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Ice Miller - IRS Clarifies Arbitrage Rules: What Issuers and Borrowers Should Know

In March 2026, the Internal Revenue Service (IRS) released proposed guidance aimed at clearing up lingering questions around arbitrage rules and the treatment of certain bond proceeds. While technical in nature, the takeaway for bond issuers and conduit borrowers is straightforward: this guidance is intended to provide clarity and reduce unintended compliance risk—not introduce new hurdles.

Of significant note, the proposed guidance makes clear that in order to accomplish a “reallocation” of an expenditure from one source (bond proceeds) to another source (taxable proceeds or equity), the source to which the expenditure is being allocated must be held or present on the date of the expenditure. This means, to reallocate bond proceeds away from a “bad cost,” an issuer or borrower must have at least an equal portion of other funds on the date the expenditure is made; there must be money in the right and left pocket.

Also, many issuers rely on State and Local Government Series (SLGS) securities as a safe, compliant way to temporarily invest bond proceeds and avoid arbitrage concerns. The IRS’s proposed rules formally clarify that when SLGS demand deposit securities roll into short term (90 day) Treasury certificates, those certificates are still treated as tax exempt bonds for arbitrage purposes.

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