Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Buttigieg Boosts Hopes For Tax-Exempt Refunding Bonds

By **David van den Berg**

Law360 (February 10, 2021, 8:23 PM EST) -- Lawmakers, bond lawyers and other proponents of tax-exempt advance refunding bonds are hopeful Congress will reinstate the instruments, bolstered by comments made by recently confirmed Transportation Secretary Pete Buttigieg.

Transportation Secretary Pete Buttigieg has said reinstating tax-exempt advance refunding bonds holds promise as a source of relief for local governments. Above, he spoke Friday at Union Station in Washington, D.C. (AP Photo/Carolyn Kaster)

Reinstating tax-exempt advance refunding bonds, **which were repealed** under the 2017 tax overhaul, could provide state and local governments with an important source of savings they could use for a variety of projects. Some lawmakers have said restoring tax-exempt advance refunding bonds is a priority and have proposed legislation in prior congressional sessions to bring them back.

During his confirmation hearing before the Senate Commerce, Science and Transportation Committee last month, Buttigieg told lawmakers "few things gave me more fiscal pleasure" as mayor of South Bend, Indiana, than to find the city could save taxpayer money by refunding previously existing debt. He said the idea of reinstating advance refunding holds promise as a source of relief for local governments.

Rep. C.A. Dutch Ruppersberger, D-Md., who co-founded and co-chairs the House Municipal Finance Caucus, welcomed Buttigieg's comments and said he wasn't surprised by them, noting Buttigieg's time in local government.

"I hope that Secretary Buttigieg's support will create the momentum we need to get this across the finish line," Ruppersberger said. "Plain and simple, the Tax Cuts and Jobs Act has stymied local investment infrastructure."

Before 2018, all parts of the tax-exempt bond market used tax-exempt advance refunding bonds as a financing method that generated hundreds of billions of dollars in interest cost savings, according to Adam Harden of Locke Lord LLP. These bond issuers included public school districts, cities, hospital systems and other core infrastructure providers facing financial challenges because of the novel coronavirus pandemic, he said.

In 2016 and 2017 alone, tax-exempt bond issuers realized more than $6 billion in savings by using tax-exempt advance refunding bonds, Harden said, citing a Government Finance Officers Association report.

When the Joint Committee on Taxation analyzed the conference report for the TCJA, it found that repealing advance refunding bonds would generate $17.4 billion over a decade. While the provision raised revenue, lawmakers might have overlooked the full effects of repeal on the budgets of those bond issuers and taxpayers who ultimately repay the bonds, Harden said. It's appropriate now to revisit how economies can be improved and funds kept closer to home, he said.

"Secretary Buttigieg's support for tax-exempt advance refunding bonds and his firsthand experience utilizing them to save money for the taxpayers in South Bend bring renewed hope for our industry," Harden said.

Michael Cullers of Squire Patton Boggs LLP said Buttigieg's comments signal the Biden administration's support for tax-exempt advance refunding bonds and come from someone well-versed in their benefits.

"This was not the testimony of a policy wonk with no practical experience in the matter," he said.

Buttigieg's comments came in response to a question from Sen. Roger Wicker, R-Miss., who in 2020 introduced legislation to restore advance refunding bonds that drew nine Democrats as co-sponsors. Wicker's question shows there's bipartisan support for the idea, Cullers said. Bipartisan legislation in 2019 that Ruppersberger sponsored also called for reinstating tax-exempt advance refunding bonds.

Rep. Steve Stivers, R-Ohio, who co-chairs the Municipal Finance Caucus and co-sponsored Ruppersberger's bill, said it's important to get bipartisan buy-in to the idea.

"While the COVID-19 relief packages included some funds for state and local governments, to solve the problem, we need to find bipartisan, lasting solutions, and I believe that advance refunding is a crucial piece of that," he said. "It remains a top priority for me, and I will continue to advocate for its inclusion in future relief packages, as well as any vehicle that is poised to make it to the president's desk."

Wicker, for his part, said restoring advance refunding for tax-exempt bonds is a proven way to give local leaders the ability to manage existing debts, cut costs and free up added money for needed projects.

"At a time when interest rates are at historic lows, Congress should allow our local governments to seize this opportunity and pass along savings to their communities," Wicker said. "I will also continue to explore ways to expand investment in the state and local bond market, including through direct-pay bonds. Increasing flexibility for communities to issue bonds is a proven way to help localities emerge from financial hardship with assets that provide value for years to come."

The 2017 tax overhaul removed the exclusion from gross income for interest on bonds issued to advance refund another bond, per the Internal Revenue Service. Refunding bonds replace bonds already issued for a particular purpose, and advance refunding describes cases where both the existing and refunding bonds are outstanding for longer than 90 days, according to a Congressional Research Service report.

Before the 2017 tax act, advance refunding bonds could generally be used for public purpose bonds once, with interest income still exempt from federal income tax, which allowed two federally tax-exempt bonds to be outstanding for the same project simultaneously, the service's report said.

Historically low interest rates caused state and local governments to issue many more taxable advance refunding bonds than they otherwise would have were tax-exempt ones available, Cullers said. But even with low interest rates, the taxable advance refunding bonds have higher interest rates than their tax-exempt counterparts would, he said.

When lawmakers took away advance refundings, they took away a long-standing financial tool used by state and local governments, according to Edwin Oswald of Orrick Herrington & Sutcliffe LLP. Municipal bonds are generally issued with 10-year call protection, and in an advance refunding deal a bond issuer can issue new tax-exempt refinancing bonds in advance of the 10-year call date of the original bonds, he said. Like homeowners' refinancing mortgages, issuers would typically issue advance refunding bonds when interest rates fall below the interest rate on the original bond to lock in interest savings, he said.

"Depending on the nature of the financing, these interest rate savings are generally passed on to taxpayers, general public users of the financed property or ratepayers in the case of public utilities," he said.

Some state and local governments as an alternative have issued taxable advance refunding bonds, which can provide savings, though not as much as tax-exempt advance refundings, Oswald said.

"While the municipal market has tried to develop other techniques as a substitute for tax-exempt advance refundings, such as conversion bonds, they have generally fallen short or proven too complex," he said.

All else being equal, Oswald said, state and local government issuers will choose a debt structure providing the lowest cost of funds. Without interest rate or credit anomalies, the tax-exempt rate will be lower when compared to taxable debt, he said. He also said possible tax increases would likely increase demand for municipal bonds, particularly among the wealthy, and that higher demand could make tax-exempt bonds more attractive relative to taxable ones. That would raise municipal bond prices and benefit municipal issuers, he said.

"In the current low-yield environment, however, initial price changes might be minimal," he said. "Of course, higher overall interest rates will make borrowing more expensive."

The 2017 tax overhaul didn't just address advance refunding bonds. It also removed the authority to issue tax-credit bonds and direct-pay bonds, the IRS said. Harden said restoring tax-exempt advance refunding bonds is the bond community's clear policy priority in 2021. Ruppersberger said it's his top bond policy priority, and Oswald called it a significant priority for state and local governments. But he said action will likely come later.

"We expect the tax changes relating to municipal finance to be implemented as part of a larger infrastructure bill, and Secretary Buttigieg will be an important player in any such bill," he said.

House Ways and Means Chairman Richard Neal, D-Mass., told Law360 that the topic had not come up in conversations on the budget reconciliation bill to respond to the novel coronavirus pandemic. When asked if it might wait for an infrastructure bill, Neal said "it could."

Advance refunding is a major bond policy priority and near the top of the list for the Government Finance Officers Association, according to Emily Brock, director of the organization's federal liaison center. The organization sees advance refunding most likely being included in the infrastructure bill.

"It makes perfect sense and has a good deal of support both in the House and the Senate," she said. "We are going to be gaining co-sponsorship throughout the year and ramping up outreach from our finance officers to highlight cost savings for jurisdictions if restoration were to happen in October of this year."

The Department of Transportation declined to comment beyond Buttigieg's hearing remarks.

--Additional reporting by Maria Koklanaris. Editing by Tim Ruel and Neil Cohen.