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Final IRS Regulations: Changes Will Impact Arbitrage Rebate

From the Investment Team of PFM Asset Management LLC

In July, the Internal Revenue Service (IRS) published new arbitrage regulations, which are intended to finalize proposed rules from 2007 and 2013. The final regulations will take effect on October 16, 2016 and will make minor changes to the proposed regulations.

While the application of the proposed rules has been optional, issuers will now be required to follow the final tax regulations. However, because many issuers have applied the proposed regulations, the final IRS rules do not present major changes for most issuers. Also, although the regulations pertain to tax-advantaged obligations issued on or after October 16, 2016, issuers may choose to apply certain provisions to obligations outstanding as of the effective date.

These new regulations do not address the more controversial issue price rules, which will be the subject of future rule making.

The table below summarizes some of the changes to the tax regulations:

Working Capital	• Changes safe harbor maturity term from 2 years to 13 months (consistent with yield restriction); • Expands eligible purposes to include extraordinary working capital expenditures; • Removes restriction on financing working capital reserves with tax-exempt bonds.
Computation Date Credit	• For bond years ending in 2007 and after, credit increased to $1,400, adjusted for inflation each year.
Recovery of Overpayment (Refunds)	• Clarifies that refunds are limited to amounts actually paid, with no future value adjustment.
Joint Bond Yield Authority	• Eliminates joint yield computations for student loan bonds and mortgage loan bonds.
Premium Callable Bonds	• Changes bond yield computation on issues including premium callable bonds from (1) assuming bonds called on date that results in lowest issue yield to (2) assuming each premium callable bond is called on the date that results in the lowest yield on that bond.
Integration of Hedges	• Clarifies when simple versus super integration may be appropriate; • Clarifies when hedges are viewed as having a significant investment element; • Clarifies that a materially modified hedge may still be treated as a qualified hedge if it satisfies the requirements of a qualified hedge; • Permits an issuer to treat a hedge that is not actually terminated — but transferred to a refunding issue — as not terminated (no need to apply new on-market rate), offsetting loss on termination; • Expands time to identify a hedge from 3 business days to 15 calendar days.

Yield Reduction Payments	• Allows payments to address basis differences between indexes used in hedges and underlying interest rates on hedged bonds in an advance refunding; • Allows payments to cover investments that an issuer purchases on a date when U.S. Treasury Obligations, State and Local Government Series (SLGS) sales are suspended (for example, failed 0% SLGS rollovers in escrows).
Valuation of Investments	• Expands the exception for mandatory fair market valuation (FMV) of investments transferring to a refunding issue to include transfers to a taxable refunding issue or when reallocated due to the universal cap.
FMV of U.S. Treasury Obligations	• Other than its purchase date, FMV is redemption price of SLGS when FMV is the required valuation method (note that transfers of yield restricted investments are generally at present value).
FMV of Guaranteed Investment Contract (GIC)	• For safe harbor bidding, clarifies that bids must be in writing and timely disseminated; writing may be electronic; disseminating may be by fax, email, internet-based website or other electronic medium regularly used to post bid specs.
External Commingled Investment Funds	• Preferential rules for treatment of administrative costs will still apply if additional smaller investors invest, as long as at least 16 unrelated investors each maintain the required minimum average investment in the fund.
Small Issuer Exception – Pooled Bonds	• Implements 2005 law that includes pool borrowings when determining whether $5M limit is met.
Transition provisions for certain State perpetual trust funds used as guarantee funds	• Increases amount of tax-exempt bonds that such funds could guarantee and expands special rule to include bonds used to finance public charter schools.