ARBITRAGE REBATE & EXCEPTIONS

What is Arbitrage?

Arbitrage is the difference between what would have been earned on the investment of bond proceeds had they been invested at the yield on the bond and what has actually been earned Arbitrage is not owed to the IRS unless the investment earnings average more than what would have been earned had such amounts been invested at the bond yield. To satisfy the rebate rules, the issuer should keep track of the investment activity made with bond proceeds from the date the bonds are issued until all of the bond proceeds are spent. Investment earnings in excess of what would have been earned had amounts been invested at the yield on the bonds ("rebatable arbitrage") are complex and detailed, so it is important to review the specific guidance provided by the Arbitrage and Use of Proceeds Certificate. Local bond counsel, as a part of the closing documentation for bond issue, prepares this Certificate. It is recommended that you seek the advice of local bond counsel if you have any questions.

Three Year Temporary Investment Period

Amounts may be invested without restriction to the investment yield for a "three-year temporary investment period", but generally are subject to rebate unless the issuer satisfies the requirements of a spending exception to the rebate. During this three-year period, following the issuance of bonds, a municipal issuer must invest the bond proceeds at the "fair market" yields. The municipal issuer of bonds may not attempt to artificially reduce the yield on investments purchased with bond proceeds.

The temporary period, however, only applies if the issuer reasonably expects to satisfy the following three tests:

Time Test: the issuer must, within six months of the issue date, enter into a binding commitment to a third party to expend at least 5% of the net sale proceeds of the project.

Expenditure Test: the issue must, by the end of the three-year period, allocate at least 85% of the net sale proceeds of the issue to expenditures on the project to be funded.

Due Diligence Test: the completion of the project(s) and the allocation of the net sale proceeds must proceed with due diligence.

If the municipal issuer satisfies these requirements, as detailed in the arbitrage and use of proceeds certificate, the bond proceeds may be invested without restriction to the yield. Such investments will be subject to rebate, unless the issuer is a "small issuer" as defined below, or one of the three spending exceptions to rebate applies.

Rebate Exceptions

Qualifying for one of the following rebate exceptions, means that the issuer does not have to pay the IRS the arbitrage earned during the temporary investment period. Spending exceptions are related to how fast the bond proceeds and investment earnings from the proceeds are spent by the issuer. There are specific requirements to qualify for a rebate exception. An issuer will need to review the Arbitrage and Use of Proceeds Certificate prepared at the time the bonds were issued to determine the exact dates and amounts by which the bond proceeds (and the investment earnings on the bond proceeds) need to be spent.

Small Issuer Exception: If, at the time bonds were issued, the issuer, who must be an entity with general taxing powers, and any subordinate entities expect to issue $5 million or less of tax-exempt bonds during the calendar year, then the bond issue qualifies for a rebate exception. For school bonds, the $5 million limitation is increased to $15 million, but only for bonds issued for school construction projects (at least 75% of the bond proceeds are spent for construction costs). If an issuer fits within one of these exceptions, no ongoing rebate compliance is necessary. Refunding bonds are subject to other limitations.

If an issuer does not qualify for the small issuer exception, then three other rebate exceptions may be available.

Six-Month Spending Exception: allows for bond proceeds, which include expected investment earnings on the proceeds, to be spent within six months of the date the bonds are issued. The rules allow an additional six months to spend an amount that does not exceed 5% of the bond proceeds held for reasonable retainage purposes.

18-Month Spending Exception: allows for bond proceeds, which include expected investment earnings on the proceeds, to be spent according to the following schedule: 15% within six months, 60% within one year, and 100% within 18 months.

Two-Year Construction Spending Exception: The rebate exception allowing the longest period for expenditure of the bond proceeds is available only if at least 75% of the bond proceeds, including current earnings, are spent for construction projects. The exception requires that bond proceeds, which include expected investment earnings on the proceeds, be spent according to the following schedule: 10% within six months, 45% within one year, 75% within 18 months, and 100% within two years. Additional time is afforded de minimis amounts under the 18-month and the 2- year spending exception rule. The spending tests include anticipated investment earnings for all dates, but the final date calculations will use actual earnings.

All of these periods are measured from the date the bonds are issued. If an issue qualifies for one of the spending exceptions, no filing with the IRS is required, however, the issuer should keep records of expenditures and investments to support the conclusion reached for a period of 6 years after the final discharge date of the bonds. Failure to satisfy any one of the spending targets will result in the issue becoming retro-actively subject to the rebate requirement.

Calculating Arbitrage Rebate

If a bond issue does not qualify for any rebate exception, then the bonds are subject to the arbitrage rebate requirements and a calculation must be prepared. Rebate payments, if any, are due to the IRS at least every five years from the date the bonds were issued and on the final maturity date of the bonds. If the issuer makes the full rebate payment once all the bond proceeds have been spent, the issuer does not have to make any future computations. Rebate payments are made by filing IRS Form 8038-T. If no rebate is owed, no filing with the IRS needs to be made. A filing may be advisable, as evidence of timely review and compliance.

It is important to consult with your bond counsel and possibly an arbitrage consultant concerning your potential rebate.