



National Association of Bond Lawyers

OPTIONS FOR COORDINATING TAX-EXEMPT FINANCING WITH STIMULUS AND ECONOMIC RECOVERY LEGISLATION

Tax-exempt financing is a known and efficient tool of States and local governments that could be utilized in conjunction with various economic stimulus proposals being considered by Congress. States and local governments routinely issue tax-exempt bonds to finance various types of governmental projects. States and local governments, however, are currently facing unusual and challenging conditions with regard to use of tax-exempt bonds. Recent turmoil in the financial system and global credit markets has significantly increased municipal borrowing costs and has severely curtailed traditional use of tax-exempt financing by States and local governments.

This document describes various options that could be considered as part of upcoming legislation to jumpstart the economy through increased infrastructure development as well as options that could provide assistance to States and local governments themselves during this difficult period. The options focus on the utilization of traditional tax-exempt bonds rather than newer financial products such as tax-credit bonds because traditional tax-exempt bonds have an established marketing infrastructure and significant market familiarity, and hence provide a better means for raising capital quickly and efficiently.

NABL was organized in 1979 for the purposes of educating its members and others in the law relating to State and local municipal bonds, providing a forum for the exchange of ideas as to law and practice, improving the state of the art in the field, providing advice and comment at the Federal, State and local levels with respect to legislation, regulations, rulings and other actions, or proposals therefore, affecting State and municipal obligations, and providing advice and comment with regard to State and municipal obligations in proceedings before courts and administrative bodies through briefs and memoranda as a friend of the court or agency. More information about NABL is available on its website www.nabl.org.

I. Coordination with Announced Infrastructure Objectives for Stimulus Legislation

Published reports state that the upcoming stimulus legislation will target improvements in areas such as education, environmental protection, energy independence, and telecommunications (including broadband Internet access). When these activities are carried out and paid for by States and local governments themselves, tax-exempt governmental bonds traditionally have been used as a financing tool. In addition, in some of these areas, tax-exempt private-activity bonds are routinely issued. The following options illustrate changes to present-law tax-exempt bond restrictions that might be considered to coordinate this tool better with stimulus expenditure provisions that may be included in the upcoming legislation. Appendix A

discusses an additional option that might be considered if Congress authorizes and appropriates additional Federal funds for infrastructure projects.

A. Create Greater Flexibility for Use of Tax-Exempt Private Activity Bond Financing

Section 141 of the Internal Revenue Code (“the Code”) authorizes the issuance of tax-exempt private-activity bonds only for defined categories of projects involving more than minimal private business use and bond security. For example, tax-exempt private-activity bonds may be issued for airports, port facilities, and certain mass transit facilities, but are available for educational facilities in only narrowly defined circumstances (sec. 142(k)).¹ Similarly, privately owned electricity companies generally are ineligible for this financing as are non-profit cooperatives and private investors generating electricity from renewable sources, and private toll roads (as opposed to public highways), except in narrowly defined circumstances, may not be financed with tax-exempt private-activity bonds. Further, where tax-exempt private-activity bond financing is authorized by present law, detailed and often complex restrictions govern qualifying projects.

Most authorized tax-exempt private-activity bonds are subject to an aggregate annual volume cap for each State (sec. 146). States must issue bonds to which they allocate volume cap in the year in which the cap arises or must carryforward the volume cap by irrevocably designating it for an identified purpose, in which case the bonds must be issued within the succeeding three years. The current financial turmoil has precluded efficient use of even existing volume cap. Further, if Congressional objectives for expanded infrastructure projects are to be realized and tax-exempt private-activity bonds are to be used in coordination with such projects, the current volume cap may prove insufficient.

Increased Financing Purposes.--For a limited period of time, States and local governments could be given flexibility to issue tax-exempt private-activity bonds for, and allocate their private-activity bond volume caps to general categories of economic stimulus projects targeted by the upcoming legislation without regard to whether projects currently are categories eligible for such financing. Should a narrower approach be desired, current exempt private-activity categories could be defined more broadly (e.g., “ground transportation facilities” instead of the current “mass commuting facilities,” “high-speed intercity rail facilities,” and “qualified highway or surface freight transfer facilities”) and limited new categories could be added to coordinate with desired infrastructure development (e.g., electric and broadband Internet transmission facilities).

¹ As stated above, this paper primarily addresses ways to coordinate tax-exempt bonds with publicly announced economic stimulus proposals. However, present law also includes tax-credit bond options for qualified zone academies (“QZABs”) and for certain renewable energy projects (“CREBs”). These bonds carry a nonrefundable income tax credit intended to equal interest that would accrue on a taxable bond. The credit is included in the income of the recipient. One option for coordinating these bonds with stimulus proposals that may be enacted would be to enhance the tax-credit bond subsidy by exempting the credit from the recipient’s taxable income if the tax-credit bond met all requirements for exemption under Code section 103 (as that section may be modified in the stimulus legislation).

Greater Volume Cap Flexibility.—The current three-year carryforward period could be extended to, e.g., five years, for projects targeted under the stimulus legislation. In addition, the requirement that issuers irrevocably identify carryforward purposes could be waived to assist States in ensuring that maximum stimulus effects are achieved. Finally, if tax-exempt private-activity bond financing is allowed for significant types of additional infrastructure projects, a temporary increase in the current volume cap amounts may be appropriate.

B. Encourage Public-Private Partnerships for Targeted Stimulus Projects

The permissible private business use and security allowed before a bond ceases to be “governmental” (*i.e.*, becomes a private-activity bond) has been 10 percent since 1986. An additional restriction limits private business use that is unrelated and disproportionate to governmental use being financed with the same bonds to five percent. Larger governmental bond issues (*i.e.*, those with more than \$15 million of private business use and payment) must receive allocations of State tax-exempt private-activity bond volume cap. Further, special restrictions apply to electricity and other output facilities that limit tax-exempt financing for facilities that today are most efficiently interconnected with like facilities owned and operated by private entities.

Relaxing or eliminating some of these restrictions could enable States and local governments to move more rapidly on targeted stimulus projects during times when their own revenue bases are strained. For example –

- The 10-percent private business limit could be increased to 25 percent for targeted stimulus projects.
- The five-percent “unrelated and disproportionate use” limit could be repealed.
- The volume cap allocation requirement for larger governmental bond issues could be repealed or suspended.
- Longer-term private-business-use arrangements for interconnected governmental and private energy facilities could be allowed and the special restrictions that apply only to publicly owned facilities (*i.e.*, \$15 million limit on private use of such facilities and prohibition on many acquisitions of existing output facilities) could be repealed or suspended.

II. Relief Targeted to States and Local Governments: Improve Access to Working Capital Financings

The current economic downturn and failure of financial structures have left many States and local governments in a precarious position with regard even to routine governmental services. Many of the affected government services are funded with “working capital financings” under present law. These financings are unique to governmental bonds and bonds issued to finance exempt activities of Code section 501(c)(3) organizations. Working capital bonds, including “tax and revenue anticipation notes” (“TRANS”) are issued to finance recurring

cash flow deficits in operating expense accounts. States and local governments commonly issue TRANs to finance operating expenses during low periods in the issuer's annual revenue cycle, e.g., before receipt of annual property tax payments. Improvement of core State and local government financing options could, in turn, enable these entities to undertake desired Federal stimulus projects more rapidly.

Sizing and issuance of TRANs are governed by a statutory sizing rule and complex Treasury Department regulations. The statutory sizing rule provides that TRAN proceeds will be considered spent for tax purposes on the date, not later than six months after issuance, when the cash flow deficit financed by the bonds reaches at least 90 percent of the bond proceeds (Code sec. 148(f)(4)(B)(iii)). Alternatively, States and local governments may comply with a sizing rule in Treasury regulations that generally permit the governments to disregard a "reasonable working capital reserve" of up to five percent of the issuer's actual working capital expenditures in the prior year (Treas. Reg. sec. 1.148-6(d)(3)(iii)(B)), provided, except for certain small governmental units, the reserve may not exceed the weighted average cash balance maintained by the government. If a governmental unit takes advantage of a larger reserve than it historically has maintained, it is deemed to have financed the larger reserve with bond proceeds. Treasury regulations further provide generally that, if a State or local government uses bond proceeds to pay operating expenses, the actual use of the bond proceeds will be disregarded if there are other "available amounts" that could have been used to pay the expenses instead (the "proceeds-spent-last rule" of Treas. Reg. sec. 1.148-6(d)(3)(i)). The maturity of TRANs is effectively limited to 13 months for most such financings by a Treasury notice. (Notice 2001-49, 2001-2 C.B. 188).

Several options could be considered to address cash-flow shortfall difficulties arising from the current financial turmoil –

- A longer maturity limit for working capital financings (*e.g.*, from two to five years) could be enacted. For States and local governments experiencing particularly dire fiscal problems, longer-term financing of deficits during a prescribed period (*i.e.*, 2009 and 2010) could be allowed. Such a provision could include a rule similar to that provided in some IRS ruling letters that all surplus revenues (if any) be used to retire bonds early.
- The definition of "reasonable working capital reserve" could be increased from five percent of the prior year's expenditures to 10 percent, and at least temporarily, the prohibition against funding a working capital reserve with tax-exempt bond proceeds could be waived.

III. Improving Market Demand

Recent turmoil in the financial system and global credit markets, which followed the collapse of the bond insurance market has resulted in a dramatic shrinkage of the State and local government bond market. The failure of the financial markets has resulted in the loss of whole classes of State and local government bond purchasers, such as hedge funds and tender option bond programs. Very little institutional investment is presently occurring. This shrinkage affects not only projects for which financing is currently authorized, but can be expected to affect

the success of targeted infrastructure projects included in stimulus legislation. Several possible options to address these “demand-side” problems are described below.

A. Modify Code Section 265 Restrictions on Bank Ownership

Code section 265(b) denies interest expense deductions to banks investing in tax-exempt bonds in proportion to the amount of the bank’s total assets that consist of tax-exempt bonds. This prorata disallowance rule, enacted in 1986, applies to bonds issued after 1986, except for governmental and qualified 501(c)(3) bonds of certain “small issuers”. Small issuers are defined generally as governmental units whose issuance does not exceed \$10 million in the year the qualified bonds are issued. Code section 265(a)(2) otherwise denies interest deductions to all taxpayers for interest incurred to purchase or carry tax-exempt bonds. A revenue procedure provides a “two-percent de minimis exception” for corporations (other than banks) before interest expense deductions are disallowed, provided the interest expense in question is not directly linked to the tax-exempt bond investments. (Revenue Procedure 72-18, 1972-1 C.B. 740).

Several options could be considered to make tax-exempt bond investments more attractive to banks and other corporations –

- The prorata disallowance rule could be repealed or suspended for a period when targeted stimulus efforts are provided.
- If the prorata disallowance rule is retained, the “small-issuer exception” could be increased from its current level and unrelated qualified 501(c)(3) borrowing could be subjected to a separate limit to facilitate bank investment.
- The two-percent de minimis exception for non-bank corporations could be increased for bonds issued during the targeted stimulus period (or for bonds issued to finance targeted stimulus projects).

B. Eliminate Alternative Minimum Tax Preference Item for Tax-Exempt Interest

Code section 57(a)(5) provides that interest on most tax-exempt private-activity bonds is a tax-preference item. Among other facilities, these bonds finance sewage and solid waste facilities, airports, ports, and other utility, environmental, or transportation projects. Repeal of this preference item could increase attractiveness of tax-exempt bonds to potential investors.²

C. Enhance Attractiveness of Tax-Exempt Bond Investments to Pension Funds

Pass-Through Income Characteristics to Pension Beneficiaries.--Under present law, pension fund distributions to beneficiaries (including distributions from Individual Retirement Accounts, Keogh plans, Code section 401(k) accounts, and qualified pension plans are taxable to the beneficiaries regardless of the nature of the income when earned. Marketability of tax-

² This option would be consistent with relief provided by the Housing Assistance Tax Act of 2008, P.L. 110-289, which eliminated the preference item for tax-exempt private-activity bonds for certain housing.

exempt bonds could be enhanced if pension funds were allowed to pass through the exempt nature of tax-exempt bond interest to their beneficiaries.

Modify Restrictions on Pension Fund Investments in In-State Tax-Exempt Bonds.—Code section 503(b) requires qualified retirement plans that purchase obligations from “substantial contributors” to obtain “adequate security” for those obligations. Alternatively, the plans may choose to comply with a safe harbor (Code sec. 503(e)) that replaces “adequate security” with stringent objective criteria designed to insure that the fund acquires the obligation at its fair market value. The safe harbor requires, among other things, that the retirement fund purchase no more than 25 percent of an “issue” of obligations, with “issue” being defined as in effect each separate maturity of a debt issuance. Tax-exempt obligations generally are safer investments than many corporate offerings, but the rule applies to both types of instruments.

The definition of “adequate security” under section 503(b) could be modified to provide that a specified creditworthiness threshold (*e.g.*, a specified credit agency rating) would constitute adequate security. Other options for modifying these rules could include (a) defining “substantial contributor”, (b) replacing the 25-percent test with other objective measures of fair market value, and (c) applying the Code section 503(e) safe harbor across broader classes of an issuer’s securities than different maturities.

D. Suspend Federal Guarantee Prohibition

Subject to limited exceptions, tax-exempt bonds may not benefit from direct or indirect Federal guarantees (Code sec. 149(b)). Suspending the Federal guarantee prohibition could enhance marketability of tax-exempt bonds. Because of the policy underlying the Federal guarantee prohibition (*i.e.*, federally guaranteed debt holds an unfair advantage over Federal debt), any such suspension could be made temporary or limited to tax-exempt bonds issued in coordination with projects targeted in the stimulus legislation.³

³ A technical issue under the Federal guarantee prohibition has arisen as a result of the recent increase in the limit for FDIC insurance to \$250,000 per depositor. As a result of this increase, certain tax-exempt bonds that were not considered federally guaranteed under the previous limit may be considered guaranteed at the new, higher limit. Clarification that bonds will not be considered federally guaranteed solely as a result of the increase in the FDIC insurance limit could be considered.

APPENDIX A

An additional option, with respect to tax-exempt bonds, that might be useful and incorporated into authorizing and appropriations provisions of stimulus legislation is included below:

Create Additional State Revolving Fund Programs. Congress could assist economic development in States by creating additional State revolving fund programs modeled on the existing Environmental Protection Agency (“EPA”) programs. Under present law (Title VI of the Clean Water Act, as amended), Congress has authorized the EPA to make capitalization grants to States in order to help capitalize State Revolving Funds (“SRFs”), to, among other things, construct public safe drinking water infrastructure. Congress could create additional SRF programs modeled on the existing drinking water and wastewater programs administered by the EPA in order to assist States to fuel economic development by helping to finance the construction of infrastructure, particularly infrastructure projects targeted in the upcoming stimulus legislation. The SRF programs permit the Federal Government, at low cost, to provide economic incentives to States to construct public infrastructure, create jobs, offer loans and enhance the credit of their bonds by using a limited amount of Federal funds that can then be leveraged by the States in perpetuity.