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# **Tax Exempt Bonds Teleconference**

on

## **Arbitrage Yield Restriction & Rebate Compliance**

*Presented by*

**IRS Office of Tax Exempt Bonds**

on

**Thursday, May 17, 2012**



# Topics & Speakers

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- An Overview of Arbitrage: Yield Restriction & Rebate
  - Christopher Woodin
- Filing Requirements, Self-Correction, VCAP & Issue Price
  - Antoine Zemor
- Arbitrage Rebate Claims Process
  - Randal Webb
- Moderator
  - Steven Chamberlin



# Disclaimer

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- The information contained in this presentation is current as of the date it was presented. It should not be considered official guidance.
- The information contained in this presentation is a summary of key points. Reference should be made to section 148 of the Internal Revenue Code, section 1.148 of the Treasury Regulations, section 7.2.3 of the Internal Revenue Manual, Notice 2008-31, and Revenue Procedures 2008-37, 2005-40 and 2006-40 in their entirety.



# **TEB Arbitrage Compliance**

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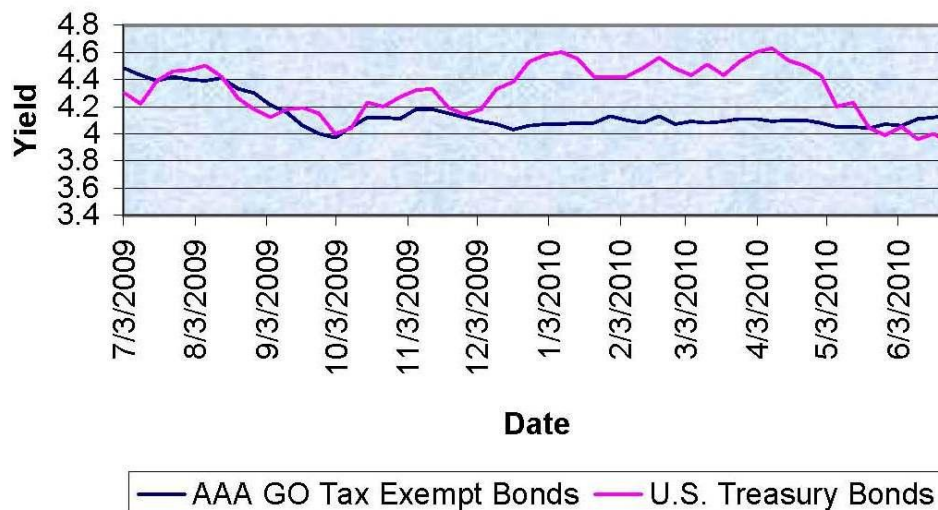
## **An Overview of Arbitrage: Yield Restriction & Rebate**

*Presented by*

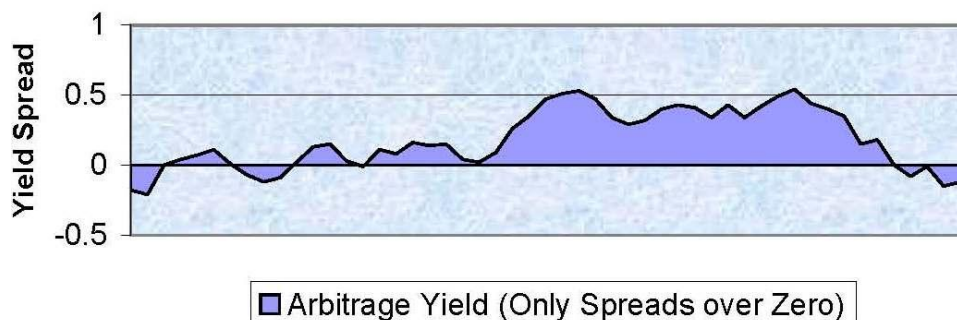
**Christopher Woodin, Tax Law Specialist**

# What is Arbitrage?

20 Year Yields - Tax Exempt Bonds v. U.S. Treasury Bonds



Arbitrage - Difference in Yield between Tax Exempt & U.S. Treasury Bonds





# Yield Restriction & Arbitrage Rebate

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- Two systems with a single objective of preventing arbitrage abuse
- The Yield Restriction limitations were initially established with the Tax Reform Act of 1969
- The Arbitrage Rebate requirements were applied to all tax-exempt bonds by the Tax Reform Act of 1986
- Any payments made under either of the two systems are mutually recognized, as permitted by the 1993 Regulations



# Proceeds of a Bond

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- Proceeds
  - Sale
  - Investment
  - Transferred
- Replacement Proceeds
- Gross Proceeds
- See Treas. Reg. § 1.148-1(b) and (c)



# Investment Categories

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- Purpose Investment – means an investment that is acquired to carry out the governmental purpose of an issue (includes program investments)
- Nonpurpose Investment – means any investment property that is not a purpose investment
- See Treas. Reg. § 1.148-1(b)





# Classes of Investments

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- Class A – Each category of yield restricted Purpose Investments and Program Investments subject to a different definition of materially higher
- Class B – Yield restricted Nonpurpose Investments
- Class C – All other Nonpurpose Investments
- See Treas. Reg. § 1.148-5(b)(2)(ii)



# Yield Restriction Rules

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- § 148(a) prohibits use of bond proceeds to acquire "higher yielding investments"
- If the investment property acquired with the proceeds of the bond issue produces a yield which is "materially higher" than the yield on the bond issue, then the proceeds of the bond issue are used to acquire higher yielding investments



# Materially Higher Yield

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- General Rule – Materially higher means  $1/8^{\text{th}}$  of 1% above the bond yield
- There are a number of exceptions to the general rule
- See Treas. Reg. § 1.148-2(d)(2)



# Materially Higher Yields

<u>Type of Investment</u>	<u>Materially Higher Rate</u>
General Rule	0.125 over Bond Yield
Refunding Escrow	0.001 over Bond Yield
Replacement Proceeds	0.001 over Bond Yield
Program Investments (other than Student Loans)	1.5 over Bond Yield
Qualified Student Loans	2.0 over Bond Yield
Qualified Mortgage Loans	1.125 over Bond Yield
Tax Exempt Obligations ( <i>not</i> considered investment property)	No Yield Limitation
See Treas. Reg. § § 1.148-2(d)(2) and	1.143(g)-1(b)(1)



# Temporary Periods

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Capital Projects	3 Years
Working Capital	13 Months
Replacement Proceeds	30 Days
Bona Fide Debt Service Fund	13 Months
Investment Proceeds	1 Year
Pooled Financings	Various
Other	30 Days
See Treas. Reg. § 1.148-2(e)	



# Reasonably Required Reserve or Replacement Fund

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- The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds
- See § 148(d) and Treas. Reg. § 1.148-2(f)(2)(i)

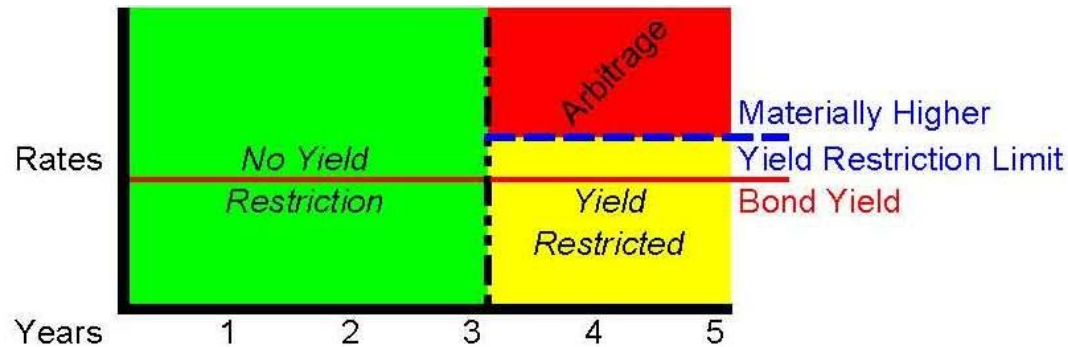


## Minor Portion

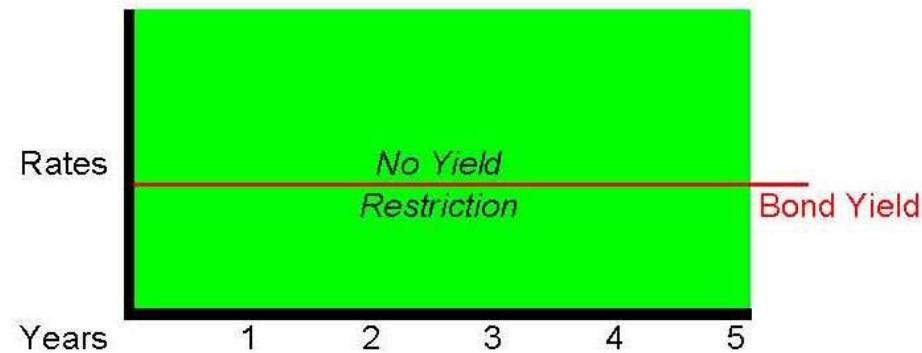
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- Bonds will not be treated as arbitrage bonds if an amount:
  - which is the lesser of \$100,000 or 5% of the proceeds of the issue
  - is invested at a yield which is materially higher than the yield on the bonds
- See § 148(e) and Treas. Reg. § 1.148-2(g)

# Yield Restriction Graphs



**Project Fund**  
(3 Year Temporary Period)



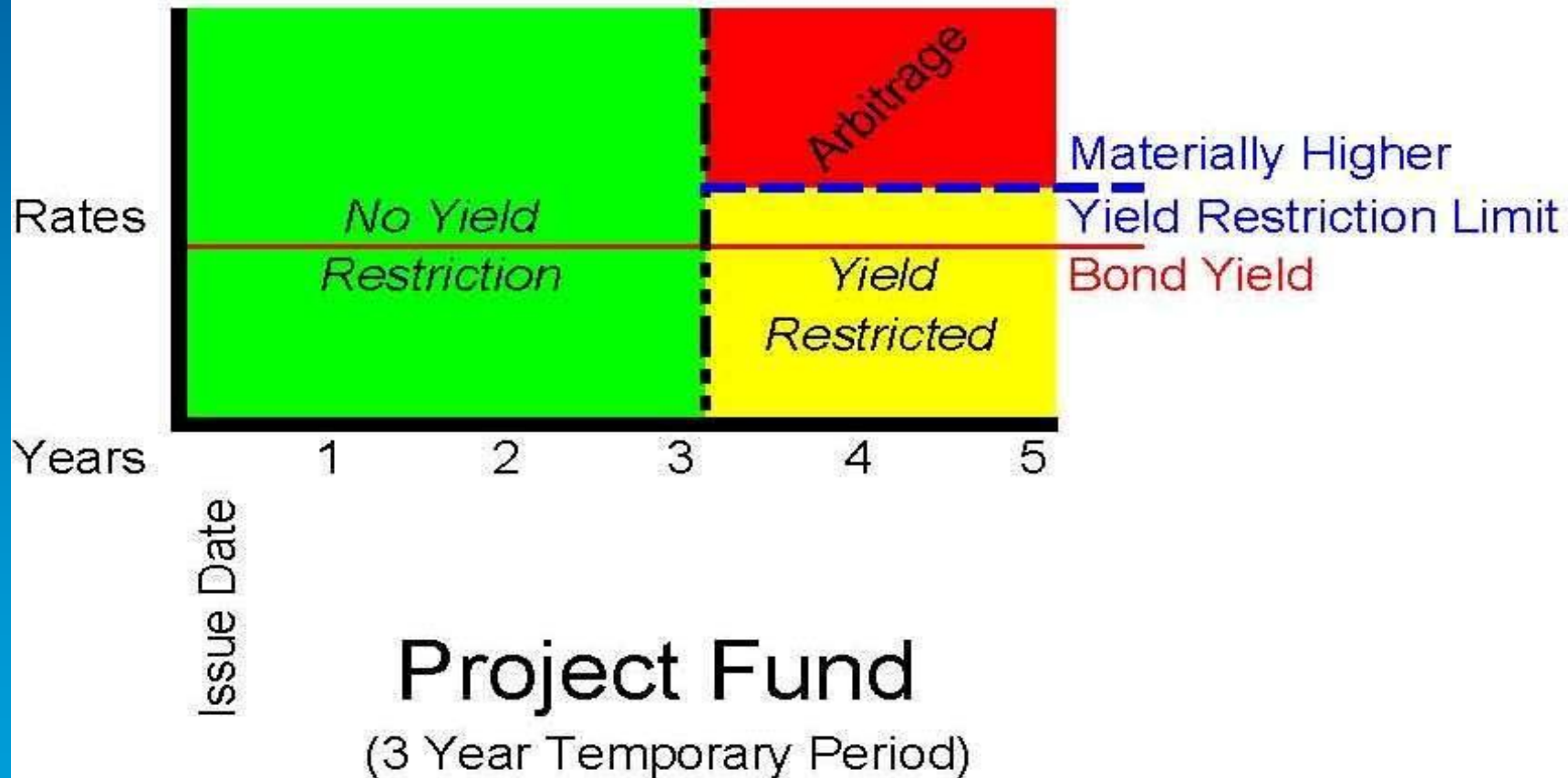
**Reserve Fund**  
(Exception for Reasonably Required)





# Yield Restriction – Project Fund

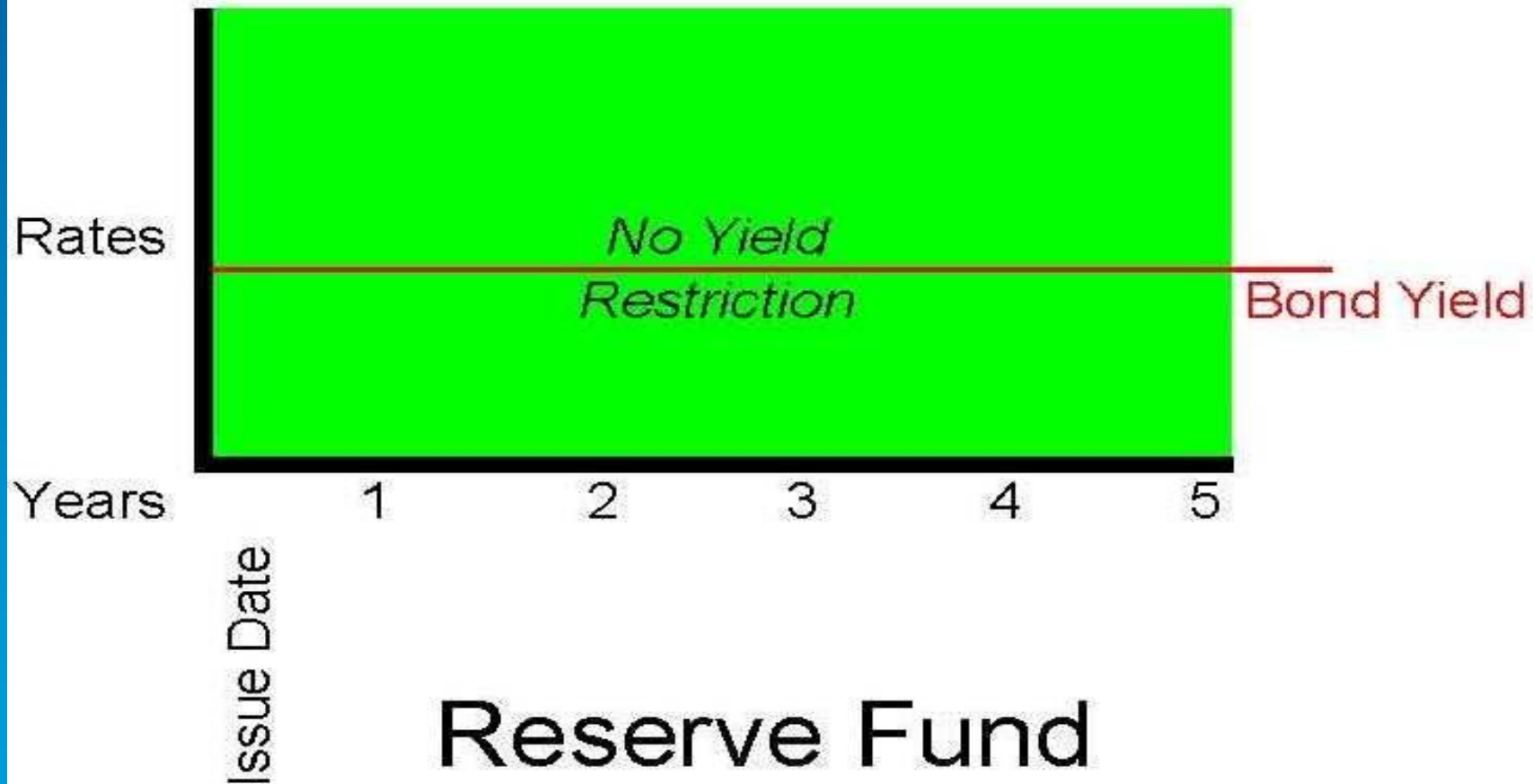
## (3 Year Temporary Period)





# Yield Restriction – Reserve Fund

## (Exception for Reasonably Required)



## Reserve Fund

(Exception for Reasonably Required)



# Arbitrage Rebate Rules

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- Tax Reform Act of 1986
- Certain earnings on Nonpurpose Investments allocable to the gross proceeds of an issue must be paid to the United States to prevent the bonds in the issue from being arbitrage bonds
- See § 148(f) and Treas. Reg. § 1.148-3



# Rebate Amount

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- Arbitrage that must be rebated is based on the difference between:
  - the amount actually earned on Nonpurpose Investments and
  - the amount that would have been earned if those investments had a yield equal to the yield on the issue
- See Treas. Reg. § 1.148-3(a)



# Exceptions to Rebate

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- Six-Month Spending Exception
- Eighteen-Month Spending Exception
  - Permitted pursuant to Treas. Reg. § 1.148-7(d)
- Two-Year Construction Spending Exception
- Bona Fide Debt Service Fund Exception
- Small Issuer Exception
- See § 148(f)(4)



# Coordination of Yield Reduction & Arbitrage Rebate Payments

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- Yield reduction payments may be included in computing rebate amount
- Rebate payments may be included in computing the yield on investments for yield restriction purposes
- In many cases, a rebate payment will also cover the need for a yield reduction payment
- However, a rebate payment may not always be enough (or may not be due at all) yet a yield reduction payment is still required
- A rebate payment may not cure a yield restriction violation



# Comparison of Arbitrage Systems

## Yield Restriction

- Tax Reform Act of 1969
- Purpose and Nonpurpose Investments
- Materially Higher Yield  
(Investment Yield Cap)
- Temporary Periods
- 4R Fund and Minor Portion Exceptions
- Yield Reduction Payment  
(Limited)

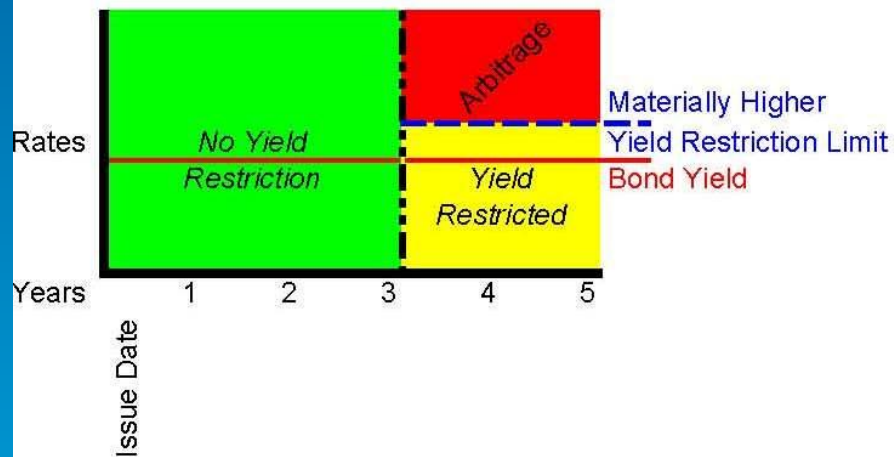
## Arbitrage Rebate

- Tax Reform Act of 1986
- Nonpurpose Investments
- Bond Yield
- Issue Date
- Certain Exceptions  
(Spending, BFDSF, Small Issuer)
- Rebate Payment
- Computation Credits

# Application of the Arbitrage Systems

## Yield Restriction

(3 Year Temporary Period)



## Arbitrage Rebate



Yield Reduction and Rebate Payments





# Summary

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- Compliance with both arbitrage systems is essential for maintaining the tax exempt status of a bond issue
- Arbitrage bonds result from earnings that exceed the allowable investment yield under either the materially higher limit in yield restriction or the bond yield in arbitrage rebate
- Arbitrage earnings must be remitted to the U.S. Treasury through a yield reduction payment (if permitted) and/or a rebate payment



# TEB Arbitrage Compliance

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## Filing Requirements, Self Correction, VCAP & Issue Price

*Presented by*

**Antoine Zemor, Tax Law Specialist**



# Topics

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- Filing Requirements
  - Filing and payment
  - Late filing and other problems
- Self-Correction Options
- Voluntary Closing Agreement Program
- Issue price



# Computation and Payment

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- How often does an issuer have to compute and pay rebate?
  - Rebate is paid in installments over life of bonds
  - Generally due at 5-year intervals from issuance
  - Final rebate payment due when bonds are discharged
  - Rebate may generally be computed more often if desired, but payments are only due on installment dates
  - Rebate amount is cumulative over life of bonds



# Rebate Filing Requirements

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- How to make rebate payments?
  - Payments are made to the US Treasury
  - Payments due within 60 days of installment date
  - Form 8038-T submitted with payment
- How much rebate to pay?
  - For installment payments, 90% of rebate amount
  - For final rebate payment, 100% of rebate amount
- No filing requirement if no rebate is due



# Yield Reduction Payments

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- Filing and payment
  - Payments follow same guidelines as rebate regarding timing and amounts due
  - Included on same Form 8038-T as rebate
- Yield reduction payments only permitted for certain investments described in Treas. Reg. § 1.148-5(c)



# Filing an Amended Return

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- Issuers may file an amended Form 8038-T
- Change or add to information previously reported
- Correct errors
- Check the box “Amended Return” at top of form
- Explanation should be attached



# Failure to Timely Pay Rebate

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- Failure to pay rebate may cause loss of tax-exemption
- How to address late payments
  - Failure not due to willful neglect
  - Payment of penalty and interest
- Penalties
  - 50% for governmental and 501(c)(3) bonds
  - 100% for other bonds
  - May be waived if paid within 180 days of discovery
  - Attach explanation
  - Penalty cannot be waived if issue under exam





## Failure to Timely Pay Rebate, continued

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- Requirements covered in Revenue Procedure 2005-40
- File payment using Form 8038-T
  - Attach explanation for late filing
- Explain lack of willful neglect in attachment
  - Factors include issuer sophistication, length of delay, steps taken to comply, steps taken to prevent a recurrence, nature of the failure, history of previous payments



# Common Filing Errors

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- Conduit borrower instead of issuer files the Form 8038-T (requires issuer signature and EIN)
- Incorrect calculation of late interest
- Missing computation date
- Missing signature and date
- Forgetting to check “Amended Return” box when required
- Insufficient explanation or documentation in request for waiver of penalty



# Voluntary Closing Agreement Program

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- Not all arbitrage compliance failures can be self-corrected
- TEB Voluntary Closing Agreement Program “VCAP” is available to resolve noncompliance
  - Resolution standards for identified violations
  - Other situations where self-correction is not available
- Follow procedures for making a VCAP request
  - Notice 2008-31 and IRM section 7.2.3
  - Click on the “TEB Voluntary Compliance” link from [www.irs.gov/bonds](http://www.irs.gov/bonds) for more information

# Issue Price & Arbitrage

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- Why is issue price important?
  - Impact on arbitrage measurements
- Affects bond yield
  - Issue price is fundamental to bond yield calculation
- Affects rebate and yield restriction
  - Incorrect issue price could invalidate all arbitrage calculations



## Issue Price, continued

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- Issue price determined by actual sale of bond
- Simplified method allows determination based on first 10% sold to public
  - All bonds must be offered to public at that price
  - Does not include brokers
- IRS reviews trading data reported to MSRB



# Summary

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- Rebate and yield reduction paid every 5 years
  - Use Form 8038-T for all payments
- VCAP available to address arbitrage problems which cannot be self-corrected
  - Identified violations
  - Other situations
- Establishing the correct issue price is essential for accurate arbitrage calculations



# TEB Arbitrage Compliance

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## Arbitrage Rebate Claims Process

*Presented by*

**Randal Webb, Revenue Agent**



# Arbitrage Refund Claim

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- General rule for refund claims
- Refund claim guidance
- Overview of the refund claim process
- Tips for efficient processing of a refund claim





# Arbitrage Refund Claim

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- Treas. Reg. § 1.148-3(i)
  - Recovery of an overpayment of rebate payments
- Treas. Reg. § 1.148-5(c)(2)(i)
  - Recovery of an overpayment of yield reduction payments



# Arbitrage Refund Claim

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- An overpayment may be recovered only to the extent that a recovery on the date that it is first requested would not result in an additional rebate amount if that date were treated as a computation date



# Arbitrage Refund Claim Guidance

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- Revenue Procedure 2008-37
  - Provides the terms and procedures for claims for recovery of overpayments
- Form 8038-R Instructions
  - Provides instructions for properly preparing and submitting a Form 8038-R
- IRM for claims processing
  - Provides IRS administrative procedures for processing a Form 8038-R (new release coming summer of 2012)



# Revenue Procedure 2008-37

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- Provides terms and procedures
- Establishes a deadline:
  - Requires issuers file the claim by no later than two years after the final computation date
- 1992 Regulations:
  - Bonds subject to Treas. Reg. § 1.148-13T of the Temporary Regulations will be treated in the same manner as claims for recovery of overpayments made under § 1.148-3(i)



# IRS Form 8038-R Instructions

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- Instructions serve as a checklist for required documents to be submitted:
  - All copies of IRS Form(s) 8038-T related to the request for refund
  - All computations from the issue date to the computation date reflecting the overpayment
  - Any additional supporting documentation



# Form 8038-R Common Mistakes

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- **Signature and consent:**
  - An authorized representative of the issuer must sign Form 8038-R, not the conduit borrower
- **Inclusion of a conduit borrower:**
  - If the issuer desires the conduit borrower to be contacted, the contact should be provided on Line 22 and the box should be checked
- **Incorrect address:**
  - Wrong address or conduit borrower's address provided
- **Missing supporting documents:**
  - Failure to provide sufficient supporting documents



# Arbitrage Refund Claim Process

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- Receipt and Establishment
  - Refund claims are submitted to the Ogden Service Center through the filing of Form 8038-R
  - Refund claim requests are reviewed at the Ogden Service Center to determine whether the issuer has satisfied the initial processing requirements



# Arbitrage Refund Claim Process

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- Initial Processing Requirements:
  - Form 8038-R has been completed in accordance with the instructions and includes supporting documentation
  - Confirms that the issuer has previously submitted a payment(s) with respect to the bond issue in question
  - Confirms that the amount requested does not exceed the amounts previously paid





# Arbitrage Refund Claim Process

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- Tax Exempt Bonds Field Operations is responsible for the administration and oversight of processing claim requests
- Field revenue agents are assigned to review the request and determine whether a recoverable overpayment occurred



# Arbitrage Refund Claim Process

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- What to expect:
  - Expect a call from the Claims Examiner to confirm receipt of claim and that the review process has begun
  - Expect a call from the Claims Examiner or Claims Technical Reviewer if additional information is needed or to perfect the claim
  - Expect a call from the Claims Examiner or Claims Technical Reviewer with the results of the review



# Arbitrage Refund Claim Process

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- Upon completion of the review of a claim, the results can be either:
  - Refund Claim Approval
  - Refund Claim Rejection
  - Refund Claim Denial (in full or in part)



# Arbitrage Refund Claim Process

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- Refund Claim Approval:
  - Notification in writing of the approval
  - Authorize a refund for the requested overpayment amount
  - Expect to receive a check within 60 days
  - If you do not receive the check within 60 days, contact the Claims Examiner that reviewed the claim



# Arbitrage Refund Claim Process

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- Refund Claim Rejection:
  - Failure to follow Revenue Procedure 2008-37
  - Failure to follow the Form 8038-R Instructions
  - Failure to provide sufficient supporting information to determine an overpayment occurred
- A rejected claim is not a Refund Claim Denial:
  - Provide a supplement to the refund claim within 45 days upon notification
  - After 45 days, resubmit the claim as long as it is resubmitted within the filing requirements set forth in Revenue Procedure 2008-37



# Arbitrage Refund Claim Process

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- Full Refund Claim Denial:
  - Agree to the claim denial
  - Request an appeal within 30 days
  - Failure to respond results in the claim denial becoming final at the end of 30 days



# Arbitrage Refund Claim Process

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- Refund Claim Denial in Part:
  - Agree to the amount denied and receive a check for the amount approved within 60 days
  - Request an appeal within 30 days
  - Failure to respond results in the claim denial becoming final at the end of 30 days



# Arbitrage Refund Claim Process

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- Appeal of a Refund Claim Denial:
  - Submit in writing to TEB within 30 days
  - Conforms to the requirements of Revenue Procedure 2006-40 and IRS Publication 5
  - Work with the issuer and/or issuer's representative to perfect the request
  - Upon completion of CPM mandatory review, the refund claim case file will be transferred to the Office of Appeals





## Recap of Key Points

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- Claims for recovery of overpayment are made using Form 8038-R
- Revenue Procedure 2008-37 and the Instructions for Form 8038-R are excellent resources
- The Claims Team will work with you in every way possible to insure an efficient processing of your refund claim
- Don't wait till the last minute to submit your refund claim



## More Information at [www.irs.gov/bonds](http://www.irs.gov/bonds)

- Click “TEB Forms & Pubs”
  - Links to Forms 8038-T & R as well as Instructions
- Click “TEB Published Guidance”
  - Links to Revenue Procedures 2008-37, 2006-40 and 2005-40 as well as other published guidance
- Click “TEB Voluntary Compliance”
  - Links to articles on self-correction options
  - Links to a guide for the VCAP IRM providing direct links to specific sections and resolution standards
- New web educational resources on arbitrage compliance coming soon!



# Contact Us With Your Questions

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- Send us an email at [TaxExemptBondQuestions@irs.gov](mailto:TaxExemptBondQuestions@irs.gov)
  - Include contact information
- Look for web updates and upcoming outreach events
  - Teleconference on the TEB Examination Process scheduled for June 7<sup>th</sup>
  - Webinar on Financial Restructurings and How to Avoid Unintended Consequences scheduled for September, 2012