REPORT ON LEGISLATION
BY THE PUBLIC FINANCE COMMITTEE AND
THE PROJECT FINANCE COMMITTEE

H.R. 2 Rep. DeFazio

AN ACT to authorize funds for Federal aid highways, highway safety programs, and transit programs and for other purposes

Moving Forward Act

S. 4129 Sen. Wicker

A BILL to amend the Internal Revenue Code of 1986 to reinstate advance refunding bonds.

Lifting Our Communities through Advance Liquidity for Infrastructure (LOCAL) Act

SUPPORT FOR THE RESTORATION OF TAX-EXEMPT ADVANCE REFUNDING FOR STATES AND MUNICIPALITIES

I. INTRODUCTION

The Tax Cut and Jobs Act of 2017 (the “TCJA”), which eliminated the ability of states and municipalities to advance refund tax exempt debt, deprived states and municipalities throughout the country of one of their most effective tools for reducing debt service costs on infrastructure and other governmental-purpose projects. The severe fiscal stress on states and municipalities caused by the COVID-19 pandemic has highlighted the need to restore the ability to advance refund bonds in order to help states and municipalities to achieve debt service savings.

II. COVID-19 AND GOVERNMENTAL FISCAL STRESS

State and municipal entities throughout the U.S. are struggling to deal with the continuing effects of the COVID-19 outbreak. The outbreak has increased state and municipal outlays as

1 “Advance refunding” refers to the practice of states or municipalities issuing new debt to refinance outstanding debt prior to the date when such outstanding debt is callable, which enables states and municipalities to take advantage of favorable interest rates and thereby reduce overall costs. See Part III, below.

governments deploy additional resources to fight the virus. At the same time, the effects of the virus have significantly reduced state and municipal revenues, depleted reserves and constrained budgets. As a result, governmental entities are examining methods to reduce costs and generate budget savings.

During periods of fiscal stress, states and municipalities have traditionally looked to refinancing of debt as a means of generating budget savings. This is especially the case when, in conjunction with an economic downturn, municipal bond market interest rates decline, as is currently the situation.

III. ADVANCE REFUNDING STRUCTURE

State and municipal tax-exempt debt is typically not pre-payable (not callable) during the first ten (10) years of the term of such debt. In order to take advantage of a favorable interest rate environment and reduce costs to achieve debt service savings during the ten (10) year no-call period, state and municipal entities had, prior to the adoption of the TCJA, used a financing structure known as an “advance refunding” to achieve such debt service savings.

In an advance refunding structure, a state or municipality issues new debt to refinance outstanding debt prior to the date when such outstanding debt is callable. The proceeds of the new debt are placed in an escrow and are typically invested in U.S. Treasury obligations, at yields not exceeding the yield on the new debt.\(^3\) The proceeds of such escrow together with investment earnings are used to pay debt service on the outstanding debt prior to the call date. The corpus of such escrow is eventually released to pay the refinanced debt on its call date.\(^4\) The revocation by the TCJA of tax-exempt advance refunding has severely limited the ability of states and municipalities to manage debt portfolios and to take advantage of favorable interest rate environments to achieve debt service savings and reduce overall costs.

The Federal Department of Treasury has been critical of state and municipal tax-exempt advance refundings because tax-exempt advance refundings result in two sets of tax-exempt bonds (both financing and refinancing the same cost) being outstanding at the same time. This modestly increases the federal subsidy of tax-exempt interest for any project debt that has been the subject of an advance refunding. However, this increased subsidy only continues during the short period that both the new debt and the refunded debt remain outstanding. The Government Finance Officers of America (“GFOA”) has estimated that the ten year net cost to the Federal Government of the advance refunding legislation is $17 billion or $1.7 billion per year, which is really quite modest when considering that the federal budget for the fiscal year 2020 was $4.79 trillion.

The inability to undertake advance refundings is particularly pronounced during periods of fiscal stress and economic decline which is currently the case as a result of the COVID-19 outbreak. Interest rates are currently at near historic lows.\(^5\) If not for the revocation of tax-exempt

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\(^3\) This is required under the Federal tax law to avoid arbitrage earnings by states and municipalities. Treasury Regulation Section 1.148-2(d)(2)(ii).


\(^5\) The Bond Buyer 20-Bond GO Index.
advance refundings, states and municipalities throughout the U.S. would be able to utilize advance refundings to achieve significant debt service savings and reduce costs to alleviate the current financial stress.

IV. PROPOSED LEGISLATION

Recognizing the fiscal constraints state and municipal entities are now experiencing, on July 1, 2020, the House of Representatives passed the Moving Forward Act, or H.R. 2, which provides for, among other things, the reinstatement of tax-exempt advance refundings. On July 1, 2020, Senators Debbie Stabenow and Roger Wicker introduced Senate Bill, Lifting Our Communities through Advance Liquidity for Infrastructure Act. Both bills effectively restore the status quo prior to the adoption of the TCJA and permit state and municipal entities to refinance outstanding debt through the use of tax-exempt advance refundings.

V. LEGISLATIVE ENHANCEMENTS

Clearly, restoring the pre-TCJA status quo for advance refundings is a laudable goal which would provide significant financial benefits to states and municipal entities. However, while restoration of tax-exempt advance refundings is being examined by federal lawmakers, such lawmakers should also consider modifying tax laws and regulations to permit expanded use of tax-exempt advance refundings. Such modifications could address the current needs of state and municipal entities, particularly in light of changes that have occurred in the municipal finance market since the enactment of Internal Revenue Code of 1986 (the “Code” or “IRC”) which provided comprehensive restrictions relating to advance refundings of governmental bonds.

Pre-TCJA, the Code in general only permitted one advance refunding per governmental purpose debt issuance. This rule, implemented in 1986, was intended to address Treasury concerns with revenue loss resulting from multiple series of advance refunding bonds being outstanding simultaneously, which greatly increases the Federal tax exemption subsidy provided to a state or municipal project. Market acceptance of longer term state and municipal debt has increased over time. It is not unusual for state and municipal bonds to have a final term of thirty (30) years or more. Limiting states and municipalities to just one advance refunding transaction per debt issue does not account for the fact there may be several interest rate cycles over a period of years during which state and municipal issuers could refinance its debt. More importantly, restoration of the one-time pre-TCJA advance refunding rules will provide no assistance to a state and municipal issuer who has already utilized its one-time advance refunding transaction. US Treasury revenue loss concerns could be addressed by simply not permitting multiple advanced refunding transactions relating to a bond issue to be outstanding at one time.

6 Ibid.
9 Pre TCJA IRC §149(d).
It is important to note that the ability to undertake additional tax-exempt advance refundings was the approach taken with respect to Federal Liberty Bond 9/11 disaster relief legislation, which permitted certain New York City issuers to undertake an additional advance refunding for debt that had already been advance refunded. This type of relief is particularly justifiable as disaster relief now in light of the financial effects of COVID-19 being felt nationwide.

One other notable aspect of the municipal finance marketplace that has increased over time is the reliance by state and municipal entities on public-private partnerships to provide essential infrastructure. In many jurisdictions throughout the US, roads, rail, airports, water, sewer and educational facilities vital for states and municipalities have been financed as public-private partnerships through the use of tax-exempt municipal bonds known as private activity bonds. Under current and pre-TJCA federal tax laws and regulations, tax-exempt private activity bonds do not qualify for tax-exempt advance refundings. This is the case even though the source of payment for such bonds is often “Availability Payments” paid directly by a state or municipal entity. Under a public-private partnership, Availability Payments are typically payments made by a state or municipal entity pursuant to a concession agreement in consideration for the design, building, financing and operation of infrastructure made available to the public by a private consortium. Since 2009, approximately half of public-private partnerships have utilized Availability Payments. Here, again, restoration of the pre-TCJA status will provide no relief for state and municipal issuers who have utilized such public-private partnerships to fund public infrastructure.

VI. CONCLUSION

Given the severe fiscal effects of COVID-19, state and municipal entities need access to basic financial tools to manage their debt portfolios and take advantage of historically low interest rates. The TCJA repeal of the tax-exempt advance refunding eliminated a basic tool that state and municipal entities had historically used to achieve debt service savings and reduce costs, particularly during periods of fiscal stress. Congress should restore the tax-exempt advance refunding. In addition to restoration of this basic tool, Congress should eliminate certain pre-TCJA restrictions on tax-exempt advance refundings to reflect the current municipal finance market and to address the current needs of state and municipal entities.

Public Finance Committee
William F. Dudine, III, Chair

Project Finance Committee
Jaime E. Ramirez, Chair

October 2020

11 Pre TCJA I.R.C.§1400L(e)(1).
12 Board of Audit And Inspection Hyun Duk Choi; A Study of Public-Private-Partnership Practices and Fiscal Integrity in the U.S., December 2017.