

OVERVIEW OF ARBITRAGE

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Lately, many of our clients have been asking questions about arbitrage and we thought that it would be beneficial to give a basic overview.

What is Arbitrage? Arbitrage is the difference between the interest paid on tax-exempt bonds and the interest earned by investing the proceeds of the tax-exempt bonds in higher-yielding taxable securities. Federal income tax laws restrict the ability to earn positive arbitrage in connection with tax-exempt bonds, except in certain limited circumstances.

Arbitrage Yield Generally, it is the overall rate being paid on the entire tax-exempt bond issue. Allowances are made to account for credit enhancement costs (such as letters of credit, bond insurance and surety bonds) which will increase the yield. Upon issuance, fixed rate tax-exempt bonds have a set arbitrage yield while for variable rate tax-exempt bonds the arbitrage yield is not set at issuance. For variable rate tax-exempt bonds, arbitrage yield is generally computed as a snapshot at the end of every five years.

Arbitrage Rebate If tax-exempt bonds proceeds have been invested and have earned greater than the arbitrage yield, a payment to the IRS may be required. The payment represents the amount, if any, of arbitrage earnings on tax-bond proceeds and certain other related funds, except for earnings that are not required to be rebated under limited exemptions provided under the Internal Revenue Code.

Exceptions Issuers may be relieved of the obligation to pay arbitrage rebate with respect to amounts earned on certain debt service funds (such as interest, principal and prepayment accounts). In addition, Issuers may be relieved of the obligation to pay arbitrage rebate with respect to amounts earned on certain construction funds if they fall under three exceptions: (a) Two Year Exception, (b) Six Month Exception or (c) Eighteen-Month Exception.

Compliance Issuers are responsible to maintain in compliance with the IRS regulations with respect to arbitrage. At a minimum, an arbitrage rebate calculation should be prepared every five years, but more frequent calculations may be advantageous to monitor the potential arbitrage liability, allowing Issuers to budget for such arbitrage liability.*

**Fieldman, Rolapp & Associates, or any of its affiliates, does not provide arbitrage rebate services. Because of the complexity of arbitrage rebate regulations and the penalty of non-compliance, Issuers should consult with their bond counsel or consultant that specializes in arbitrage rebate calculations. ◆*

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