Arbitrage and Rebate
The Basics

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General Concept

What is Arbitrage? Difference between taxable and tax-exempt interest and rates

Purpose of the arbitrage rules – what purposes do the rules serve to accomplish?

Arbitrage Overview

Three broad sets of rules:

Yield Restriction – answers the question "can an issuer earn arbitrage at all?" In other words, are there circumstances under which the tax law even allows an issuer to invest gross proceeds (or components of gross proceeds) at a yield above the bond yield?

Rebate – answers the question "in the event that an issuer is permitted to earn arbitrage in the first place, can the issuer keep that arbitrage amount?"

Structuring issues – answers the question "can you do it?" Certain threshold rules to avoid arbitrage bond status

Arbitrage Overview (cont.)

Analytical question 1 – what amounts are subject to the arbitrage rules?

- "Gross proceeds"
- Gross proceeds consists of:
  - Sale proceeds
  - Investment proceeds
  - Transferred proceeds
  - "Replacement proceeds" – "nexus" between the bond issue and the amount – sinking funds, pledged funds, "negative pledges"
  - Disposition proceeds

Bond Yield and Issue Price

The "bond yield" is a *compounded interest rate* that makes debt service on the issue equal to the *issue price* on a present value basis as of the issue date

Ex. If an issue is issued on 04/21/2023 and has an issue price of $10mm and a fixed interest rate, create a debt service schedule and solve for a constant, compounded rate of interest that results in a PV of all of the debt service payments on 04/21/2023 of $10mm.

Bond Yield and Issue Price (cont.)

The issue price is a tax measurement for the dollar value the issuer received from the sale of the bonds

- Ex. – Issuer sells bonds in a private placement transaction for $10mm. The issuer pays costs of issuance of $200,000. The issue price is $10mm.
- Establishing issue price – the Treasury Regulations contain detailed rules on how issue price is established. For bonds sold in exchange for money, there are three rules: General rule (first price at which 10% of a maturity of a bond is sold to the public), hold-the-offering-price rule (underwriters agree to "hold" at a certain price for no less than 5 business days after the sale), and a special "3-bid" rule for qualifying competitive sale.

Bond Yield and Issue Price (cont.)

Computation mechanics

- Fixed vs. variable rate deals
- Original issue discount and premium; redemption assumptions
- Qualified guarantees (e.g., bond insurance)
- Qualified hedges – integrated hedges and super-integrated hedges

Yield Restriction

- General rule – no investing gross proceeds at a yield "materially higher" than the bond yield
- Definition of materially higher
- Temporary periods and exceptions
  - Project Funds, Reasonably Required Reserve Funds, Minor Portion, Bona Fide Debt Service Funds
- Yield reduction payments (check the Treas. Reg. – <u>not</u> always available)

Rebate

General rule – if you can earn it, have to pay it over to the IRS

Exceptions from rebate requirement

Spending exceptions – 6 month, 18 month, and 2 year (for governmental and 501(c)(3) issues)	Small issuer exception ($5mm in the calendar year; increases to up to $15 mm for public school construction issues)

Rebate Mechanics

- Future value method
- Computation dates
- Procedure for payment

  (Form 8038-T; timing)
- Failure to make timely payment (penalties, interest; potential for taxability of bond interest)

Role of the Tax Certificate

Expectations regarding yield restriction and rebate

Oftentimes includes expectations as to other issues (private activity, 149, etc…)

For the “issue”

Multipurpose issues

Accounting for Expenditures

- Amounts remain subject to the arbitrage rules until they are spent, no longer held in a way that creates replacement proceeds, or allocated to another issue under the universal cap or as transferred proceeds

- The accounting rules answer the question of "when is an amount considered spent?"
  - Capital expenditures
  - Reimbursements
  - Working capital
  - Final Allocations

Hedge Bonds

Purpose of the rule is to ensure that tax-exempt bonds are issued close to when the issuer needs the money for a bona fide governmental purpose

Three ways to comply:

1. Do not be a hedge bond – 85% of spendable proceeds expected to be spent in 3 years, no investing 50% or more of the proceeds at substantially guaranteed yield for four years or more
2. Be a "qualified" hedge bond (specific spenddown schedule expected over 5-year period following issue date)
3. Invest the bond proceeds in "non-AMT" tax-exempt bonds

Anti-Abuse Rules

Overburdening

Exploitation

Questions