



Issue Brief: **ARBITRAGE REBATE**

Updated January 2008

Background

Arbitrage refers to the interest income (or profit) issuers of tax-exempt bonds may be able to earn by investing bond proceeds obtained from the sale of tax-exempt bonds in higher-yielding taxable securities. The purpose of the federal arbitrage rules is to prohibit the excessive and premature issuance of tax-exempt bonds so that governments will not benefit from the investment of bond proceeds in income-producing securities. There are two sets of overlapping arbitrage restrictions. Yield-restriction rules impose limitations on the interest that can be earned on invested bond proceeds and arbitrage rebate requires issuers to pay the profit from investing bond proceeds to the U.S. Treasury.

The federal arbitrage restrictions are among the most complex aspects of the U.S. tax code and the arbitrage rebate requirement is perhaps the most costly provision of the 1986 Tax Reform Act for state and local governments. To comply with various arbitrage rebate rules, issuers are required to perform numerous tests and calculations for each of their outstanding bond issues that divert staff resources from important governmental activities. Furthermore, these governments must undertake significant ongoing expenditures for legal advice, investment advice, computer and accounting support, records storage, and general management oversight. A survey released in 1999 by GFOA and NACo found that average staff time spent complying with the arbitrage rebate mandate was 303 hours, but the highest was 3,360, equivalent to 1.5 full-time positions. Average annual costs were \$33,305 and the highest was \$490,000. In fact, 70 percent of the bonds from jurisdictions having the highest compliance costs & spending the most staff time had no rebate due.

State and local governments need greater freedom from onerous compliance burdens and flexibility in financing facilities now that federal financial assistance has been substantially reduced and state and local governments have to shoulder more financing responsibilities.

Recommendations

The Government Finance Officers Association (GFOA) supports the simplification of arbitrage rebate requirements in the federal income tax code through the creation of a new arbitrage rebate safe harbor. GFOA and the National Association of Counties (NACo) developed a safe-harbor proposal endorsed by 18 other state and local government organizations that is intended to simplify compliance for municipal bond issuers by redefining the mechanics for determining the presence or absence of the need to make a rebate payment prior to the sale of a municipal tax-exempt bond.

The GFOA-NACo arbitrage rebate safe-harbor proposal provides that an issuer of municipal tax-exempt bonds (or a borrower from a pool) would not be deemed to have earned arbitrage subject to the rebate requirement if all of the following conditions are met:

the issue is a new money issue; the issuer reasonably expects to spend 15 percent of the bond proceeds within one year of the date of the bond issue and at least 95 percent within three years of the date of issue; the bonds are governmental bonds or are private activity bonds for governmentally owned facilities that are exempt from the state volume cap; the bonds are fixed-rate; the bonds are long-term (i.e., the average weighted maturity is greater than five years); and if a bond-financed reserve fund for the issue exists, it will be yield-restricted.

Outlook for 2008

In Fall of 2007 Treasury proposed changes to arbitrage rebate rules. While GFOA supports most of the proposed regulations, we have expressed our opposition to the provision which does not allow issuers to receive an interest payment from the IRS on arbitrage rebate overpayments. GFOA's comment letter suggested that the IRS reconsider this position. Additionally, our comment letter favorably acknowledged other provisions including: allowing for electronic GIC bidding, allowing issuers to make yield reduction payments with respect to advance refunding escrow investments when the SLGS window is closed, and clarifying the rules that apply to interest rate swaps and hedges. Additional changes to arbitrage rebate regulations are expected to be proposed throughout 2008, although no legislative proposals to structurally change the tax code with regard to arbitrage rules are anticipated.

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