Recent Developments in Federal Tax Law Affecting State and Local Government Finance

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The Three Most Significant Recent Developments

- Loss of Advance Refundings
- Facilitation of Privatization/P3s/Reuse of Bond-Financed Property
- Opportunity Zone Financing

Loss of Advance Refundings

Under the Tax Cuts and Jobs Act (“TCJA”) a bond issued after December 31, 2017, to advance refund a tax-exempt bond cannot qualify for tax-exempt status.

A bond is treated as issued to advance refund another bond if it is issued more than 90 days before the redemption of the refunded bond.

Even after TCJA, an issuer may still do an unlimited number of tax-exempt current refundings.

Loss of Advance Refundings (cont.)

Significant because most publicly offered fixed-rate tax-exempt bonds have featured 10-year call protection.

Since the 1986 Tax Reform Act issuers had been allowed one tax-exempt advance refunding of a new money tax-exempt governmental bond issue.

From the Joint Committee on Taxation Bluebook on TCJA (pp. 250-251):

The primary Federal tax law concern with advance refundings is that they result in two issues of tax-exempt bonds that remain outstanding simultaneously for more than 90 days to finance the same project or activity and that thereby results in increased Federal revenue cost for multiple Federal subsidies.

Problems

For state and local governments: Loss of a tool for achieving debt service savings, debt service restructurings and relief from burdensome debt covenants.

For the underwriting/financial advisor/bond counsel community: Far lower volume (although this may be good news for issuers with new money needs or current refunding opportunities).

Alternatives to Advance Refunding for Outstanding Bonds:

- Taxable Bonds
- Negotiation with Existing Bondholders
- Tender Offer
- "Cinderella Bonds"
- Forward Delivery Bonds
- Forward-Starting Swaps

Taxable Bonds

- Simple, but harder to achieve debt service savings.

- Can the taxable bonds be refunded later with tax-exempt bonds?

Negotiation with Existing Bondholders

- "Sell" right to call bonds for optional redemption.

- Reissuance concerns/treatment of sale proceeds.

Tender Offer

- Offer to purchase outstanding bonds.
- Issue new bonds to raise funds to purchase outstanding bonds.
- Outstanding bonds canceled on the purchase date.

Cinderella Bond

- Initially issued in taxable form.
- Conversion to tax-exempt occurs within 90 days of the refunded bonds' redemption date.
- Conversion normally requires delivery of bond counsel opinion – concern about intervening law changes.

Forward Delivery Bonds

- Date between bond sale and bond closing longer than normal—bond closing occurs within 90 days of refunded bonds redemption date.
- Risk of intervening law changes – may prevent closing.
- Risk of intervening financial condition changes – Supplement to Official Statement delivered at closing in public sales.
- Investors demand higher interest rates to compensate for increased risk.

Forward-Starting Swaps

- Effectively lock-in interest rate at the time the current refunding bonds would be issued.

- Create synthetic fixed-rate refunding if issuer issues variable rate bonds on the swap start date.

- Swaps not much used by Virginia local governments.

Structuring Considerations for New Issues

- Bank Loans/Private Placements
- Shorter No-Call Periods
- Make-Whole Calls
- Variable Rate Bonds
- Defeasance Transactions/"Cash Optimization Programs"

Structuring Considerations for New Issues (cont.)

Bank Loans/Private Placements – may have more flexible prepayment terms.

Shorter No-Call Periods – for example, offer a 5-year no-call period with a redemption premium that declines over time.

Make-Whole Calls – Bonds callable at any time at amount equal to present value of remaining debt service payments; common in taxable bond market.

Variable Rate Bonds

- Generally callable at any time.
- Generally require liquidity support, such as a bank letter of credit.
- Expose issuer to interest rate risk.

Defeasance Transactions/"Cash Optimization Programs"

- Issuer uses cash on hand to defease outstanding bonds.

- After defeasance, issuer sells "new money" bonds.

- Differing views on issuing bonds before or after defeasance and the appropriate length of time between defeasance and bond issuance.

Recent Bright Spots

Legislation introduced to restore advance refundings.

IRS has approved tax-exempt advance refundings of direct-pay Build America Bonds.

- BABs are taxable bonds.
- “Turn off” direct-pay subsidy on refunding bond issue date.

Facilitation of Privatization/P3s/Reuse of Bond-Financed Facilities

- Liberalization of Management Contract Safe Harbors.
- Addition of New Remedial Actions.

Management Contracts and Their Effects

One of the most common structures in the privatization/P3 arena is for a state or local government to contract with a for-profit firm to operate or manage a function of the government.

But if the management contract pertains to property financed with tax-exempt governmental bonds, the contract may result in private business use of the property and cause the bonds to lose tax-exempt status.

Why? Congress wants to limit proprietary interests in tax-exempt governmental bond-financed property.

Definition of "Management Contract"

Means generally a management, service or incentive payment contract between a state or local governmental entity and a private service provider under which the service provider provides services for managed property – financed in whole or in part by tax-exempt governmental bonds.

Example: A contract under which a private company operates a cafeteria in a bond-financed high school.

Qualified Management Contracts Pre-2017

Congress and the IRS have long recognized the benefits of private operators and the IRS has for many years provided "safe harbor" rules under which certain management contracts would not create private business use.

Before 2017, under Revenue Procedure 97-13 a management contract would be "qualified" if, among other things, the compensation provisions and the term of the contract fell within tightly circumscribed limits.

For example, a management contract under which the service provider received a per-unit fee could not exceed 3 years and be terminable by the governmental owner after 2 years.

Qualified Management Contracts Pre-2017 (cont.)

The compensation categories under Revenue Procedure 97-13 were overly specific and were increasingly unreflective of current business practices.

The length of contract term allowed under Revenue Procedure 97-13 were generally considered to be too short.

Revenue Procedure 2017-13

In early 2017 the IRS instituted a new safe harbor management contract regime.

Revenue Procedure 2017-13 applies a more flexible and less formulaic approach to allow variable compensation for longer-term management contracts of up to 30 years.

Safe Harbor Compensation

Revenue Procedure 2017-13 generally permits any type of fixed or variable compensation that is reasonable compensation for the services rendered under the management contract.

Service provider cannot share in the net profits or bear the burden of any net losses from the operation of the managed property.

Safe Harbor Compensation (cont.)

Determination of compensation cannot take into account both the revenues and expenses of the managed property for any fiscal period.

Limited deferrals of compensation payments not deemed to a bearing of net losses; deferral can last no more than five years after the original due date.

Incentive compensation allowed if the eligibility for the compensation is determined by meeting one or more standards that measure quality of services, performance, or productivity.

Safe Harbor Contract Term

The term of the management contract, including all renewal options, can be up to the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property.

Land gets a 30-year life if at least 25 percent of the proceeds of the issue that financed the managed property were used to acquire the land. Otherwise the land is disregarded.

Other Notable Requirements under Revenue Procedure 2017-13

Governmental entity must exercise **significant control** over managed property – including approving the annual budget and rates charged, capital expenditures and property dispositions.

Governmental entity must bear **risk of loss** upon damage or destruction of managed property.

Service provider may take **no inconsistent tax positions** (for example, no depreciation deductions).

No circumstances **substantially limiting the governmental entity's exercise of contract rights**.

Remedial Actions

Many localities have issued long-term tax-advantaged bonds to build or renovate buildings that become obsolete or redundant long before the bonds are scheduled to be retired or may be more effectively used in a P3 arrangement.

These localities want to get these properties into private hands and onto the tax rolls, but are hampered because, in many cases, a sale or lease of the bond-financed property will cause the bonds to become taxable.

A sale or lease of bond-financed property to a private entity constitutes private business use.

Pre-2018 Remedial Action Options

Until the spring of 2018, issuers of tax-exempt governmental bonds had only three options to remediate the effects of a privatization of the bond-financed property –

- **Redemption or defeasance** of the nonqualified bonds within 90 days after the deliberate action;
- **Alternative use of the disposition proceeds** within two years after the deliberate action; or
- An **alternative use of the facility** if the alternative use would satisfy the rules for an issue a tax-exempt private activity bonds.

Limitations of Pre-2018 Remedial Action Options

- The first two options were practically available only in situations in which the bond-financed facility was being sold for a one-time cash payment (and not most types of leases).

- The third option applies only in limited cases.

- None of the options covered projects financed with direct-pay bonds (for example, direct-pay BABs, QZABs and QSCBs issued during the Stimulus Act period) or most types of tax-credit bonds.

Revenue Procedure 2018-26

- Appeared in the spring of 2018.
- Provided remedial action that was workable for long-term leases of bond-financed property to private entities.
  - Long-term leases are common in privatization/P3 structures.
  - New remedial action similar to existing "alternative use of disposition proceeds."
- Provided a commonsensical remedial action to allow privatizations of direct-pay bonds.

Basics of Long-Term Lease Remedial Action

- Lease has to be an "eligible lease“ – cash lease payments only with a term generally of the lesser of 20 years or the remaining term of the bonds.

- The present value of the lease payments (determined by using the bond yield as the discount rate) is applied to a qualified alternative use within two years of the effective date of the lease.

Basics of Direct-Pay Bond Remedial Action

- "Turn off" subsidy allocable to the nonqualified direct-pay bonds on and after the date of the deliberate action.

- Use disposition proceeds either (i) to redeem or defease nonqualified direct-pay bonds within 90 days or (ii) for a qualified alternative use.

Remedial Actions for Tax-Credit Bonds

- Revenue Procedure 2018-26 extends all of the available remedial actions to tax credit bonds.

- If the defeasance option is available and selected, issuer allowed to yield-restrict escrow through rebate payments.

A Few Words about Opportunity Zones

In the TCJA Congress added Sections 1400Z-1 and 1400Z-2 to the Internal Revenue Code.

The provisions seek to encourage investment in designated distressed communities ("qualified opportunity zones") by providing Federal income tax benefits to taxpayers who invest in businesses located within these zones.

212 Qualified Opportunity Zones in Virginia—in both urban and rural areas.

Opportunity Zone Tax Breaks for Investors

- Deferral of taxation of certain capital gains to the extent that they are reinvested in a "qualified opportunity fund."

- Basis "step-ups“ – 10 percent at 5 years and another 5 percent at 7 years.

- Exclusion from gross income of the post-acquisition gains on qualified opportunity fund investments held for 10 years.

Potential Application

Many types of local government projects – especially buildings newly constructed or rehabilitated for community centers, libraries, administration buildings and schools – should be able to be financed as qualified opportunity zone business properties and leased to local governments.

Would require ownership (at least initially) by a qualified opportunity fund or a qualified opportunity zone business financed by a qualified opportunity fund.

A Deadline

In general, to obtain the maximum benefits from an investment in a qualified opportunity fund, by **December 31, 2019**, an investor must make the investment and there must at least be specific written plans for spending the investment proceeds on qualified property within 31 months.

Many benefits still obtainable after December 31, 2019.

Questions or Comments?

www.mcguirewoods.com

Contact Information

Arthur E. Anderson II
aanderson@mcguirewoods.com
(804) 775-4366

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