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Locke Lord QuickStudy: Is Arbitrage a Thing Again??

Locke Lord LLP

WRITTEN BY

Todd L. Cooper

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What is arbitrage?

Generally, arbitrage is the simultaneous buying and selling of securities in different markets to exploit the difference in pricing. Specific to the tax-exempt bond market, arbitrage arises when a borrower borrows on a tax-exempt basis (the selling of securities in the tax-exempt market) and invests the proceeds in taxable securities (the buying of securities in a different market, the taxable securities market).

What is negative arbitrage?

Negative arbitrage occurs when a borrower invests the proceeds of a tax-exempt obligation in securities the yield on which is below the yield on those tax-exempt obligations.

What is positive arbitrage or an arbitrage profit?

Positive arbitrage, sometimes described as an arbitrage profit, arises when the borrower invests the proceeds of a tax-exempt obligation (such as a bond, a bond anticipation note, or a lease) in investments that have a yield above the tax-exempt obligation yield ("Higher Yielding Investments"). If the borrower is not a federal income taxpayer, such as a state or local government or a nonprofit corporation, the value of positive arbitrage increases because no federal income taxes are owed on the investment earnings.

Why are there arbitrage restrictions?

In the 1950's and 1960's, market conditions allowed borrowers to issue tax-exempt bonds and invest the proceeds in taxable securities and make significant positive arbitrage. Congress became concerned that borrowers were motivated to issue tax-exempt debt not solely by the need to finance their projects but also by the opportunity to make an arbitrage profit and that more tax-exempt bonds were being issued than was necessary to fund the projects. Subject to market fluctuations, the ability to make an arbitrage profit continued into the early 2000's. After that, and until recently, market conditions did not generally allow borrowers to make an arbitrage profit and so no one needed to pay much attention to the arbitrage provisions of the Internal Revenue Code ("Code") or the applicable Treasury Regulations ("Arbitrage Regs"). Recent changes in the marketplace for tax-exempt and taxable securities have made it possible once again to earn positive arbitrage in certain circumstances.

What do the Internal Revenue Code ("Code") and the Arbitrage Regs promulgated thereunder say about arbitrage?

Congress originally enacted what is now Section 148 of the Code in 1969 and the Internal Revenue Service ("IRS") came out with the first version of Arbitrage Regs in 1972. The Code and Arbitrage Regs have been amended and expanded many times over the years. The Code and the Arbitrage Regs generally prohibit borrowers from investing the proceeds of tax-exempt debt in Higher Yielding Investments, i.e., investments whose yield is materially higher (generally 1/8%) than the yield on the tax-exempt debt from which the proceeds are derived. This basic rule is often referred to as the "Yield Restriction Rule." But there are many important exceptions in the Code and in the Arbitrage Regs.

What is Arbitrage Rebate?

After receiving many comments about the difficulty of compliance with the Yield Restriction Rule, Congress amended the Code to allow borrowers to invest in Higher Yielding Investments in many circumstances as long as the borrowers then returned any positive arbitrage to the IRS. This return of the arbitrage profit was ironically labeled in the Code as a "rebate" of the arbitrage to the IRS and so is often described as the "Rebate Rule."

What are yield reduction payments?

While the Rebate Rule provided much needed relief, its scope was somewhat limited and more comments followed. Congress took no action so the IRS provided additional relief by allowing borrowers to avoid the difficulty of buying yield restricted investments and instead deem the yield restriction to be accomplished by making "Yield Reduction Payments." In effect, the ability to make Yield Reduction Payments is really just an expansion of the Rebate Rule.

The exceptions.

The Code and the Arbitrage Regs provide several important exceptions to the Yield Restriction Rule and/or the Rebate Rule, including, but not limited to:

The Temporary Period Exception. Generally, the Arbitrage Regs allow a borrower to invest proceeds of a tax-exempt obligation deposited in a capital project fund in Higher Yield Investments for up to 3 years.

The Bona Fide Debt Service Fund Exception. The Arbitrage Regs allow a borrower to invest in Higher Yield Investments for monies held in a bona fide debt service fund ("BFDSF"). A BFDSF is a fund whose primary purpose is to achieve a proper matching of revenues with the principal and interest due on the tax-exempt obligation each year and is depleted each year, except for a reasonable carry-over amount which is generally equal one month's debt service. For many general obligation issues, an issuer may not have a specially designated fund and the debt service is paid from the general fund. In that situation, the relevant portion of the general fund is deemed to be the BFDSF.

The Current Refunding Exception. The Arbitrage Regs provide a temporary period for the proceeds of a current refunding obligation of ninety (90) days during which the proceeds of the current refunding may be invested in Higher Yield Investments. The Arbitrage Regs also provide an exception to the Rebate Rule if the proceeds of the current refunding obligation are spent within ninety (90) days.

The Small Issuer Exception. The Code and the Arbitrage Regs provide an exception to the Rebate Rule, but not the Yield Restriction Rule, for small governmental issuers. A small issuer is a governmental issuer with general taxing powers that issues not more than $5M of tax-exempt obligations in that year. The $5M limit can be expanded by up to an additional $10M if that additional amount is spent solely for school construction purposes. This provision has complex rules regarding the treatment of premium on the tax-exempt obligations and regarding refundings.

The Spending Exceptions. The Code and the Arbitrage Regs provide several exceptions to the Rebate Rule, but not the Yield Restriction Rule, when money is spent in a reasonable time frame ("Spending Exceptions"). The basic premise of the Spending Exceptions is that the proceeds of the tax-exempt obligation will not be around long enough for arbitrage profit to be a sufficient motivator to issue more tax-exempt obligations than are needed for the project. Generally, and subject to several specific modifications, the Rebate Rule will not apply if (i) all of the proceeds of the tax-exempt obligation are spent within six months after issuance, (ii) the proceeds of a tax-exempt obligation are spent at a required pace over eighteen months (15% within six months, 60% within one year, and 100% within eighteen months), or (iii) for an issue that funds projects that include at least 75% construction expenditures, the proceeds are spent at a required pace over two years (10% within six months, 45% within one year, 75% within eighteen months, and 100% within two years).

What does the Tax Certificate say?

The Tax Certificate for every tax-exempt obligation details the arbitrage rules and requires the borrower who executes that Tax Certificate to comply with the arbitrage rules.

How do I comply?

A borrower must monitor its expenditures and its investments of tax-exempt obligations and keep careful, detailed records of those expenditures and investments. A borrower must retain those records for the life of the tax-exempt obligations and any obligations that refund the original tax-exempt obligations, plus 3 years. For example, if a borrower issued a one year bond anticipation note, followed by another bond anticipation note that refunded that original bond anticipation note, and then refunded the second bond anticipation note with a 30 year bond, the borrower must keep those expenditure and investment records for 35 years from the date of the original bond anticipation note.

If any of the proceeds of a tax-exempt obligation do not qualify for one of the exceptions described above, then the borrower must determine if an arbitrage profit was made and if a rebate payment or a Yield Reduction Payment is owed to the IRS. Further, a borrower must determine whether the proceeds cannot be invested in Higher Yield Investments and, if so, invest accordingly.

When do I need to make a rebate or yield reduction payment?

Unless a spending exception applies, a rebate or yield reduction payment is due within 60 days after the earlier of

(i) the fifth anniversary date of the issue or the original issue if there are any refundings, and (ii) final maturity of the issue or each issue if there are any refundings. ?

Do I need an appropriation of the rebate or yield reduction payment?

G.L. c. 44, §53H, provides ?as follows: ?

Notwithstanding the provisions of section fifty-three, any city, town, district, regional refuse ?disposal district or regional school district issuing bonds or notes may rebate to the federal ?government, without further appropriation, any amount deemed necessary by the officers ?authorized to issue the bonds or notes in order to have interest paid on the bonds or notes ?be excluded, in whole or in part, from gross income for federal income tax purposes. Such ?payment made by a city, town or district shall be reported by the auditor or accountant of the ?city or town or other officer having similar duties or by the treasurer, if there is no such ?officer, to the assessors, who shall include the amount so reported in the determination of ?the next annual tax rate, unless the city, town or district has otherwise made provisions ?therefor. The amount of such payment made by a regional school district or regional refuse ?disposal district shall be included in the next annual district operation and maintenance ?budget, unless the regional district committee has otherwise made provisions therefor. The ?director of accounts may promulgate guidelines, rules and regulations to govern such ?rebates and any such rebates made under authority of this section shall be subject to any ?such guidelines, rules and regulations of said director.?

When does an arbitrage concern typically arise?

While there are many possibilities, the most common case that raises arbitrage concerns arises when a portion of the proceeds of the tax-exempt obligation remain unspent after 3 years. Unexpected project delays can arise for any number of reasons including: permitting problems; supply chain issues; failure of a contractor or subcontractor to perform; delays in obtaining needed property, rights or way, or easements; and litigation.

How do I invest in yield restricted investments?

The Arbitrage Regs require a borrower to invest at fair market value. In some case, open market securities may be available at compliant yields. If open market securities are not available or if it is simply more convenient, the Bureau of Public Debt of the United States Treasury provides for the purchase of United States Treasury Obligations – State and Local Government Series (“SLGS”) as a way to invest yield restricted proceeds. SLGS are easy to purchase and Bond Counsel can assist with their purchase.

I cannot possibly figure all of this out myself. Where do I get help?

The arbitrage rules are voluminous and complex federal tax rules and require special expertise. Bond Counsel has that expertise and so the first step is typically to contact Bond Counsel. If a calculation of rebate, Yield Reduction Payments, or yield restriction compliance is required, there are a number of providers available to assist with those calculations.

Does the IRS audit arbitrage matters?

Yes.

Disclaimer.

This is a brief summary of complex federal income tax rules. Please consult with Bond Counsel to discuss any arbitrage concerns.

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