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Tax-Exempt Bond Issuers: Investment Compliance Risks in a Rising Interest Rate Environment

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The Federal Reserve has recently raised the federal funds rate several times, to an overall effective rate of 3.75-4.00%. These rate increases have impacted everything from borrowing costs to housing demand. The Fed's current monetary policy also has caused interest rates on savings accounts and similar investment vehicles to rise. As of October 2022, many money market funds are advertising rates of return well above 2%, with other short-term fixed investments seeing similarly improved returns.

This GT Alert is a reminder about the tax rules regarding arbitrage (i.e., investment earnings in excess of the yield on the related bonds) and rebate (i.e., the requirement to pay excess earnings to the Treasury Department in connection with the investment of gross proceeds of tax-advantaged debt). Generally, any gross proceeds subject to the rules restricting arbitrage must be invested at or below the yield on the subject bonds unless a specified "temporary period" is currently applicable to such proceeds. Where arbitrage may be earned, it must be rebated to the Treasury unless an exception to rebate can be applied.

For several years most issuers and borrowers have been trying to avoid "negative arbitrage" and not worrying about positive arbitrage. While it is important to monitor investments involving tax-exempt bonds, a period of sustained rising interest rates merits increased diligence. If the rate of return on any issuer or borrower investments is above the yield on the related tax-exempt bond issue, a review of the applicable bond documents is in order to determine if those proceeds are permitted to be invested at that higher rate and/or whether such proceeds are subject to rebate liability. Additionally, when investing using an investment agreement in Treasuries (including State and Local Government Series) or other vehicles, the applicable regulations impose certain rules concerning the valuation of these investments, including a number of safe harbors, which have an impact on determining the yield on those investments for arbitrage and rebate purposes.

In summary, now is the time to review, reconsider and ask some questions concerning how the proceeds of, and amounts securing, your tax-advantaged bonds are invested.

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