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FINANCE, INVESTMENT AND TAX-RELATED LEGISLATION

Tax-exempt advance refundings: Could something be better than nothing?

By Charles Almond April 02, 2018, 10:32 a.m. EDT 6 Min Read

I read with great interest Steven Gortler's March 27 piece "Why we need a hold harmless approach to advance refunding bonds," proposing a "hold-harmless payment" to resurrect advance refundings' tax exemption. Mr. Gortler's thinking about his hold-harmless payment is similar to thoughts I have had about a "toll charge" I discuss in a Commentary piece (printed below) that I had prepared prior to reading Mr. Gortler's piece.

However, there is at least one big difference.

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I believe it is unrealistic to expect that the Internal Revenue Service could or would ever permit tax exemption for advance refunding bonds, as Mr. Gortler suggests, by implementing a hold-harmless-payment regime as part of its VCAP program. Types of information and representations elicited in the VCAP process

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agree to allow an impermissible advance refunding bond, whose "impermissibility" is knowingly and deliberately planned before the bonds are issued, to remain outstanding tax-exempt with a modest hold-harmless payment.

Moreover, considering the bonds must be issued and outstanding to enter the VCAP program, how could bond counsel ever deliver a putative "tax-exempt" opinion in the face of a planned ab initio tax law violation? Mr. Gortler acknowledges this dilemma, but expresses confidence that the IRS is "resourceful." In this case, I wouldn't be very confident about that.

While I agree with Mr. Gortler that a "hold harmless" payment or toll charge, could turn out to be "fairly modest" in many transactions, I would envision the toll charge being calculated formulaically based on the number of days in excess of 90 that two sets of bonds remain outstanding. So, when "double-up" periods extend beyond a certain length, the payment could become significant and take deals out of the money.

Nonetheless, I like the way Mr. Gortler is thinking. I just believe it will be difficult for a reinstatement of advance refundings' tax exemption to sidestep Congress. However, as I discuss in my piece below, a toll-charge proposal could disarm congressional opponents and create some hope for legislative success—at least more hope than for a simple prior-law reinstatement of tax exemption—which, I agree with Mr. Gortler, is quite unlikely anytime soon.]

What's not to like about tax-exempt advance refundings?

The objection some federal policy makers have to tax exemption for *advance* refundings stems from what is viewed as the "double subsidy" that is created temporarily by the "advance" part of the deal. The federal government views any tax-exempt bond as providing an indirect federal subsidy to the issuer. Many federal government policymakers point out that *advance* refunding bonds "double" the subsidy for the same project(s) during the period two bond issues remain outstanding. Tax reform's denial of tax exemption to advance refunding bonds reflects the decision of a majority of Congress that the cost to the federal government of doubling the subsidy for more than 90 days (estimated at

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The 90-day rule that differentiates between a *current* refunding that still can be tax-exempt and an advance refunding that cannot is an arbitrary "cliff-effect" type of rule. In other words, when proceeds of a refunding bond are used to redeem refunded bonds four months after the refunding bond is issued, that bond will be a taxable advance refunding just the same as if proceeds were not used to redeem bonds for five years. In both instances, the bonds receive the same taxable treatment even though (taking into account the allowable 90-day overlap) the "double" subsidy to which Congress objects is 57 times less in the first case (one month) than in the second (57 months).

What about a toll charge?

Considering the foregoing, objections to advance refundings being tax-exempt should be considerably diminished if the "double" subsidy could be eliminated or, significantly minimized for any given advance refunding issue. A straightforward way to accomplish that would be a rule that allows issuers of advance refunding bonds to make a one-time up-front payment to the federal government (I'm calling it a toll charge) on the issue date to make an advance refunding bond issue tax-exempt.

The amount of the toll charge could be calculated formulaically (based on a formula established by statute or regulation) to approximate an estimate of the cost of the extra "subsidy" during the more-than-90-day double-up period. The shorter the double-up period, the lower the toll charge would be.

In developing a formula for a toll charge that approximates the cost of doubling the subsidy, the two most significant factors federal government revenue estimators are likely to take into account are an assumption about the yield on taxable investments assumed to be displaced by tax-exempt advance refunding bonds during the double-up period and an assumption about the rate at which that yield would be taxed.

Although it is risky for the uninitiated to speculate about the mysteries of federal revenue estimating, there are reasons to be hopeful that a toll charge based on those two factors would be cost-competitive with other options currently under consideration by issuers and their financial advisors

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those other options, a formulaic toll charge could not achieve complete "revenue neutrality" it would still reduce the price tag of reinstating tax exemption for advance refundings to only a fraction of the $17 billion tax reform estimate.

Swing for the fences or get on base?

Some State and local issuers may question whether consideration of a toll charge is premature, because they are hopeful that Congress will quickly reverse course, and simply re-enact prior law to allow tax exemption for advance refundings. H.R. 5003, proposed by Rep. Hultgren (R-Ill.), which would do just that, is a positive development. However that bill currently has only five co-sponsors, only one of whom is a member of the Ways & Means Committee.

Resistance to reversing tax reform decisions generally (especially among Republican leadership and members of the tax-writing committees), combined with a $17 billion price tag (for which some offset/pay-for would probably need to be found), make a simple prior-law reinstatement of tax exemption a very steep hill to climb—particularly considering that advance refundings have been in the crosshairs of congressional tax-writing committee staff for more than 30 years.

Widespread fiscal crises among high profile State and local governments might facilitate reconsideration of a simple prior-law reinstatement of tax exemption. But who wants to look forward to that?

In contrast to focusing only on a potentially quixotic prior-law-reinstatement effort, an advance-refunding toll-charge approach that significantly reduces or eliminates the "double subsidy" (and its corresponding $17 billion price tag) could be a fresh attention-getting approach to reinstatement of tax exemption. Addressing the federal government's fiscal concerns should have a disarming effect on those in Congress (both staff and members) who have historically opposed tax exemption for advance refundings based on the "double subsidy." Although "never give up" can be an admirable attitude, it is sometimes smart to consider whether "something is better than nothing."

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