

UNDERSTANDING

IRS POST ISSUANCE

COMPLIANCE





Our mission is to serve as a trusted advisor for our clients by providing the expert guidance, solutions, and services that achieve their definition of success.

Rebate compliance and the IRS's expectations of issuers has evolved over the past 34 years. Today, the IRS's expectations are that issuers are compliant with the four Ps.

- **Profit** – Issuers are allowed to earn and keep a rate of return equal to the bond yield they are paying their bond holders. If an issuer earns more on investing unspent proceeds in taxable investments, they must rebate this profit to the Treasury every five years and at final maturity.
- **Proof** – Issuers must maintain records of investments and expenditures to support their profit calculations and that the bond proceeds were expended for the issue's purpose. This information must be maintained for the life of the issue plus up to six additional years ("Document Retention").
- **Private Use** – Because of the benefits of issuing tax-exempt obligations, the IRS wants the general public to benefit from these subsidies. Governmental issues are allowed 10 percent private use. Private active issuers, including Section 501(c)(3) issuers, are only allowed five percent private use.
- **Policies and Procedures** – The IRS has established a standard that issuers compile, maintain, and follow a set of issuer specific written post-issuance policies and procedures.

These rules apply to any type of tax-exempt and Stimulus Act taxable obligations (BABs, QSCBs, and QZABs). Collectively referred to as "tax-advantaged" obligations. The IRS rules related to these types of obligations are interrelated and very complex. The following is intended to provide a very high-level overview of the rules. Issuers should seek assistance from a qualified IRS post issuance compliance provider and work with them to develop and implement a plan.

WHAT IS ARBITRAGE REBATE? (PROFIT)

Arbitrage is the profit from buying in one market and selling in another. For issuers of tax-exempt obligations, it consists of borrowing in the tax-exempt market and investing in the taxable market. Rebate is the profit from taking advantage of the market differentials.

THE BASICS OF REBATE COMPLIANCE

Rebate and yield restriction liabilities must be paid to the Treasury every fifth bond year (or each one-year period ending on the date selected by the issuer). Installment payments are due 60 days after either the fifth bond year or the final maturity of the issue.

Each issue's liability is determined separately. The IRS does not allow issuers to net negative and positive liabilities.

Ninety percent of the liability must be paid at each fifth bond year and 100 percent of the liability at the final maturity date.

Payments are made by filing Form 8038-T. The IRS only requires issuers to file a Form 8038-T along with a check for the required payment. No supporting calculations are required. If no payment is due, there is no filing requirement.

If payments are not made timely, the IRS can assess a penalty of 50 percent of liability for governmental and 501(c)(3) issuers and 100 percent for other private activity issuers. Interest is due on the underpayment and the penalty. Issuers not under IRS audit can request a waiver of the penalty.

Overpayments of prior liabilities can be requested on Form 8038-R. Refunds must be requested no later than two years after the final maturity date of the issue.

ALLOCATION OF BOND PROCEEDS TO EXPENDITURES

Contrary to what you might think, you do not spend bond proceeds. You allocate expenditures to them. An issuer can allocate proceeds to expenditures and investments based upon any reasonable, consistently applied accounting method. There must be a current outlay of cash to create an expenditure.

The IRS rules limit the time periods that expenditures can be reallocated to proceeds. An issuer must account for the allocations of expenditures to proceeds not later than 18 months after the expenditure is paid or, if later, 18 months after the financed property is placed in service. These time periods are subject to a maximum time limit of 60 days after the fifth anniversary of the issue date or 60 days after the final maturity of the issue.

Expenditures prior to the issuance of the bonds can be reimbursed with bond proceeds as long as the issuer makes a Declaration of Official Intent to reimburse the pre-issuance expenditures before the expenditure is made or within 60 days after the expenditure has been made.

Official intent does not apply to preliminary expenditures including architectural, engineering, survey, and soil-testing costs. Preliminary expenditures do not include land acquisition, site preparation, or similar construction commencement costs. Preliminary expenditures cannot exceed 20 percent of the issue price of the issue(s).

EXCEPTIONS TO REBATE

While there are exceptions to the arbitrage rebate requirements, the IRS has made these exceptions technically challenging to meet. Issuers should seek assistance in verifying compliance if they believe an issue may qualify for an exception.

Small Issuer Exception

If a governmental entity with general taxing powers, on the date of issuance, reasonably expects not to issue more than an aggregate limit during the calendar year, they are exempt from the rebate rules.

For municipal issuers, the aggregate limit of tax-exempt debt issued is \$5 million. For school districts (K-12) the aggregate limit is \$15 million, as long as no more than \$5 million is for non-construction. Taxable issues are not included in the aggregate limit.

The small issuer exception is an exception from the rebate rules. Typically, if proceeds of the tax-exempt issue are not spent within three years of the date of issuance, they will be subject to the yield restriction rules (see yield restriction below).

Investing in Tax-Exempt Investments

If the proceeds of a tax-exempt issue are invested in non-alternative minimum tax tax-exempt obligations, the rebate rules do not apply to those investments. The issuer is borrowing tax-exempt and investing tax-exempt, thus no arbitrage.

Spending Exceptions

There are three spending exceptions that issuers can meet: the 6-month, 18-month, and 24-month exceptions. There are interim semi-annual spending benchmarks that must be met. The cumulative expenditures for the benchmarks are calculated based upon the bond proceeds and the investment earnings on those proceeds. If any single benchmark is not met, the exception is no longer available to the issuer.

For purposes of the 18- and 24-month exceptions, an issue can have unspent proceeds at the final benchmark equal to the lesser of three percent of the issue price or \$250,000 and still meet the exception. If a reasonable retainage amount has been specified in the contract, the unspent amounts at the final benchmark is increased by an additional amount equal to a maximum five percent retainage amount. The retainage must be spent within one year of the final benchmark.

6-Month Exception

All proceeds and investment earnings, except amounts in a reserve or debt service fund, are spent on any type of capital assets within six months of the date of issuance. All types of issuers qualify.

18-Month Exception

All proceeds and investment earnings, except amounts in a reserve or debt service fund, are spent on any type of capital assets with cumulative expenditures in the first six months of 15 percent, first twelve months of 60 percent, and the first 18 months of 100 percent. All types of issuers qualify.

24-Month Exception

All proceeds and investment earnings, except amounts in a reserve, cost of issuance, or debt service fund, are spent with cumulative expenditures in the first six months of 10 percent, first 12 months of 45 percent, first 18 months of 75 percent, and 100 percent in first twenty-four months. Seventy-five percent of the expenditures have to be for construction. This exception only applies to governmental and Section 501(c)(3) issuers.

Debt Service Funds

Debt service funds are exempt from rebate if they meet both an annual income and depletion test.

Income

Each issue's debt service fund is limited to \$100,000 of investment income per year. Long-term, fixed rate governmental issues are not subject to the income limitation. Issues with an average annual debt service not in excess of \$2,500,000 are also not subject to the income limitation.

Depletion

At some time during the year, the invested balance of an issue's debt service fund must drop below a reasonable carryover amount, which is typically 1/12th of the preceding year's debt service.

If both the income and depletion tests are met, the debt service fund is excluded from the rebate calculation ("Bona Fide").

COMMINGLED FUNDS

A commingled fund contains proceeds of a tax-exempt issue and more than \$25,000 of amounts that are not proceeds of the issue. In addition, all of the amounts in the fund are invested and accounted for collectively. Allocations must be made to all of the participants in a commingled fund no less frequently than as of the close of each fiscal period. A fiscal period is defined as a period that does not exceed three months (e.g. daily, weekly, monthly, or quarterly). Expenditures in a commingled fund can be allocated among the participants based upon any of these "safe harbor" methods:

- Specific tracing
- Pro-rata
- First-in, first-out
- Gross proceeds spent first

Income in a commingled fund can be allocated among the participants under one of the following safe harbor methods:

- The average daily balances
- The average of the beginning and ending balances

Mark-to-market accounting is required for commingled funds if the average investment maturity of the fund is more than 18 months. Mark-to-market accounting treats all of the investments as sold for their fair market value on the last day of each fiscal period.

REFUNDINGS AND TRANSFERRED PROCEEDS

A refunding issue uses its proceeds to pay principal, interest, or a redemption price of a refunded issue(s). A refunding is performed to reduce interest costs or eliminate restrictive covenants.

There are two types of refundings:

- Current Refunding – Within 90 days of issuance
- Advance Refunding – After 90 days of issuance

Per the IRS rules, the yield on an advance refunding escrow cannot be more than .001 percent above the refunding issue bond yield.

Unspent proceeds of the refunded issue transfer to the refunding issue as the refunding issue makes principal payments on the refunded issue.

Advance refundings are only allowed for governmental and Section 501(c)(3) issuers.

Bonds issued after 1985 may only be advance refunded once. There is no limit on current refundings.

If the advance refunding produces interest savings, the issuer must redeem the refunded bonds on the first optional call date.

YIELD RESTRICTION

Yield restriction is a separate set of rules from the rebate rules. Rebate is the excess earnings over the bond yield (profit) on a cumulative basis from the inception of the issue. The yield restriction rules govern when an issuer can legally earn arbitrage without jeopardizing the tax-exempt status of the obligations.

Yield restriction starts after a temporary period or is based upon a size limitation and is calculated at a materially higher yield.

Unlike rebate liability payments, 100 percent of the yield restriction liability is due at any required payment date.

Temporary Period

During the temporary period an issuer can earn a yield on their investments in excess of the bond yield. However, the investments are still subject to the rebate rules during the temporary period.

Project funds typically have a three-year temporary period. In order to receive a three-year temporary period, an issue must reasonably expect as of the date of issuance:

- That 85 percent of the project proceeds will be spent within three years after the date of issuance.
- The issuer will contract for at least five percent of the project proceeds within six months after the date of issuance.
- That the issuer will proceed with due diligence to complete the project.

Replacement proceeds (monies that bondholders are legally entitled to in the case of financial difficulties of the issuer) have a 30-day temporary period. Replacement proceeds include non bona fide debt service funds, non-bond proceeds assets pledged for the benefit of the bondholders, or reserve funds funded with non-bond proceeds issuer contributions.

Size Limitations

Reserve funds are subject to a size limitation. This size limitation is referred to as the “reasonably required reserve” amount. If the reserve fund balance is less than the size limitation, it will not be subject to yield restriction. Any excess above the size limitation will be yield restricted.

The IRS size limitation is based upon the lesser of a three prong test. The reasonably required reserve amount is the lesser of:

- 10 percent of the par amount
- Maximum annual debt service
- 125 percent of average annual debt service

Materially Higher Amount

The yield restriction calculation takes all of the yield restricted assets and compares their investment yield to the bond yield plus an adder. The adder is either .125 percent or .001 percent.

The adder depends upon the type of yield restricted assets.

For bond-proceeds-funded projects, cost of issuance, capitalized interest, and reserve funds, the materially higher adder is .125 percent.

For advance refunding escrows and replacement proceeds, the materially higher amount is .001 percent.

If you have both types of assets in the calculation, the lowest adder is used for all of the yield restricted assets.

The IRS yield restriction rules permits an issuer to exclude amounts invested in higher yielding investments equal to the lesser of \$100,000 or five percent of the sales proceeds of the issue.

POST ISSUANCE COMPLIANCE (POLICIES AND PROCEDURES)

The IRS believes that issuers with written post issuance policies and procedures are more likely to be in compliance with their post issuance responsibilities and document-retention requirements. Post issuance policies and procedures should include:

- Assignment of responsibilities for who is responsible for what functions
- Document retention policies and procedures
- Arbitrage and yield restriction calculation requirements

- Procedures for monitoring private business use
- A training plan that avoids the turnover factor

Document Retention (Proof)

Closing documents, investment support, expenditure support, and any other documents material to the issue must be maintained for the life of the issue plus three years. If the issue is refunded, the documents must be maintained for the life of the refunding issue plus three years.

Monitoring Private Business Use (Private Use)

The IRS limits the amount of private use on tax-exempt financed property. Governmental issues are allowed 10 percent private use. Private active issuers, including Section 501(c)(3) issuers, are only allowed five percent private use. Issuers are required to track and maintain records documenting any private business use and the fact that it does not exceed the allowable limits.

An issue can lose its tax-exempt status if the private activity tests are exceeded. These tests include:

- Ownership
- Private use and private security/payment
- Private loan financing

These rules encompass the following items that may generate private use:

- Transfer of ownership
- Management or service contracts
- Advertising or naming rights
- Lease or rental by an external party

HILLTOP SECURITIES CAN HELP

HilltopSecuritiesAssetManagement's(HSAM)Arbitrage Rebate Compliance Services Group was established in 1987. Since its inception, HSAM has performed more than 55,400 calculations for approximately 910 issuers on more than 6,000 bond issues. Our experience serving a diverse client base enables us to understand the unique statutory, industry specific, and time constraint needs of our clients. Currently, HSAM serves as an independent arbitrage rebate provider to 520 clients across 27 states, comprising more than 3,200 bond issues with an aggregate par value of \$207 billion. HSAM's senior rebate staff has on average more than 27 years of rebate

compliance experience. Fifty-eight percent of our calculations contain commingled construction, debt service, or reserve funds.

In addition to the standard rebate compliance functions, HSAM provides issuers with service after the calculation. This includes:

- Annual post issuance compliance training
- Unlimited consultation
- Process improvement suggestions
- Post issuance compliance and document retention monitoring and feedback

HSAM prides itself on its commitment to post issuance compliance education. Since 1993, HSAM has sponsored annual post issuance compliance seminars devoted solely to the topic of IRS and SEC compliance. To date, the seminars have been held in 14 states and have had more than 4,800 attendees.

HSAM takes great pride in that approximately 70 percent of its rebate compliance clients have been with us for 10 years or more. This retention history demonstrates not only HSAM's technical abilities, but our ability to continue to maintain a high level of client satisfaction over time.

In order not to limit HSAM's pre-issuance tax advisory services to its clients or run afoul of the FINRA rules on municipal advisory representatives, each member of the senior management team of HSAM's Arbitrage Rebate Compliance Services Group is certified as a municipal advisory representative (Series 50 securities license).

HilltopSecurities also provides the following post issuance compliance services:

- SEC continuing disclosure
- Investment advisory services
- Structured products (swaps, investment contracts)
- GASB and FASB reporting for financial statement valuation

POST ISSUANCE COMPLIANCE QUIZ

What is your post issuance compliance score? Answer each of the questions “yes” or “no.” For each “yes” answer you will receive five points. If the question does not apply, consider it a “yes.”

1. Do you have formal written Post Issuance Policies and Procedures (“PIPP”)?
2. Do you have detailed procedures in place for each of the functional areas responsible for post issuance compliance?
3. Have you followed up to ensure that the people assigned with responsibilities are performing those functions?
4. Do you review your PIPP annually for compliance and make necessary revisions?
5. Do you segregate bond related legal documents, requisitions/invoices, and investment support?
6. Are you maintaining records related to your bond issues for the life of the issue plus three years? Or, if the issue is refunded, the life of the refunding issue plus three years?
7. Have you recently audited your document retention procedures to determine they are being followed?
8. At a minimum, are you having rebate calculations performed at IRS computation dates?
9. Do you review and adjust expenditure allocations within 18 months of the project being placed in service?
10. If you are trying to take advantage of the small issuer, spending, or debt service fund exceptions, do you have documentation that supports meeting the exception?
11. At a minimum, are you spending at least 85 percent of your project proceeds in the first five years?
12. If the issue is a refunding issue, did you have a final calculation performed on the refunded issue?
13. Do you have procedures in place to monitor that necessary Zero SLGS Rolls are being made by your escrow agent?
14. Are you having yield restriction calculations performed?
15. Do you have policies and procedures in place to monitor private business use?
16. Have you entered into any leases, management contracts, or naming rights with private parties?
17. Do you have documentation to support the amount of private use?
18. Have you recently audited your private business use procedures to determine if they are being followed?
19. Do you provide annual post issuance compliance training for anyone responsible for a post issuance compliance function?
20. For any new post issuance compliance responsible personnel, have you confirmed that they understand their responsibilities and they have been properly trained to perform them?

COMPARE YOUR SCORES TO THE FOLLOWING TABLE:

SCORE	RANKING	ACTION
0-25	Needs Improvement	Seek Assistance
26-50	Work in Process	Formulate a Plan
51-75	Getting There	Focus on Non-Compliance
76-100	Looking Good	Continue to Refine the Process

CONTACT US

Develop a plan to get your post issuance compliance house in order. Call or email us today.

BRIAN HELMING

Managing Director

214.953.8716

Brian.Helming@hilltopsecurities.com

COLBY JACKSON

Senior Vice President

214.953.8760

Colby.Jackson@HilltopSecurities.com

HEADQUARTERS

717 N. Harwood St., Suite 3400

Dallas, TX 75201

800.678.3792 | HILLTOPSECURITIES.COM

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