

Municipal Bond Enforcement Update – Requesting a Refund of Arbitrage Rebate from the IRS

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This article is written for issuers and borrowers who dutifully pay their arbitrage rebate timely, but discover that they paid too much in error or are due a refund because of negative arbitrage in later periods. This article answers questions concerning refund filings. Questions such as: when and where one should file, what form one should use, and whether filing a refund request increases the chance of an audit. This article will analyze the history of rebate refunds, provide insights into the current processes for seeking a rebate refund, and warn about potential pitfalls and legal issues.

Overview

Congress requires issuers to make payments of arbitrage rebate on a regular basis in order to preserve the tax-exempt status of their municipal obligations.¹ Payments of arbitrage rebate are generally made once every five years, and after the last bond is retired.² A rebate payment is made when it is filed with the Internal

Revenue Service (“IRS”) at the place designated by the Commissioner and accompanied with the Form 8038-T, “Arbitrage Rebate.”³

The IRS has no rights to assess rebate or to take any collection activities to recover rebate from the issuer.⁴ If the issuer fails to timely pay arbitrage rebate, the IRS’s remedy is to tax bondholders on the interest income they received on the bonds. The IRS is required to tax bondholders through use of the normal deficiency procedures applicable to all taxpayers.⁵

Under current law, an issuer may seek the refund of an overpayment of arbitrage rebate by establishing to the satisfaction of the Commissioner of Internal Revenue that an overpayment has occurred.⁶

The History of Rebate Refund Requests

Arbitrage rebate has not always been refundable.⁷ In the early years of the program, it was believed that, by requiring issuers to pay only 90

percent of the amount due every five years, there would be few instances when a refund would be necessary.⁸ Therefore, the earliest discussions within the IRS and the Treasury Department focused on when, if ever, rebate refund requests would be allowed.⁹

In 1989, a compromise was reached to allow refunds, but only upon “mistakes,” which were mostly regarded as being limited to “mathematical” mistakes.¹⁰ It was not until the 1993 regulations that the refund provisions were expanded to allow for refunds for all purposes.¹¹ Soon thereafter, refund requests exploded both in number of requests and size of refunds requested.¹²

By 1994, the IRS examination function was beginning to slowly evolve and become a factor in the municipal marketplace.¹³ Early enforcement seminars often focused on the question of whether or when an examination would be initiated based on a request for a refund of arbitrage.¹⁴ Also, during this early period of IRS examination activity, Washington-based personnel made a startling discovery – rebate payments were not being processed onto IRS computers, and Forms 8038-T were sitting in boxes, some with checks still attached.¹⁵ To complicate matters, the IRS was not inputting payments into a system that could tie a refund request to an earlier payment, and rebate claims were not being worked on on a timely basis.¹⁶

Standup of the Office of Tax Exempt Bonds occurred in early 2000.¹⁷ By then, the IRS was well on its way to developing a methodology to capture rebate payments in the IRS computer system.¹⁸ This task was completed soon after standup. Once the method of capturing payments was completed, the IRS reinvigorated its efforts to speed up the process of resolving rebate claims.¹⁹

In 2000, the average time to refund a rebate payment was well over a year after the request was received. Because the IRS does not pay interest on rebate refunds, it was determined that the period of time to refund payments should be accelerated.²⁰ To accomplish this task, dedicated staff were trained and assigned to work rebate refund requests, and these returns were provided priority over regular examination activities.

Nevertheless, delays and confusion still persisted. To reduce delays, the IRS designed and published a special form for rebate refund requests, the Form 8038-R, “Request for Recovery of Overpayments Under Arbitrage Rebate Provisions.”²¹ By using a special form, the processing of requests from the IRS Service Centers to the examination review function was quickened.

In 2006, the Office of Tax Exempt Bonds informally moved the function of rebate refund request review from the field offices to Washington.²² Currently, three employees in Washington review all arbitrage rebate refund requests.²³

Current Refund Process

An “overpayment” of arbitrage rebate is defined as the excess of the amount paid to date as arbitrage rebate, less the amount owed as of the most recent computation date.²⁴ A request for a refund of an overpayment of arbitrage rebate is filed on the Form 8038-R, “Request for Recovery of Overpayments Under Arbitrage Rebate Provisions.”²⁵ The issuer files its request with the IRS Service Center in Ogden, Utah.²⁶ IRS regulations require the Form 8038-R to be signed by the issuer, even when the bond proceeds are lent to a conduit borrower.²⁷ Issuers are generally advised by the IRS to forward their computations with their refund requests.²⁸ Further, because refund requests are being subjected to 100 percent review at this time, sending in documentation (such as the rebate report and offering statement) with refund requests avoids having to send in those documents upon a later request and may ultimately speed the processing of the refund.

As before, there are no guarantees that a refund request will not result in a referral of the bond issue to the examination function.²⁹ The persons reviewing filed requests have significant experience in identifying arbitrage issues. If an issuer is concerned about the chances of an audit, it would be well advised to seek a professional review of its request prior to submission.

If an issuer is unable to resolve its claim with the IRS Office of Tax Exempt Bonds, it can seek a review of the denial by requesting an independent review by the IRS Office of Appeals.³⁰ In certain instances, issuers can also seek review of any legal issues involved in its claims by requesting “technical advice” from the IRS Office of Chief Counsel.³¹ Lastly, if all of these options are exhausted, or if the issuer simply chooses to skip one or more of these processes, it can file for a refund with a court of law.³²

What Your CPA Needs to Know

Certain common legal issues have arisen with respect to claims for rebate refund. One of the most common is whether the recipient is entitled to compensation for the time value of money.

Assume an issuer makes a payment of \$100,000 in arbitrage rebate at the end of year 5. Under the rebate “future value” system, this rebate payment has grown to equal a credit of \$135,000 by year 10. Assume the year 10 rebate calculation shows total rebate due on the issue of \$95,000, with a net rebate liability of (\$40,000). Can the issuer submit a refund request for \$40,000 (\$135,000 less \$95,000), or is the refund limited to \$5,000 (\$100,000 less \$95,000)?

The answer to this question is complicated by conflicting messages in the 1993 Arbitrage Regulations.³³

Attempts to clarify this language have, unfortunately, led to further misinformation and inconsistent treatment.³⁴ The inconsistent treatment is due, in large part, to conflicts between the IRS Office of Chief Counsel and the IRS Office of Appeals.³⁵ After becoming aware of these conflicts, the IRS Office of Tax Exempt Bonds sought further guidance and, in the interim, informally determined to refund requested overpayments consistent with Example 2 of the regulations, with one proviso, that the total amount of refunds cannot exceed the total amount paid in as arbitrage rebate.³⁶ Therefore, in this example, the IRS would refund \$40,000 to the issuer.³⁷

Another common legal issue, and perhaps the biggest trap for the unwary in this process, concerns when an issuer must file its suit in a court of law to protect its rights to a judicial review of its refund claim. Generally, government officials are not authorized to refund rebate payments if the claim is not filed within a six year statute of limitations applicable to claims against the government.³⁸ The IRS has used this statute to deny a request filed more than six years after the retirement of the bonds.³⁹

On the other hand, the IRS has informally agreed to process refund requests submitted before six years after the last bond is retired, based on legal advice from the IRS Office of

Chief Counsel.⁴⁰ This very lengthy timeline is, however, deceiving.

Although generally favorable for issuers, the IRS analysis that permits it to review claims many years, if not decades, after the initial payment of rebate, should not be assumed to be correct.⁴¹ Issuers should, instead, protect their rights to a refund by filing a claim with the U.S. Court of Federal Claims within six years of the earlier of the following dates: the date the issuer made a rebate payment by mistake, or the date they are aware of the right to a refund due to negative arbitrage.⁴²

Assume the issuer makes a rebate payment in year 5, then in year 10 receives a second arbitrage rebate report that indicates the year 5 payment was made in error. The issuer files a claim for refund (Form 8038-R) with the IRS in year 11, but the IRS does not begin working the claim until year 12. Upon a denial of its claim in year 12, the issuer files a claim for refund in the U.S. Court of Federal Claims.⁴³ Because the year 5 payment was made in error, is the claim to the U.S. Court of Federal Appeals in year 12 timely?

Although no court has ruled on the application of the six-year statute of limitations to the arbitrage rebate refund process, the issuer in the above example is running a significant risk

that its claim will not be heard by a court of law as it was filed more than six years after its mistaken payment.

Conclusion

The IRS has worked hard to improve the process for refund overpayments of arbitrage rebate and we should be thankful for their continued efforts in this respect. Nevertheless, issuers and borrowers should be cautious about requests that highlight potential examination issues, and for potentially allowing the time period for contesting a refund request to lapse.



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¹ I.R.C. §§ 103, 148(f).

² I.R.C. § 148(f)(3).

³ Treas. Reg. § 1.148-3(g).

⁴ See *City of Galt v. United States*, 804 F. Supp. 1275, 1278 (E.D. Cal. 1992) (wherein the Court found, in part, that "the arbitrage payment is not itself a tax.").

⁵ I.R.C. §§ 6211-6215.

⁶ Treas. Reg. § 1.148-3(i)(1).

⁷ See former Treas. Reg. § 1.103-15AT(e)(3) (1985).

⁸ I.R.C. § 148(f) requires "installment payments" to be made at least once every five years in an amount equal to 90 percent of the total potential rebate payment. The final rebate payment is due shortly after retirement of the bonds.

⁹ The author worked in the Office of Chief Counsel in the late 1980's and was assigned responsibility for working with the Office of Treasury on the development of the 1989 Arbitrage Regulations.

¹⁰ The preamble to the 1989 Temporary Regulations provided that "[r]ebate payments are not refundable. However, it is anticipated that the regulations will provide that issuers generally may recover overpayments if . . . the excess was paid as a result of a mistake (e.g., a mathematical error)." A similar rule was carried over into later regulations. Treas. Reg. § 1.148-13T (1992). See *Galt*, 804 F. Supp. at 1277-8.

¹¹ Treas. Reg. § 1.148-3(i)(1) provides that an issuer may recover an overpayment simply by establishing to the satisfaction of the Commissioner of Internal Revenue that an overpayment occurred. Rev. Proc. 92-83, 1992-2 C.B. 487, provided the initial procedures for requesting an overpayment refund.

¹² By 2002, almost 100 refund requests per year were being worked by the Office of Tax Exempt Bonds.

¹³ The examination function for bonds was an outgrowth from the GAO report of 1993, "Tax Policy and Administration: Improvements for More Effective Tax-Exempt Bond Oversight," GAO/GGD-93-104. The official announcement of a consolidated IRS audit program for municipal bonds was made in Announcement 93-92, 1993-24 I.R.B. 66.

¹⁴ Early Internal Revenue Manual ("IRM") provisions did not preclude the use of a rebate refund filing as a basis for the institution of an examination of the bond issue.

¹⁵ Rebate payments and Forms 8038-T were initially mailed to the IRS Service Center in Philadelphia, PA. The processing of arbitrage rebate payments and claims was officially transferred to the Ogden Service Center in the Spring of 1998. Notice 2005-32, 2005-28 I.R.B. (July 11, 2005), officially changed the place of filing for rebate returns filed pursuant to the 1989 or 1992 rebate regulations. Processing of examinations of rebate claims were initially posted onto the IRS NMF systems. See TIGTA Report 2000-10-047 (March 2000), and IRM § 4.81.1.9.1(2).

¹⁶ In 1994, the IRS discovered more than a dozen pending claims in the Philadelphia Service Center, some of which were close to three years old.

¹⁷ The office was officially created in 1999, but the selection of the Director and key personnel were not made until March 2000.

¹⁸ As an indicator of the size of this problem, rebate payments in 1999, 2000, and 2001 totaled approximately \$258,180,000, \$172,120,000, and \$66,030,000, respectively.

¹⁹ Refunds of arbitrage rebate generally do not include compensation for the time value of money. (See discussion under “What Your CPA Needs to Know,” below.)

²⁰ The IRS does not treat the payment of rebate as a payment of tax. Under this analysis, the refund of an overpayment is not entitled to the overpayment rate of interest per IRC § 6611. See *Galt*, 804 F. Supp. at 1278.

²¹ Announcement 2001-115, 2001-48 I.R.B. 539, formally announced the availability of the Form 8038-R, “Request for Recovery of Overpayments Under Arbitrage Rebate Provisions.”

²² Former procedures required only claims in excess of \$1,000,000 to be reviewed in the Washington office. IRM §§ 4.81.1.27(1)d and 4.81.1.8.1(7).

²³ Michael Muratore, Christopher Woodin, and Jyoti Athavale.

²⁴ Treas. Reg. § 1.148-3(i). In addition, this provision further limits recoveries by providing that an overpayment will not be approved to the extent that a recovery on the date the refund is requested would result in having an additional rebate liability as of that date.

²⁵ Announcement 2001-115, 2001-48 I.R.B. 539 (Nov. 26, 2001).

²⁶ Instructions to Form 8038-R.

²⁷ Treas. Reg. § 1.148-1(b) defines “issuer” to include conduit borrowers, except with respect to provisions “regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations.”

²⁸ Form 8038-R, Line 17 and instructions thereto.

²⁹ Per IRM § 4.81.1.8.1(6), opening an examination of a claim for matters beyond verifying correctness required approval by the Field Operations Manager. It is unclear under current processes whether or how this requirement is being implemented.

³⁰ Section 3.01 of Rev. Proc. 2006-40, I.R.B. 2006-42.

³¹ Section 3 of Rev. Proc. 2007-2, I.R.B. 2007-1.

³² The provisions of I.R.C. §§ 6532(a) and 7422(a) do not technically apply to claims for refunds of arbitrage rebate. No provisions of the Code or regulations require the filing of a claim prior to the filing of a suit. See Tech. Adv. Mem. 2004-46-021 (Aug. 6, 2006), in which the Service found that “no periods of limitations existed for the prescribed refund procedures that was distinct from the period of limitations if Issuer *had chosen to forego the administrative refund process.*” (italics added.)

³³ Compare the wording of Treas. Reg. § 1.148-3(i)(1) with the illustration thereof in Example 2, part (iii)(D) of the regulations (which implies that an issuer would be entitled to a refund of the future value of its payment).

³⁴ Tech. Adv. Mem. 2000-51-001 (Jun. 15, 2000).

³⁵ Appeals’ case resolution memorandums are not available for public review.

³⁶ See ILM 200512019 (Feb. 16, 2005).

³⁷ Section 148(f)(5) of the Code excludes the payments of rebate from gross income. Therefore, under general tax principles, it is likely that the return of said payments should be treated as gross income in the year of receipt for most taxable conduit borrowers.

³⁸ 28 U.S.C. §§ 2401, 2501.

³⁹ Tech. Adv. Mem. 2004-46-021 (Aug. 6, 2004).

⁴⁰ The IRS interpretation was based on an analysis of common law rules relating to claims, as opposed to the treatment of the installment payments as tax deposits versus tax payments. See *Rosenman v. U.S.*, 323 U.S. 658 (1945).

⁴¹ Every claim is time-barred unless the petition to the court arrives within six years of the date the claim first accrues. *Kinsey v. U.S.*, 852 F.2d 556, 557 (Fed.Cir.1988). This jurisdictional requirement is a condition of the government’s waiver of sovereign immunity and, as such, is strictly construed. *Hopland Band of Pomo Indians v. U.S.*, 855 F.2d 1573, 1576-7 (Fed.Cir.1988). This statute of limitations cannot be waived by government agents. *Mentis v. U.S. Postal Service*, 547 F. Supp. 164, 166 (W.D.N.Y. 1982).

⁴² Rebate claims are subject to a six-year statute of limitations. 28 U.S.C. §§ 2401, 2501; Tech. Adv. Mem. 2004-46-021 (August 6, 2004). The first date of this statutory period is based on common law rules relating to when all events fix the government’s alleged liability have occurred and the claimant was or should have been aware of the government’s liability. *General Instruments Corp. v. U.S.*, 33 Fed. Cl. 4, 7-8 (1995). For restitutions based on payments by mistake, courts generally regard the statutory period to begin to run when the payment is made. See *Norwest Bank Minn. Nat’l Ass’n. v. Federal Deposit Ins. Corp.*, 312 F.3d 447 (D.C. Cir. 2002). A refund claim filed with the Office of Tax Exempt Bonds does not stay the running of the statute of limitations. Rev. Rul. 57-242, 1957-2 C.B. 452.

⁴³ Generally, the U.S. Court of Federal Claims will have sole jurisdiction over most rebate refund claims. Compare 28 U.S.C. § 1491 (jurisdiction of U.S. Court of Federal Claims) with 28 U.S.C. § 1346 (jurisdiction of U.S. District Courts) in light of conclusion that rebate payments are not “tax” payments.