

# GFOAT SPRING CONFERENCE

Interest Rates are going up.....do I need to worry about Arbitrage Rebate?

.....

April 15, 2024



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## Agenda:

1. General Rebate Requirements
2. Payment Dates and Filing Requirements
3. Exceptions to Rebate

# General Rebate Requirements



The General Rebate Requirements sections provide participants with:

1. A high level Background on the Reasons behind the Rebate Rules,
2. Rebate Terminology,
3. Funds Subject to Rebate,
4. Computation and Payment Dates,
5. IRS Penalties for not filing on a Timely Basis.



- Arbitrage is Profit from Buying in one market and Selling in another.
- In our case, Borrowing in the Tax-Exempt Market and Investing in the Taxable Market.
- Interest rates are generally Higher in the Taxable market to compensate investors for Taxes.
- Arbitrage is the Profit from taking Advantage of the Market Differentials.
- **Difference between Yield Restriction and Arbitrage Rebate Rules**



### Why Arbitrage/Rebate?

- Up Front Windfall of Proceeds.
- Issuers are Tax-Exempt.
- Bond Holders Receive Tax-Exempt Interest.
- Federal Government wants its share – The Profits.
- No Subsidies or Offsets.



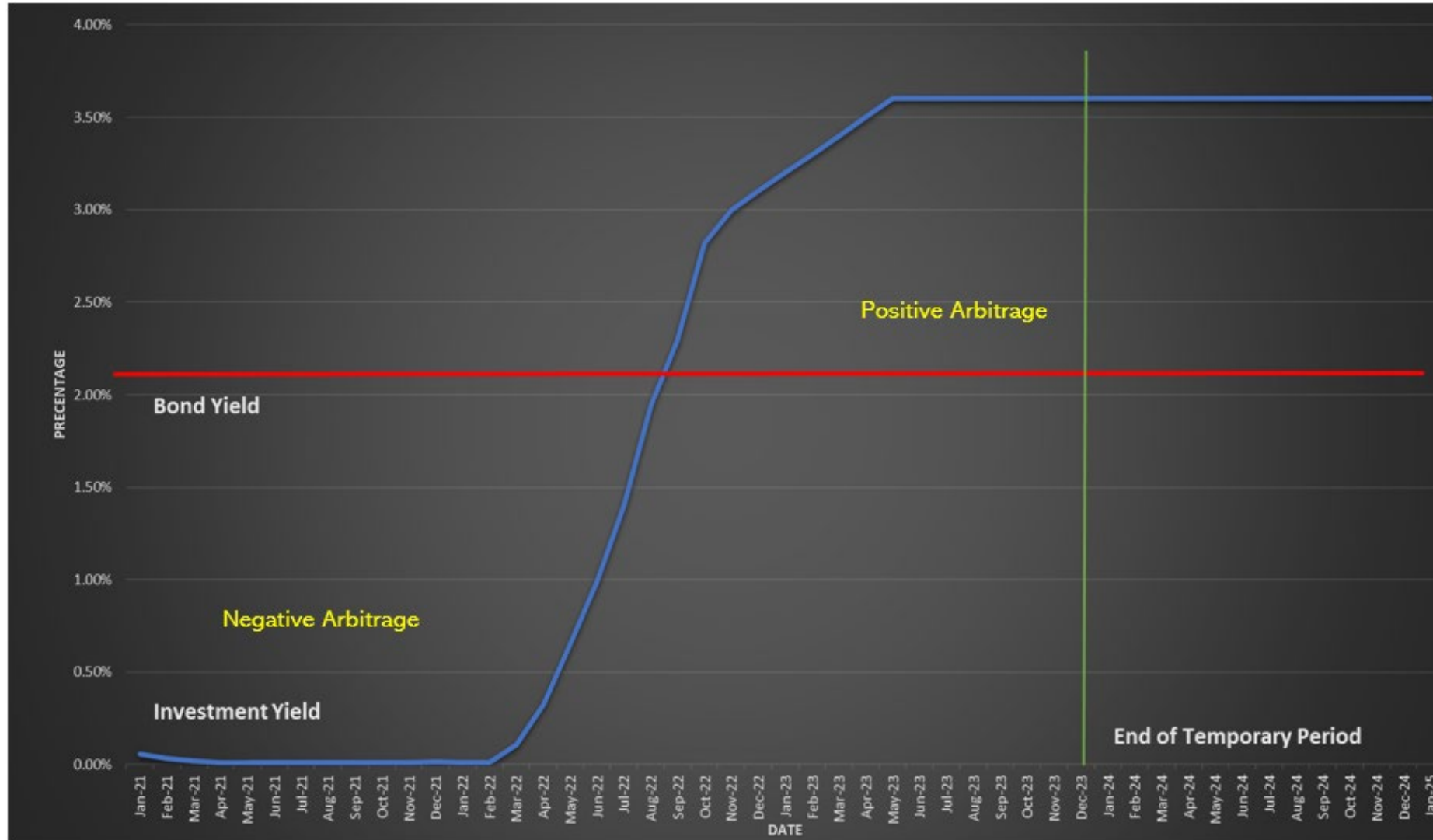
- Too Much
- Too Soon
- Too Long





- Present Value Principal and Interest payments (Bond Yield).
- Future Value Investment Cash Flows at Bond Yield.
- If Investment Yield Greater Than Bond Yield you Owe.
- Less Than, too Bad. No Subsidy or Offset.

# Rebate Big Picture





### IRS Examinations:

- Proceeds Invested in Guaranteed Investment Contracts
- Qualified Hedges (Swaps)
- Remedial Actions for Excessive Private Use
- Investment beyond a Temporary Period



# Terminology

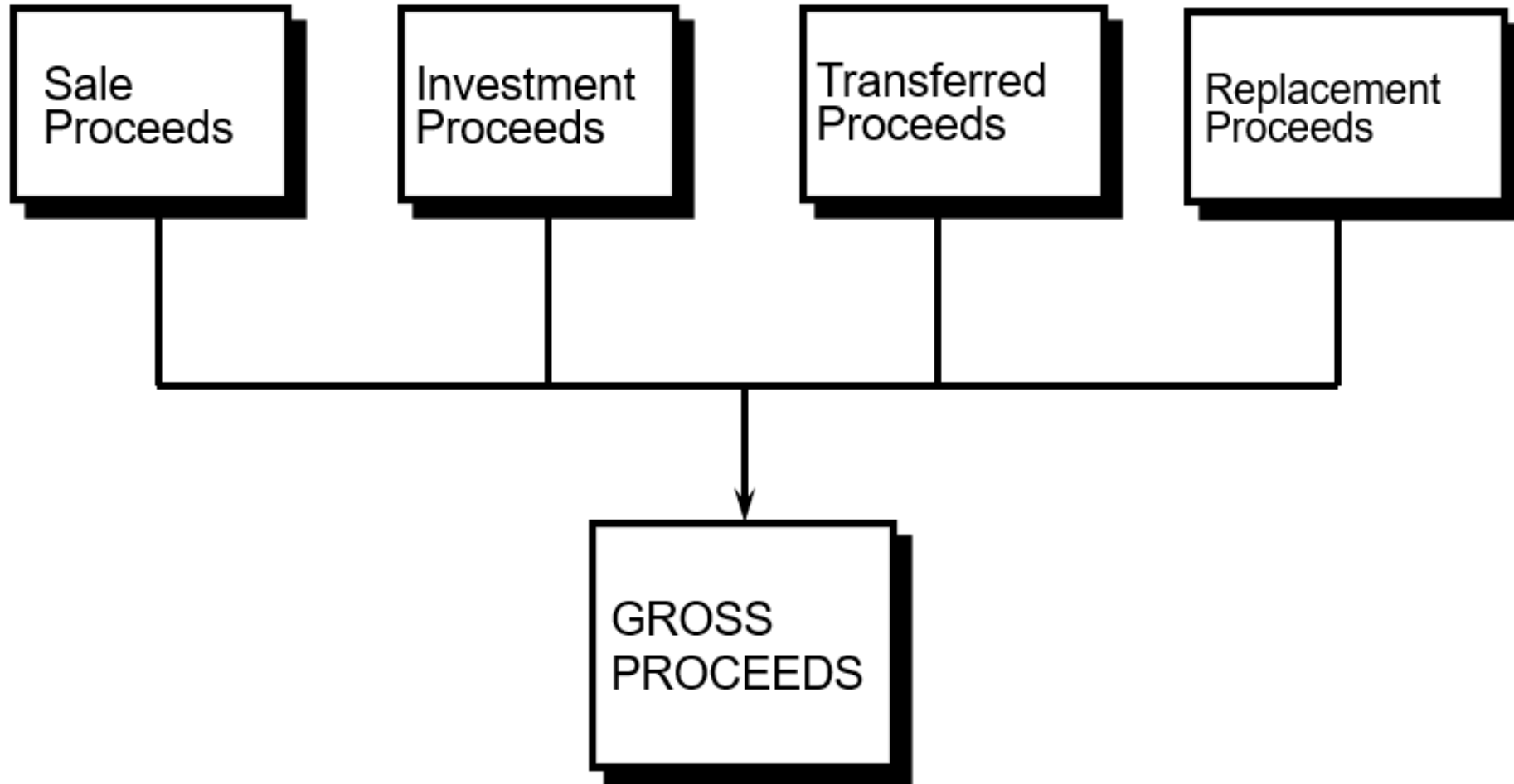


- Governmental Bonds – Issued to finance facilities for general public use (roads, bridges, or a public school) or for use by the government itself.
- Private Activity Bonds – Bonds issued for the benefit of a private (nongovernmental) entity or group.
  - Section 501(c)(3) Organization - Organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. (Hospitals, Nursing Homes, Universities)



# Funds Subject to Rebate

# Funds Subject to Arbitrage Requirements (“Gross Proceeds”)





- Replacement Proceeds – Revenues or Amounts that have a sufficient Direct Nexus to the issue or the governmental purpose of issue to conclude that such amounts would have been used for the purpose of the issue if the issue were not used for such purpose.
- Debt Service - Bond Holders can look to in case of Financial Difficulty to Pay Debt Service.
- Debt Service Replacement Proceeds include:
  - ✓ Debt Service Funds
  - ✓ Redemption/Sinking Funds
  - ✓ Reserve Funds
  - ✓ Pledged Funds



# Payment Dates and Filing Requirements

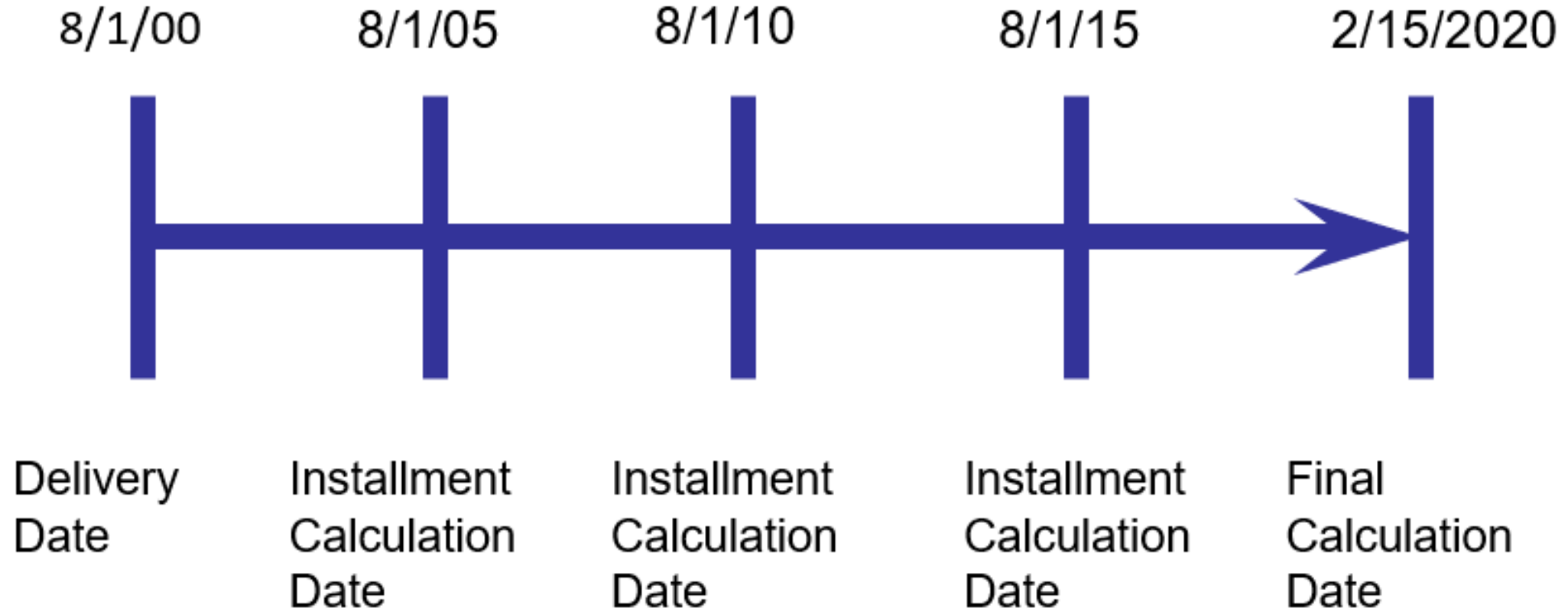


- Installments must be paid at least every 5th Bond Year (§1.148-3(f)).
- Bond Year is each one-year period ending on the date selected by the Issuer.
- If no date is selected by the Issuer, bond year ends on each anniversary date of the issue.
- Installment payable within 60 days.



- Date all bonds of an issue have been retired (matured or redeemed early).
- Cash defeasance or refunding may accelerate.
- Payment due within 60 days.

# IRS Reporting Dates for Arbitrage Rebate Payments





- Installment Date: Amount that when added to future value of previous payments equals at least 90% of rebate amount .
- Final Computations: 100% of unpaid rebate amount.



- \$1,000 annually in each year gross proceeds are present plus \$1,000 on final computation date. Computation credits were adjusted to \$1,400 for Bond Years ending in 2007 and then adjusted annually for inflation. The credit in 2024 is \$2,070.



- Complete Form 8038-T.
- Make check payable to the United States Treasury.
- Mail Rebate Payments to IRS Center in Ogden, UT.
- IRS Only Wants Form 8038-T and a Check. No copy of the Calculation.
- If No Payment, No Filing.







### Penalties of Noncompliance:

- Loss of Tax-Exemption on the issue; or
- Assessment of Penalties and interest.



- Bonds will be declared taxable unless:
  - ✓ Failure was not due to willful neglect; and
  - ✓ Issuer pays a penalty to the United States.



- Penalty equal to:
  - ✓ 50 percent for Governmental or §501(c)(3) bonds; or
  - ✓ 100 percent for Private Activity bonds, excluding qualified §501(c)(3) bonds.
  
- **Interest also payable on Correction Amount at the Corporate Underpayment Rate.**



- May be waived if rebate amount, plus interest, paid within 180 days of the failure's Discovery.
- Waiver not allowed if IRS determines the failure was due to Willful Neglect or issue is under Examination by the IRS.



- Filed on Form 8038-R.
- Prior Payment must have been Made.
- No Overpayment Interest.
- Refund only to the extent that a recovery would not result in additional rebate amount if that date were treated as a computation date.
- Overpayments of less than \$5,000.00 may not be recovered before the final computation date.
- Refunds must be requested **No Later Than 2 Years and 60 Days** after the Final Computation Date.



- Define the Cause of the Need to Request a Refund.
- Seriously consider the If you should Request a Refund.
- Complete Form 8038-R Packet – Form, Calculation, With and Without.
- Mail to the IRS Center in Ogden, UT.
- Be Patient.

# Exceptions to Rebate



- Small Issuer Exception
- 6-Month Exception
- 18-Month Exception
- 24-Month Exception
- Debt Service Funds
- Investments in Tax-Exempt Obligations





# Small Issuer Exception to Rebate



- Governmental entity with general taxing powers (no private activity bonds).
- At least 95% of the proceeds must be used for local governmental activities within the issuer's boundaries.
- On the date of issuance, the issuer must reasonably expect not to issue more than the aggregate limit during the **Calendar Year**.



- Municipal Issuers Issue \$5 million or less in tax-exempt debt during a calendar year.
- School Districts (K-12) \$15 million or less during a calendar year (no more than \$5 million for non construction).
- Subordinate entity debt included.
- Taxable Issues do not apply.
- \$5/\$15 Limit Includes Premiums.



### Refunding Issues –

- Current Refunding Bonds with No Increase in Face Amount are Disregarded in determining the Limit.
- Refunding Bonds (Current or Advance) can qualify for the Exception provided:
  - The Refunded issue Qualified for the Limit
  - Aggregate Face amount of Refunding less than \$5 million
  - Weighted Average Maturity of the Refunding Bonds does not exceed the Refunded Bonds
  - The Refunding Bonds do not mature more than 30 years after the issuance of the Original Bonds.



# Spending Exceptions

## Who Can Use Which Exceptions?



6-Month

All Issuers, All Expenditures

18-Month

All Issuers, All Expenditures

24-Month

Governmental and Section 501(c)(3),  
75% Bricks and Mortar



- Investment Income counts as Proceeds that must be spent.
- Issuance Date Income Estimates can be used for all but the Final Semiannual Spending Date.
- Reserve Fund Sales Proceeds not Proceeds that need to Spent.
- May count Interest Paid on the Issue, not Principal, as Expenditures.



# 6-Month Spending Exception





- Gross proceeds (including earnings) spent for governmental purpose within six months.
- Minor portion (less than 5% of issue size) given additional six months (Governmental and 501(c)(3)).
- Reserve Fund/Debt Service Fund ignored for test. (Reserve subject to rebate from delivery)

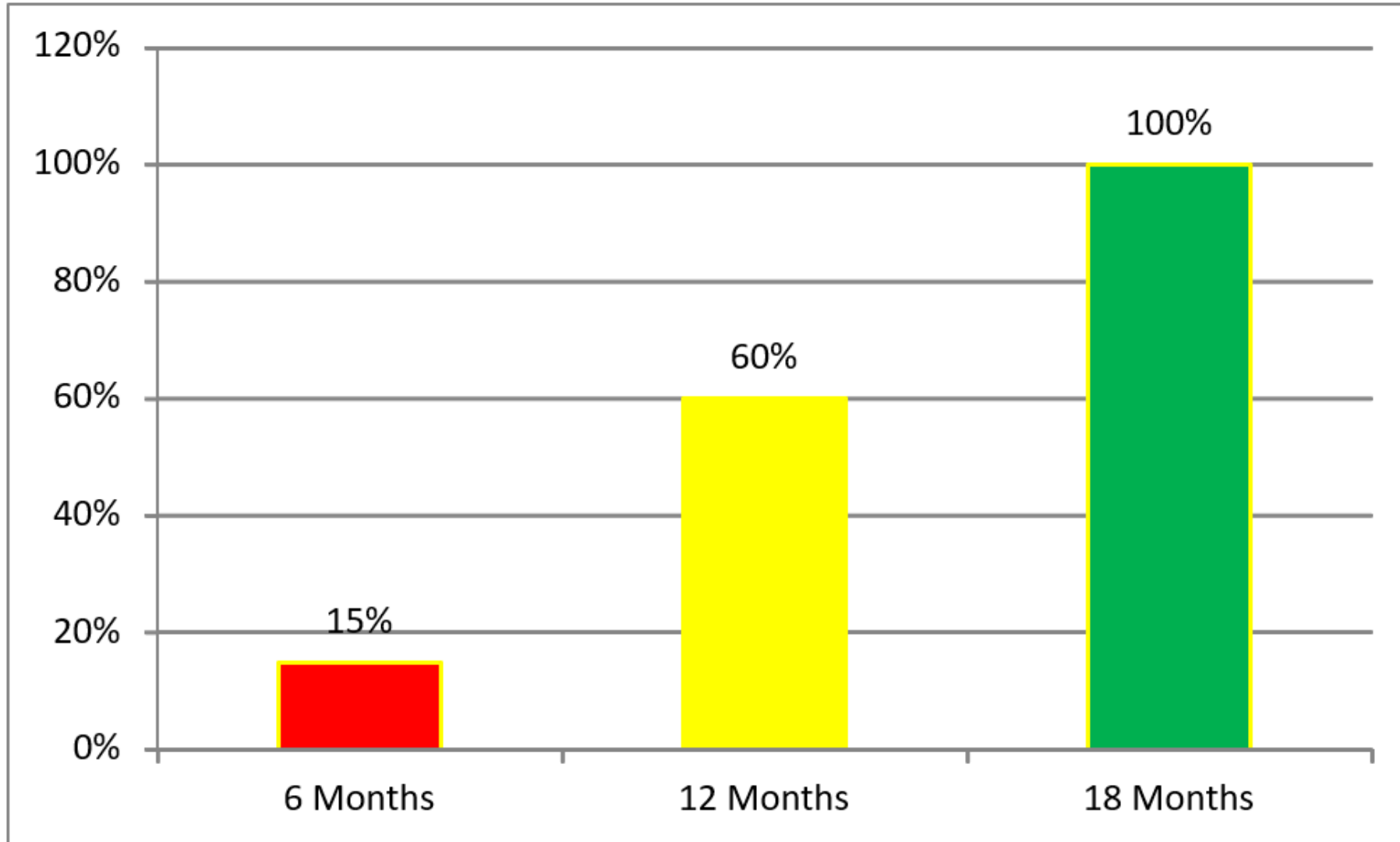


# 18-Month Spending Exception



- Applies only to bonds issued after June 30, 1993.
- Gross Proceeds exempt from rebate if all semi-annual spending requirements met.
- Must include reasonably expected earnings in determining benchmarks.

# 18-Month Exception – Cumulative Spending Benchmarks





- For the Eighteen-Month and Two-Year exception you can have small shortfalls.
- A failure to spend an amount at the final payment date is disregarded if the amount does not exceed the lesser of 3% of the issue price or \$250,000, and
- The issuer exercises due diligence to complete the project.



- An issuer has an additional twelve months to spend a “reasonable retainage” limited to 5% of the proceeds (18-Month Net Sales Proceeds, 24-Month Available Construction Proceeds).
- A reasonable retainage is an amount retained for reasonable business purposes related to the financed property.
- The retainage must be specified in the original contract.



# 24-Month Spending Exception



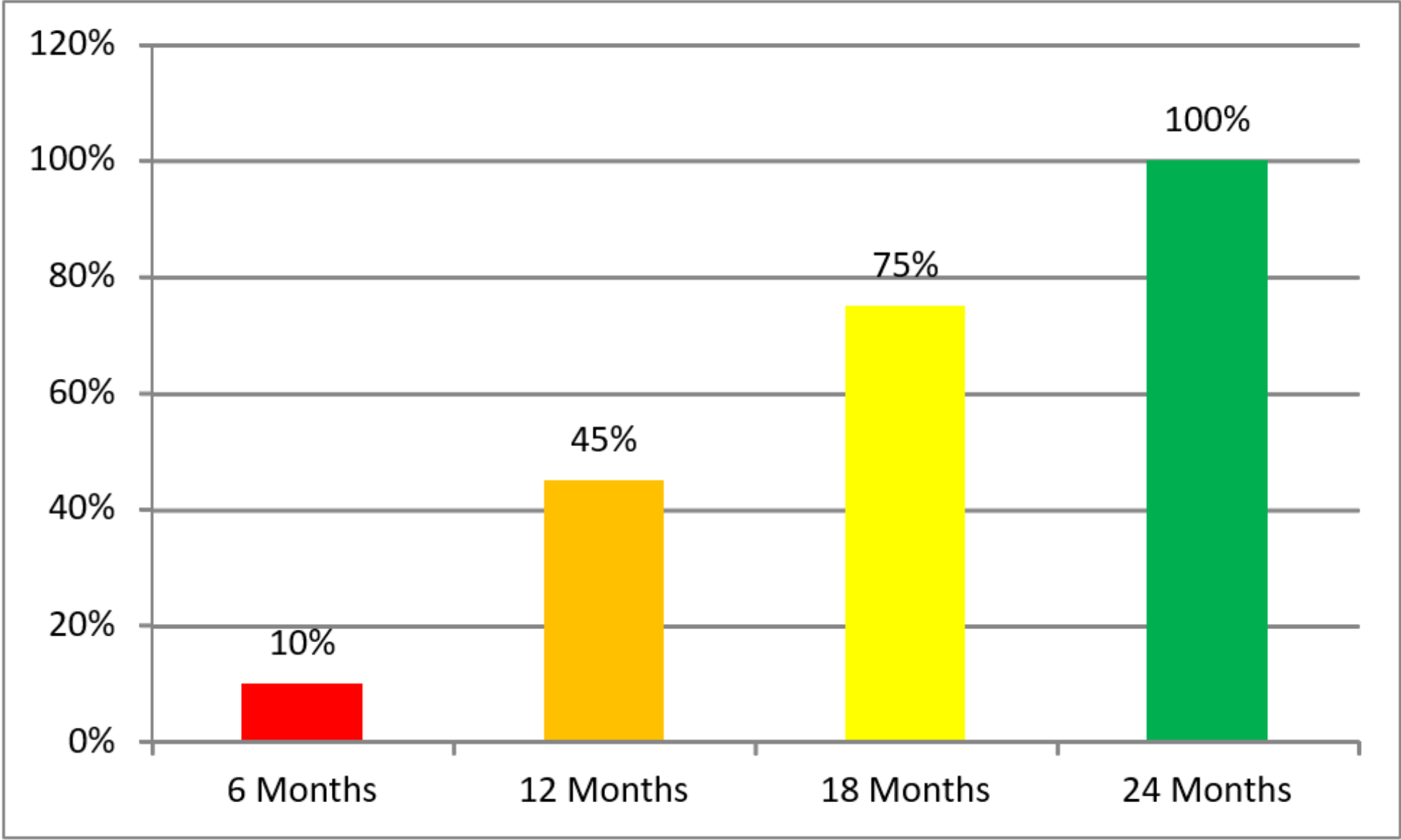
- Available Construction Proceeds exempt from rebate if all semi-annual spending requirements met (including reasonably expected earnings).
- Governmental and 501(c)(3) ONLY
- 75% Construction (Bricks and Mortar)





- Generally defined as amounts realized from the sale of the bonds other than funds used to pay COI and deposited in a Reserve Fund.
- Reserve Fund - Unless an election is made to exclude earnings during the construction period, the earnings are included in ACP.
- Earnings on COI are ACP.

# 24-Month Spending Exception – Cumulative Spending Benchmarks





# Debt Service Funds



- Definition: A fund used primarily to achieve a proper matching of revenue and debt service within each bond year.
- May be subject to Income Limitations.
- Depleted at least once a year except for a Reasonable Carryover Amount.



# Income Limitations



- Limitation of \$100,000 of earnings.
- Long-Term, Fixed Rate Governmental issues - DSF not subject to Earnings Limitation regardless of amount of investment earnings.
- Long-term defined as Weighted Average Maturity of the issue is at least 5 years.
- Short-term, fixed rate issues and variable rate issues - include in rebate calculation if investment earnings are \$100,000 or more earned in bond year.



- An issue with an average annual debt service that is not in excess of \$2,500,000 will be treated as satisfying the \$100,000 limitation.
- If you fail the income limitation, the debt service fund is not bona fide and does not meet the exception.



# Depletion





Greater of:

- Earnings on fund for preceding bond year; or
- $1/12^{\text{th}}$  of principal and interest payments for preceding bond year



- If the depletion required is not met, the Debt Service Fund does not technically meet the Bona Fide Debt Service Fund definition of §1.148-1(b) and would be included in the calculation as Replacement Proceeds.
- A second school of thought (practiced in Texas by Tax Counsels), is that the fund is Bifurcated into a Bona Fide portion and a Residual, or a Reserve portion.
- The Tax or Non-Arbitrage Certificate will indicate the treatment of the Debt Service Fund.



# Investing in Tax-Exempt Securities

# What types are Exempt? IRC 148(b)(3) and 143(b)(3)(B)



Governmental and Section 501(c)(3)



Non-AMT Only

Other Private Activity



AMT  
Non-AMT



### Demand Deposit State and Local Government Series (Demand Deposit SLGS)

- A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series Program described in 31 CFR Part 344.
- State and Local Government Series (SLGS) securities are special purpose securities issued by the US Treasury to state and local governments to assist with compliance of federal tax laws and IRS regulations governing the investment of cash proceeds generated from a tax-exempt bond issuance
- Most are familiar with Subscription SLGS – fixed term SLGS frequently used as investment vehicle for refunding escrows.
- Though lesser known, the US Treasury also offers a demand deposit SLGS program (DD SLGS)
- Interest income earned from the DD SLGS program is considered tax-exempt and is ***not subject to arbitrage rebate or yield restriction.***

# Features of Demand Deposit SLGS



- Demand Deposit SLGS are an obligation of the United States government.
- Demand Deposit SLGS are liquid. Amounts less than \$10 million may be withdrawn with one day's notice, amounts over \$10 million require three day's notice.
- Interest rate is variable, resetting weekly on a ratio based on the 3-month T-bill auction.
- Current Demand Deposit SLGS rate is 4.16% (as of 4/1/24). The rate is expected to decline as the Fed eases policy.
- Interest is paid and compounded daily.
- More information can be found here:
  - About SLGS – TreasuryDirect  
<https://www.treasurydirect.gov/government/slgs/>
  - More About SLGS – TreasuryDirect  
<https://www.treasurydirect.gov/help-center/slgs-faqs/>

# Questions?





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