

TAXING ISSUES

The Jones Hall Municipal Finance Tax Newsletter

By: David Walton

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What's New in Washington

This appears to be the year of positive legislative interest in tax-exempt bonds. Summarized below are a few of the current Federal legislative proposals with relevance to California issuers.

QZABs , QSMBs and BABs Proposals

In the last issue of *Taxing Issues* I described qualified zone academy bonds or "QZABs". As far as I am aware, only two QZABs have been issued since the inception of this program in 1998. Jones Hall acted as Bond Counsel for one of these QZABs. To say that the QZABs program has been underutilized to date would be an understatement (of the \$200 million authorized for 1998, apparently less than \$25 million was issued). Reasons for this underutilization include (i) a limited market for these bonds (only banks, insurance companies or corporations actively engaged in the business of lending money are eligible for the tax credit), (ii) risk surrounding the ability to use the tax credit (if the holder has no taxable income for the year, the tax credit is worthless, and may not be carried forward), and (iii) the 110% of AFR tax credit rate is too low for QZABs to trade at par (both of the QZABs sold to date were sold at an original issue discount).

In spite of this underwhelming response to QZABs, the Clinton Administration in its fiscal year 2000 budget has proposed expanding and modifying QZABs and adding two new categories of tax-credit bonds ("credit bonds") called "Qualified School Modernization Bonds" or "QSMBs" and "Better America Bonds" or "BABs" (aren't acronyms fun?). Legislation regarding QZABs and QSMBs has been introduced in both the House (HR 340) and Senate (S. 223). No legislation has yet been introduced regarding BABs. The proposal would expand the QZABs program by extending authorization for two more years and allowing \$1 billion of bonds in 2000 and \$1.4 billion in 2001. In addition, QZABs would be permitted to be used for school construction (QZABs are currently limited to renovating buildings, acquiring equipment, developing course materials and training teachers).

QSMBs

Under the proposal, QSMBs could be used to finance the construction, rehabilitation, or repair of public elementary and secondary schools. \$11 billion of QSMBs would be authorized for each of the years 2000 and 2001, of which approximately \$5.5 billion would be allocated among the States under the Federal school grant formula. The remaining authorization would be allocated to the 100 school districts with the largest number of children living in poverty and to an additional 25 school districts designated by the Secretary of Education (\$200 million would also be reserved for the Bureau of Indian Affairs). Carryover of unused credit to 2001 and 2002 would be permitted. Unused allocations could be carried forward up to three years. The U.S. Department of Education would have to approve a State or school district's modernization plan demonstrating that a comprehensive survey of construction and renovation needs had been undertaken and describing how the bond proceeds would be used under the plan. Note that the big difference between QZABs and QSMBs is that you do not need private donations for QSMB projects.

BABs

Under the proposal, BABs could be issued for (1) the acquisition of land for open space, wetland, public parks or green ways owned by a political subdivision or nonprofit environmental preservation corporation, (2) construction of visitor's facilities owned by a political subdivision or

qualifying nonprofit, (3) remediation of land acquired in (1) to improve water quality or of publicly owned open space, wetlands, or parks (by controlling erosion and remediating toxic conditions), (4) acquisition of easements on private open land to prevent commercial development and other changes in the use or character of the land, or (5) assessment and remediation of contaminated property owned by a political subdivision through abandonment by the prior owner. All land acquired with BABs proceeds would be required to be available to the general public. BABs would be limited to \$1.9 billion annually for 2000 through 2005 and a volume cap allocation would be made by the U.S. Environmental Protection Agency. Unallocated volume cap could be carried forward to the next year and unused allocations could be carried forward for up to 3 years. No depreciation or deduction for expenses would be allowed for BABs-financed property. Under certain circumstances a qualifying nonprofit corporation could have an option to purchase the BABs-financed property.

Provisions Common to Credit Bonds

The proposal also contains provisions common to all credit bonds. In an effort to have credit bonds trade at par, the credit rate would be determined based on the yield of AA corporate bonds on the day prior to the date of issue of the bonds. The maximum term of these bonds would be 15 years. Unused credits could be carried forward for up to five years. At least 95 percent of bond proceeds (including investment earnings) would have to be expected to be used for qualifying purposes within three years. A binding obligation to spend 10 percent of the proceeds within 6 months of the issue date would also be required. For the 3-year period after the date of issue, bond proceeds would be required to be invested only in bank accounts or U.S. Treasury securities with a maturity of 3 years or less. After the 3-year period, any unspent proceeds would be required to be used to redeem bonds within 90 days. The bond-financed property would have to be used for qualifying purposes for at least 15 years (failure to do so would result in discontinuance of the credit and an obligation to repay past credits) and the property would be required to be owned by a governmental entity. Finally, any sinking fund established for the bonds would have to be invested in United States Treasury Securities, State and Local Government Series ("SLGS") (no yield restriction is mentioned). As is the current case with QZABs, the credit would continue to be treated as taxable income to the bondholders.

While it is very encouraging that the President's budget includes the credit bonds proposal, it is only a proposal and has not been enacted by Congress. A downside to the proposal is that it involves limited volume caps which issuers must compete for and generally is limited to school facilities.

Bill Would Allow Private Activity School Bonds and Increase Rebate Exemption

A bill has been introduced that would increase the small issuer rebate exemption for school construction bonds from the current \$10 million to \$15 million (the rebate exemption for school construction bonds was increased in 1997 from \$5 million to \$10 million). If passed, this would mean that a school district could issue up to \$15 million of bonds a year and not be subject to rebate. Presumably, of the \$15 million, no more than \$5 million could be for purposes other than new school construction. In addition, this bill would extend the 2-year rebate spend-down exception to 4 years. The most interesting provision of the bill is the creation of private activity school construction bonds under which private companies could build public schools which would be leased by school districts (ownership would revert to the school districts when the bonds were paid off). These private activity bonds would be subject to a \$10 per capita (minimum \$5 million) volume cap.

As with the President's proposal, any proposed relief for tax-exempt obligations is appreciated. However, municipalities also have infrastructure needs and it would be nice if the rebate small issuer relief applied to general governmental obligations in addition to school bonds.

Volume Cap Increase Proposed

Bills have been introduced in both the House and the Senate to increase the private activity bond volume cap from its current level of \$50 per capita (with a minimum of \$150 million) to \$75 per capita (with a minimum of \$225 million) with annual increases indexed to inflation. A bill in Congress

last year would have increased the volume cap to these levels with a phase-in beginning in 2003 and ending in 2007 (but with no increase for inflation). That bill never passed and the new bill would make the entire increase effective January 1, 2000. Major users of the volume cap in California are low-income multifamily housing bonds, single family housing mortgage bonds, and small issue private activity bonds. During the last decade, demand for volume cap has far exceeded supply and the increase would be beneficial to the State. But, as is the case with the credit bond proposals, this bill has not been enacted nor signed by the President.

New Treasury Regulations on Bidding Open Market Escrow Securities and Guaranteed Investment Contracts

On December 30, 1998, the Treasury Department released final arbitrage regulations (the “Final Regulations”) concerning the investment of bond proceeds in guaranteed investment contracts (“GICs”) and in securities held in yield-restricted defeasance escrows (together the “Targeted Investments”). The Final Regulations were drafted in response to “yield burning” abuses alleged to have occurred with respect to investments of advance refunding bond proceeds in open market escrows and investments of bond proceeds in GICs. Yield burning occurs when an issuer pays more for an investment than its fair market value (e.g., an issuer pays \$110,000 for a Treasury bond that was generally available for \$100,000). The Final Regulations provide a “safe harbor” for the investment of bond proceeds in Targeted Investments that, if met, will deem the price paid for the Targeted Investments to be fair market value and; therefore, the yield on the investment will not be questioned by the IRS.

The Final Regulations replaced regulations proposed on June 27, 1996 (the “Proposed Regulations”). The Final Regulations apply to transactions occurring on and after March 1, 1999. The Proposed Regulations were not particularly well received when released and the Final Regulations, although not perfect, are a significant improvement over the Proposed Regulations. The Final Regulations only apply to GICs and investments in yield-restricted escrows (e.g., project fund and reserve funds are not subject to these rules). A GIC is defined as an investment with specifically-negotiated withdrawal or reinvestment provisions and a specifically-negotiated interest rate including an agreement to supply investments on two or more future dates (e.g., a forward supply agreement). This definition has caused some uncertainty as to which types of investments constitute a GIC (some people have argued that an escrow with forward delivery agreements is a GIC). Yield-restricted defeasance escrows generally refer to investments in typical advance refunding escrows **not funded with SLGS**.

The safe harbor consists of the following requirements:

- (1) Written bids containing all relevant terms affecting the yield of the investments (including an expected draw-down schedule for GICs) must be forwarded to potential purchasers on a timely basis (the broker running the bidding cannot bid).
- (2) By submitting a bid, the potential provider represents that it did not consult with any other potential provider about the bid, that the bid was made without regard to any agreement with the issuer or any other person, and that the bid is not being submitted merely as a “courtesy” to the issuer (the bidder has to really want to win!).
- (3) The bid terms must be commercially reasonable and cannot be there solely for the purpose of reducing the yield on the investment.
- (4) All potential providers must have an equal opportunity to bid and none can have the ability to review other bids (a “last look”).
- (5) At least three reasonably competitive providers with established industry reputations as competitive providers of the type of investment being purchased (“Reasonably Competitive Providers”) must be solicited for bids.

(6) At least three bids must be received from solicited providers (at least one of which is a Reasonably Competitive Provider) with no material financial interest in the issue. The following have a material financial interest: (i) a lead underwriter in a negotiated underwriting transaction for a period of 15 days after the date of issue; (ii) a financial advisor with respect to the purchase of the investments who was acting in that capacity at the time the bids were solicited; and (iii) any person or entity related to any provider with a material financial interest in the issue.

(7) The winning bid for securities must meet each of the following: (i) the bid is the lowest cost bona fide bid (including any broker's fees) determined on the basis of the lowest cost bid for the entire portfolio, or the lowest cost bid for each investment in the portfolio, with any payments received with respect to a GIC (e.g., an escrow float contract) being taken into account; and (ii) the lowest cost bona fide bid (including any broker's fees) does not exceed the cost of the most efficient portfolio comprised of SLGS determined at the time that bids are required to be submitted. If SLGS are available at the maximum permitted yield, a purchase of open markets will not generally meet the safe harbor. For GICs the winning bid must produce the highest yield (net of broker's fees).

(8) The issuer must retain the following records: (i) records of the amounts actually paid for the investments (including any administrative costs) or a copy of the GIC; (ii) the name of each person or entity submitting a bid, the time and date of the bid, and the bid results; and (iii) an explanation of any deviation in the terms of the purchase agreement or the GIC from the bid solicitation form.

(9) The broker's fee for yield restricted escrow investments cannot exceed the lesser of \$10,000 or .1% of the initial principal amount of investments deposited into the escrow and .05% of the weighted average amount reasonably expected to be invested each year under a GIC (e.g., a float contract). The broker's fee for GICs that are not part of an escrow must be reasonable and cannot exceed .05% of the weighted average amount reasonably expected to be invested each year under the GIC. The broker must also certify that its fee is comparable to a fee that it would have charged for reasonably comparable investments of funds other than gross proceeds of tax-exempt bonds.

As shown above, the safe harbor contains many detailed rules. By making compliance with the safe harbor difficult, the IRS is apparently trying to encourage investments in SLGS whenever feasible.

Jones Hall Welcomes Steve Melikian and Scott Ferguson

Jones Hall is pleased to announce that Steven G. Melikian has joined the Firm as a principal and Scott R. Ferguson has joined the Firm as an associate. Steve is a nineteen year veteran of the California municipal finance business and has special expertise in multifamily housing, tax increment, water, wastewater, Mello Roos, assessment, private activity bond and lease revenue financings. Scott has substantial real estate and housing experience. We are delighted to have these two highly qualified lawyers join us.

A Final Thought - "The best things in life are free, but sooner or later the government will find a way to tax them." Unknown.

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Taxing Issues is also available through our Web Site

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