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Arbitrage

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What is Arbitrage?

The profit from buying something in one market and selling in another

Effects tax-exempt bonds/notes issued by municipal governments

- Taxable bonds pay higher rates to compensate for investor income taxes
- Arbitrage rules prevent issuance of tax-exempt arbitrage bonds

History of Arbitrage

Established to limit issuers from:

- Issuing bonds that were not intended for governmental purposes
- Issuing more than needed
- Issue earlier/later than needed

1969 – Governed yield restriction and temporary periods

1986 – Established arbitrage rebate

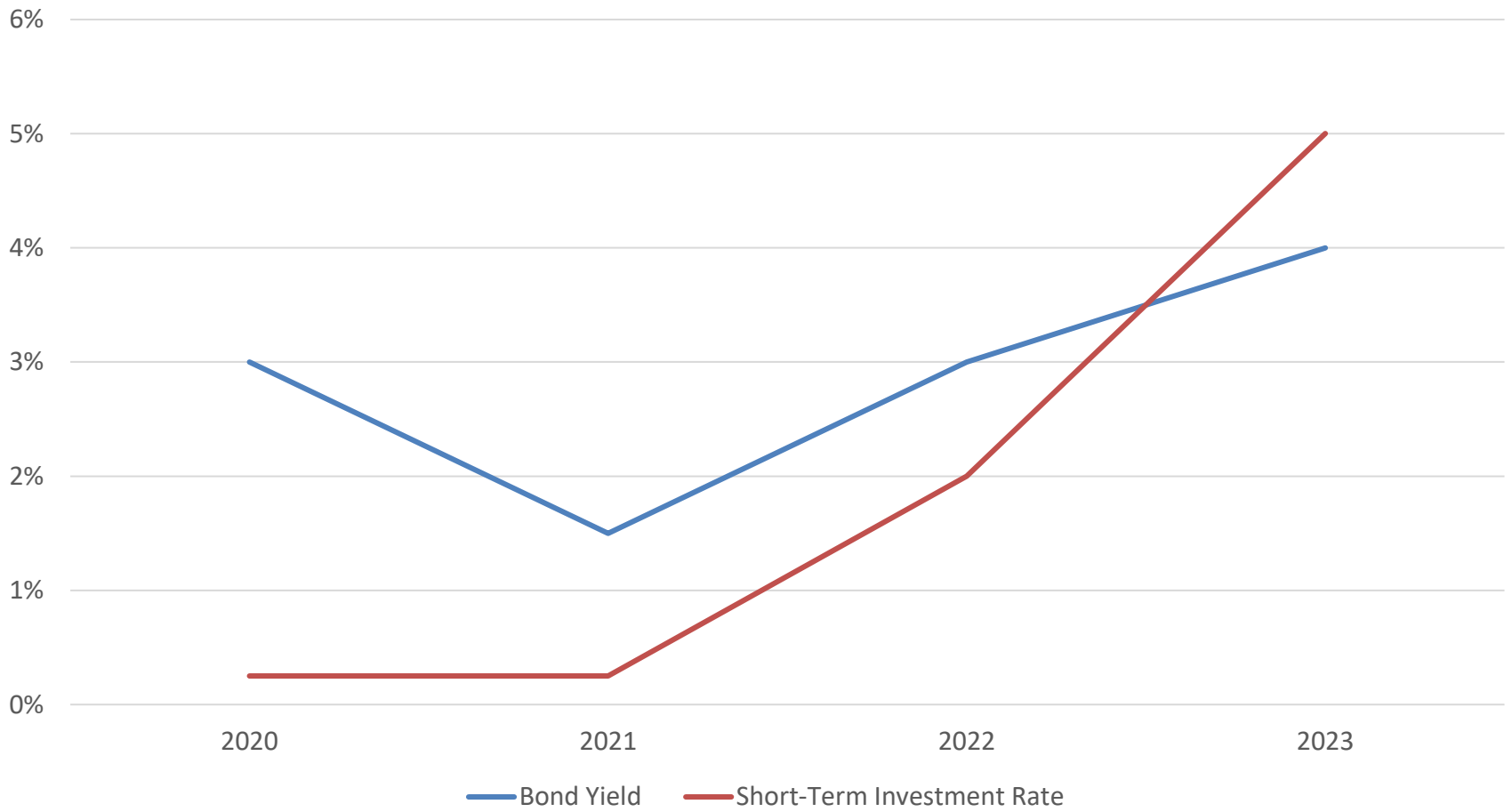
Arbitrage Bonds

The issuer expects to invest the proceeds at a yield that is materially higher than the bond yield

Any arbitrage that is earned must be rebated

Exceptions to arbitrage rules do not apply

Bond Yield Vs. Short-Term Investment Rate



Investment in Tax-Exempt Securities

Investments in tax-exempt securities are not subject to the arbitrage rules

- “SLGS”
- Even if there is a profit
- Tax-exempt securities subject to AMT are subject to the arbitrage rules

Two Sets of Rules

1. Yield Restriction

2. Rebate

- Similar payment process
- Similar calculation and reporting
- Different exceptions!

Yield Restriction

Exceptions:

- Unrestricted investments are permitted for capital projects within a temporary period of three years
- Unrestricted investments are also permitted for proceeds held in a required reserve fund
- De minimis exception allows issuers to invest a minor portion of lessor of \$100,000 or 5%

Yield Restriction

Yield restricted proceeds

- Cannot be invested at a rate *materially* higher than the bond yield
- *Materially* higher is defended by context
 - .125% after three-year temporary period

Excess is paid via yield reduction payments

Rebate

Any profit from investing bond proceeds at yield above the bond yield will belong to the federal government

Funds subject to rebate can be unrestricted to yield (exempt from yield restriction rules)

Rebate

Exceptions:

- Small issuer
- Proceeds are spent within a specified period under a construction issue

Small Issuer Rebate Exemption

May not issue more than \$5 million in the calendar year

\$15 million for school districts

- At least \$10 million used for school construction

Includes bonds issued by controlled entities

- PG: \$5M + CU: \$5M = \$10M

Current refunding bonds are excluded

- \$10M bonds - \$7M current refunding = \$3M towards limit

Construction Issue

At least 75% of the available construction proceeds will be used for construction expenditures

Construction expenditures:

- Excludes purchase of existing property and land

Expenditures must relate to property owned by a government unit or 501(c)(3)

Spending Exception

| | 6 Months | 12 Months | 18 Months | 24 Months |
|----------------|----------|-----------|-----------|-----------|
| Gross Proceeds | 100% | | | |
| New Money | 15% | 60% | 100% | |
| Construction | 10% | 45% | 75% | 100% |

For 18- and 24-month exceptions, disregard if remaining proceeds is lesser of 3% of the issue or \$250,000 and issuer exercised due diligence to complete the project.

Escrow/Defeasance Fund

Yield Restriction:

- Unrestricted for 90 days for current refunding
- *Materially* higher of .001% after

Rebate:

- Exempt if under small issuer threshold
- Exempt if refunded (spent) within 6 months

Reminder: Current regulations do not allow advance refunding of tax-exempt bonds

Key Debt Documents

Bond Indenture

8038-G

Arbitrage/Tax Certificate

Bond Indenture

Contract between the issuer and the trustee for the bondholders

Governs how proceeds will be used/held

Includes covenants

Not required and not as common in G.O. bonds

8038-G

Form **8038-G**

(Rev. October 2021)

Department of the Treasury
Internal Revenue Service

Information Return for Tax-Exempt Governmental Bonds

► Under Internal Revenue Code section 149(e)

► See separate instructions.

Caution: If the issue price is under \$100,000, use Form 8038-GC.

► Go to www.irs.gov/F8038G for instructions and the latest information.

OMB No. 1545-0047

Part I Reporting Authority

Check box if Amended Return ☐

| | | | |
|--|------------|--|--|
| 1 Issuer's name | | 2 Issuer's employer identification number (EIN) | |
| 3a Name of person (other than issuer) with whom the IRS may communicate about this return (see instructions) | | 3b Telephone number of other person shown on 3a | |
| 4 Number and street (or P.O. box if mail is not delivered to street address) | Room/suite | 5 Report number (For IRS Use Only) | |
| 6 City, town, or post office, state, and ZIP code | | 7 Date of issue | |
| 8 Name of issue | | 9 CUSIP number | |
| 10a Name and title of officer or other employee of the issuer whom the IRS may call for more information | | 10b Telephone number of officer or other employee shown on 10a | |

Part II Type of Issue (Enter the issue price.) See the instructions and attach schedule.

| | |
|--|----|
| 11 Education | 11 |
| 12 Health and hospital | 12 |
| 13 Transportation | 13 |
| 14 Public safety | 14 |
| 15 Environment (including sewage bonds) | 15 |
| 16 Housing | 16 |
| 17 Utilities | 17 |
| 18 Other. Describe ► | 18 |
| 19a If bonds are TANs or RANs, check only box 19a <input type="checkbox"/> | |
| b If bonds are BANs, check only box 19b <input type="checkbox"/> | |
| 20 If bonds are in the form of a lease or installment sale, check box <input type="checkbox"/> | |

Part III Description of Bonds. Complete for the entire issue for which this form is being filed.

| | (a) Final maturity date | (b) Issue price | (c) Stated redemption price at maturity | (d) Weighted average maturity | (e) Yield |
|----|-------------------------|-----------------|---|-------------------------------|-----------|
| 21 | | \$ | \$ | years | % |

Part IV Uses of Proceeds of Bond Issue (including underwriters' discount)

| | | |
|----|--|----|
| 22 | Proceeds used for accrued interest | 22 |
| 23 | Issue price of entire issue (enter amount from line 21, column (b)) | 23 |
| 24 | Proceeds used for bond issuance costs (including underwriters' discount) | 24 |
| 25 | Proceeds used for credit enhancement | 25 |
| 26 | Proceeds allocated to reasonably required reserve or replacement fund | 26 |
| 27 | Proceeds used to refund prior tax-exempt bonds. Complete Part V | 27 |
| 28 | Proceeds used to refund prior taxable bonds. Complete Part V | 28 |
| 29 | Total (add lines 24 through 28) | 29 |
| 30 | Nonrefunding proceeds of the issue (subtract line 29 from line 23 and enter amount here) | 30 |

Part V Description of Refunded Bonds. Complete this part only for refunding bonds.

| | | |
|----|--|-------|
| 31 | Enter the remaining weighted average maturity of the tax-exempt bonds to be refunded | years |
| 32 | Enter the remaining weighted average maturity of the taxable bonds to be refunded | years |
| 33 | Enter the last date on which the refunded tax-exempt bonds will be called (MM/DD/YYYY) | |
| 34 | Enter the date(s) the refunded bonds were issued ► (MM/DD/YYYY) | |

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 63773S

Form **8038-G** (Rev. 10-2021)

Arbitrage/Tax Certificate

Certifies the expectations of the use of the proceeds at the date of the issue

Includes:

- Use of proceeds
- Defines funds holding proceeds
- Spending exceptions
- Yield restrictions
- Rebate calculation and payment requirements

Bond Proceeds

Sale proceeds – Gross cash paid for the bonds at the initial sale

Investment proceeds – Amounts received from investing the proceeds of the issue

Transferred proceeds – If proceeds from a refunding issue are used to pay off a prior issue, any remaining proceeds become transferred proceeds

Replacement proceeds – Amounts that will be used to pay debt service, but would have been used for the capital project

Common Debt Funds

- *Project Fund* – Holds bond proceeds to be used to pay costs of constructing the project
 - Direct payment or transfers to an operating fund
- *Reserve Fund* – Holds bond proceeds to pay future debt service in case revenues are inadequate to pay debt service

Common Debt Funds

- *Debt Service Fund* – Receives transfers from other funds to pay debt service
- *Operating Fund* – Holds revenue from operations and makes deposits to other funds
 - Not subject to arbitrage unless proceeds are transferred where they will be held for the purpose of paying debt service

Sinking Funds

Includes the following:

- Debt Service Fund
- Redemption Fund
- Reserve Fund
- Replacement Fund
- Or any other fund used to pay debt service

Sinking Funds

Bona Fide Debt Service Fund

- Cannot hold funds for more than a 13-month period
- Generally, not subject to rebate and yield restriction

Reserve Fund

- Generally, 10% of issue
- Generally, not subject to yield restriction
- Subject to rebate

Computation

Sum of the future value of the activity of the applicable fund(s) at the bond yield rate

Less the investment balance of the applicable funds as of the computation date

Equals negative/positive arbitrage

Bond Yield

Fixed-Yield Bonds

- Calculated once at the date of issuance
- Included on the 8038-G

Variable-Yield Bonds

- Calculated for each computation period

Investment Yield Blending

Applicable to Yield Restriction

Two or more investments are treated as one investment within the same “class”

Separate classes include:

- Yield restricted investments
- Unrestricted yield investments
- Each investment subject to a “materially higher” threshold

Rebate allows blending of all funds

Reporting and Payment

Applicable for both Yield Restriction and Rebate:

- Computation of successive five-year periods
- \$1,000 per year credit is applied to the amount due
- If applicable, payment of 90% is due within 60 days, remaining due with final payment
- Failure can result in interest, penalty, and bonds being declared taxable

Record Keeping

Debt documents

- 8038-G
- Arbitrage/Tax Certificate
- Often included with closing documents

Documentation of expenditures of proceeds

Investment Statements

- Maintain all statements and have them readily available

Keep track of computation dates

Keep all records for life of bonds plus three years

Take Aways

Arbitrage is complex

Two sets of rules must be considered

Exceptions, exceptions, exceptions!

Keep adequate records

Investment rates are on the rise, now is the time to keep up with calculations

Don't go at it alone

Sources

- ABC's of Arbitrage, The Rules for Investment of Bond Proceeds By Municipalities, 2018 Edition
– Vicky Tsilas and Kimberly Betterton

Questions? Contact Me!



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