Arbitrage Rebate Compliance and Strategies for Bonds in the Current Interest Rate Environment – Session B05

April 24, 2024

Christopher J. Iamarino
Thrun Law Firm, P.C.
517-374-8862
ciamarino@thrunlaw.com

David Walters
PFM Asset Management LLC
414-373-0647
waltersd@pfmam.com

What is Arbitrage Rebate?

Arbitrage

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

Rebate

- Essentially a 100% tax
- Issuer’s “rebate” or pay excess earnings to the IRS

Purpose

- Financial disincentive to violate the rules
- Non-compliance could result in taxable bonds

Arbitrage Rebate & Yield Restriction

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

Prevents:

- 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.

Applies to **every** tax-exempt borrowing and some taxable subsidy (eg, tax credit) obligations

- Measured on an issue-by-issue basis
- Arbitrage Rebate begins on the issue date
- Yield Restriction begins at the expiration of a temporary period

Tax law and regulations create financial disincentives to **prevent** issuance of tax-exempt debt for profit-driven reasons

- Yield restriction – IRC Section 148(b)
- Arbitrage rebate – IRC Section 148(f)
- Overlapping requirements – “Belt & Suspenders”

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

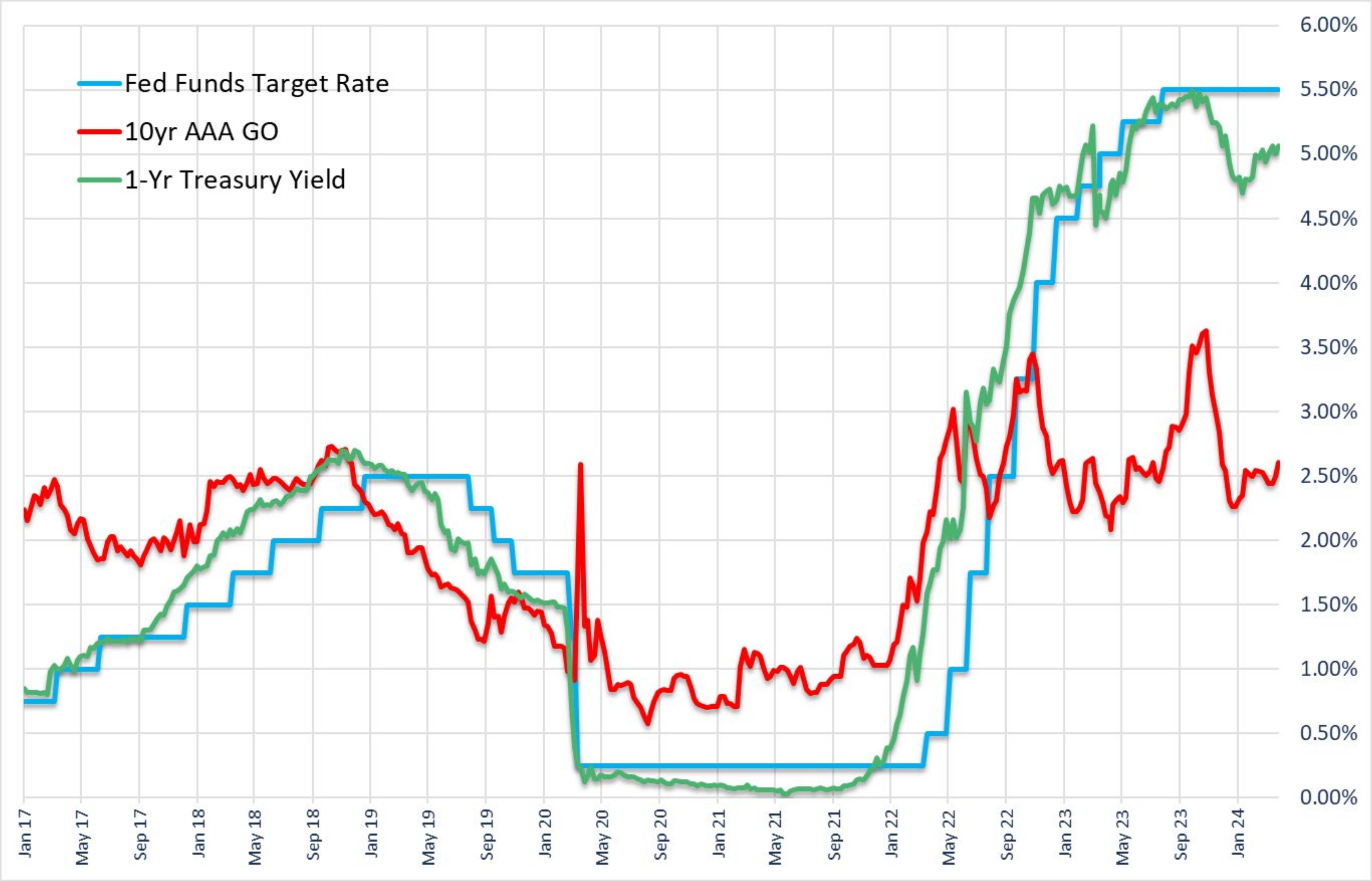
State Aid / Working Capital Funding

Short Term Obligation Arbitrage Concepts

- Generally Applicable to SAN, TAN and LOC
- Sizing Your Note
  - Cashflow is King
  - Greatest Shortfall
  - Reasonable Working Capital Reserve
- Small Issuer Exception from Rebate
  - $5 Million/$15 Million
  - Large Issuer Six Month Certificate of Cash Flow

Positive Arbitrage – It’s Back

Arbitrage Environment



Sources: Bloomberg, Refinitiv, EMMA. See important disclosures at the end of this presentation

Positive and Negative Arbitrage

Actual investment earnings yield

– Average borrowing rate (aka, the *arbitrage yield*)

= 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

Polling Question #1

True or False. I can take negative arbitrage from my 2015 Series I Bonds and use it to offset positive arbitrage on my 2024 Series II Bonds.

a) True

b) False

ANSWER	b

Bond Funds Subject to Rebate

PROCEEDS	+	REPLACEMENT PROCEEDS	=	GROSS PROCEEDS
Sale Proceeds / Investment Proceeds • Project / Construction Funds • Capitalized Interest Funds • Debt Service Reserve Funds • Escrow Funds • Costs of Issuance Funds • Interest earnings Transferred Proceeds Any of the above		Cash / Equity / Revenue Funded • Debt Service Funds • Debt Service Reserve Funds • Any "Pledged" Fund		All subject to Rebate Exceptions may apply

Exceptions to Arbitrage Rebate

- Small Issuer Exception
- Spending Exceptions
  - 6-month
  - 18-month
  - 2-year
- “Bona Fide” Debt Service Fund Exception
- Electing to pay the 1.5% penalty in lieu of rebate
- Investing in tax-exempt obligations (eliminating the “arbitrage”)

Exceptions to Arbitrage Rebate

Small Issuer Exception

Exception to Arbitrage Rebate Only

- 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

Small Issuer Exception – Review & Test Annually

Bond Type/Calendar Years	2017	2023	2024 (Expected)
(a) School Building and Site Bonds	10,000,000	10,000,000	15,000,000
(b) Current Refunding Bonds	8,000,000	5,000,000	7,000,000
(c) Tax-Exempt Advance Refunding Bonds	6,000,000	--	--
(d) Other State Aid Notes, Leases	2,000,000	2,000,000	2,000,000
(e) Taxable Bonds	--	5,000,000	5,000,000
Total Calendar Year Bond Issuance	26,000,000	22,000,000	27,000,000
Total Bond Issuance Subject to Test (a+c+d)	18,000,000	12,000,000	17,000,000
Small Issuer Exempt?	**NO**	**YES**	**NO**

For illustrative purposes 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		18-Month		2-Year (ACP)	
All gross proceeds		All new money		Construction issues	
✓ 6 months	100%*	✓ 6 months	15%	✓ 6 months	10%
		✓ 12 months	60%	✓ 12 months	45%
		✓ 18 months	100%**	✓ 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

- 2023 Bonds must be a "Construction" issue
  - At least 75% of the project is construction
- Must meet each benchmark, no catch-up allowed
- ACP = Available Construction Proceeds
  - Project Fund plus Expected Earnings

2023 Project Fund	$25,000,000
Expected Earnings *	$1,000,000
ACP - Denominator	**$26,000,000**

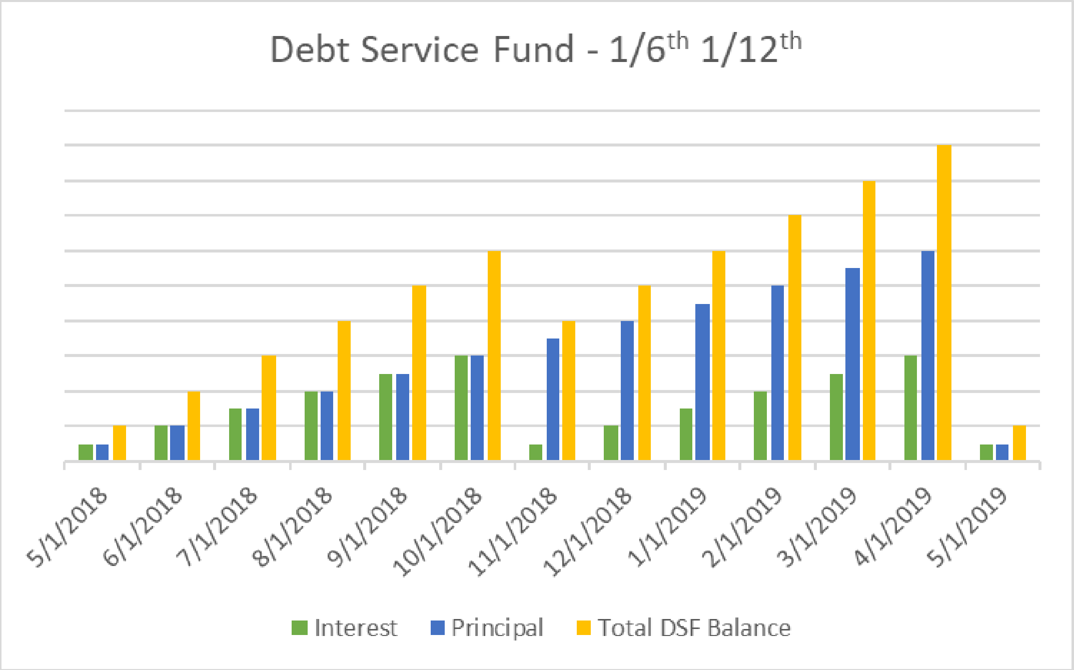
	Benchmark Date		% Required Expenditures	$ Required Expenditures	$ Actual Expenditures	Met Benchmark?
	Issue Date	10/26/2023				
	6 months	4/26/2024	10%	$2,600,000	?	Yes / No
	12 months	10/26/2024	45%	$11,700,000	?	Yes / No
	18 months	4/26/2025	75%	$19,500,000	?	Yes / No
	24 months	10/26/2025	100%**	$26,000,000	?	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*

Exceptions to Arbitrage Rebate

“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

For illustrative purposes only

Polling Question #2

The District 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

ANSWER	d

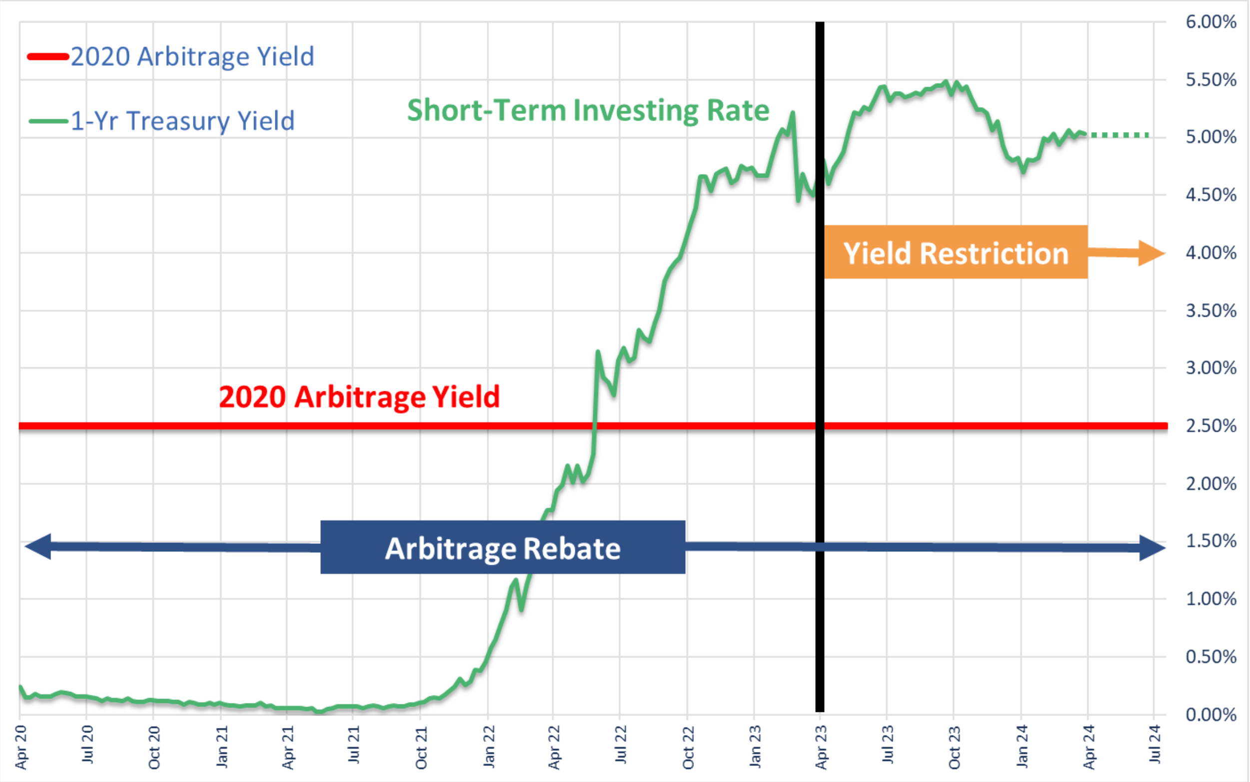
Yield Restriction Compliance

What is Yield Restriction?

- Like rebate, restriction against investing above the arbitrage yield
- Only applies to proceeds that are subject to yield restriction
- Exceptions apply
- Temporary periods
  - Exception for “Reasonably Required” Reserve Fund
  - Minor Portion

Arbitrage Rebate vs. Yield Restriction

- Arbitrage Rebate and Yield Restriction are separate calculations
- Yield Restriction only applies to proceeds that are subject to yield restriction
- Cannot blend positive arbitrage of yield restricted proceeds with negative arbitrage of unrestricted proceeds
- Exceptions apply
  - Exception for "Reasonably Required" Reserve Fund
  - Minor Portion
  - Temporary periods



How long will short-term interest rates remain this high?

Sources: Bloomberg, Refinitiv, EMMA. See important disclosures at the end of this presentation

Yield Restriction Compliance Methods

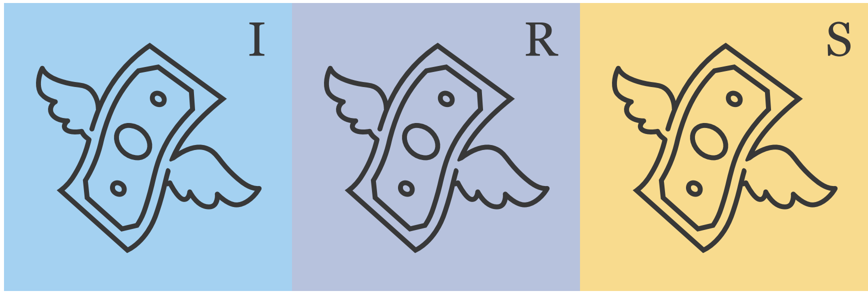
- Active Yield Restriction
  - Investments must be purchased at fair market value
- Yield Reduction Payments
  - Rebate like payments
  - Limited availability for advance refunding issues
- Other Options
  - Longer construction fund temporary period (5-years vs. 3-years)
  - Waiver of temporary period at issuance

Calculation Requirement

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 & IRS Form 8038-T



- Do not submit calculations

- No filing required if no payment is due

Late Payments & Refunds

Late Payments

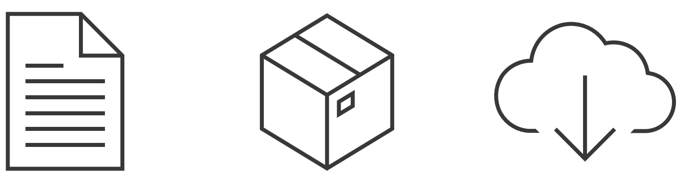
- Governmental bonds [including qualified 501(c)(3) bonds)]
  - 50% of rebate amount, plus interest
- Interest computed @ underpayment rate (reset quarterly)
- Late payment explanation required
- Penalty (excluding interest) is typically waived if:
  - Liability plus interest is paid within 180 days 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

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

Can I Earn Positive Arbitrage?

Proceeds	Able to Earn Positive Arbitrage?
Current Refunding	**YES**
Tax-Exempt Advance Refunding (currently unavailable)	**NO**
Defeasance Escrow	**NO**
Project Funds	**YES**
Reserve Funds	**YES**

Dual Requirements of Arbitrage

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 under “small issuer”	**Project Fund and Capitalized Interest**	• Generally, a 3-year temporary period applies (5-years with certification for a longer period 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 under “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 under “small issuer”
• Exempt if the 6-month spending exception is met
	Escrow Fund	• Yield restricted at the bond yield + 0.001% after the end of the applicable temporary period:
		    • Advance Refunding: 30 days
		    • Current Refunding: 90 days

• Exempt from rebate if qualified as a bona fide debt service fund (generally depleted annually) • If failed in compliance, subject to rebate	**Debt Service Fund**	• Exempt from yield restriction if qualified as a bona fide debt service fund (generally depleted annually) • If failed in compliance, yield restricted at the bond yield + 0.001%
• Subject to rebate from issue date, *unless:* • Exempt if the issue qualifies under “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 applies

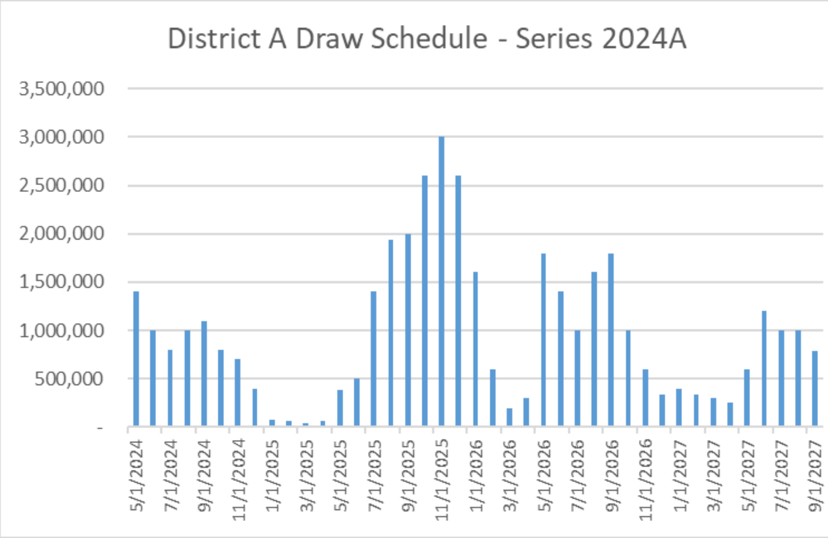
Hypothetical – District A

The Situation: The District of We Need A New High School ("District A") is selling Series 2024A School Building and Site 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. How confident is District A in the draw schedule?
2. Does District A expect to meet a spending exception? Should the spending exception be applied?
3. Does District A expect to earn positive arbitrage?
4. Is waiving the 3-year temporary period an option?



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

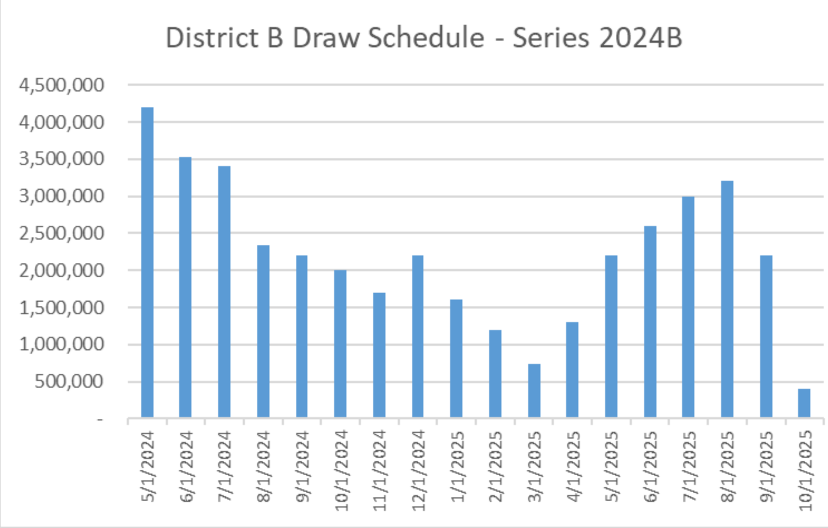
Hypothetical – District B

The Situation: The District of We Need a New Middle School ("District B") is selling Series 2024B School Building and Site Bonds with the following characteristics:

Par Amount	$40,000,000
Construction Fund Deposit	$40,000,000
Estimated Draw Schedule	~18 mos
Arbitrage Yield	3.50%
Current Investment Yield	4.50%

Questions to consider:

1. How confident is District B in the draw schedule?
2. Does District B expect to meet a spending exception? Should the spending exception be applied?
3. Does District B expect to earn positive arbitrage?
4. Is waiving the 3-year temporary period an option?



Expected Gross Earnings	**$1,300,000**
Expected Positive Arbitrage	**$310,000**
Expected Net Earnings	**$1,300,000**

Polling Question #3

True or False. Earning positive arbitrage is a bad thing?

a) True

b) False

c) Sounds like a trick question

ANSWER	b or c

Tips for a Smooth Process

- Be familiar with the tax or non-arbitrage certificate
- Create an organized file system
  - Avoids having to find records from 5-years ago
  - Consider hiring a consultant when the bonds are issued
- Schedule your calculation at least 60 days or more in advance
- Know the exceptions
  - If eligible, find out which one, and what that means for the issue
- Consider having calculations prepared more frequently
  - Can help in keeping an eye on spending exceptions
  - Allows you to plan for a future liability
- Ask questions!

Exception to Arbitrage Rebate

Exception to Yield Restriction

Questions?

Thank You!

Disclaimer

Investment advisory services are provided by PFM Asset Management LLC (“PFMAM”), an investment adviser registered with the U.S. Securities and Exchange Commission and a subsidiary of U.S. Bancorp Asset Management, Inc. (“USBAM”). USBAM is a subsidiary of U.S. Bank National Association (“U.S. Bank”). U.S. Bank is a separate entity and subsidiary of U.S. Bancorp. U.S. Bank is not responsible for and does not guarantee the products, services or performance of PFMAM. The information contained is not an offer to purchase or sell any securities. Additional applicable regulatory information is available upon request.

For more information regarding PFMAM’s services please visit www.pfmam.com.