THE BOND BUYER

TRUMP TAX PLAN

Why we need a 'hold harmless' approach to advance refunding bonds

By Steven Gortler March 27, 2018, 10:16 a.m. EDT 4 Min Read

I don't know about you, but I sure do miss advance refunding bonds. Thankfully, however, help is on the way in the form of a simple, transparent and risk-free new approach to issuing advance refunding bonds.

To wit, I propose that public agencies once again be permitted to issue tax-exempt advance refunding bonds, provided they pay the U.S. Treasury an amount equal to the "tax expenditure" associated with each such issue. In other words, let's allow public agencies to issue advance refunding bonds provided they pay the U.S. Treasury an amount equal to the forgone federal income tax revenue owing to the interest deduction on such bonds. I call this the "hold-harmless" approach.

It only makes sense, since the reason advance refunding bonds were eliminated was to raise revenue for the federal government. So in that spirit, why not simply pay the U.S. Treasury their due and move on. With the hold-harmless approach, issuers of advance refunding bonds reap the rewards of lower interest rates on their bonds while the federal government is off the hook for the added cost. It's win-win.

The 2% solution

THE BOND BUYER

on the couponing and term structure, costs of issuance, reserve requirement, amount of any original issue discount, escrow term, negative arbitrage and arbitrage yield, my calculations indicate the hold-harmless payment for most investment-grade advance refunding bonds, assuming current market conditions, is approximately 2% of the refunded par amount, as measured on a present-value basis.

In other words, if an advance refunding generates 10% net present value (NPV) savings before accounting for the hold-harmless payment, then it will generate about 8% NPV savings afterward. So, in addition to being simple, transparent and risk free, this approach is also relatively inexpensive. Moreover, as an added bonus this approach would allow for an unlimited number of advance refundings, and even the ability to advance refund private activity bonds, since any prohibition on advance refundings would effectively be rendered moot. Pretty nifty, eh?

Don't hold your breath

No doubt there are still a few holdouts who believe that someday a sympathetic Congress will reauthorize the issuance of advance refunding bonds. But realistically that's not likely to happen anytime soon, because the United States is awash in debt and deficits and can't even afford the tax expenditures we have now. We're in the ninth year of an economic recovery with unemployment at a 17-year low and the stock market near its all-time high, and yet the federal budget deficit is expected to top $1 trillion this year, on top of the $20 trillion in debt we already have. Given these stark fiscal realities it seems highly unlikely that advance refundings will be resurrected anytime soon, regardless of which party holds power in Washington.

We have all read with great interest about the many newfangled approaches to filling the void left by the elimination of advance refunding bonds. No doubt, under the right circumstances there is a useful role for *taxable* advance refunding bonds, forward-delivery bonds, forward-starting swaps, Cinderella bonds and various other multisyllabic bond structures. However, as a purely practical matter these approaches are simply too complex, opaque, illiquid, risky and/or costly to ever achieve broad market-wide acceptance and application.

THE BOND BUYER

How to

Federal law grants the Internal Revenue Service broad authority to interpret and enforce the Internal Revenue Code and applicable Income Tax Regulations. As such, I would argue the IRS possesses the legal authority to sanction the hold-harmless approach and thus *no new legislation is required*.

More specifically, through its Tax Exempt Bonds (TEB) Voluntary Closing Agreement Program (VCAP) I believe the IRS has the authority to enter into Closing Agreements with issuers of advance refunding bonds that would, in effect, sanction the hold-harmless approach. TEB administers the Voluntary Closing Agreement Program specifically to help governmental issuers comply with applicable tax laws by resolving violations through the execution of closing agreements, and a primary objective of VCAP is to provide a vehicle to correct tax law violations as expeditiously as possible. In fact, Part 7 Chapter 2 Section 3 of the Internal Revenue Manual specifically cites "Impermissible Advance Refunding" as one of the very federal tax law violations that may be remedied by a closing agreement.

Moreover, the VCAP process is relatively straightforward. All that is required to initiate the process is for an issuer to submit IRS Form 14429 together with a proposed closing agreement.

Overall, in both word and deed VCAP is the perfect vehicle to establish the propriety of the hold-harmless approach, with one minor caveat. VCAP is normally used to remedy tax law violations for bonds that are already outstanding, as opposed to pre-emptively curing violations that have yet to occur. So, it's fair to say the IRS will need to demonstrate a modicum of flexibility in order for this approach to pass muster. But not to worry, the IRS is nothing if not resourceful.

Realistically, the IRS is unlikely to enter into Closing Agreements with every issuer of advance refunding bonds in perpetuity. More likely, the IRS will be persuaded to provide the market with formal guidance establishing the hold-harmless approach as a safe harbor, so that issuers may once again issue simple, transparent and risk-free advance refunding bonds with impunity.

THE BOND BUYER

REPRINT

TRUMP TAX PLAN TAX LOOPHOLES

TRENDING

BOND ELECTIONS

St. Louis returning to voters for bond authority after coronavirus-driven delay

If voters grant $500 million in new bond authority, the agency can hold down rate increases to fund mandatory projects.

By **Yvette Shields**

5h ago

NOT-FOR-PROFIT HEALTHCARE

Trinity Health dumps unwanted Chicago hospital into Chapter 11

The Michigan-based nonprofit hospital chain expects a restructuring charge from the Mercy Hospital bankruptcy but no impact to its municipal bond debt.

By **Yvette Shields**

6h ago

SECONDARY BOND MARKET

Muni yields steady while billions more pour into mutual funds

Refinitiv Lipper reported $2.64 billion of inflows into municipal bond mutual funds. The overwhelming demand for the large deals priced this week demonstrates the flood of available cash that continues to support a strong market.

By **Lynne Funk**

6h ago

THE BOND BUYER

FEDERAL RESERVE

Federal Reserve unlikely to create new muni programs if direct aid comes through

Vaccinations and a strong push for direct aid makes it less likely for the municipal market to need help from the Federal Reserve.

By **Sarah Wynn**

7h ago

STATE BUDGETS

Connecticut looks to pad coffers with legalized marijuana, sports betting

The governor, in his $46 billion biennial budget proposal, called for both as the state seeks to plug a deficit from the effects of COVID-19. The plan also has a bond provision.

By **Paul Burton**

9h ago

THE BOND BUYER

TRANS

State conduit plans notes for schools facing California budget deferrals

The California School Finance Authority has received 148 applications from districts and charter schools seeking to borrow almost $1.4 billion.

By **Keeley Webster**

10h ago

PRIMARY BOND MARKET

Inflows in the billions and munis grind to lower yields still

While most observers expect inflation to grow as the economy heals, the latest CPI numbers suggest that it hasn't yet arrived.

By **Lynne Funk**

February 10

PUERTO RICO

Puerto Rico Board reaches new deal but keeps it confidential

The Oversight Board asked the court to extend its deadline for submitting various documents including a term sheet to restructure the central government debt.

By **Robert Slavin**

February 10

THE BOND BUYER

CAREER MOVES

Jay Goldstone pauses retirement to return to San Diego as interim COO

Goldstone, who helped the city return to the bond markets after SEC sanctions, will help recently elected Mayor Todd Gloria get his administration rolling.

By **Keeley Webster**

February 10

THE BOND BUYER