PMA™ SECURITIES

Arbitrage Strategies for the Issuance of Bonds

Introduction

When a municipal entity sells tax-exempt bonds or other types of debt obligations, the issuer must comply with IRS regulations guiding how bond proceeds are used. This provision of tax law offering a tax-exemption is designed to encourage investment in public projects and lower the cost of the financing for governmental entities. Since investors do not pay federal taxes on interest earnings, this exemption comes at a cost to the federal government; therefore, the IRS has developed rules on when and how the tax-exemption can be used.

These rules include limitations on how much interest an issuer can earn on tax-exempt bond proceeds. Generally speaking, the IRS does not want an issuer to earn a higher rate of interest on the bond proceeds than the rate it is paying on the bonds. A bond issued for the purpose of earning a higher rate than it is paying in interest is called an "Arbitrage Bond." Arbitrage bonds are not allowed to be tax-exempt because they incentivize issuers to borrow larger amounts and more frequently, burdening the US Treasury with higher costs in the form of a larger tax-exempt subsidy. The rules limit the amount of interest that an issuer can earn on bond funds and require an issuer to rebate any excess earnings back to the IRS.

While I know you are excited to read about the rebate calculations, the purpose of this article is not to review in detail the method of calculating the amount of interest earnings allowable on bond funds but rather aims to outline some broad strategies that can be built into a finance plan. Understanding IRS Arbitrage/Rebate rules will allow issuers to maximize the amount of interest earnings that can be kept to enhance the project fund.

In 2023, we have experienced a new market environment where short term investment rates are higher than long term borrowing rates. In this market it is very likely that an issuer of tax-exempt debt will be able to invest bond funds at a rate higher than the rate being paid on the debt. The IRS Arbitrage/Rebate rules need to be considered not only when investing bond funds but also prior to the bond sale in building the financing plan. In working with our clients, here are a few strategies that the PMA public finance team have incorporated:

Small Issuer Exception

The IRS provides an exception to rebating the excess earnings to the IRS for issuers of less than $5 million of tax-exempt debt in a calendar year. This $5 million limit is increased to $15 million for public school construction issues.

PMA used this exception to the benefit of school district clients. An example is a district that passed a bond referendum in 2022 for $22 million. Instead of issuing all $22 million at one time, PMA advised the issuer to split the issue in two bond sales with the first $10 million being sold in calendar year 2022 and the remaining $12 million sold in calendar year 2023. This allows both issues to qualify for the small issuer exception meaning that the school district will be able to keep excess earnings on the bond fund through the construction period. We are estimating that this will add about $750,000 to the project that would have otherwise been sent back to the IRS via a rebate payment.

Timing of Bond Sale with Construction Drawdown Schedule

The regulations provide an additional exception for issuers that spend bond construction proceeds within a set amount of time. If the issuer meets the following spend down schedules, it can avoid rebating arbitrage earnings back to the IRS:

6 month exception

- 100% of gross proceeds spent within 6 months

18 month exception

- At least 15% of gross proceeds spent within 6 months
- At least 60% of gross proceeds spent within 12 months; and
- 100% of gross proceeds spent within 18 months

24 month exception

- At least 10% of construction proceeds spent within 6 months
- At least 45% of construction proceeds spent with 1 year
- At least 75% of construction proceeds spent within 18 months; and
- 100% of construction proceed spent within 2 years

We typically talk about bond sale timing only in the context of interest rate markets but these spending exceptions should be a part of the conversation on bond sale timing. Prior to selling bonds, an issuer should work with construction consultants/architects to develop a projected draw schedule

for the bond proceeds. PMA has advised clients to consider matching the construction draw schedule and bond sale timing to provide the best opportunity for an issuer to maximize the investment earnings that can be used for project expenses. This could include strategies to meet the spending exceptions and requires a thorough analysis prior to the development of the final finance plan.

Consider the Use of Taxable Bonds

If the project construction plan and finance plan do not allow an issuer to meet one of these exceptions, an issuer could consider issuing taxable bonds instead of tax-exempt bonds for a portion of the project financing. This allows an issuer to retain all interest earnings on the taxable portion of the issuance without consideration of the arbitrage rules.

Recently, we split a $50 million borrowing into a $35 million tax-exempt bond issue and a $15 million taxable bond issue in which the respective sizes were determined by the spend down of the project. When structuring these two issues together, always consider strategies that will pay down the principal and interest on your highest cost debt (taxable) first. Conversely, when putting together your investment portfolio, evaluate the opportunity to lock up the taxable proceeds for as long as possible and spend down the tax-exempt proceeds first.

Other Key Considerations

In considering the timing of a bond sale, issuers should reasonably expect to spend at least 85% of the bond proceeds within three years from the date of the bonds. This may cause an issuer to split a financing into multiple years if the project is expected to last longer than three years. In some cases, this can be extended to five years based on an analysis from an architect or engineer explaining why the project will extend beyond three years. This analysis must be performed prior to the sale of the bonds.

The regulations surrounding arbitrage/rebate include many other nuances not described here. It is important that issuers consult with legal counsel and tax professionals in developing a plan.

The PMA public finance team is ready and excited to help facilitate those discussions and build the best finance plan for your project.

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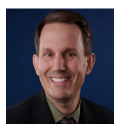

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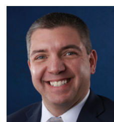

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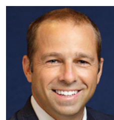

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