

Understanding Arbitrage Rebate

January 9, 2026

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What is Arbitrage Rebate?

Understanding Arbitrage Rebate

Arbitrage

When the yield on taxable investments exceeds the tax-exempt restricted rate

Rebate

Issuer's "rebate" or pay excess earnings to the IRS

Purpose

Financial disincentive to violate the rules
Prevent issuance of tax-exempt debt for profit-driven reasons

Positive and Negative Arbitrage

$$\begin{aligned} & \text{Actual investment earnings yield} \\ & - \text{Average borrowing rate or "arbitrage yield"} \\ \hline & = \text{Arbitrage \%} \end{aligned}$$

“Positive Arbitrage” =

Actual earnings > Earnings @ arbitrage yield
(*positive earnings yield spread*)

“Negative Arbitrage” =

Actual earnings < Earnings @ arbitrage yield
(*negative earnings yield spread*)

- **Arbitrage Rebate Liability =**
- Earnings of bond proceeds invested in taxable securities less (-)
- Earnings of bond proceeds invested at the arbitrage yield
 - Future value methodology
 - Measured on an issue-by-issue basis
 - Cumulative from the issue date

Arbitrage Rebate and Yield Restriction

Applies to every tax-exempt borrowing and some taxable subsidy obligations

- Measured on an issue-by-issue basis
- Non-compliance could result in taxable bonds
- Overlapping requirements – “Belt & Suspenders”
 1. **Arbitrage Rebate – IRC Section 148(f):**
Arbitrage Rebate begins on the issue date
 2. **Yield Restriction – IRC Section 148(b):**
Yield Restriction begins at the expiration of a temporary period

Requirement #1

Arbitrage Rebate



Exceptions to Arbitrage Rebate

Small Issuer Exception

- Calendar year exception
 - \$5 million of governmental bonds for municipalities
 - \$15 million per year for public school construction
- Requirements
 - General taxing powers
 - Governmental bonds (not private activity bonds)
 - At least 95% of the proceeds must be used for local governmental activities
- Exclusion of current refunding issue in certain circumstances

**Exception to
Arbitrage Rebate
Only**

Exceptions to Arbitrage Rebate

Spending Exceptions (Can Be Internally Monitored)

- “Reward” for spending bond proceeds quickly
- Allowed to keep positive arbitrage
- Simple way to establish compliance (no future value, no yields)
- Must meet each benchmark, no catch-up allowed

**Exception to
Arbitrage Rebate
Only**

6-Month	18-Month	2-Year (ACP)
All gross proceeds ✓ 6 months 100%*	All new money ✓ 6 months 15% ✓ 12 months 60% ✓ 18 months 100%**	“Construction” issues only ✓ 6 months 10% ✓ 12 months 45% ✓ 18 months 75% ✓ 24 months 100%**

* Exceptions for 5% of the proceeds of the issue if spent within one year.

** De minimis (lesser of 3% or \$250K) and reasonable retainage (5% spent in 12 months) exceptions may apply for last benchmark.

Requirement #2

Yield Restriction



Dual Requirements

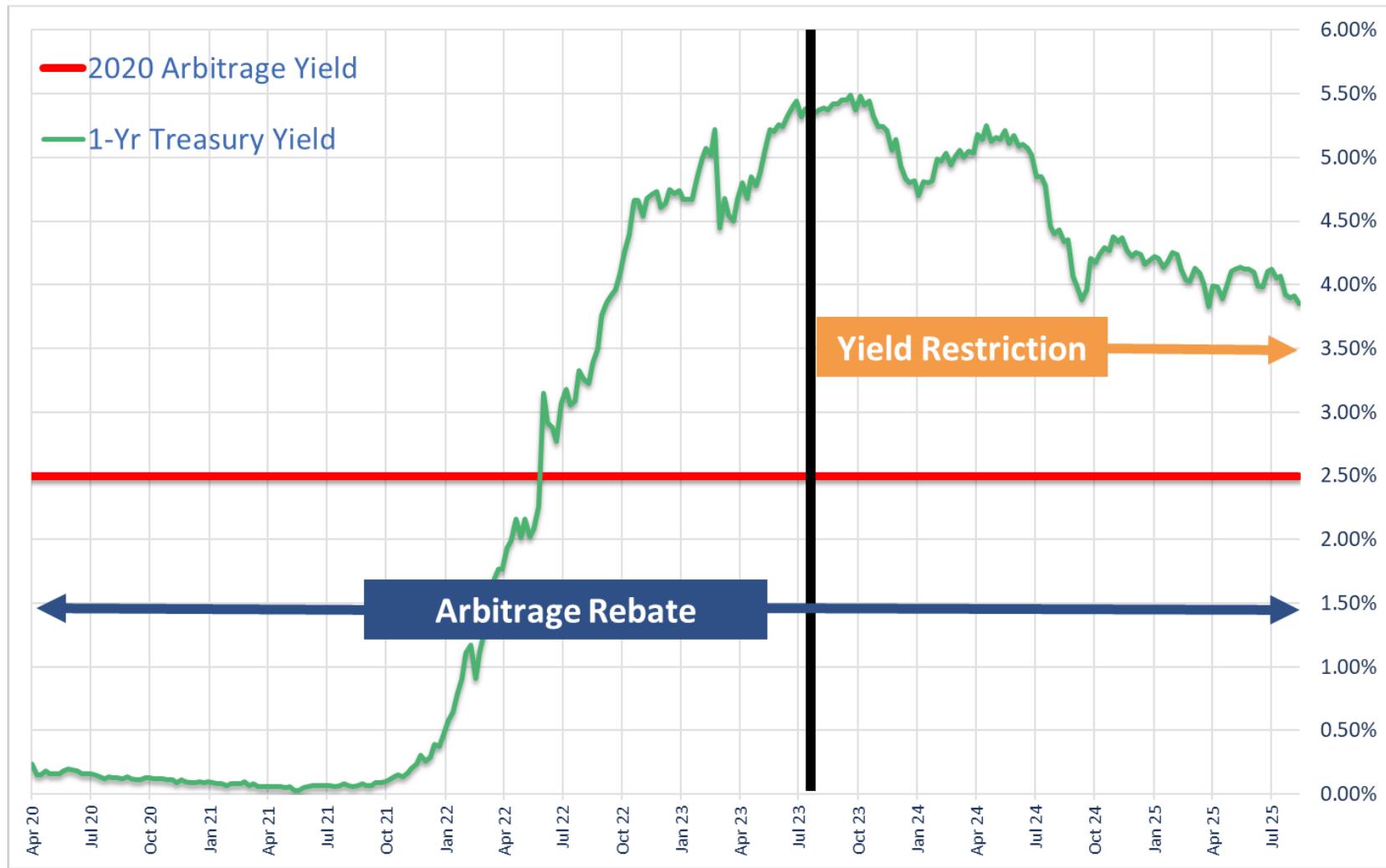
Key differences are timing and amounts restricted

Separate requirements require separate calculations

- Cannot blend Arbitrage Rebate and Yield Restriction liabilities
- Common situation to end up with negative arbitrage rebate but positive yield restriction or vice versa

	Construction Funds	
	Arbitrage Rebate	Yield Restriction
Requirement Begins	Issue Date	Typically, after a 3-year Temporary Period (may be waived or extended to 5-years)
Amounts Restricted	Sale Proceeds	Unspent Proceeds

Arbitrage Rebate vs. Yield Restriction



For illustrative purposes only.

Sources: Bloomberg, Refinitiv, EMMA. Rates as of August 29, 2025.

Yield Restriction Compliance Methods



Active Yield Restriction

- Investments must be purchased at fair market value
- Tax exempt investments



Yield Reduction Payments

- Rebate-like payments
- Limited availability for advance refunding issues and defeasance escrows



Other Options

- Longer construction fund temporary period (5-years vs. 3-years)
- Waiver of temporary period at issuance

Calculation Requirement



Calculation and Filing Requirement

- Payment due no later than 60 days after the computation date
 - No later than 5-years after the issue date
 - Every 5-years thereafter until the final maturity date
 - At least 90% of the liability
 - As of final maturity date, 100% of the liability
- Submit check and IRS Form 8038-T
- Do not submit calculations
- No filing required if no payment is due
- Late Payments
 - Require explanation and payment of late interest
 - May also require payment of a penalty (50%)
- Overpayment
 - Refunds can be requested if liability reverses
 - IRS will not pay interest on overpayment

Questions?



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