High Interest Rates May Be Troubling for Issuers of Tax-Exempt Bonds

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Over the past year and half, interest rates have increased significantly. For most investors, the increase in interest rates is welcome. But for issuers of tax-exempt bonds, or cities, states and other qualifying governmental entities, the rise in interest rates may be a cause for concern.

Under the Internal Revenue Code (Code) and Treasury Regulations (Regulations), governmental entities are allowed to issue tax-exempt bonds to finance many different capital projects such as constructing public infrastructure and utilities, government buildings, and public schools.

A tax-exempt bond is a promise by the governmental entity to pay back the principal amount of the bond with interest. Because the interest on tax-exempt bonds is not subject to federal income taxes, investors are willing to accept lower interest rates on the bonds. For the interest on tax-exempt bonds to be and remain tax-exempt, governmental entities must comply with several rules in the Code and Regulations. One such rule, known as the “yield restriction rule,” requires governmental issuers to invest tax-exempt bond proceeds in investments with yields that are lower than the interest rate on the bonds. Failure to comply with this rule could result in the interest on the tax-exempt bonds being taxable.

Specifically, the yield restriction rule prohibits the investment of the proceeds of tax-exempt bonds at a yield that is higher than the bond yield by more than 0.125% such investments being called “higher yielding investments.” If the proceeds are invested in higher yielding investments, the issuer will earn a profit, or arbitrage, on the proceeds of the bonds.

However, earning arbitrage on bond proceeds does not automatically cause bonds to lose their exempt status. In the 1950s and 1960s, much like today, interest rates were high making it difficult for governmental issuers to comply with the yield restriction rule. Therefore, Congress enacted an additional rule, known as the “rebate rule,” allowing governmental issuers to pay, or rebate, to the Internal Revenue Service any arbitrage earned on the proceeds of tax-exempt bonds.

Arbitrage is required to be calculated every five years following the date the tax-exempt bonds are issued. Any arbitrage earned during this five year period must be rebated to the Internal Revenue Service. In addition, the Code requires that governmental issuers retain records related to the tax-exempt bonds such as arbitrage calculations and rebate payment information until at least three years after the bonds are paid off.

Generally, if governmental issuers earn arbitrage and fail to pay rebate to the Internal Revenue Service, the tax-exempt bonds may lose their tax-exempt status and the interest would be taxable to the investors. However, there are several exceptions to the yield restriction rule and the rebate rule that may apply. Because this article barely scratches the surface of the ins and outs of arbitrage and rebate, these exceptions will be the topic of future articles.

Due to the current high interest rate environment, it is important for governmental issuers to know how its tax-exempt bond proceeds are invested and if arbitrage is being earned. Paying close attention to these post-closing investment rules and maintaining proper record retention practices help governmental issuers ensure that the interest on their bonds remains tax-exempt and that the investors remain happy.