Is your five-year rebate analysis due? A reminder to tax-exempt bond issuers

A post-issuance compliance reminder for political subdivisions

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Public entities that issue tax-exempt bonds or notes, or other securities such as certificates of participation (COPs)[1], are required to complete a rebate computation as of the fifth anniversary date of the issuance date of the bonds, and every fifth year thereafter. Any rebate payment owed to the US Department of Treasury must be paid within 60 days of the relevant anniversary date. Some issuers complete rebate computations more often than the required every five years in order to identify and plan for potential rebate liabilities.

Many bonds issued in 2021 and 2022, were sold in a lower interest-rate environment than exists today. As investment yields have increased in subsequent years, it is possible that issuers have earned or are earning investment returns on bond proceeds that exceed the arbitrage yield limit on their bonds, increasing the possibility of rebate exposure.

What is rebate?

In general, rebate is owed when the yield an issuer earns by investing bond proceeds exceed the arbitrage yield on the bonds (i.e., when the issuer has earned positive arbitrage). Stated another way, the rebate amount is generally the difference between the amount actually earned on an investment of bond proceeds, and the amount that would have been earned on that investment had it earned a yield equal to the arbitrage yield on the bonds. For fixed rate bonds, the arbitrage yield on the bonds can be found on Form 8038-G, which should have been filed with the Internal Revenue Service shortly after the bonds were issued. The yield on variable rate bonds and the yield the issuer earned by investing the bond proceeds will need to be calculated by a rebate consultant.

Are there exceptions to rebate?

Certain bond issues may qualify for exceptions to the rebate requirement. Qualifying for an exception from rebate means that the issuer can keep all of the investment earnings on the bond proceeds that qualify for the exception.

On the issuance date of the bonds, the issuer may qualify for the small issuer exception from rebate by certifying that it does not expect to issue more than $5 million of bonds in that calendar year, or more than $15 million of bonds for construction of public school facilities in that calendar year.

There are also three spending exceptions that an issuer can qualify for in order to avoid owing rebate, as follows:

1. A six-month spending exception whereby all gross proceeds[2] of the bonds are spent within 6 months of the issue date of the bonds. Current refundings of prior bonds oftentimes qualify for this exception, which also happens to be the only rebate exception refundings can qualify for.
2. An 18-month spending exception whereby all gross proceeds of the bonds are spent within 18 months of the issue date of the bonds. In order to qualify for this exception, the issuer generally must also meet the following spending targets:
    a. At least 15% of gross proceeds within six months;
    b. At least 60% of gross proceeds within one year; and
    c. 100% of gross proceeds within 18 months.

1 In the interest of simplicity, the remainder of this client alert shall refer to all such tax-exempt obligations as "bonds."

2 Gross proceeds generally include (a) sale proceeds (amount paid for the bonds by the purchaser), (b) investment proceeds (earnings on the investment of proceeds), (c) transferred proceeds (remaining proceeds of a prior bond issue when a refunding occurs) and (d) replacement proceeds (which most commonly consist of amounts in the debt service fund for the bonds, or other collateral for the bonds not acquired with bond proceeds).

3. A 24-month spending exception for a construction issue[3] whereby all the available construction proceeds[4] of the construction issue are spent within 24 months of the issue date of the issue. In order to qualify for this exception, the issuer generally must also meet spending targets:

    a. At least 10% of available construction proceeds within six months;

    b. At least 45% of available construction proceeds within one year;

    c. At least 75% of available construction proceeds within 18 months; and

    d. 100% of available construction proceeds within two years.

It is important to note that, even if the above spending targets are met, there may be earnings on amounts not included in the spending exception (e.g., amounts held in a reserve fund allocable to the bonds) that may be subject to rebate. Also, although amounts in the debt service fund for the bonds are included in the definition of gross proceeds, earnings on qualifying bond debt service funds are often excepted from rebate. Due to the complexity of the spending exceptions, it is advisable to review any potentially applicable spending exception with bond counsel to determine whether all the criteria have been met.

Why does this matter?

Failure to timely pay a required rebate amount may result in the bonds being treated as arbitrage bonds under federal tax law, potentially jeopardizing the tax-exempt status of the bonds.

Recommended action steps

Issuers should begin by identifying the issuance date of all outstanding bond issues and then determine whether a five-year rebate computation date has occurred or is approaching. If so, the issuer should review any potential exception to rebate with bond counsel, and, if it appears that no exception applies, engage a rebate consultant to determine whether any rebate is or will be owed by the issuer.

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3 A construction issue is an issue of governmental use bonds or qualified 501(c)(3) bonds where at least 75% of the available construction proceeds (defined below) will be used for construction expenditures. Construction expenditures are capital expenditures allocable to the cost of constructing real property and certain tangible personal property.

4 Available construction proceeds generally consist of sale proceeds and investment proceeds, and can include earnings on a reserve fund allocable to the bonds.

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