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[What's in Treasury's Newly Released Final Arbitrage Rules.]

WASHINGTON – The Treasury Department and the Internal Revenue Service released final arbitrage rules on Friday that address issues relating to advance refundings, long-term working capital financings, hedges, investments, and grants among other things.

The 78-page package of rules, which consolidate and finalize arbitrage proposals made in 2013 and 2007, are expected to be published in the Federal Register on Monday and to take effect around Oct. 17.

They are designed to address certain market developments, simplify provisions, address certain technical issues and make existing rules more administrable, the agencies said.

“This basically cleans up the outstanding proposals in the arbitrage area from 2007 and 2013,” said John Cross, the Treasury Department’s associate tax legislative counsel.

The only arbitrage rules left outstanding are those on issue price, which proved to be so controversial when they were first proposed in 2013, they were separated out into their own regulatory package. Those rules were re-proposed in June 2015 and are awaiting further action.

Bond lawyers generally praised many of these final arbitrage rules, but this was not a surprise since most of the proposals were favorably received years ago.

“Overall they’re favorable to the bond community,” Matthias Edrich with Kutak Rock in Denver said about these final arbitrage rules. “It will take some time for everyone to put these rules into practice to see how well they work.”

Chas Cardell, a lawyer at Orrick Herrington & Sutcliffe in San Francisco said the overall package “is extensive in that it deals with a large number of issues that have been percolating for some time.”

“In general, they did a great job of listening to the industry’s concerns and coming up with rules to solve those concerns,” he said. “There are a few instances in which their solution is not the one I would have chosen and in which there seems to be some clunky-ness in the operation of the new rule, but I do not as yet see anything that I think is unfair or misses the mark. In fact, they really did a nice job on these overall in finding a compromise between the industry requests and their compliance concerns.”

“It’s a great coup for the IRS to consolidate these” because of the lengthy six year period between the proposals, said Vicky Tsilas, who had Cross’ position at Treasury before returning to Ballard Spahr early last year. “There are some great nuggets in there.”

Bond lawyers were particularly happy that the rules allow issuers to make yield reduction payments for advance refundings. This will help issuers avoid arbitrage problems when the Treasury Department is forced to stop selling state and local government series securities (SLGS) because the federal government has reached its debt ceiling – something that has happened 11 times since 1995, including four times in the last three years.

SLGS are specially tailored securities that issuers can purchase for advance refunding escrows to ensure their investment yields stay below their bond yields and arbitrage is not generated. When the SLGS window is closed, issuers must buy Treasury securities in the open market and that increases the risk their investment yields will exceed their bond yields. The rules allow issuers to simply make payments to the government to reduce their investment yields when they need to.

The rules also provide a new safe harbor for long-term working capital financings, when bonds are issued to finance operating or other non-construction costs. Currently there are no statutory prohibitions against long-term working capital financings. But if the issuer can't demonstrate long-term financial stress, the IRS can go after the issuer for having more bonds outstanding than necessary and can find the bonds are taxable under arbitrage abuse rules. The IRS has provided some safe harbors that allow issuers to avoid problems in short-term capital financings, but none exist for long-term deals.

The final rules provide, as Cross said, a "road map" for issuers that need to do long-term working capital financings without running into arbitrage problems.

Under the safe harbor, the issuer must reasonably expect to not have any available amounts of money for working capital for at least five years. For every year after the fifth year, the issuer must determine it has no unrestricted amounts of money it can use for working capital. If it does have available money it can take steps to avoid arbitrage problems by: redeeming some bonds; buying tax-exempt bonds; buying SLGS; or spending the money within 30 days for a governmental purpose.

The rules also contain a section on hedging transactions that provide a significant modification or material change standard for interest rate swap terminations. Termination payments are taken into account in determining whether arbitrage is generated. Under the rules, interest rate swaps won't be treated as terminated unless there is a significant modification of the swap, such as a material change in the interest rates used in the swap.

Cross said this section was spurred in part by the financial crisis when bond insurers were downgraded, Lehmann Brothers filed for bankruptcy and tax lawyers had to restructure or modify thousands of swaps. Under existing rules, modifications forced many of those swaps to be terminated.

The final rules also give issuers 15 instead of three days to identify whether a swap is a "qualified hedge" whose yield can be taken into account with the bond yield in determining whether arbitrage has been generated. They detail how taxable indexes, such as LIBOR, may be used for qualified hedges.

Additionally, the rules clarify that when bond proceeds are used to make grants to unrelated parties, the issuer has to consider whether the grant was used for private business. Existing rules don't require grants to be tracked after awarded to an unrelated party.

The rules also clarify when investments need to be valued at fair market or present value.

Several lawyers said they are still studying the rules. "For the most part, Treasury and the IRS did a good job of addressing comments by making positive changes and clarifications," said Tom Vander Molen with Dorsey & Whitney in Minneapolis. "I am, however, disappointed that Treasury and the IRS did not adopt the suggested changes to the definition of fair market value of qualified hedges on termination. A number of suggestions on other items were described as beyond the scope of the project, but further guidance on some of these should be given in the future. In particular, I would like to see Treasury and the IRS expand the situations in which yield reduction payments may be used."

The Bond Buyer

By Lynn Hume

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