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Abusive Arbitrage Devices – It’s Time to Get Reacquainted (Episode 3 – What Happens to the Arbitrage Sinners and the Arbitrage Saints?)

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Episode 3 – What Happens to the Arbitrage Sinners and the Arbitrage Saints?

As you may remember, in Episode 1 we discussed some background regarding the prohibition against abusive arbitrage devices and the policy behind that prohibition – to encourage investment of tax-exempt bond proceeds in long-lived, tangible assets, while discouraging the generation of arbitrage on the investment of such proceeds. In Episode 2 we discussed the three factors the federal government examines to determine whether an issuer has overburdened the tax-exempt bond market, which results in an abusive arbitrage device if the issuer has also successfully exploited the difference between taxable and tax-exempt interest rates. In this episode, we will describe the penalties imposed upon rule-breakers and the rewards offered to rule-followers.

What happens if you have an abusive arbitrage device? The tax-exempt bonds become taxable arbitrage bonds.   Thus, issuers of tax-exempt bonds will want to be mindful of the rules (i.e., the guardrails) set by the federal government to avoid an abusive arbitrage device. A more fun way to think about it is that, given the serious consequences of straying off of the envisioned path, issuers will want to drive the old-fashioned cars at the amusement park that keep you on track, rather than the Dodgems.

What happens if you follow the arbitrage rules? The tax-exempt bonds will remain tax-exempt (assuming, of course, that all non-arbitrage rules governing tax-exempt bonds are followed). As a bonus, the issuer may also qualify for an exception to rebate and be able to retain its positive arbitrage. For a detailed description of the various spending exceptions to rebate, please tune in to our spin-off rebate miniseries which will be coming soon to the Public Finance Tax Blog.

What is the moral of the arbitrage story for issuers? Know the basic rules. Invest and spend your tax-exempt bond proceeds wisely and efficiently while adhering to the rules, and you may end up with both tax-exempt bonds and arbitrage that you can keep.

The end.

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