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GOVERNMENT FINANCE OFFICERS
ASSOCIATION OF PENNSYLVANIA

Navigating the Complexities of Arbitrage and Rebate Compliance

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Agenda

- Presenter Introductions
- Market Update
- Basic Understanding of Arbitrage and Rebate Regulations
- Arbitrage and Rebate Computations
- Compliance and Required Filings
- Key Takeaways and Closing Remarks

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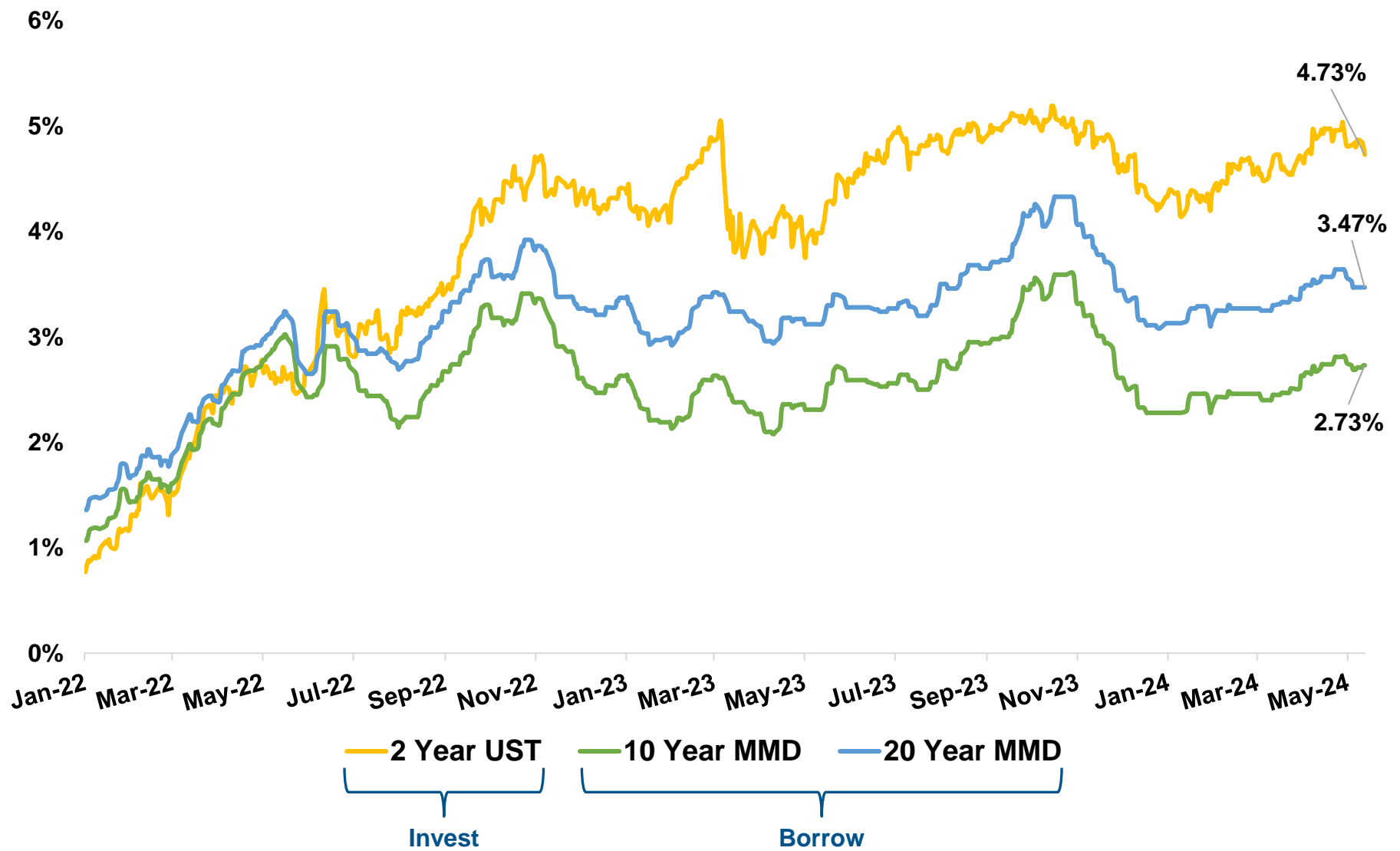
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Market Update

Market Update

- The Federal Open Market Committee (FOMC) rapidly tightened monetary policy starting in March 2022 through July 2023, with the federal funds rate currently in a range of 5.25% to 5.50%, **the highest level in 23 years.**
- The FOMC has held the fed funds rate steady at its last six meetings since September 2023. The next FOMC meeting will be held on June 11-12, 2024.
- One positive result of the current rate environment is that bond proceeds could potentially be **invested at high short-term interest rates.**
- The interest rate environment will continue to be heavily influenced by **economic data**, and particular attention should be paid to inflation, jobs and GDP growth.
- Strong economic data continues to be published in 2024, warranting the FOMC to keep rates **higher for longer.**

Market Update



Basic Understanding of Arbitrage and Rebate Regulations

Overview of Arbitrage and Rebate

- What is Arbitrage? Can an issuer invest the proceeds of its bonds at a yield greater than the yield on its bonds—i.e. **“can you earn it”**?
- What is Rebate? When must an issuer remit net investment earnings above the yield on its bonds to the IRS—i.e. **“can you keep it”**?
- Exceptions in the Internal Revenue Code and related Treasury Regulations allow, in certain limited circumstances, net positive arbitrage to be earned and retained.

Arbitrage General Rule and Exceptions

- General Rule--issuers cannot invest bond proceeds at a yield that is materially higher than the yield on the bonds.
- There are several exceptions that permit unrestricted investment earnings during certain periods. The most common exception is for new money capital projects—generally, issuers may invest such proceeds at a higher yield for three years (up to five years for certain projects that have longer construction periods).

Arbitrage General Rule and Exceptions

Temporary Periods

- A period where an issuer may invest bond proceeds without yield restrictions.
- The length of a Temporary Period will vary based on the use of the bond proceeds.

Temporary Period for Capital Projects

Proceeds to be expended for capital projects qualify for a temporary period of up to 3 years after issuance if an issuer *reasonably expects* to:

- 1) Spend at least 85% of the proceeds on capital projects within 3 years from issue date;
- 2) Incur a binding obligation to expend at least 5% of proceeds within 6 months of issue date;
and
- 3) Proceed with due diligence to complete the capital project.

Rebate General Rules and Exceptions

- Rebate General Rule: even if positive arbitrage is permitted to be earned under an exception to the arbitrage rules, rebate rules still require the issuer to pay net positive arbitrage to the Federal government unless a specific exception applies.
- Exceptions: there are limited exceptions based on the size of the issue or certain spending requirements.

Small Issuer Rebate Exception

An issue is exempt from rebate if they qualify under the following **size-based** exceptions.

- As long as the issuer has governmental taxing powers and does not expect to or has not issued more than **\$5,000,000** in tax-exempt bonds in a calendar year, an exception would apply.
- The threshold increases to **\$15,000,000** in tax-exempt bonds in a calendar year for school construction issues.
- If an issue is allocated as a multi-purpose issue, a small issuer exemption would apply only to the new money portion of the issue.

Time Based Exceptions to Rebate

Time-Based Exceptions: The Issuer must meet the following spending timelines pursuant to the Code and the Regulations:

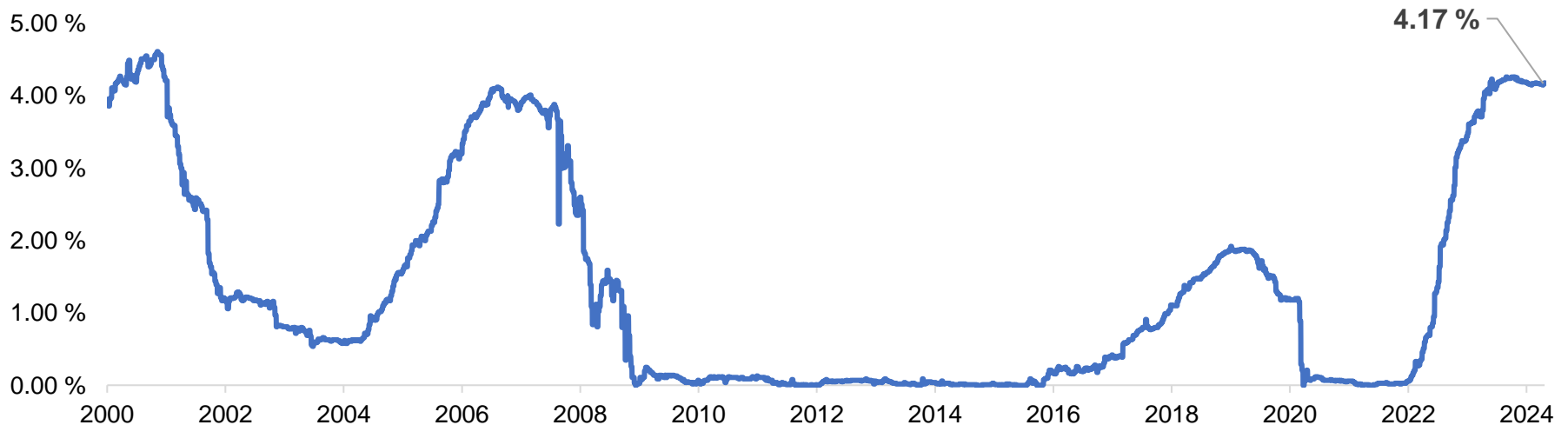
- 6 Months - Available for all issues, including refunding issues
- 18 Months - New money issues only
- 24 Months - Only available for construction issues
- If proceeds are not spent quickly enough to meet all the required benchmarks, the proceeds are subject to arbitrage rebate requirements

Spend-down Requirement	6-Months	12-Months	18-Months	24-Months
6-Month Exception	100%			
18-Month Exception	15%	60%	100%	
24-Month Exception*	10%	45%	75%	100%

State and Local Government Series (SLGS)

- Tax-exempt securities designed to help municipal issuers comply with yield restriction or arbitrage rebate provisions of the Internal Revenue Code.
- Sold by the US Treasury Department to states, municipalities, and other local government bodies to potentially generate legally retainable positive arbitrage above the bond yield.
- Most commonly purchased to invest tax-exempt proceeds raised in new municipal bond offerings or in municipal bond refunding's.

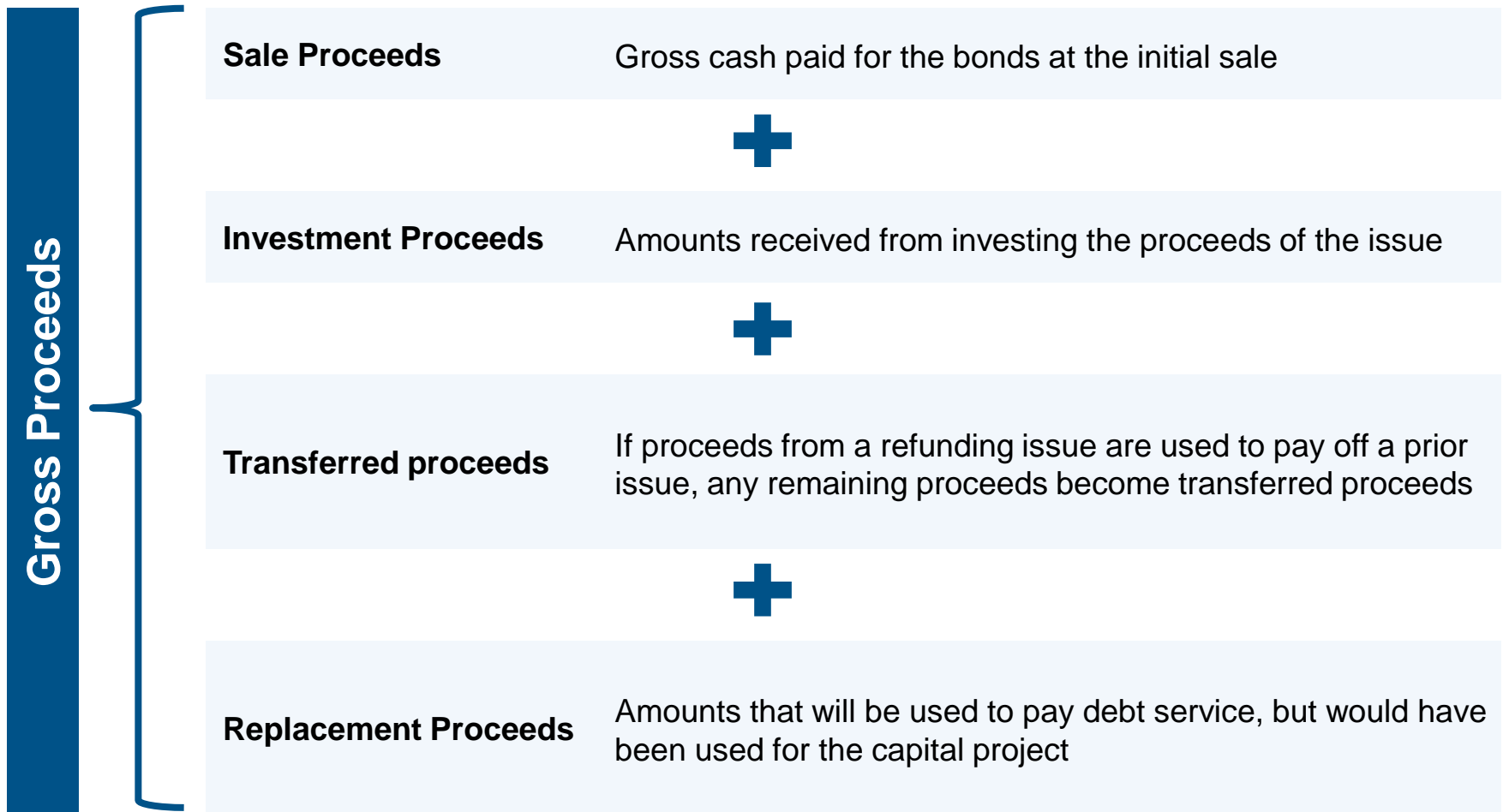
Demand Deposit SLGS Rates



Arbitrage Computations

Gross Proceeds Calculation

Both Arbitrage and Rebate rules apply to the “Gross Proceeds” of the bond issue.



Common Debt Funds

Project Fund

Holds bond proceeds to be used to pay costs of constructing the project

- Direct payment or transfers to an operating fund

Reserve Fund

Holds bond proceeds to pay future debt service in case revenues are inadequate to pay debt service

Debt Service Fund

Receives transfers from other funds to pay debt service

Operating Fund

Holds revenue from operations and makes deposits to other funds

- Not subject to arbitrage unless proceeds are transferred where they will be held for the purpose of paying debt service

Arbitrage and Rebate Rules by Fund Type

Fund	Arbitrage	Rebate
Project Fund	Not subject during 3-5 year temporary period, yield restricted to bond yield +0.125% after temporary period	Subject to rebate unless spending exception is met or a small issuer
Reserve Fund	Exempt if a reasonably required reserve fund, if not, yield restricted to bond yield +0.001%	Subject to rebate unless a small issuer
Debt Service Fund	Exempt if a bona fide debt service fund, if not, yield restricted to bond yield +0.001%	Subject to rebate if not a bona fide debt service fund

Computation



Sum of the future value of the activity of the applicable fund(s) at the bond yield rate



Less the investment balance of the applicable funds as of the computation date



Equals negative/positive arbitrage

Bond Yields

Fixed-Yield Bonds

- Calculated once at the date of issuance
- Included on the 8038-G

Variable-Yield Bonds

- Calculated for each computation period

Investment Yield Blending

- Applicable to Arbitrage Yield Restriction Only
- Two or more investments are treated as one investment within the same “class”
- Separate classes include:
 - Yield restricted investments
 - Unrestricted yield investments
 - Each investment subject to a “materially higher” threshold
- Rebate allows blending of all funds

Record Keeping



Debt Documents (8038-G & Arbitrage/Tax Certificate)



Documentation of expenditures of proceeds



Investment Statements

Keep track of all records and have them readily available for the life of bonds plus three years.

Compliance and Required Filings

Reporting and Repayment of Arbitrage

Applicable for both Arbitrage and Rebate rules:

- Computation of **successive five-year periods**
- Annual credit is applied to the amount due
- If applicable, payment of 90% is due **within 60 days**, remaining due with final payment
- Failure can result in **interest, penalty, and bonds being declared taxable**

Key Bond Documents

Form 8038-G

Form **8038-G** Information Return for Tax-Exempt Governmental Bonds
 (Rev. October 2021)
 Department of the Treasury Internal Revenue Service

OMB No. 1545-0047

Under Internal Revenue Code section 149(e)
 See separate instructions.
 Caution: If the issue price is under \$100,000, use Form 8038-GC.
 Go to www.irs.gov/F8038G for instructions and the latest information.

Part I Reporting Authority Check box if Amended Return

1 Issuer's name
 2 Issuer's employer identification number (EIN)
 3a Name of person (other than issuer) with whom the IRS may communicate about this return (see instructions)
 3b Telephone number of other person shown on 3a
 4 Number and street (or P.O. box if mail is not delivered to street address) Room/suite
 5 Report number (For IRS Use Only)
 6 City, town, or post office, state, and ZIP code
 7 Date of issue
 8 Name of issue
 9 CUSIP number
 10a Name and title of officer or other employee of the issuer whom the IRS may call for more information
 10b Telephone number of officer or other employee shown on 10a

Part II Type of Issue (Enter the issue price.) See the instructions and attach schedule.

11 Education	11
12 Health and hospital	12
13 Transportation	13
14 Public safety	14
15 Environment (including sewage bonds)	15
16 Housing	16
17 Utilities	17
18 Other. Describe ▶	18

19a If bonds are TANs or RANs, check only box 19a
 b If bonds are BANs, check only box 19b
 20 If bonds are in the form of a lease or installment sale, check box

Part III Description of Bonds. Complete for the entire issue for which this form is being filed.

	(a) Final maturity date	(b) Issue price	(c) Stated redemption price at maturity	(d) Weighted average maturity	(e) Yield
21		\$	\$	years	%

Part IV Uses of Proceeds of Bond Issue (including underwriters' discount)

22 Proceeds used for accrued interest	22
23 Issue price of entire issue (enter amount from line 21, column (b))	23
24 Proceeds used for bond issuance costs (including underwriters' discount)	24
25 Proceeds used for credit enhancement	25
26 Proceeds allocated to reasonably required reserve or replacement fund	26
27 Proceeds used to refund prior tax-exempt bonds. Complete Part V	27
28 Proceeds used to refund prior taxable bonds. Complete Part V	28
29 Total (add lines 24 through 28)	29
30 Nonrefunding proceeds of the issue (subtract line 29 from line 23 and enter amount here)	30

Part V Description of Refunded Bonds. Complete this part only for refunding bonds.

31 Enter the remaining weighted average maturity of the tax-exempt bonds to be refunded years
 32 Enter the remaining weighted average maturity of the taxable bonds to be refunded years
 33 Enter the last date on which the refunded tax-exempt bonds will be called (MM/DD/YYYY)
 34 Enter the date(s) the refunded bonds were issued ▶ (MM/DD/YYYY)

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63773S Form **8038-G** (Rev. 10-2021)

Arbitrage/Tax Certificate

- Certifies the expectations of the use of the proceeds at the date of the issue
- Certificate includes the following information:
 - ✓ Use of proceeds
 - ✓ Bond funds and restrictions
 - ✓ Arbitrage restrictions / exceptions
 - ✓ Rebate requirements / exceptions
 - ✓ Rebate calculation and payment requirements

Key Take Aways and Closing Remarks

Key Take Aways

- Arbitrage and rebate are complex — don't go it alone!
- Consider the two distinct sets of arbitrage and rebate rules and the different exceptions:
 - 1) Arbitrage—can you earn it?
 - 2) Rebate—can you keep it?
- Maintain adequate records and have them readily available.
- It is crucial to keep up with calculations, especially in an elevated interest rate environment.

Sources

- ABC's of Arbitrage, The Rules for Investment of Bond Proceeds By Municipalities, 2018 Edition
 - *Published by Vicky Tsilas and Kimberly Betterton*
- The Issue Spot Public Finance in Focus: “Spend Down Rules”
 - *Published by Bracewell LLP*
- A Quick Guide to Yield Restriction and Rebate Exceptions
 - *Published by Pacifica Law Group*
- Tax Exempt Bonds Phase II - Lesson 1 Review of Arbitrage and Rebate
 - *Published by IRS*

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