

## **PART I**

### **NEW TAX EXEMPT BONDS TECHNICAL TOPICS**

#### **A. TAX EXEMPT BONDS CORRESPONDENCE EXAMINATION: TIMELY USE OF PROCEEDS – ARBITRAGE COMPLIANCE INITIATIVE**

by  
**Charles Anderson**

##### 1. Introduction

Over the past few years, the Service has been performing correspondence examinations as part of an arbitrage compliance initiative. The purpose of the compliance initiative has been to measure the level of issuer compliance with the arbitrage rebate requirement of I.R.C. § 148(f). The compliance initiative commenced with the selection of a statistically valid sample of Forms 8038 for the years 1992 and 1993. The criteria for return selections included the following: (1) a \$10,000,000 issue size minimum limitation and (2) a requirement that the bonds be non-refunding bonds. A total of eighty-nine returns were selected with 1992 or 1993 issue dates.

The size of the issues ranged from \$10,000,000 to \$350,000,000 with the average being \$52,000,000. A total of \$4,700,000,000 of bonds was represented in the selection.

##### 2. Findings

Most of the issues selected were fixed rate bonds issued in 1992 or 1993 which preceded a period of declining interest rates. For these issues, there was a high incidence of negative arbitrage because yields on investment of bond proceeds trended lower while yield on bond issues remained fixed.

For the few variable rate bond issues selected, the bond yield trended downward while investment yield remained stable or declined less severely, thereby providing a bias toward positive arbitrage. Understatements of rebate liability were discovered for certain variable rate bond selections.

Out of the eighty-nine issues selected as part of the compliance initiative, only 3 had actually filed Form 8038-T and paid rebate. This was due mainly to the timing that favored negative arbitrage. There were nineteen cases that showed rebate inaccuracies. Of those, eight involved significant errors in rebate computation that resulted in no additional rebate due. These were not expanded into field examinations. Many of these

revolved around inclusion/exclusion of credit enhancements, valuation of investments, timing issues, etc. Eight additional cases involved significant errors related to arbitrage rebate and were referred for field examinations to determine whether there was an outstanding rebate obligation. Additional cases referred for field examination included three cases where no rebate calculation was done as well as two cases where issuers failed to respond to the initial opening correspondence letter.

Other correspondence examinations were expanded into field examinations for reasons other than potential arbitrage compliance problems. These examination selections involved the following types of bond issues:

1. Solid waste bond issues (4);
2. Blind 501(c)(3) pool issues (2);
3. Airport AMT issue vs. non-AMT issue (1); and
4. Single family mortgage revenue bond issue (1).

In summary, out of the eighty-nine correspondence examinations, twenty-two were expanded into field examinations. The percentage that required expansion, approximately 25 percent, was substantially higher than the 10 percent that the Service initially estimated would require such action.

### 3. Conclusions

While the sample of cases did not show as significant an error rate as an earlier compliance initiative focusing on qualified small issue bonds<sup>1</sup> it did show that a statistically valid sample of qualified private activity bonds would identify significant numbers of cases for which a field examination was necessary. It also allowed the Service to identify issuers that failed to comply with the arbitrage rebate requirements of I.R.C. § 148(f) and other Code provisions applicable to tax-exempt bonds.

As a result, the Service concluded that a follow-up correspondence examination initiative would be appropriate to measure arbitrage compliance. This initiative will sample Forms 8038-G filed for bonds issued in 1995 or 1996. This time period was selected in order to review calculations of rebate liability during periods of rising interest rates.

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<sup>1</sup> See Tax Exempt Bonds Compliance Initiative: Qualified Small Issue Bonds, Continuing Professional Education Tax Exempt Bonds Technical Instruction Program for FY 2002 Training 4233-001, p. 31.

## **APPENDIX**

*This article is reprinted from Continuing Professional Education Exempt Organizations  
Technical Instruction Program for FY 2000 Training 4277-051, p. 245.*

### **TAX-EXEMPT BOND PROGRAM CORRESPONDENCE EXAMINATION TIMELY USE OF PROCEEDS - ARBITRAGE**

by

**Clifford J. Gannett and Gerald V. Sack**

#### 1. Introduction

In 1999, the Service will design and implement a correspondence examination project directed at measuring the level of issuer compliance with the arbitrage rebate requirement of section 148(f) of the Internal Revenue Code. In the 1980s, Congress determined that, in addition to the arbitrage yield restriction rules, arbitrage rebate rules were needed to curb the issuance of investment motivated tax-exempt bonds. The rebate rules were designed to create additional safeguards against issuers obtaining an "arbitrage" benefit by either issuing bonds prematurely or using bond proceeds in an improper or untimely fashion. Given this critical role that the arbitrage rebate rules play in ensuring that bonds are issued for proper governmental purposes, the Service has decided to initiate this project.

#### 2. Project Design

The Service will open correspondence examinations of between 100 and 200 new money tax-exempt bond issues by issuing a letter (sample letter set forth in Addendum A) and a questionnaire (sample questionnaire set forth in Addendum B) to issuers. The bond issues examined will be selected by statistically sampling Forms 8038 filed in 1991 and 1992. Responses to the correspondence examination letter will be reviewed to determine whether any additional examination activity by a field office is warranted. If additional examination activity is unnecessary, the examination will be closed.

Data provided during the examinations will be compiled and evaluated. Initial baseline measurements of noncompliance will be developed from the findings and results of the examinations.

#### 3. Use of Project's Results/Findings

The results of the correspondence examinations will be used to assess the extent to which issuers of tax-exempt bonds are complying with the arbitrage rebate rules. In particular, the Service will assess whether issuers are generally calculating and paying

rebate to the Service in a timely manner. If substantial noncompliance is identified in this regard, consideration will be given to developing additional compliance initiatives.

If particular areas of noncompliance are identified through these examinations, the Service will consider publicizing such areas of noncompliance in an effort to educate issuers regarding their legal obligations to pay rebatable arbitrage under section 148(f) of the Code.

#### 4. Conclusion

The arbitrage rebate rules are intended to eliminate any incentive on the part of issuers to issue bonds in order to take advantage of an investment opportunity. This goal can only be met if issuers meet their obligations under section 148(f) of the Code. This project is designed to accomplish the critical task of measuring issuer compliance in this regard.

**ADDENDUM A**

(Sample Letter)

Issuer	Person to Contact
Street Address	ID #
City, State, Zip Code	Contact Telephone Number
	Date

EIN

Re: [Insert name of bond issue from line 7 of Form 8038 and/or CUSIP number(s) and/or Report Number(s)]

Dear Sir or Madam:

In Announcement 93-92, the Internal Revenue Service (the “Service”) announced that it would initiate an expanded compliance program for tax-exempt bonds. We have selected the bond issue named above for examination as part of a correspondence examination project initiated by the Service to measure compliance with the arbitrage rebate requirement of section 148 of the Internal Revenue Code.

The examination relates only to the identified municipal financing arrangement. No other municipal financing arrangements or the general operations of the issuer are within the scope of the examination.

This examination is designed to be conducted through correspondence. Attached you will find a list of questions by which we request certain information regarding the issue under examination. Please submit your reply within 30 days of the date of this letter to:

Key District Office  
Street  
City, State ZIP

Whether further examination activity is necessary with respect to the bond issue will be determined based on your responses to the attached questions.

Issuer Name

If you intend to authorize a representative to represent you with respect to this matter, a power of attorney must be filed with the Service before your representative can receive or inspect confidential information from the Service. A Form 2848, Power of Attorney and Declaration of Representative, or any other properly written power of attorney or authorization may be used for this purpose.

Thank you for your cooperation in this matter. Please feel free to call me at the telephone number listed above.

Sincerely,

(Agent & Contact)

## **ADDENDUM B**

### (Sample Questionnaire)

#### **ATTACHMENT**

1. In Part I, line 6, of the Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues, that you filed with respect to your issuance of [Name of Issue], you state that the date of issue of the bond issue was [Date of Issue]. Please confirm that this information is accurate.
2. If the issue has been discharged, please indicate the date that the issue was discharged.
3. Based on the issue date set forth on the Form 8038, the first due date for any necessary rebate payment has passed. Payments of rebate under section 148(f) of the Code must be made for a computation date that is not later than 5 years after the issue date and in 5-year intervals after such date. In addition, a final rebate computation must be made as of the date the issue is discharged. Please provide the following information with respect to your determination of whether you owed rebate on any rebate payment date:
  - a. State the dates you treated as rebate computation dates and rebate payment dates.
  - b. Provide copies of any rebate computations including bond yield computations completed with respect to your rebate liabilities with respect to the issue. If no rebate computations were completed, please explain why such computations were not completed.
  - c. Under the Code and applicable regulations, a variety of exceptions may apply to a bond issue that would reduce or eliminate the requirement to pay over arbitrage earnings. Please state which exceptions, if any, have been relied upon to reduce or eliminate the need to make rebate payments and provide copies of all applicable elections. If any elections constitute part of a larger document, you may, instead of sending the entire document, send the first page, the page(s) that includes the pertinent elections, and the signature page(s).
  - d. Please state the amount of proceeds allocated to reimburse expenditures incurred before the date of issue of your issue.

- e. If rebate was owed as of any payment dates, were Forms 8038-T, Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate, filed with the Service and payment made on a timely basis? If yes, provide copies of filed Forms 8038-T. If not, please explain why the Forms were not filed.
  
- f. Did you elect under section 148(f)(4)(C) of the Code on or before the issue date to pay penalty in lieu of rebate? If you did, please provide a copy of your election. As indicated above, you do not need to send the entire document if the first page, the page(s) including the election and the signature page(s) are provided. Also, provide a schedule or other documentation regarding expenditures and copies of any Forms 8038-T filed to pay such penalties.
  
- g. Have you made any claims to recover an overpayment of rebate? If so, please provide copies of any claims submitted and any correspondence from the Service indicating a recovery of overpayment from the Service.

These questions are designed to gather the information needed to measure compliance with the arbitrage rebate requirement. Please feel free to provide us with whatever additional information you believe may assist us in this effort.