ARBITRAGE
AN OVERVIEW FOR MUNICIPALITIES

The subject of arbitrage is one of the most important concepts in the municipal bond field. Unfortunately, it is also quite complex and exceedingly technical. For this reason, this article will attempt to provide the reader with an overview of this subject, emphasizing the practical effects that these concepts may have on the financing plans of a typical municipality. Please note that this article should not be read as a comprehensive treatise on this subject, nor as providing advice on specific financing plans. More detailed information is available in Section 148 of the Internal Revenue Code of 1986, as amended (the "Code") and its accompanying regulations.

BASIC CONCEPTS AND POLICY CONSIDERATIONS

Municipalities are "favored borrowers" in the sense that they are able to borrow money at interest rates that typically are substantially lower than those payable by commercial borrowers. These reduced rates are a direct result of the fact that purchasers of municipal bonds do not need to pay federal income taxes on the interest paid to them by municipal borrowers. (Interest paid by municipalities is often excluded from the imposition of state income taxes as well.) In order to be tax-exempt, bonds or notes issued by municipalities need to comply with the detailed requirements established in the Code, especially those found in Sections 103 and 141 – 150.

Section 103 of the Code indicates that an "arbitrage bond" under Section 148 will not be tax exempt. For this reason, in order for a municipality to be able to access the lower interest rates available for tax-exempt borrowings, it needs to show that its bonds will not be "arbitrage bonds."

From a policy perspective, the arbitrage rules found in the Code can largely be understood as an effort by the Internal Revenue Service to keep municipalities from borrowing money at low tax-exempt rates and then turning around and investing the proceeds of their bonds or notes at a yield that is "materially higher" than the interest rate they are paying on their bonds. (The amount by which investment earnings exceed such interest payments is often referred to as "positive arbitrage.")

THE BASIC RULE

The basic arbitrage rule is that a municipality may not invest the proceeds of a tax exempt note or bond in such a manner so that the yield on the invested funds exceeds the interest rate being paid on its borrowing by more than .125%. If this rule is violated and the municipality does not qualify for an exception to this rule (noted below), its borrowing will be an "arbitrage bond" and consequently will not be tax-exempt under Section 103 of the Code. As such, the issuer will not be able to take advantage of the below-market interest rates that are typically available to municipal borrowers.

THE "SPENDING EXCEPTION" TO THE BASIC RULE

As is often the case under the Code, there is an exception to the Basic Rule for which many municipal borrowings qualify. The policy behind this "spending exception" is that if a municipality expects to spend its bond proceeds in a reasonably short period of time, its ability to earn a significant amount of positive arbitrage will be limited to such an extent that the IRS will not be concerned.

To qualify for the spending exception, a municipality must be able to certify that, at the time of closing, it reasonably expects:

(1) to spend at least 85% of the proceeds of the bonds (with some adjustments) within three years of the date of issuance;

(2) to incur a "substantially binding commitment" to spend at least 5% of the bonds within six months of the date of issuance; and

(3) to continue to complete the project being financed with the bonds with due diligence.

DETERMINATION OF ARBITRAGE STATUS TO BE MADE AT TIME OF CLOSING

Since bond counsel must render an opinion regarding the tax-exempt status of the bonds at the time that the bonds are being purchased, the determination of whether or not the obligation in question is an "arbitrage bond" needs to be made at the time of closing. In order for bond counsel to render such an opinion, the governing board of the municipality will be asked to sign a certificate at the closing of the bonds setting forth its expectations regarding the use of the bond proceeds. The certificate will specifically focus on whether the bond proceeds will be spent in such a way so as to qualify for the "spending exception" described above.

So long as the expectations of the municipality were reasonable when made, the occurrence of subsequent events that could not have been anticipated at the time of closing will not make the bonds taxable. (For example, if the reason that a building project was not completed within the anticipated three years was due to an unforeseen labor strike, the bonds will not become taxable arbitrage bonds because the project is not completed within three years.) It needs to be noted, however, that certain intentional acts that are designed to impermissibly take advantage of the arbitrage rules may have adverse tax consequences.

OPTIONS AVAILABLE TO MUNICIPALITIES THAT DO NOT QUALIFY FOR THE SPENDING EXCEPTION

Several options are available to communities that do not appear to qualify for the three-year spending exception. First of all, for large projects that are not capable of being completed within the three-year period, this time frame may be extended for up to five years if the issuer can produce a certificate from an architect or engineer that the project will take this additional amount of time to complete. Second, in some cases it may be possible to split up a large bond issue into two distinct components, where the bond proceeds in each separate phase of the project will be expended with the requisite three-year period. (This segregation must be one of substance and not just form. For example, it would likely not be permissible to separate an issue into two series of bonds that were sold within days of each other.) Third, it may be possible to avoid the earning of positive arbitrage by agreeing not to invest the proceeds of the bonds so that the yield on the invested proceeds would exceed the yield on the bonds (a practice known as "yield restricting"). Finally, the arbitrage rules may be ignored completely, in which event the bonds would be issued on a taxable basis, a result that would have the practical effect of increasing the interest rate payable by the municipality.

COMMON ARBITRAGE PITFALLS

Certain recurring situations can raise arbitrage concerns, such as issuing bonds when the plans for the project being financed have not been sufficiently finalized, issuing bonds too early, issuing bonds in an amount in excess of the sum reasonably needed for the project, and issuing bonds that have maturities that may be significantly in excess of the useful lives of the assets being financed. Therefore, communities should try to avoid such situations.

REBATE REQUIREMENTS

Assuming that the bonds being issued are not arbitrage bonds because they qualify for the spending exception, the issue of whether or not the issuer can keep for its own account any potential positive arbitrage is determined under the Code's "rebate" requirements. This is a complex subject that is beyond the scope of this article. In fact, it would be worthy of its own separate article.

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