

# Arbitrage Rebate Update: Important Reminders for Tax-Exempt Issuers

Issuer Insight | May 2020



## What Issues Could be Affected Right Now?

Earning positive arbitrage becomes more likely as interest rates rise and borrowing rates fall. That is good news for tax-exempt bond issuers because interest earnings can become a legitimate contributor to project budgets. However, it also means paying closer attention to arbitrage rebate strategy. At the moment, there are two critical categories of issues to consider:

- 1. New bond issues with low borrowing rates (arbitrage yields) that are or have the potential to earn positive arbitrage.** Good credits and short-term borrowings are the most vulnerable. Debt obligations with low bond yields have an opportunity to earn positive arbitrage.
- 2. Bond issues from 2014 to 2017 with unspent balances in project funds.** If not previously waived, the three-year temporary periods have expired in a higher interest rate environment. Issuers that waived temporary periods in these years likely made a great strategic move.

## Spending Exceptions – Use It or Lose It

Monitoring spending of new money bond proceeds is becoming more important than ever. The spending exceptions are rewards from the IRS that allow issuers to keep positive arbitrage if they spend bond proceeds quickly. In addition, unspent bond proceeds have been a topic of interest with the IRS, so the timely expenditure of bond proceeds is vital.

Issuers must spend proceeds (and interest earnings) based on prescribed six-month benchmark spending requirements to meet one of the exceptions (see chart below). Since there is no catch-up provision, once an issuer misses a spending benchmark, the ability to meet the exception is lost.

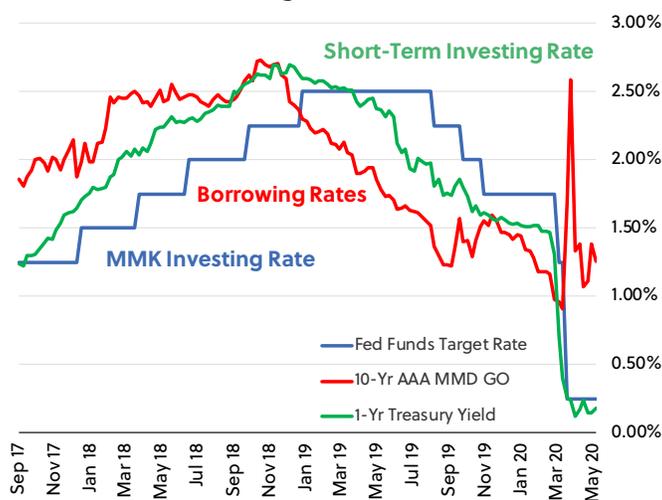
Spending Exception	6 Months	12 Months	18 Months	2 Years
6-Month   All Gross Proceeds	100%			
18-Month   All New Money	15%	60%	100%	
2-Year   Construction Issues	10%	45%	75%	100%

## Small Issuer Exception

Governmental issuers can issue up to \$5,000,000 of tax-exempt bonds per calendar year that are exempt from arbitrage rebate. School districts are the fortunate recipients of an increased borrowing allowance for the small issuer exception and can issue up to \$15 million of tax-exempt bonds per calendar year. Issuers and school districts that issue bonds with the following characteristics can issue tax-exempt bonds up to the calendar year limit that are exempt from arbitrage rebate<sup>1</sup>:

<sup>1</sup> IMPORTANT – The small issuer exception is an exception to the arbitrage rebate requirements, but not yield restriction. Generally, new money bonds with unspent proceeds remaining after three years will require yield restriction liability calculations.

Arbitrage Environment



Sources: Bloomberg, Refinitiv.



- Governmental issuer with general taxing powers
- Not private activity bonds
- Aggregate face amount of bonds not in excess of \$5,000,000 (\$15,000,000 for school districts)
- Current refunding bonds can generally be excluded from the calendar year limit

## Yield Restriction and Temporary Periods – to Waive or Not to Waive

Yield restriction is a secondary set of regulations that issuers of tax-exempt and tax-advantaged bonds must adhere to, regardless of meeting an exception to rebate. However, unlike arbitrage rebate, yield restriction generally starts after a temporary period. Typically, proceeds used for a capital project are eligible for a three-year temporary period. During this time, proceeds may be invested at an unrestricted yield. After the temporary period expires, proceeds must be invested at a yield not materially higher than the bond issue’s arbitrage yield. While there are exceptions, the applicable materially higher yield is 12.5 basis points or 0.125% above the arbitrage yield.

Even in today’s uncertain interest rate environment, it may still make sense to waive the three-year temporary period on new project funds. The table below should help you decide whether this is a conversation worth having with bond counsel.

Draw Schedule	Arbitrage Yield		
	Low	Mid	High
Short (<18 months)	NO	NO	MAYBE
Medium (18-24 months)	NO	MAYBE	YES
Long (>24 months)	MAYBE	YES	YES

Note that the recommendations in the table above are based on *current* market conditions and *current* expectations for borrowing rates (arbitrage yields) and investment rates for bond proceeds. Remember that evaluating whether or not to waive the temporary period is a conversation to have with bond counsel while working on the bond issue. It is a tax election that must be made in writing at settlement and cannot be changed thereafter.

Here are some strategies to consider when monitoring and mitigating potential risks:

- Consult with your financial advisor and bond counsel to understand the compliance status of each bond issue.
- Talk to your rebate analyst and financing team in advance of pricing to discuss strategy and tax implications.
- Small Issuer Exempt Bonds - set a reminder to review any unspent balance prior to the three-year anniversary date. If unspent proceeds remain after three years, engage a rebate analyst to prepare yield restriction liability calculations.
- Other Tax-Exempt Bonds - fifth-year reporting is a must; annual reporting is better.
- If you issued new money debt in 2014-2017, review unspent project fund balances, and determine if temporary periods have expired or will be expiring soon.
- Ask your investment advisor about how they can help you to potentially maximize retainable earnings.

To learn more or discuss in greater detail, please contact us:

**Michael Steinbrook** | Director  
 steinbrookm@pfm.com | 717.232.2723  
 arbitragerebate@pfm.com

Investment advisory services are provided by PFM Asset Management LLC which is registered with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940. To ensure compliance with U.S. Treasury Regulations governing tax practice, we inform you that any U.S. federal tax advice contained in this communication, including any attachments, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any penalties under U.S. federal tax law, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. Please consult with tax and legal professionals for additional information based upon your specific circumstances. The information contained is not an offer to purchase or sell any securities. Applicable regulatory information is available upon request.

The views expressed constitute the perspective of PFM’s asset management business at the time of distribution and are subject to change. The content is based on sources generally believed to be reliable and available to the public; however, PFM cannot guarantee its accuracy, completeness or suitability. This material is for general information purposes only and is not intended to provide specific advice or a specific recommendation. PFM is the marketing name for a group of affiliated companies providing a range of services. All services are provided through separate agreements with each company. Financial advisory services are provided by PFM Financial Advisors LLC and Public Financial Management, Inc. Both are registered municipal advisors with the SEC and the Municipal Securities Rulemaking Board under the Dodd-Frank Act of 2010. For more information regarding PFM’s services or entities, please visit [www.pfm.com](http://www.pfm.com).