REPEAL OF ADVANCE REFUNDINGS AND THE RISE OF TAXABLE MUNICIPAL BONDS

I. Background.

A. Factors leading to the increase in the issuance of taxable debt.
   1. Repeal of advance refundings.
   2. Strong credits with significant volumes of debt.
      a) Trading based on spread to Treasuries. Bonds with durations in excess of typical 30-year maximum for tax-exempt bonds.
   3. Bond Buyer reporting on rise of taxable bonds as undercutting the need for advance refunding relief.
   4. Need for working capital.
   5. Increased private business use, including additional consideration of P3 structures and outsourcing of services.

II. Reimbursement and prior issues of taxable debt.

A. Applicable rules:
   1. Treasury Regulation Section 1.142-4: applies to bonds described in Section 142(a) (exempt facility bonds)
   2. Treasury Regulation Section 1.150-2.

B. Do the reimbursement rules apply to prior issues that are taxable debt?
   1. Are there any reasonable arguments that the Internal Revenue Service (IRS) could try to make that Treasury Regulation Section 1.150-2 applies to prior issues that are taxable debt?
   2. Why would the IRS try to argue that the Treasury Regulation Section 1.150-2 applies absent an abuse?
3. Does it make a difference if the taxable debt is “old and cold” or if the taxable debt was recently issued?

III. Proceeds spent last rule and prior issues of taxable debt.

A. Applicable rules: Treasury Regulation Section 1.148-6(c)(3).

B. Does the proceeds spent last rule apply to prior issues that are taxable debt?

C. What reasonable arguments could the IRS try to make that Treasury Regulation Section 1.148-6(c)(3) applies to prior issues that are taxable debt?

D. Does it make a difference if the taxable debt is “old and cold” or if the taxable debt was recently issued?

IV. Hedge bond rules and prior issues of taxable debt.

A. Applicable rules: Internal Revenue Code (“IRC”) Section 149(g)

   1. What is the meaning of “original bond”? Is it the earliest in the chain of refunded and refunding bonds, or is it the earliest tax advantaged bond?

B. Discussion regarding circumstances where issuer/borrower was not contemplating issuing tax-exempt bonds at the time the taxable debt was issued.

C. Assume taxable bonds were issued and the hedge bond rules were not satisfied at the time the taxable bonds were issued.

D. As a practical (real world) matter, is a tax-exempt refunding likely to be considered?

   1. If so, what issues arise?

   2. Does everyone agree that tax-exempt refunding bonds can be issued with respect to the portion of the prior taxable bonds for which proceeds have been expended?

   3. Discussion of advance refundings and escrow longer than 3 years.

V. Allocations and prior issues of taxable debt.

A. Assume that taxable debt was used to finance multiple purposes (e.g., working capital, multiple capital facilities, refunding prior taxable debt, refunding prior tax-exempt debt (“Prior Tax-Exempt Debt”). Assume further that tax-exempt bonds (the “New Bonds”) are to be issued to either current or advance refund the taxable bonds.

B. Examples of prior taxable debt in general:
1. Lines of credit and grid loans extended to nonprofits with significant enterprises.

2. Issuers with taxable commercial paper programs, particularly where eligibility for tax-exemption is uncertain at time of issuance.

C. Must the multipurpose allocation rules in Treasury Regulation Section 1.148-9(h) and Treasury Regulation Section 1.148-13 be applied, either generally or with respect to certain aspects of tax-exempt refunding?

D. For example, if the New Bonds include a refinancing of the Prior Tax-Exempt Debt, what issues arise?

1. May “other replacement proceeds” (“ORPs”) arise if the duration of the New Bonds attributable to the Prior Tax-Exempt Debt is extended? Is the ORPs concern addressed by establishing that the New Bonds do not exceed 120% of the remaining economic life of the assets financed?

E. Treasury Regulation Section 1.148-13(d) provides that “[e]ach of the separate issues under the [multipurpose] allocation must consist of one or more tax-exempt obligations.” With regard to prior taxable bonds, what is to be said of this language? Can it simply be ignored?

F. Tracing of proceeds to original expenditures.

1. Presumably a “step in the shoes” approach applies with respect to refundings and use of the proceeds of the prior taxable debt.

2. Discuss tracing of original expenditures to refinancing with New Bonds.

3. If capitalized interest on the prior taxable debt is to refinanced, should any tracing of expenditures of the proceeds of prior taxable debt be undertaken.

VI. Original issue discount (“OID”) and prior issues of taxable debt.

A. OID is to be determined exclusively under IRC Section 1273 and 1274 (not under IRC Section 148).

1. If an underwriter sells taxable bonds to another broker who then marks up the bonds, OID is determined by the first price at which the bonds are sold to the 1273 definition of “public.”

2. A common reason for OID is a long coupon debt instrument that does not have interest payable at least annually. That may happen because tax supported bonds may be issued too late in the levy cycle to allow taxes to be collected in time to make a payment within a year of issuance. This occurs for tax-exempt bonds as well, but no one really cared.
B. IRC 1275(c) and IRS Form 8281

1. Code §1275(c) and regulations thereunder require information (a) reporting of OID on publicly offered taxable debt and (b) legending of privately placed taxable debt with OID.

2. Information reporting is on Form 8281.

   a) Form 8281 provides that an issuer who fails to timely file Form 8281 will be subject to a penalty of 1% of the aggregate issue price of the debt instruments, unless such failure is due to reasonable cause and not to willful neglect. The maximum penalty with respect to any issue is $50,000.

VII. Original tax-exempt bonds, advance refunding with tax-exempt bonds, followed by taxable bonds. Is a subsequent tax-exempt advance refunding permitted?

A. Assume tax-exempt bonds are issued for new money purposes and are advance refunded with a second issue of tax-exempt bonds (“Second Issue”). Assume further that the Second Issue is either current refunded or advance refunded with an issue of taxable bonds (“Taxable Bonds”). Assuming that the advance refunding escrow with regard to the Second Issue has matured, may the Taxable Bonds be advance refunded with tax-exempt bonds?

   1. Subsequent to the issuance of the Taxable Bonds two sets of tax-exempt bonds will not be outstanding simultaneously.

   2. Was the answer to this question clear under IRC Section 149(d) prior the changes made by the 2017 Tax Cuts and Jobs Act?

   3. Assuming the advance refunding was prohibited under prior Section 149(d), is or should the result be any different under the IRC Section 149(d) language made by the 2017 Tax Cuts and Jobs Act?

      a) The legislative history for the 2017 Tax Cuts and Jobs Act specifically identifies the concern of two sets of tax-exempt bonds outstanding simultaneously as the reason for repealing advance refunding.

      b) Is the absence of this concern sufficient to allow the advance refunding of the Taxable Bonds?

B. If Bond Counsel is not comfortable concluding that a tax-exempt advance refunding is permitted, anytime a tax-exempt advance refunding of taxable debt is considered, diligence needs to be undertaken to establish if there was a prior tax-exempt advance refunding.
VIII. Miscellaneous

A. The “first call date” rule is not applicable to taxable advance refundings.
   1. Example. Assume that the first call date is 8/1/2025, but there are Treasury strips that mature 8/15/2025. The most efficient escrow may be to 8/15/25. Reserving right to extend or contract escrow may increase savings.

B. Universal cap considerations and taxable advance refunding.
   1. If a taxable advance refunding amortizes more quickly than the associate escrow it provided, the escrow might be released from being proceeds of the taxable advance refunding bonds through operation of the Universal Cap. Then the released portion of the escrow would become gross proceeds (a sinking fund) for the refunded tax-exempt bonds. The regulations require that the investments be valued at fair market value at the time of release because it is going from taxable proceeds to gross proceeds of a tax-exempt issue. If the bond yield of the refunded bonds is higher than the escrow yield when invested, it might not be so on the release date (or dates). There is no upper limit of the required YRP.

a) The potential YRP became more prevalent and with the 2016 change to the arbitrage rules which require that SLGS be valued at valued at fair market value instead of at par

b) While the about of the YRP cannot be determined at the time the taxable advance refunding bonds are issued, a “sensitivity analysis” can be undertaken to provide a range of YRPs.

C. IRS Form 8937. Does it apply to defeased bonds?
   1. IRC Section 6045B, Treasury Regulation Section 1.6045B-1 and IRS Form 8937 address “organizational actions” affecting debt instruments, which includes organizational actions that affect the basis of a security (including significant modifications to debt instruments).

   2. Exceptions exist for exempt recipients (which include C corporations) and certain money market funds.

   3. Compliance through filing of IRS Form 8937 or by posting IRS Form 8937 on the Issuer’s website.

   4. Assuming that there are bondholders that are not exempt recipients or that it is not possible to determine whether or not bondholders are exempt recipients, is there a basis to conclude that Form 8937 is not required?

D. Tax Disclosure
   1. How much disclosure is necessary? Long-form disclosure or short-form disclosure.
IX. Refunding Build America Bonds ("BABs") with tax-exempt bonds

A. Legal defeasance and economic defeasance

1. Legal defeasance.

   a) CCA 201843009 addresses the advance refunding of BABs where there is a legal defeasance. The legal defeasance provides for a reissuance.

   b) Revenue Procedure 2018-26 provides for a remedial action to cure a nonqualified use with respect to BABs by reducing the amount of the refundable Federal tax credit to eliminate the amount allocable to the nonqualified bonds. Specific procedures are provided in the revenue procedure can be followed for legal defeasances

2. Economic defeasance.

   a) Under state law, legal defeasance may not be achievable. Specific IRS guidance has not been issued with respect to economic defeasances although there has been much discussion regarding such guidance using the remedial action approach of Revenue Procedure 2018-26 for reducing the amount of refundable tax credit.