INTRODUCTION TO TAX FOR PUBLIC FINANCE

Tax Presentation

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Introduction to Tax for Public Finance

- What is the tax-exemption for state and local bonds?
- Types of tax-exempt bonds
- Overview of federal income tax requirements
  - Use of proceeds and financed project (private use, eligible projects, etc.)
  - Arbitrage and Rebate
  - Other tax requirements
- Definitional terms
  - New money, reimbursement, and refunding
  - Issuer and “Issue”

Tax-Exemption for State and Local Bonds

- Federal Tax Exemption. Interest on tax-exempt bonds is not included in gross income for federal income tax purposes
  - Indirect federal tax subsidy to state and local governments
- AMT vs. Non-AMT. Interest on certain types of tax-exempt bonds is captured by alternative minimum tax, reducing benefit of subsidy
- Bank Qualified. Banks generally cannot benefit from tax-exempt interest, but bank qualified bonds are an exception
- State taxation of interest varies.
- Green Bonds, Community Reinvestment Act Bonds, etc., are non-tax designations

Inefficiency in Tax-Exempt Subsidy

- Tax policy concerns about inefficiency of subsidy

Taxable Coupon	Tax Bracket	Equivalent Tax-Exempt Coupon (i.e., rate investors should require)
6.00%	25%	4.50%
	28%	4.32%
	33%	4.02%
	35%	3.90%
	39.6%	3.62%

Historic typical spread, resulting in windfall to higher-bracket taxpayers

- Direct pay and tax-credit bonds are alternatives intended to eliminate inefficiency by providing direct subsidy payment to state and local governments or tax credits directly to investors

Types of Tax-Exempt Bonds

- Tax classification—determined by the project being financed and how will it be used
  - Generally independent of revenue source or issuance structure (bonds, COPs, loans, etc.)
- Major categories of tax-exempt bonds
  - Governmental bonds (§141). Governmentally owned projects that do not exceed private activity limits (i.e., private business use, private loan). Schools, transportation, infrastructure, municipally-owned utilities, etc.
  - Multifamily housing bonds for private developers (§142(a)(7))
  - 501(c)(3) Bonds (§145). Hospitals/health care, universities, museums, charter schools, etc.
  - Governmentally owned airports and ports (§142(a)(1)-(2))
  - Privately owned sewage and solid waste (§142(a)(5)-(6))

Overview of Federal Income Tax Restrictions

1) What is the project being financed and how will it be used?
   – Determines classification of tax-exempt bonds under §§141-145

2) How will the proceeds be invested until spent on the projects?
   – Arbitrage and rebate restrictions under §148

3) Other restrictions
   – Volume cap (§146) for certain types of bonds
   – Private activity bond restrictions, including TEFRA (§147)
   – Registration requirement, federal guarantee, 8038 filings, hedge bond, advance refunding, pool loan restrictions (§149)
   – Reimbursement (§150)

Use of Proceeds and Financed Project
Private Activity Restrictions

- Private activity restrictions. Governmental bonds subject to private activity restrictions are the most common. In general, any use of property by an entity other than a state or local government is potential private use.
  - No more than the lesser of 5% or $5mm of proceeds can be used for private loans
  - No more than the lesser of 10% or $15mm can be used to finance projects that are subject to private business use (“PBU”), if either (i) more than 10% or $15mm are secured by property used for PBU or by payments with respect to such property (“private security”), or (ii) payments with respect to PBU of the financed property will exceed 10% or $15mm (“private payments”)
  - Additional private activity limitations apply to output facilities

Use of Proceeds and Financed Project
Private Activity Restrictions, cont'd

Private Business Use

- Ownership of bond-financed property
- Leases
- Management or service contracts (safe harbors)
- Research contracts
- Output facilities—contracts for sale of water, electricity or gas
- Special legal entitlements

Exceptions

- General public use
- Short term leases (<50, <100, or <200 days)
- Grants—may have PBU, but no private payments or security
- Safe harbors for management or service contracts

Use of Proceeds and Financed Project, cont'd
Privately Used Projects

- 501(c)(3) Bonds. 501(c)(3)'s are private users unless the bonds are qualified as 501(c)(3) bonds
  - Use by 501(c)(3)'s can be treated as governmental use (unless UBIT)
- Exempt Facility Bonds. Certain types of facilities that can be financed on a tax-exempt basis regardless of private business use
  - Airports, ports, mass commuting and environmental improvements for hydroelectric facilities. Requires governmental ownership.
  - Water, sewage, solid waste, hazardous waste, low-income housing, high speed rail, local furnishing of gas or electricity, local heating or cooling, high speed rail.
  - Federal allocation for qualified public education, green building and sustainable design, highway or surface freight.
- Mortgage bonds, small issue, student loan, & redevelopment bonds

Arbitrage and Rebate

- Arbitrage restrictions (can you earn it)
  - Track investment of the bond proceeds until spent
  - Unless exception applies, cannot invest proceeds above the bond yield
    - Broad exception for new money bonds allowing investment at higher rates
    - For conduit loans, restrictions on spread between loan yield and bond yield
- Rebate requirement (can you keep it)
  - If bond proceeds were allowed to be invested above the bond yield, unless an exception applies, all earnings above bond yield must be rebated to IRS.
  - Spenddown exceptions for new money issues. If proceeds are spend quickly enough, may qualify for an exception from rebate.

Other Federal Income Tax Restrictions

Important other restrictions (not comprehensive)

- Volume cap (§146). Purpose is to limit amount of bonds that can be used for privately used facilities. Does not apply to governmental, 501(c)(3), or exempt facility bonds that require governmental ownership.
- TEFRA (§147(f)). Gives public an opportunity to comment on issuance of bonds. Does not apply to governmental bonds.
- Other private activity bond restrictions (§147). No acquisition of used property, limitations on financing land, no airplanes, skyboxes, health clubs, gambling or packaged liquor, 2% COI limit.
- Federal Guarantee (§149(b)). Prevents issuance of bonds where debt service is guaranteed by federal government.
- Information reporting (§149(e)). Requires filing of Form 8038-G/8038.
- Pool loan limitations (§149(f)). Restricts issuance of bonds to make future loans.
- Hedge Bonds (§149(g)). Generally requires that at least 85% of bond proceeds are expected to be spent within 3 years from issuance.

Tax Definitions—New Money vs. Refunding

- New money. Bonds issued to fund or reimburse costs of projects
  - Reimbursement rules. Generally require declaration of official intent to issue bonds to reimburse pre-issuance costs, and impose timing limitations.
- Refunding. Bonds issued to repay prior debt. Tax analysis looks through to projects financed or refinanced by prior debt.
  - Current refunding. Bonds issued within 90 days of date that prior debt will be repaid.
  - Advance refunding. Bonds issued more than 90 days before prior debt will be repaid.
    - Yield restriction on advance refunding escrows
    - Generally only one advance refunding allowed for governmental and 501(c)(3) bonds (no advance refunding allowed for most other types)

Tax Definitions—Issuer and "Issue"

- Qualified issuer. Tax-exempt bonds generally can only be issued by a state or by a political subdivision of a state.
  - Specific guidance on issuing authorities created to issue on behalf of a qualified issuer.
- "Issue" of tax-exempt bonds.
  - Tax restrictions generally apply in aggregate to each issue.
  - A single issue include all bonds that are:
    1) Sold less than 15 days apart;
    2) Sold pursuant to the same plan of financing
    3) Expected to be payable from the same source of funds
- A single issue can include bonds of different tax classifications, but requires allocations to be made between the different types

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