CHAPTER 1

Introduction to Arbitrage

Interest on a municipal bond—that is, a bond issued by a city or state or any other qualifying governmental entity—is exempt if the issuer complies with the requirements of the Internal Revenue Code. No rule of federal tax law has a clearer practical consequence. From the viewpoint of the governmental issuer, a bond issue is just a way to borrow money from the bondholders. Each bond is a promise to pay back the principal amount of the bond with interest at the bond rate. Since the interest on the bonds is tax-exempt, investors will accept lower rates of interest than those offered on conventional taxable bonds. The result is a bottom-line savings to the municipality, often as much as one or two percentage points of interest cost.

The Internal Revenue Code provides that interest on bonds is not exempt from tax if the bonds are arbitrage bonds. The definition of *arbitrage bonds* is complex—it is what this book is about—but it has a simple purpose: to prevent municipalities from issuing bonds to earn arbitrage.

A. Arbitrage Summary

What is arbitrage? At the most basic level, arbitrage is profit from buying something in one market and selling it in another. In the present context, the two markets are the market for tax-exempt bonds issued by a municipality and the market for taxable bonds issued by a corporation or by the federal government. Interest rates are higher in the taxable market to compensate the investor for having to pay taxes on the interest. In the world of municipal bonds, arbitrage is a municipality's profit from borrowing funds in the tax-exempt market and investing them in the taxable market.

The arbitrage rules have two main branches:

1. Bonds are arbitrage bonds if the issuer expects to invest the proceeds at a *yield,* or technically computed interest rate, that is materially higher than the bond yield. Exceptions permit unrestricted in-

vestment during a *temporary period,* generally three years for capital projects, or in a *reasonably required reserve fund,* generally limited to 10 percent of the proceeds.

2. Any arbitrage that the issuer in fact earns, for example during a temporary period or in a reasonably required reserve fund, must be *rebated* to the federal government, unless one of several specific exceptions to the rebate requirement applies to the issue.

Any issue of tax-exempt bonds may be subject to yield restriction, rebate, or both.

Yield Restriction Summary

In an attempt to put the overlap of rules and exceptions in some sort of order, one can begin by restating the exceptions to the general rule prohibiting investment of bond proceeds at a yield materially above the bond yield:

1. Unrestricted investments are permitted for "reasonably expected" to be spent on capital projects within a temporary period of three years. Thus, if an issuer issues bonds to finance a new city hall with a three-year construction period, the issuer can draw on the proceeds as needed from time to time during the three-year period to pay construction costs and can invest the undisbursed balance at unrestricted yield under the temporary period rule.
2. Unrestricted investments are also permitted for proceeds held in a reasonably required reserve fund. This type of fund is defined generally as a fund in which the issuer sets aside up to 10 percent of the proceeds of an issue to have a reserve source for payment of principal or interest on the issue in the event that the stated source of principal and interests falls short at some future date.
3. Additionally, a de minimis exception allows an issuer to invest a "minor portion" of its proceeds of a bond issue. A minor portion is defined generally as the lesser of $100,000 or 5 percent of proceeds.

These exceptions from yield restriction allow issuers in many common financings the convenience of investing their proceeds in conventional securities purchased in ordinary market transactions, without having to worry about the yield on the investment. However, as discussed below, earnings above bond yield during these "temporary periods" may still have to be rebated to the federal government.

Proceeds that do not qualify for an exception from yield restriction may not be invested at a yield materially higher than the yield on the bonds. These proceeds are generally referred to as *yield restricted,* and the investments made with them are generally referred to as *yield restricted investments.* The specific yield restriction will come directly from the definition of *materially higher,* which the tax laws define differently in different contexts.

For example, proceeds remaining on hand after the expiration of the three-year temporary period may not be invested at a yield more than .125 percent (one-eighth of one percentage point) above the bond yield. Except in certain limited circumstances, the tax laws allow an issuer to comply with this restriction by purchasing conventional securities at market rates of interest and paying the excess yield to the federal government in the form of "yield reduction payments." Yield reduction payments are similar to rebate payments and represent one of many different points of interaction between yield restriction and rebate.

Another instance in which proceeds are subject to yield restriction is an "advance refunding." A "refunding issue" provides funds for the issuer to use to pay off a prior issue. A refunding is an advance refunding if the issuance of the refunding issue occurs more than ninety days before the date on which the prior issue is paid off. The arbitrage rules prohibit the investment of the proceeds of an advance refunding issue at a yield more than .001 percent (one-thousandth of a percentage point) higher than the yield on the refunding issue, pending application to pay off the prior issue.

An issuer generally must comply with the .001 percent restriction by investing in Treasury securities of the *State and Local Government Series,* known as SLGs. The Treasury offers these securities to municipalities at below-market yields for the specific purpose of compliance with yield restrictions. Yield reduction payments might be more convenient than SLGs, but they are generally not allowed for advance refundings.

Yield Restriction in Perspective

Being exempt from yield restriction is not the same thing as being exempt from rebate. For example, qualifying for the three-year temporary period means that an issuer can select investments without regard to whether their yield exceeds the bond yield plus .125 percent. But any arbitrage—that is, any profit from the spread between the yield on the investments and the yield on the issue—will have to be rebated to the federal government under the rebate branch of the arbitrage rules, unless one of the rebate exceptions applies.

The yield restriction exceptions have been part of the arbitrage rules since they were first enacted in 1969. These exceptions, applying principally to investments for a limited period pending expenditures on projects or to investments in limited amounts in a reserve fund, resulted from Congress's attempt to strike a balance in policies. On the one hand, municipalities have an interest in being able to finance needed projects without undue interference by the federal government. On the other hand, the federal government, as well as municipalities, has an interest in preventing the market for tax-exempt securities from being taken over by arbitrage-motivated issuers competing for investor funds and undermining the federal tax base.

As originally enacted in 1969, the policy balance allowed issuers both the convenience of unrestricted investments and the economic benefit of any arbitrage earned from the investments. The rebate requirement, enacted in