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# Planning for Arbitrage

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# What is Arbitrage?

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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

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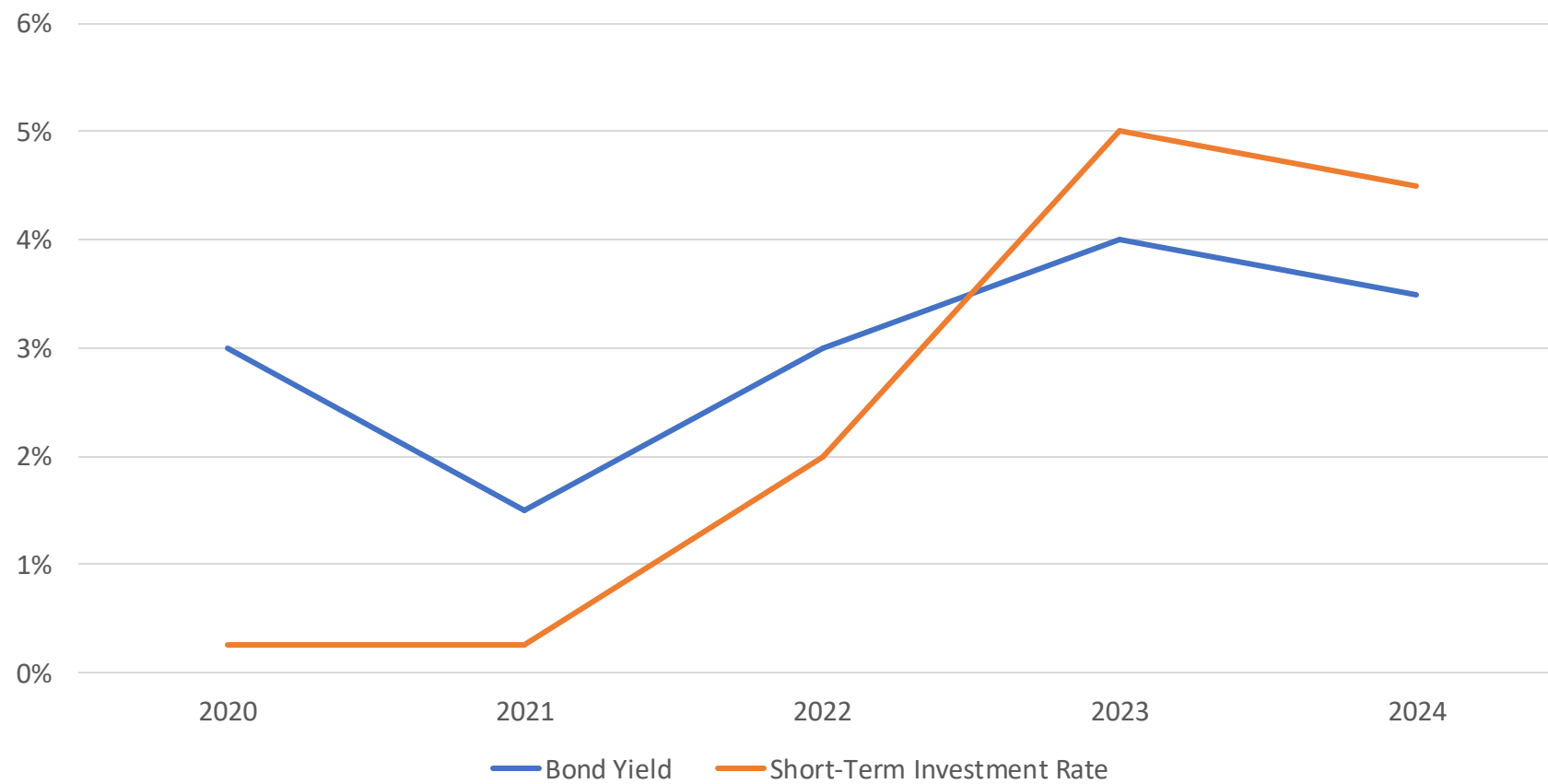
Established to limit issuers from:

- 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

# Bond Yield Vs. Short-Term Investment Rate



# Two Sets of Rules

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## 1. Yield Restriction

## 2. Rebate

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

# Yield Restriction

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## 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

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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

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## 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

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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
<b>Gross Proceeds</b>	<b>100%</b>			
<b>New Money</b>	<b>15%</b>	<b>60%</b>	<b>100%</b>	
<b>Construction</b>	<b>10%</b>	<b>45%</b>	<b>75%</b>	<b>100%</b>

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.

# Key Debt Documents

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Bond Indenture

8038-G

Arbitrage/Tax Certificate

# Arbitrage/Tax Certificate

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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

# Computation

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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

# Things to Consider...

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Did you issue bonds in during 2020-2022?

- Your bond yield may be lower than you thought

Was your bond financed project delayed?

- Supply constraints may put you beyond the expenditure exemption period

Are bond proceeds invested?

- Yield on money markets accounts could be significant

# Things to Consider...

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## Yield Restriction Example

- Issued in 2020 when rates were at an all time low
- Yield restriction has a 3 year “unrestricted period”
  - However, was during an all-time low interest rate period
- Restricted period started in 2023 when rates increased
  - No negative arbitrage to offset positive arbitrage

# Things to Consider...

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## Rebate Example

- Issued pre-pandemic, with a rate of 3%
- Projects were delayed due to the pandemic
- Investment rates increased end of 2022 significantly
- Negative arbitrage > positive arbitrage
  - For first 5-year computation period your likely in the clear
  - Second 5-year computation period, might not be!

# Is Arbitrage really a “bad” thing?

Not maximizing investment earnings is a missed opportunity

Spending excess (positive arbitrage ) earnings creates the problem

Monitoring and planning is key

# Is Arbitrage really a “bad” thing?

## Investment Example:

- \$5 million of unspent bond proceeds
- Bond yield is 4%
- Money market account yields 5%
- 5-year computation period

# Is Arbitrage really a “bad” thing?

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- ❑ 5-year \$5 million investment at 5% investment yield
  - Creates approximately \$1.4 million in investment income
- ❑ 5-year \$5 million investment at 4% bond yield
  - Is approximately \$1.1 million
- ❑ Arbitrage liability of \$300K

# Is Arbitrage really a “bad” thing?

## Investment example:

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# Is Arbitrage really a “bad” thing?

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- ❑ 5-year \$5 million investment at 4% investment yield
  - Creates approximately \$1.1 million in investment income
- ❑ 5-year \$5 million investment at 5% bond yield
  - Is approximately \$1.4 million
- ❑ \$300K of investment earnings that could have been earned and used

# Arbitrage Planning

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- ❑ Understand your yield and where you have proceeds invested
- ❑ Forecast your spending schedule and what impact delays caused
- ❑ Maximize investment returns
- ❑ Plan for repayment of arbitrage and not “spending” it

# Record Keeping

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## 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

# Common Issues

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- ❑ Information from several years ago is not readily available
- ❑ Expenses are capital in nature and are not getting the same “attention” as operating
- ❑ Account balance is viewed as available for spending
- ❑ Arbitrage escrows are not considered
- ❑ Eye-balling the calculation is not that easy unless the investment rate never exceeded the bond yield
  - Consider missed opportunity of investment earnings

# Take Aways

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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

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- 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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