDE DEBT SERVICE FUND – Replacement proceeds that are deposited into a debt service fund and held for no more than 13 months (plus investment earnings) from the closing date.

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Temporary Periods and Yield Restriction

TEMPORARY PERIOD - Period when proceeds may be lawfully invested at a "materially higher" yield than the bond yield and are subject to rebate. Different classes of funds have different temporary periods. General temporary periods are as follows:

- Construction proceeds - three years if substantial binding obligation to commence projects or expend at least 5% of net sale bond proceeds within 6 months.
- Current refunding proceeds - 90 days.
- Replacement proceeds - "bona fide debt service funds" and "reasonably required reserve funds"

YIELD RESTRICTION - Investment earnings restrictions placed on certain classes of funds following the temporary period. General restrictions are as follows:

- One-eighth of 1 percentage point (0.125%) for investments typically held in a project fund.
- One-thousandth of 1 percentage point (0.001%) for investments in a refunding escrow or allocable to replacement proceeds (e.g., debt service fund).

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Written Procedures

- Review and follow!

43	If the issuer has established written procedures to ensure that all nonqualified bonds of this issue are remediated according to the requirements under the Code and Regulations (see instructions), check box . . . . ▶	☑
44	If the issuer has established written procedures to monitor the requirements of section 148, check box . . . . . ▶	☑

Revised IRS Form 8038 in September 2011 – IRS initiative

- Question 44: Check the box if the issuer has established written procedures to monitor the requirements of Section 148
- Question 43: Check the box if the issuer has established written procedures to ensure that all nonqualified bonds of this issue are remediated under the Code and the Regulations

Written policies and procedures

- Not required by Internal Revenue Code
- Good practice, raises “red flag” if box left unchecked
- Will assist during audit or VCAP process

Written Procedures (cont.)

- Procedures/Designation
- At Issuance
- Arbitrage Rebate and Arbitrage Yield Restriction
- Private Use of Bond-Financed Facilities
- Reissuance
- Recordkeeping

Recordkeeping – The FD will:

(a) Establish a plan for keeping relevant books and records as to the investment and the expenditure of bond proceeds.

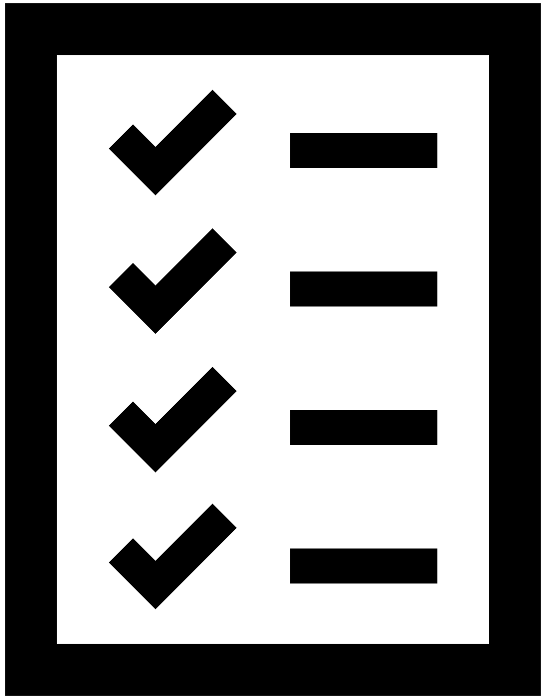
(b) Keep accurate records including:
- Basic records relating to the bond transactions (including the trust indenture, loan agreements, and bond counsel opinion; see Transcript of Proceeding, above);
- Documentation evidencing the expenditure of bond proceeds;
- Documentation evidencing use of bond-financed property by public and private users (i.e., copies of management contracts, lease contracts, agreements for use of bond-financed property);
- Documentation evidencing all sources of payment or security for the bonds;
- Documentation pertaining to any investment of bond proceeds (including the purchase and sale of securities, SLGS subscriptions, yield calculations for each class of investments, actual investment income received from the investment of proceeds, guaranteed investment contracts, and rebate calculations); and
- Documentation evidencing the on-behalf issuer status of the Corporation, including the Corporation's organizational and governing documents and the three most recently filed IRS Form 990, Return of Organization Exempt From Income Tax.

(c) Keep all records in a manner that ensures their complete access to the IRS so long as they are material. While this is typically accomplished through the maintenance of hard copies, records may be kept in an electronic format if certain requirements are satisfied, in accordance with the guidelines in Revenue Procedure 97-22, 1997-1 C.B. 652.

(d) Keep the relevant records for each issue of bonds for as long as such issue of bonds is outstanding (including any bonds issued to refund such issue of bonds) plus three years after the final redemption date of the bonds.

Computation Dates

- The date that any accumulated rebate and/or yield restriction liability becomes payable.
- No less than every five years (Computation Dates) and upon the final maturity date of the bonds (Final Computation Date).
- The initial Computation Date can be selected by the Issuer.
- No less than 90% of the rebate and/or yield restriction liability must be paid to the U.S. Treasury within 60 days of the Computation Date.
- 100% of the rebate and/or yield restriction liability must be paid to the U.S. Treasury within 60 days of the Final Computation Date.
- IRS Form 8038-T is used for this transmittal.
- No filing is necessary if no liability exists. Issuer keeps calculations for records.



The Perfect Storm for a Yield Restriction Liability

1. COVID-19

2. Supply Chain Delays

3. Rising Investment Rates

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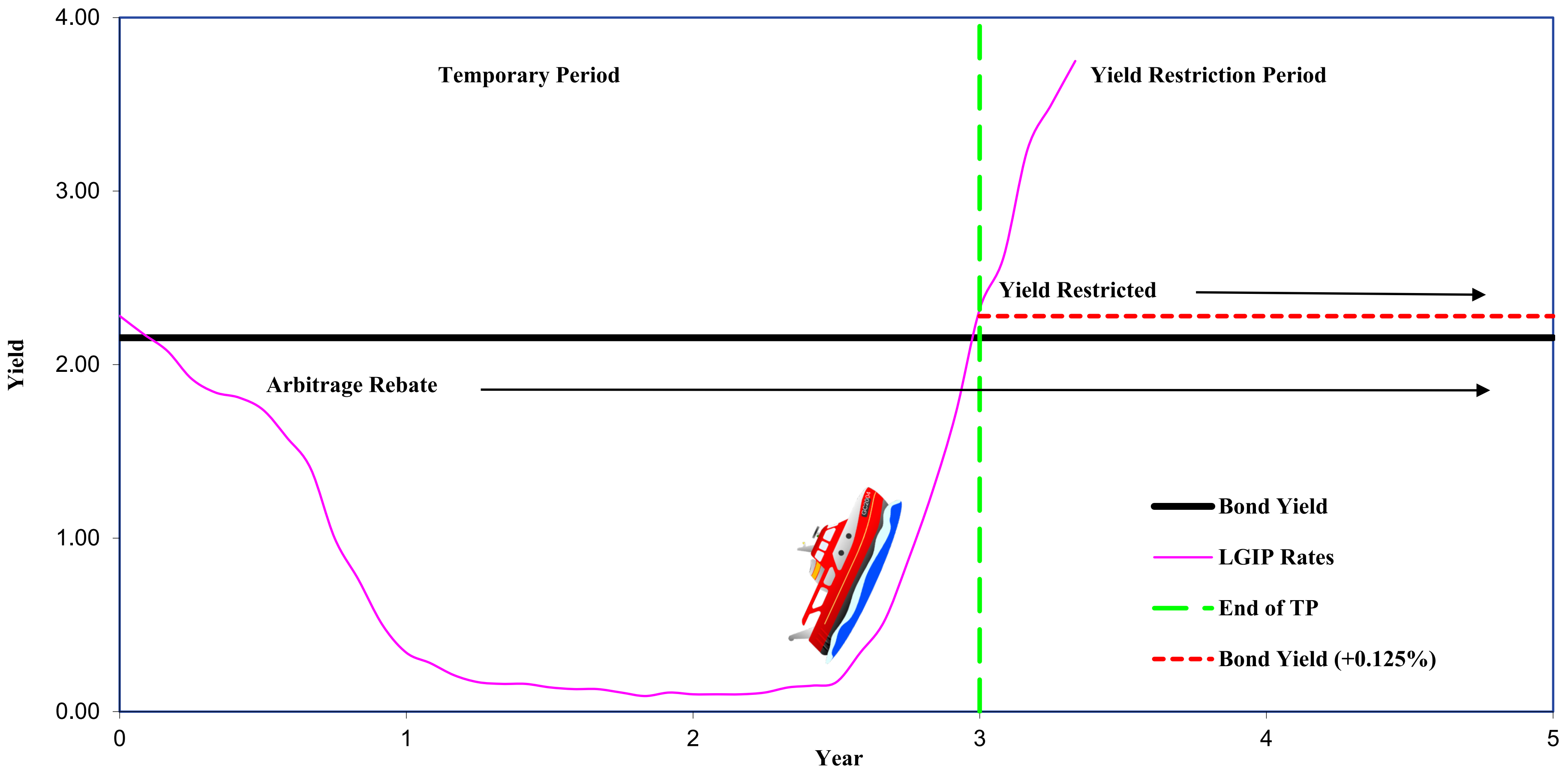
The Perfect Storm for a Yield Restriction Liability



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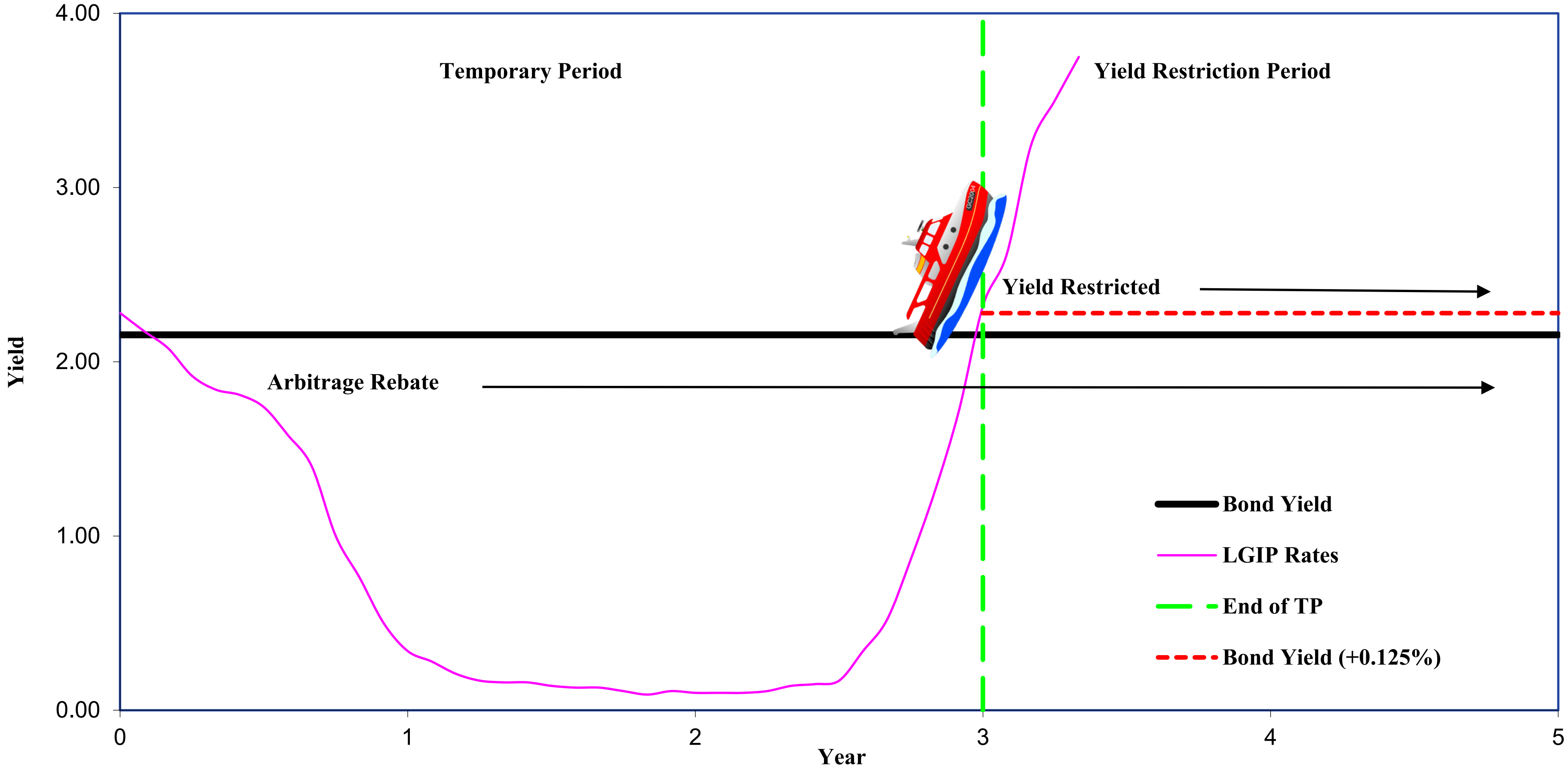

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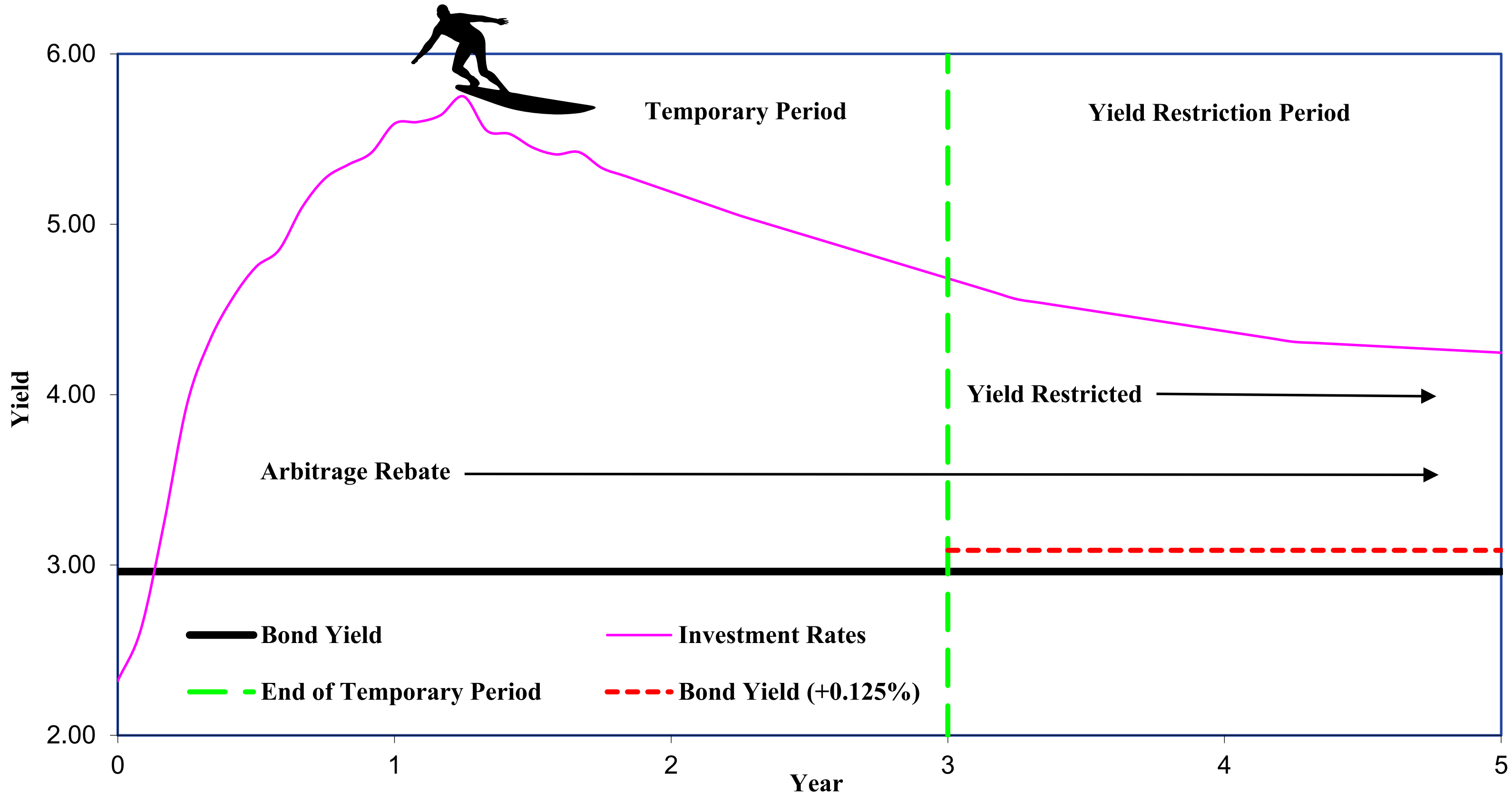
Riding the Return Wave



*Actual pool rates through surfer

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Best Practices

- Engage rebate service provider early – be proactive.
  - ❑ Take the **Active Approach!**
- Separate account for bond proceeds – commingled funds are more difficult to track.
- Small issuers can still engage rebate service provider to monitor and provide any required calculations.
- With higher interest rates:
  - ❑ Determine pro-forma rebate liability or exception prior to sale.
  - ❑ Calculate rebate no less than every six months for the initial two-year period and annually thereafter.
  - ❑ Establish reserve for liabilities.

Timeline	The ACTIVE Approach	The PASSIVE Approach
New Issue Closing Date	▪ Issuer engages rebate consultant to initiate Internal Revenue Code and Arbitrage Regulations compliance	▪ Issuer is too busy to engage rebate consultant ▪ Decision is made to wait until due date for rebate calculation is closer
Six Months from Closing Date	▪ Issuer receives initial rebate report and knows if rebate exception is possible	▪ Issuer is unaware of specific rebate exception rules and whether rebate liability has accrued
One Year from Closing Date	▪ Issuer knows rebate liability exists and has established a reserve ▪ Issuer receives investment portfolio results and repositions investments to earn maximum income	▪ Issuer is not focused on rebate analysis ▪ Lack of portfolio performance information prevents opportunity for investment optimization
Two Years from Closing Date	▪ Issuer receives updated accumulated rebate liability and confirms reserve amount	▪ Issuer has no knowledge about whether a rebate liability has accumulated ▪ Issuer considers options and reinvests in lower yielding investments as a safeguard
Three Years from Closing Date	▪ Proceeds are spent, project is completed ▪ Rebate liability is identified and proceeds are set aside for future payment ▪ Additional earnings on investment portfolio are used to offset other issuer expenses	▪ Proceeds are spent, project is completed ▪ Additional earnings are disbursed without regard to potential rebate due
Five Years from Closing Date	▪ Rebate calculation is updated and liability is paid	▪ Auditors/IRS request rebate calculation ▪ RFP process for rebate consultant begins ▪ Important records now five years old and not easily located due to staff turnover and software upgrades ▪ Staff members work to reconstruct necessary details ▪ Rebate consultant has considerable difficulty interpreting data due to missing accounting records, process continues and clock is ticking ▪ Rebate calculation is eventually completed
Final Outcome	**Tax compliance is achieved**	Rebate liability has accumulated and money must be pulled from other sources unexpectedly, **creating budget challenges**

THANK YOU!

IF YOU WOULD LIKE TO DISCUSS ANY TOPICS, PLEASE DO NOT HESITATE TO CONTACT US.

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