Arbitrage Rebate Compliance

July 5, 2016

Introduction and Purpose

Arbitrage is defined as the investment earnings representing the difference between what could be earned on bond proceeds if they were invested at the yield on the bonds and the amount actually earned on the investment of the proceeds. The Internal Revenue Code regulates the amount and conditions under which positive arbitrage on the investment of bond proceeds is permissible. Any arbitrage profits earned must be rebated to the federal government unless the exceptions to arbitrage rebate apply.

Negative arbitrage, the condition of earning less than the yield on the bonds, is not the University's preference. Unless the allowable 36-month "temporary investment period" has expired, it is the University's goal to invest bond proceeds to the bond yield or higher – and then meet the exceptions to arbitrage rebate. This practice maximizes the amount of available bond funds to spend on the projects. Absent meeting the spending exceptions, arbitrage up to the yield on the bonds can be kept by the University and only the amount of arbitrage in excess of the yield on the bonds will be rebated to the federal government.

Temporary Periods

During "temporary periods", gross proceeds may be invested in higher yielding investments.

<u>Three-Year Temporary Period</u>

A general three-year temporary period is provided for the investment of original and investment proceeds of new money issues if it is reasonably expected at the time the bonds are delivered that each of the three tests below will be satisfied for each project financed by the proceeds of the issue. This general new money temporary period is provided in recognition of the fact that bond proceeds are not generally spent immediately for project involving construction or acquisition. Even if a bond issue meets the three tests below, any arbitrage earned on higher yielding investment during the temporary period is subject to rebate, unless the issue qualified for a rebate exception.

1. Time Test: The issuer has a reasonable expectation on the date the bonds are issued that the issuer will incur within 6 months from the date of delivery a substantial binding obligation to a third party to expend at least 5% of the net sales proceeds of the issue on the capital projects.
2. Due Diligence Test: The issuer expects to proceed with work on or acquisition of the project being financed with bond proceeds with due diligence to completion once a substantial binding obligation has been incurred.
3. Expenditure Test: The issuer reasonably expects on the date the obligations are issued that an amount equal to 85% of the net sales proceeds of the bonds allocated to projects will be spent on the projects within three years of the date the obligations are delivered.

Five-Year Temporary Period

A longer temporary period of up to five years for the unrestricted investment of new money bond proceeds is available if the following conditions are met:

1. The project being financed is a construction project;
2. The time test and due diligence test are satisfied;
3. Both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project.

Spending Exceptions

Once the above general conditions are met, all non-purpose investments are still subject to rebate if they earn a rate of return greater than the "yield" on the bonds themselves, and that excess must be returned to the US Treasury, unless certain exceptions are met:

1. The 6-month expenditure exception in Code Section 148-(f)(4)(B)(ii);
2. The 18-month exception under the 1993 regulations;
3. The 2-year expenditure exception for certain bonds in Code Section 148(f)(4)(C); or
4. The $5,000,000 small issue exception.

6-Month Rebate Exception

If all gross proceeds of an issue have been expended within 6 months of the issue date, the rebate rules are inapplicable to those gross proceeds. The 6-month spending period is extended for an additional 6 months if the unspent gross proceeds at the end of 6 months does not exceed the lesser of 5% of the issue price. A refunding issue satisfies the 6-month exception if all gross proceeds (other than transferred proceeds) of the refunding issue are expended with 6 months after the date of issue. The transferred proceeds are subject to rebate even if they are spent within 6 months of the date of issue of the refunding bonds, unless the 6-month exception was satisfied for the refunded bonds.

18-Month Rebate Exception

In the case where the bond proceeds are being used for purchase or construction of equipment (e.g. a data network), the exception to arbitrage rebate is 18 months. In order to comply with the 18-month exception, gross proceeds must be spent in the following percentages in the following time periods measured from the date of issue:

- At least 15% are spent within 6 months
- At least 60% are spent within 12 months
- 100% are spent within 18 months

The 18-month exception is not violated as a result of "reasonable retainage" if such retainage is allocated to expenditures within 30 months of the issue date.

2-Year Rebate Exception for Certain Construction Projects

Generally, the University strives to meet the 2-year expenditure exception for construction projects. The following minimum aggregate percentage of available construction proceeds must be spent by the end of the following periods (measured from the date of issuance) for the governmental purpose in order to fully utilize the 2-year exception:

- 10% within 6 months,
- 45% are spent within 1 year
- 75% are spent within 18 months,
- 100% within 2 years (the 4th spending requirement).

The issuer will not fail to satisfy the 4th spending requirement as a result of unspent amounts for "reasonable retainage" if such amounts are spent within 3 years of the issue date. "Reasonable retainage" means an amount not to exceed 5% of Available Construction Proceeds (ACP, as defined in the Treasury Regulations) as of the end of 2 years that is retained for reasonable business purposes.

Any failure to satisfy the final spending requirement of the 18-month or 2-year exception is disregarded if the University exercises due diligence to complete the project and the unspent amount does not exceed the lesser of 3% of the issue price or $250,000.

Use of the Small Issue Exception at the University

Due to the tax status of the University as that of an integral part of the State of Minnesota, from a policy perspective this small issue exception can never be used by the University since the State may always be an issuer of debt in any given year over and above this limit.

Contact

If you have questions about arbitrage rebate compliance, please contact the Tax Management Office at taxhelp@umn.edu or 612-624-1053.