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Abusive Arbitrage Devices - It's Time to Get Reacquainted - Squire Patton Boggs

Sometimes it is a good exercise to remind ourselves of some basic rules governing tax-exempt bonds. One such rule is that bonds are taxable arbitrage bonds if an “abusive arbitrage device” is used in connection with the bonds. An abusive arbitrage device is any action that has the effect of: (1) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and (2) overburdening the tax-exempt bond market.[1] (Keep in mind that an “abusive arbitrage device” is only one specific type of “arbitrage bond.” We chose to cover abusive arbitrage devices because they are of renewed relevance and they touch on many arbitrage concepts.) The first element of an abusive arbitrage device has been difficult (to the point of impossibility) to satisfy since *Mad Men* first aired.[2] However, the Federal Reserve’s hawkish monetary policy has now made it much easier to exploit the difference between tax-exempt and taxable interest rates. Thus, it’s time to get reacquainted (or acquainted, depending on where you are in your career) with the concept of abusive arbitrage devices. The Public Finance Tax Blog is here to help, with a three-part mini-series of posts on this topic.

Episode 1 - Background and Arbitrage Basics

Background. Issuers are able to issue tax-exempt bonds at a lower interest rate than taxable bonds, because the interest on tax-exempt bonds is not subject to federal income tax. Because the federal government provides the subsidy for tax-exempt bonds, by foregoing the tax revenue on the interest earned, it has put in place various restrictions to ensure that the subsidy is used for its intended purpose. The federal government’s primary goal in providing the subsidy, which allows issuers to borrow at a lower cost, is to promote investment by state and local governments, 501(c)(3) organizations, etc. in long-lived, tangible assets. Accordingly, the federal government is willing to provide the subsidy, but only with guardrails that steer the issuer in the right direction (of issuing bonds the proceeds of which are used to finance capital projects).

What is arbitrage? In the tax-exempt bond world, arbitrage is the difference between the yield of the tax-exempt bonds and the yield at which the issuer invests proceeds of those bonds in the taxable market. For example, an issuer of tax-exempt bonds with a 3% interest rate that invests the tax-exempt bond proceeds in taxable securities with a 5% rate of return has made a 2% profit (i.e., positive arbitrage).

Why is it bad? Because the federal government says arbitrage is bad. The exploitation of the difference between the tax-exempt and taxable markets generally does not advance the federal government’s primary goal of encouraging investment in long-lived, tangible assets. In fact, if left unchecked, the ability of issuers to earn positive arbitrage could shift the entire cost of a capital project to the federal government. The primary rule that the federal government put in place to prevent issuers from exploiting the difference between these markets is the requirement that an issuer rebate any positive arbitrage to the federal government. Stated another way, the issuer generally cannot retain earnings from the investment of tax-exempt bond proceeds to the extent that those earnings exceed the yield of the tax-exempt bonds. Compliance with the rebate requirement

will oftentimes preserve the tax-exempt status of interest on the bonds - but not always.

Preview of Episode 2 - Overburdening (Generally) Not Allowed.

Sometimes paying rebate will not suffice to keep the bonds tax-exempt. Where an issuer has exploited the difference between tax-exempt and taxable interest rates (i.e., earned positive arbitrage) and has also overburdened the tax-exempt bond market, the issuer's bonds will generally be taxable arbitrage bonds, a status that compliance with rebate will not rectify. So what constitutes overburdening?

Stay tuned . . .

[1] Treas. Reg. Section 1.148-10(a)(2).

[2] 2007.

By Cynthia Mog on February 5, 2023

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