Module N

Introduction to Rebate Concepts

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Overview

Purpose

The rebate rules have the same basic purpose as yield restriction. They are designed to remove incentives for the issuance of arbitrage-motivated bonds.

In general, arbitrage profits earned from investing proceeds of an issue in nonpurpose investments must be paid to the United States as rebate unless a specific exception to the rebate requirement applies to the issue. Otherwise, the bonds will be arbitrage bonds.

Small issuer or spending exceptions may apply to exclude certain arbitrage profits from the rebate requirement. For example, an issuer that places certain proceeds of an issue in a project or construction fund may not be required to rebate arbitrage earned on the proceeds if the proceeds are expended in a timely fashion (as defined in the spending exceptions) on the project financed by the issue.

With respect to proceeds placed in a reasonably required reserve fund that are not required to be yield-restricted under IRC section 148(a), the fact that an issuer expected that such proceeds would earn arbitrage will not cause the bonds to be arbitrage bonds as long as the arbitrage is rebated to the United States.

The payment of rebate is a requirement that must be met for interest on bonds to be excludable from income. It is assessable against issuers.

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Objectives

At the end of this module you will be able to:

1. Explain the statutory and regulatory history of rebate.
2. Given a set of facts, determine if an issue qualifies for any of the following exceptions:
   - small issuer
   - bona fide debt service fund
   - 6 month spending
   - 18 month spending
   - 2 year construction spending.
3. Given a set of facts, complete the steps for computing rebate owed by an issuer on a fixed yield issue as of an interim payment date and final payment date.
4. Given a set of facts, complete the steps for computing rebate owed by an issuer on a variable yield issue as of an interim payment date and final payment date.

In this module

This module contains the following sections:

Section 1

Historical Perspective

Overview

Introduction

The first rebate requirements, enacted in 1980 and in 1984, applied only to industrial development bonds. The major change, however, was made in the Tax Reform Act of 1986. The Act contained a variety of tighter provisions for tax-exempt bonds, including tougher arbitrage rules under new IRC section 148.

In this section

This section contains the following topics:

Code Changes

Code Changes

IRC section 148(f) extended the rebate rules to all categories of tax-exempt bonds.

Instead of the "reasonable expectation" standard, IRC section 148(f) looks to actual investment of bond proceeds (i.e. what really happens, not just what the issuer predicts will happen).

The exceptions in the 1969 Act that permit unrestricted yield under certain conditions are generally retained by the 1986 Act, but investment earnings received are subject to the rebate rules of IRC section 148(f).

Example

An issuer can fund a reserve fund ("4-R Fund") that does not have to be yield restricted. The fund will earn arbitrage profits and not be considered an arbitrage bond. The issuer, however, cannot keep the profits. They must be rebated unless an exception for rebate applies.

Regulations

Rebate Regulations

The first rebate regulations were issued in January 1985 at Treas. Reg. section 1.103-15AT. These regulations applied only to the rebate requirement that applied to certain types of industrial development bonds under former IRC section 103(c)(6)(C) and (D) and are now of very limited significance.

1989 Temporary Regulations

Temporary regulations under new IRC section 148 were issued in May 1989. These regulations (which appeared at Treas. Reg. section 1.148-0T through 1.148-9T) focused on the new rebate requirement under IRC section 148(f). For the most part, the 1979 arbitrage regulations continued to be effective and provided the rules for yield restriction. In some respects, however, the May 1989 regulations superseded the 1979 regulations.

The May 1989 regulations were strenuously criticized for the following reasons:

- State and local governments viewed the regulations as:
    - too complex,
    - poorly organized,
    - lacking guidance on fundamental issues, and
    - overly detailed in their treatment of some obscure abusive transactions.

- One problem is that no real attempt was made to mesh the 1979 arbitrage regulations with the new rebate rules. This makes the two sets of regulations somewhat difficult to read together. For example, the May 1989 regulations use certain newly defined terms that are not the same as the comparable terms under the 1979 regulations.

1991 Amendments

In response to these criticisms, simplifying amendments were issued in May 1991. This regulation (which we refer to as the "1991 bullet regulation") was a "quick fix" of the worst problems with the May 1989 rebate regulation and was not a complete rewrite.

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1992 Proposed Regulations

In January 1992, proposed regulations were issued on rebate accounting rules, rebate spending exceptions and refunding rules. The accounting rules and the spending exceptions rules were new. The refunding rules significantly changed the rules under the May 1989 regulations.

In May 1992, the proposed regulations were finalized, along with the rest of the May 1989 temporary regulations, with some changes.

In November 1992, new proposed regulations were issued under IRC section 148. These regulations were a complete rewrite and reorganization of the 1979 arbitrage regulations and the May 1992 rebate regulations.

1993 Final Regulations

The 1992 proposed regulations were finalized in June 1993.

The new regulations mesh the yield restriction and rebate rules, and are simpler and better organized than the old regulations.

The regulations achieve simplification in part by relying heavily on general anti-abuse rules.

The regulations have been changed and revised, in part, by temporary and final regulations issued in 1994 and 1997.

Section 2

General Arbitrage Rebate Rules

Introduction

General Rule

IRC section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds.

Treas. Reg. section 1.148-3(a) provides that the 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.

Treas. Reg. section 1.148-3(b) provides that as of any computation date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

EXAMPLE

If an issue of Marsh City bonds has a yield of 8 percent, and the proceeds of the issue are invested at a yield of 10 percent, the 2 percent investment earnings, plus any additional earnings from investing that 2 percent, must be paid to the United States in order for the bonds to be tax-exempt.

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Application of the Rebate Rules

Compliance with the rebate rules can be analyzed through a series of steps, as follows:

Step	Action
1	Determine compliance with small issuer exception.
2	Identify gross proceeds of the issue.
3	Identify the funds in which gross proceeds of an issue are held.
4	Identify gross proceeds of the issue not qualifying for an exception.
5	Determine computation and payment dates.
6	Calculate yield on the issue.
7	Identify the nonpurpose investments to which gross proceeds are allocated.
8	Create a schedule of the cash flows of the nonpurpose investments (payments for and receipts of nonpurpose investments).
9	Future value the cash flows.
10	Subtract the future values of all the payments from the future value of all receipts to determine the total rebate amount.
11	Confirm timely payment.

Exceptions to Rebate

There are two major types of exceptions to rebate:
(1) small issuer exception and
(2) spending exceptions.

In addition, the Code and the regulations provide certain additional exceptions to simplify computations.

Section 3 discusses the Small Issuer Exception, while Section 4 explains the Spending Exceptions.

Section 3

Small Issuer Exception to Rebate

Qualifications

Step 0ne - Small Issuer Exception

The first step in determining compliance with the rebate requirements is to determine whether an issue qualifies for this exception.

General Rule

Under IRC section 148(f)(4)(D), governmental bonds issued by a governmental unit that does not expect to issue more than $5 million of governmental bonds in that calendar year are excepted from the rebate requirements, but not yield restriction rules.

To Qualify

In order to qualify for the small issuer exception:

- the issuer must be a governmental unit with general taxing powers,
- no part of the issue can be a private activity bond,
- 95 percent or more of net proceeds are to be used for local governmental activities of the issuer or of governmental units located within the issuer's boundaries, AND
- the issuer must either:
    - reasonably expect, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during that calendar year will not exceed $5 million

      OR
    - actually issue tax-exempt bonds (other than private activity bonds) during that calendar year the aggregate face amount of which does not exceed $5 million.

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Size Limit

The $5 million size limit applies to the sum of the following:

(1) The issue to which the small issue exception applies,

(2) Previous issues of governmental bonds in the same calendar year,

(3) Reasonably expected issues of governmental bonds in the same calendar year, and

(4) Issues by related entities that are subject to aggregation.

Aggregation Rules

Treas. Reg. section 1.148-8(c)(2) sets forth the following aggregation rules for purposes of applying the $5 million size limitation:

(1) An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

(2) Any bonds issued by an entity ("subordinate entity") that is directly or indirectly controlled by the issuer is generally treated as issued by the issuer. There is, however, an exception in certain instances in which specific allocations of the bonds are made by the issuer.

(3) An entity formed or availed of to avoid the $5 million size limitation and all entities that would benefit from the avoidance are treated as one issuer.

Special $10 Million Limit Rule

The Taxpayer Relief Act of 1997 increases the $5 million limitation up to an additional $5 million for bonds issued to finance construction of public school facilities.

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Yield Restriction Rules Still Applicable

This exception makes the rebate requirement completely inapplicable to an issue. If an issue meets this exception, only the yield restriction rules apply. This means the issuer must use the exceptions to yield restriction, like the 4-R fund exception, correctly. If used correctly, all profits can be retained. But if too much money is placed in the 4-R fund, the bond will be an arbitrage bond.

Section 4

Spending Exceptions

Overview

Applicability

Spending exceptions may apply to except from the rebate requirement arbitrage earned on certain proceeds of an issue if the issuer spends the proceeds in accordance with prescribed six-month, eighteen-month, or two-year schedules. The spending exceptions usually do not apply to all of the proceeds of an issue. For example, the spending exceptions generally don't apply to amounts held in a reasonably required reserve fund. Even if investment earnings on some proceeds are excepted from rebate, rebate may still be due on investment earnings on the reserve fund. Thus, in the process of determining compliance with the rebate requirements, step two and three, as set forth below, must be made prior to applying the spending exceptions.

Step Two - Identify Gross Proceeds

Gross proceeds of an issue must be determined. Gross proceeds includes any sales proceeds, investment proceeds, transferred proceeds, and replacement proceeds of the issue. These terms are defined in Treas. Reg. sections 1.148-1(b) and (c) and 1.148-9.

Step Three - Identify Funds

The funds in which proceeds of an issue are held must be identified (e.g. project fund, reserve fund, debt service fund).

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Step Four - Identify Gross Proceeds Not Excepted

Upon completing these steps, it must then be determined whether any gross proceeds of an issue are not excepted under the spending exception rules of Treas. Reg. section 1.148-7 or any other exception (e.g., bona fide debt service fund exception).

The rules of Treas. Reg. section 1.148-6(d) for allocating gross proceeds to expenditures are pertinent when applying the spending exceptions rules. Treas. Reg. section 1.148-6(d)(1)(ii) provides that an allocation of gross proceeds to an expenditure must involve a current outlay of cash for a governmental purpose of the issue.

When, in addition to bond proceeds, funds from other sources are being spent on a project, an issuer may have to determine which amounts are spent first for the project. Note in particular the rules in Treas. Reg. section 1.148-6(d)(3) that generally provide that, for working capital expenditures, bond proceeds are treated as being spent last.

In this section

This section contains the following topics:

Six-Month Exception

General Rule

IRC section 148(f)(4)(B) provides that an issue meets the rebate requirements if:

(1) The gross proceeds (as the term is modified for purposes of this exception) of the issue are allocated to expenditures for the governmental purposes of the issue within the six-month period beginning on the issue date; and

(2) The rebate requirement is met for amounts not required to be spent within the six month spending period (excluding earnings on a bona fide debt service fund).

Amounts Not Considered Gross Proceeds

For purposes of the six-month exception:

- Among other amounts, "gross proceeds" does not include:

  (1) Amounts in a bona fide debt service fund,

  (2) Amounts in a reasonably required reserve or replacement fund, or

  (3) Gross proceeds that arise after the six-month period and that were not reasonably anticipated on the date of issuance. **(See Treas. Reg. section 1.148-7(c)(3).)**

- The rebate requirement must be met for (1) amounts in a reasonably required reserve or replacement fund, and (2) unanticipated gross proceeds arising after the 6-month period, but not for earnings on a bona fide debt service fund. This is the case regardless of the fact that all of the gross proceeds of the issue (as defined for purposes of this exception) are spent within the initial 6-month period.

Applicability

The exception applies to all types of bond issues (i.e., governmental, private activity, new money, and refunding).

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Extension of Time Period

IRC section 148(f)(4)(B)(ii) provides that, for governmental bonds (except tax and revenue anticipation notes) and qualified 501(c)(3) bonds, the six-month time period is extended to one year for an amount of gross proceeds that does not exceed the lesser of:

- five percent of the proceeds, or
- $100,000.

The Taxpayer Relief Act of 1997, however, removes the $100,000 limitation but retains the five percent limit.

No De Minimis Exception

There is no de minimis exception (i.e. must spend all gross proceeds within required time period).

18 - Month Exception

General Rule

Treas. Reg. section 1.148-7(d) provides that an issue meets the rebate requirement if:

- The gross proceeds (as the term is modified for purposes of this exception) of the issue are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule measured from the issue date-
    a. At least 15 percent within six months,
    b. At least 60 percent within 12 months, and
    c. 100 percent within 18 months;

- The rebate requirement is met for amounts not required to be spent within the 18-month spending period (excluding earnings on a bona fide debt service fund); AND

- All the gross proceeds (as the term is modified for purposes of this exception) qualify for the 3-year period with respect to bonds for capital projects. This means that the issue must meet the expenditure test, the time test, and the due diligence test of the capital projects temporary period.

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Amounts Not Considered Gross Proceeds

For purposes of the 18-month exception:

- Among other amounts, "gross proceeds" does not include:
  - Amounts in a bona fide debt service fund,
  - Amounts in a reasonably required reserve or replacement fund, or
  - Gross proceeds that arise after the 18-month period and that were not reasonably anticipated on the date of issuance (e.g., insurance or lawsuit recoveries). **(See Treas. Reg. sections 1.148-7(c) and 1.148-7(d)(3).)**
- The rebate requirement must be met for:
  - amounts in a reasonably required reserve or replacement fund, and
  - unanticipated gross proceeds arising after the 18-month period, but not for earnings on a bona fide debt service fund.

This is the case regardless of the fact that all of the gross proceeds of the issue (as defined for purposes of this exception) are spent in accordance with the 18-month spending schedule.

Estimated Earnings

Estimated investment earnings must be taken into account to determine compliance with the first two spending periods.

Reasonable Retainage

The 18-month time period is extended to 30 months (i.e., one additional year) for not more than a reasonable retainage. "Reasonable retainage" means an amount not to exceed five percent of net sale proceeds that is retained for reasonable business purposes relating to the property financed (e.g., retention to ensure compliance with a construction contract).

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De Minimis Rule

Treas. Reg. section 1.148-7(b)(4) provides that a failure to meet the last spending requirement does not cause the issue to fail the spending exception if:

- the unspent proceeds do not exceed the lesser of:
    - three percent of the issue price, or
    - $250,000, and
- the issuer exercises due diligence to complete the project.

No Retroactive Effect

Issuers cannot elect to apply the 18-month exception retroactively. It only applies to bonds issued on or after July 1, 1993.

General Rule

IRC section 148(f)(4)(C) provides that, in the case of a construction issue, the rebate requirements shall not apply to the available construction proceeds of such issue if the spending requirements are met in accordance with the following schedule:

- 10 percent of the available construction proceeds of the issue are allocated to expenditures for the governmental purposes of the issue within the six months beginning on the date the bonds are issued,
- 45 percent of such proceeds are allocated for such purposes within the one-year period beginning on such date,
- 75 percent of such proceeds are allocated for such purposes within the 18-month period beginning on such date, and
- 100 percent of such proceeds are allocated for such purposes within the two-year period beginning on such date.

Construction Issue

An issue is a "construction issue" if:

- all of the bonds which are part of such issue are:
  - qualified 501(c)(3) bonds,
  - bonds which are not private activity bonds, or
  - private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization; and
- the issuer reasonably expects that at least 75 percent of the available construction proceeds of the construction issue will be used for construction expenditures with respect to property which is to be owned by a governmental unit or a 501(c)(3) organization.

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Available Construction Proceeds

IRC section 148(f)(4)(C)(vi) provides that the term "available construction proceeds" generally means issue price, plus certain earnings, minus amounts deposited in a reasonably required reserve or replacement fund and amounts of proceeds used to finance issuance costs.

Earnings on the reserve fund are generally included in available construction proceeds until the earlier of the close of the two-year period or the date construction is substantially completed.

The issuer may, however, elect to exclude earnings on the reserve fund from available construction proceeds altogether. If this election is made, the reserve fund is subject to the rebate requirement.

Construction Expenditures

Generally, construction expenditures include capital expenditures allocable to real property or constructed personal property, but not expenditures for acquisition of interests in land or other existing real property.

Turnkey contracts can qualify as long as the property has not been built or installed at the time the parties enter into the contract.

Constructed personal property means certain tangible personal property or specially developed computer software.

Reasonable Retainage

The two-year time period is extended to three years for not more than a reasonable retainage.

Reasonable retainage means an amount not to exceed five percent of available construction proceeds that is retained for reasonable business purposes relating to the property financed (e.g. retention to ensure compliance with a construction contract).

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De Minimis Rule

Treas. Reg. section 1.148-7(b)(4) provides that a failure to meet the last spending requirement does not cause the issue to fail the spending exception if:

- the unspent proceeds do not exceed the lesser of:
  - three percent, or
  - $250,000, AND
- the issuer exercises due diligence to complete the project.

Bifurcation

For purpose of applying this exception, the issuer may elect to treat the issue as two separate issues, as long as all construction expenditures are allocated to one of the issues (i.e., a construction issue and a non-construction issue).

Penalty in lieu of rebate

An issuer of a construction issue may elect on or before the issue date to pay a "penalty in lieu of rebate" under the two-year exception**. (See IRC section 148(f)(4)(C)(vii).)** The penalty is 1.5 percent of the amount by which an issue fails to meet the spending requirement as of any spending date. The penalty payment is in lieu of the obligation to pay the rebate amount on available construction proceeds upon failure to satisfy the spending requirements.

The 1.5 percent penalty is calculated separately for each six-month spending period from the date of issue, including each semiannual period after the end of the fourth spending period, until the earliest of :

- the issuer's election to terminate the penalty,
- the expenditure of all available construction proceeds, or
- the final maturity of the original bonds and all refunding bonds.

The 1.5 percent penalty must be paid to the United States no later than 90 days after the end of the spending period to which it relates.

Applying more than one exception

An issuer may elect to apply the exceptions to different portions of an issue as provided in IRC section 148(f)(4)(C)(v). For example, a portion of an issue could qualify for the 2-year construction exception and another portion could qualify for the 6-month exception.

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Two - Year Construction Exception, Continued

Bona Fide Debt Service Exception

IRC section 148(f)(4)(A)(ii) provides that investment earnings on bona fide debt service funds are excluded from rebate in certain cases.

Amounts earned on a bona fide debt service fund shall not be taken into Account for purposes of the rebate requirement if the gross earnings on such fund for the bond year are less than $100,000.

Treas. Reg. section 1.148-3(k) provides that an issue with an average annual debt service that is not in excess of $2,500,000 may be treated as satisfying the $100,000 limit.

The $100,000 limit is disregarded if:

- no bond of an issue is a private activity bond,
- the average maturity of the issue is at least 5 years, and
- the rates of interest on bonds of the issue do not vary during the term of the issue.

Thus, the exception generally applies to fixed rate governmental bonds with an average maturity of 5 years or more.

The 1997 Act provides that, in instances where the spending requirements of the two-year spending exception are met with respect to the available construction proceeds of a construction issue, earnings on a bona fide debt service fund will be excluded from rebate.

Section 5

Computing Rebate

Overview

Introduction

If there are gross proceeds of an issue that do not qualify for an exception, steps five through ten should be taken for purposes of calculating rebate. Step eleven is the actual payment of rebate due. This section discusses these final steps, and includes examples of computing rebate.

In this section

This section contains the following topics:

Computation and Payment Dates

General Rule

If there are gross proceeds of an issue that do not qualify for an exception, steps five through eleven should be taken for purposes of calculating and paying rebate. The general rule for the calculation of rebate set forth in IRC section 148(f)(2) and Treas. Reg. section 1.148-3 is that the issuer of bonds must pay to the Federal government an amount equal to the amount earned on all nonpurpose investments less the amount that would have been earned if the nonpurpose investments were invested at a rate equal to the yield on the bonds.

Step Five - Computation and Payment Dates

According to Treas. Reg. sections 1.148-3(e)(1) and 1.148-3(f), in order to calculate rebate, the computation and payment dates must first be determined. The general rule is that an issuer must compute rebate for successive five-year intervals from the date of issue.

Computation Date and Period Defined

Computation date means each date on which the rebate amount for an issue is computed under Treas. Reg. section 1.148-3(e). Computation period means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date.

Fixed Yield Issue

An issuer of a fixed yield issue may treat any date as a computation date.

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Variable Yield Issue

For a variable yield issue, an issuer may treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid as a computation date but may not change that treatment after the first payment date. After the first required payment date, an issuer must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date.

Final Computation Date

The date that an issue is discharged is generally the final computation date.

For an issue retired within three years of the issue date, the final computation date need not occur before the end of eight months after the issue date or during the period in which the issuer reasonably expects that any of the spending exceptions will apply to the issue.

Rebate Installment Payment Date

Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates.

Step six - Yield Calculated

Yield on the issue of bonds is then determined. Yield is calculated the same way, for the most part, for rebate purpose as it is for yield restriction purposes. **(See Treas. Reg. section 1.148-4(a).)**

Step seven - Proceeds Allocated to Nonpurpose Investments

Next, proceeds of the issue must be allocated to nonpurpose investments.

Treas. Reg. section 1.148-6(a)(1) provides that an issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures.

Amounts are generally allocable to only one issue at a time as gross proceeds. **(See Treas. Reg. section 1.148-6(b)(1).)**

Amounts cease to be allocable to an issue as proceeds only when those amounts:

- are allocated to an expenditure for a governmental purpose,
- are allocated to transferred proceeds of another issue, or
- cease to be allocated to that issue at retirement of the issue or under the universal cap rule of Treas. Reg. section 1.148-6(b)(2).

Amounts cease to be allocated to an issue as replacement proceeds only when those amounts:

- are allocated to an expenditure for a governmental purpose,
- are no longer used in a manner that causes those amounts to be replacement proceeds of the issue, or
- cease to be allocated to that issue at retirement of the issue or the application of the universal cap rule.

Treas. Reg. section 1.148-6(c) provides that, upon purchase or sale of a nonpurpose investment, gross proceeds of an issue are not allocated to a payment for that nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of the nonpurpose investment as of the purchase or sale date.

Step Eight - Cash Flow Schedule Created

Next, a schedule of the cash flows of the nonpurpose investments must be made. The cash flows are shown as either payments or receipts.

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Payments

For purposes of creating a schedule, **payments** are:

- Amounts paid to acquire a nonpurpose investment;
- For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired or that becomes subject to the rebate requirement on a date after it is actually acquired, the value of the investment on that date;
- For a nonpurpose investment that was allocated to an issue at the end of the preceding computation period, the value of that investment at the beginning of the computation period;
- On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of $1,000; and
- Yield reduction payments on nonpurpose investments.

The size and number of the computation credits that should be included in a schedule as payments will depend, in part, on which set of regulations applies. For instance, the 1993 regulations provide for a $1,000 computation credit as described above while the 1992 regulations provide for a computation date credit of $3,000 on each eligible computation date.

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Receipts

For purpose of creating a schedule, **receipts** are:

- Amounts actually received from a nonpurpose investment, such as earnings and return of principal;

- For a nonpurpose investment that ceases to be allocated to an issue before its disposition or redemption date or that ceases to be subject to the rebate requirement on a date earlier than its disposition or redemption date, the value of that nonpurpose investment on that date; and

- For a nonpurpose investment that is held at the end of a computation period, the value of that investment at the end of that period.

Qualified Administrative Costs

Treas. Reg. section 1.148-5(e) provides that qualified administrative costs are taken into account in determining payments and receipts on nonpurpose investments. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments.

Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but NOT legal and accounting fees, recordkeeping, custody, and similar costs, and general overhead costs.

Information Sources

Information regarding the payments for and receipts of nonpurpose investments must be obtained from the issuer. Generally, not all the required information will be in the bond transcript, because the bond transcript is put together to show what happened on the closing date, and investments are typically made after the closing date.

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Step Nine - Future Value Payments/ Receipts

Next, the future value of the payments and receipts as of the computation date must be computed. These amounts equal:

- the value of the payments or receipts when paid or received (or treated as paid or received) plus
- interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and counting convention used to compute that yield.

Future valuing provides for a mechanism which takes into account the time value of money when comparing amounts paid or received at different times.

Step Ten - Net Payments and Receipts

The future value of the payments and receipts are then netted against each other, and the net amount is the rebate amount.

Payment of Rebate

Step Eleven - Timely Payment

The last step requires the timely payment of rebate.

IRC section 148(f)(3) requires that rebate be paid at least once every five years during the life of the bonds. The regulations, however, provide issuers with the flexibility to make earlier installment payments.

Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. The last rebate payment is due no later than 60 days after the last bond is redeemed. Any rebate payment paid within the 60-day period may be treated as paid on the computation date to which it relates.

Except for the final payment, the amount of each required installment payment is 90 percent of the rebate amount as of that computation date (future value past rebate payments for the issue).

An issuer is required to file Form 8038-T with its rebate payment.

An issuer that fails to pay rebate when required for a reason other than willful neglect may pay a penalty in lieu of loss of tax-exemption for interest on the bonds.

Penalty for Late Payments

For governmental and 501(c)(3) bonds, the penalty is rebate owed plus 50 percent of the rebate amount not paid when required to be paid, plus interest on that amount.

The penalty is automatically waived in certain cases.

The penalty for private activity bonds (other than qualified 501(c)(3) bonds) is 100 percent rather than 50 percent. Interest accrues at the underpayment rate under IRC section 6621.

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Recovery of Rebate Overpayment

Treas. Reg. section 1.148-3(i) provides that an issuer may recover an overpayment of rebate. There is an overpayment if the amount previously paid exceeds the sum of the rebate amount of the issue as of the most recent computation date plus any other amounts due (e.g. penalty in lieu of rebate) under IRC section 148 as of the date the claim is made.

General Limitation: An overpayment can only be recovered if the recovery on the date it is first requested would not result in an additional rebate amount if that date were treated as a computation date.

Additional Limitation: Except for overpayments of penalty in lieu of rebate, an overpayment of less than $5,000 may not be recovered before the final computation date.

No interest is allowed on recoveries of an overpayment amount.

Example 1: Fixed Yield Issue

On January 1, 1994, City A issues $49,000,000 of fixed yield bonds and invests all the sale proceeds. The bonds have a yield of 7% per year compounded semiannually and mature January 1, 2004. City A receives income from the investment of the bond proceeds and spends this income, as well as the sale proceeds themselves, for the governmental purpose of the issue according to the following schedule:

2/1/94	**$3,000,000**
5/1/94	**5,000,000**
1/1/95	**5,000,000**
9/1/95	**20,000,000**
3/1/96	**22,000,000**

The total equals $55,000,000. This represents $49,000,000 of original proceeds plus $6,000,000 of investment proceeds. That high an amount of earnings indicates a high yield on the investment of the sale proceeds. The presence of arbitrage profits is shown by the rebate calculation.

City A selects a bond year ending on January 1, so the first required computation date is 5 years later on January 1, 1999. The rebate amount as of this date is computed by determining the future value of the receipts and the payments for the investments, using the same compounding interval used to compute the yield on the bond issue. The future value of these amounts, plus computation credits, as of January 1, 1999, is shown on the table on the following page.

Continued on next page

Date	Receipts (Payments)	FV (7%)
1/1/94	($49,000,000)	($69,119,339)[a]
2/1/94	3,000,000	4,207,602[b]
5/1/94	5,000,000	6,893,079
1/1/95	5,000,000	6,584,045
1/1/95	(1,000)	(1,317)[c]
9/1/95	20,000,000	25,155,464
1/1/96	(1,000)	(1,229)[c]
3/1/96	22,000,000	26,735,275
1/1/97	(1,000)	(1148)[c]
Rebate amount (1/1/99)		**$ 452,432**

[a]This is the same as the amount you would receive on 1/1/99 if you invested the proceeds from the sale of the bonds at 7% (the yield on the bonds) from 1/1/94 to 1/1/99.

[b]This amount, and the four following amounts, is what you would receive if you took your investment receipts (which are composed of both principal and interest from the investments) and invested them at 7% (the yield on the issue), compounded semiannually, from the date you received the money through the date of the rebate calculation.

[c]Computation credit.

The amount of $69,119,339 is the future value of the $49,000,000 you invested, assuming a yield on the investments equal to the yield on the bonds. You need to find out if that figure, plus the future value of the computation credits, is greater than or less than the future value of your receipts. If it is less, rebate is owed. Here, $69,119,339 plus $3,694 (the future value of the computation credits) equals $69,123,033. The future value of the receipts add up to $69,575,465. So, $69,575,465 minus $69,123,033 equals the rebate amount of $452,432.

City A files Form 8038-T and pays 90 percent of the rebate amount ($407,189) to the United States within 60 days of January 1, 1999.

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On January 1, 2004, City A redeems all the bonds, and thus this date is the final computation date. The future value of the receipts and payments as of this date is:

Date	Receipts Payments	FV (7%)
1/1/99	$452,432	$ 638,200
1/1/04	(1,000)	(1,000)
Rebate Amount (1/1/04)		$ 637,200

As of this computation date, the future value of the payment made on January 1, 1999, is $574,380 and thus an additional rebate payment of $62,820 is due. This payment reflects the future value of the 10 percent unpaid portion, and thus would not be owed had the issuer paid the full rebate amount as of any prior computation date.

Example 2: Variable Yield Issue

On July 1, 1994, City B issues $30,000,000 of variable yield bonds and invests all of the sale proceeds. As of July 1, 1999, there are nonpurpose investments allocated to the issue. Prior to July 1, 1999, City B receives amounts from nonpurpose investments and immediately expends them for the governmental purpose of the issue as follows:

DATE	AMOUNT
8/1/1994	$5,000,000
7/1/1995	8,000,000
12/1/1995	17,000,000
7/1/1999	650,000

City B treats the last day of the fifth bond year (July 1, 1999) as a computation date. The yield on the variable yield issue during the first computation period is 6% per year compounded semiannually. The value of the nonpurpose investments allocated to the issue as of July 1, 1999, is $3 million. The rebate amount as of July 1, 1999, is computed by determining the future value of the receipts and the payments for the nonpurpose investments, using the same conventions used to compute the yield on the bond issue. The future value of these amounts and of the computation date credits as of July 1, 1999, is:

DATE	RECEIPTS (PAYMENTS)	FV (6%)
7/1/1994	($30,000,000)	($40,317,491)
8/1/1994	5,000,000	6,686,560
7/1/1995	(1,000)*	(1,267)
7/1/1995	8,000,000	10,134,161
12/1/1995	17,000,000	21,011,112
7/1/1996	(1,000)*	(1,194)
7/1/1997	(1,000)*	(1,126)
7/1/1998	(1,000)*	(1,061)
7/1/1999	650,000	650,000
7/1/1999	3,000,000	3,000,000
7/1/1999	(1,000)*	(1,000)
Rebate amount (7/01/1999)		$1,158,694

*Payments include computation credits of $1,000. **(See Treas. Reg. section 1.148-3(d)(1)((iv)).**

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- The future value of the initial $30,000,000 payment to acquire nonpurpose investments is $40,317,491. $40,317,491 plus $5,648 (the future value of the computation credits) equals $40,323,139. The future value of the receipts add up to $41,481,833. This amount includes the value of the nonpurpose investments held at the end of the computation period ($3,000,000). So, $41,481,833 minus $40,323,139 equals the rebate amount of $1,158,694.

- City B pays 90 percent of the rebate amount ($1,042,825) to the United States within 60 days of July 1, 1999.

On July 1, 2004, City B redeems all of the bonds. Thus, the next computation date is July 1, 2004. On July 30, 1999, City B chose to compute rebate for periods following the first computation period by treating the end of each fifth bond year as a computation date. The yield during the second computation period is 5% per year compounded semiannually. The computation of the rebate amount as of this date reflects the value of the nonpurpose investments allocated to the issue at the end of the prior computation period. On July 1, 2004, City B sells those nonpurpose investments for $3,925,000 and expends that amount for the governmental purpose of the issue.

As of July 1, 2004, the future value of the rebate amount computed as of July 1, 1999, and of all other payments and receipts is:

DATE	RECEIPTS (PAYMENTS)	FV (5%)
7/1/1999	$1,158,694	$1,483,226
7/1/1999	(3,000,000)	(3,840,254)
7/1/2000	(1,000)	(1,218)
7/1/2001	(1,000)	(1,160)
7/1/2002	(1,000)	(1,104)
7/1/2003	(1,000)	(1,051)
7/1/2004	(2,000)*	(1,000)
7/1/2004	3,925,000	3,925,000
		1,561,439

As of the July 1, 2004, final computation date, the future value of the payment made on July 1, 1999, is $1,334,904 and thus an additional rebate payment of $226,535 is due.

* This payment includes computation credits of $1,000 for amounts allocated to gross proceeds of an issue subject to rebate and $1,000 for the final maturity. **(See Treas. Reg. section 1.148-3(d)(1)(iv).)**

Audit Techniques

Audit Issue

Gross proceeds of an issue can not be allocated to a payment for a nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of that nonpurpose investment. **(See Treas. Reg. section 1.148-6(c).)**

This is a common concern in the arbitrage area. Often issuers do not have a real incentive to invest at the highest possible yield, because investment profits above the bond yield generally need to be paid over to the United States. Purchasing an investment for more than it is worth can be a way of transferring rebatable arbitrage profit to someone else.

This area should be looked at closely on examination to determine if fair market value was paid for investment.

Summary

Review of Module N

Module N answers the question: Even if arbitrage can be earned under the yield restriction rules, can it be retained without forfeiting the exclusion under IRC section 103, or must it be paid to the United States?

Although some of the rebate rules are similar to the yield restriction rules, the requirement to rebate arbitrage is separate from the requirement to restrict yield.

The rebate rules concentrate on **actual cash flows** rather than **expected cash flows.**

Before computing rebate, it must be determined whether any gross proceeds of the issue are excepted under any of the exceptions.

Rebate is computed using the future value method under the regulations.

Preview of Module O

Module N concludes the text's discussion of technical topics. Module O provides an in-depth discussion of auditing and closing procedures, and disclosure concerns. Module O also contains a case study which ties many issues together.