By Ryan Callender and Mike Cullers

Taxable Advance Refundings—All the Rage

On December 22, 2017, President Trump signed into law the 2017 Tax Cuts & Jobs Act ("Act"). The Act greatly affected the finances of school districts across the nation. Among the many applicable provisions affecting your school district's budget was the elimination of the ability to "advance refund" your existing tax-exempt debt with newly issued tax-exempt debt.

We know that everyone reading this article is knowledgeable about advance refundings, but here's a short refresher: an "advance refunding bond" is a refunding bond that is issued more than 90 days before some portion of the proceeds of the refunding bond will be used to pay debt service on another bond. Advance refundings are predominantly used to take advantage of a lower interest rate environment by refinancing debt and reducing debt service, thereby saving school districts, and hence taxpayers, oodles of money. Prior to the effective date of the Act, a school district might save hundreds of thousands of dollars, maybe even millions, over the life of its debt by advance refunding current debt with new tax-exempt bonds. Since school district bonds are often voted bonds, those savings flowed directly into the taxpayers' pockets.

So why did the federal government eliminate the ability to save local taxpayers money? Congress thought the elimination of this subsidy would add to federal revenues. According to the Joint Committee on Taxation, eliminating tax-exempt advance refunding bonds would provide additional revenue to the federal government of $16.8 billion over the succeeding 10 years. It is difficult to ascertain how much money this has (and will) cost school districts (and other local governments) over the same time period, but it is likely to exceed the $16.8 billion.

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If school districts can no longer issue advance refunding bonds, why has every financial advisor and investment banker in the state phoned/visited/emailed/texted/faxed/telegraphed/ carrier-pigeoned your district a proposal for one or more advance refunding issues!?!? To be clear, the prohibition applies to tax-exempt bonds for advance refunding (other than a tax-exempt advance refunding of taxable bonds that are not tax-advantaged bonds). A school district can still issue taxable bonds to advance refund tax-exempt bonds, and with crazy low interest rates (the technical term used by Wall Street investment bankers), today's taxable rates are often lower than past years' tax-exempt rates. But why would a school district consider a taxable advance refunding, how do these taxable advance refundings work, and what should treasurers know about them?

One general benefit to issuing taxable bonds is that a school district can bypass those nettlesome tax regulations that govern tax-exempt bonds. That is not necessarily the case, however, for the taxable advance refunding of tax-exempt bonds. As long as the advance refunded tax-exempt bonds are still outstanding for tax purposes (even if defeased under state law), the tax regulations still apply to the advance refunded tax-exempt bonds. School districts still need to plan for some tax-exempt bond law limitations while utilizing taxable bonds—in particular, the arbitrage regulations and limitations on private use of the bond-financed assets.

Moreover, once tax-exempt bonds are defeased in a taxable advance refunding structure, there are fewer remedies that can be pursued for changes in use. School districts should contemplate whether use of the bond-financed assets could change before the advance refunded tax-exempt bonds are discharged. If there is a change in use of bond-financed assets after the advance refunded tax-exempt bonds are defeased but are still outstanding, the remedial action option to redeem or defease the "nonqualified bonds" would obviously be unavailable. In some cases, this could leave a school district without a remedy for a change in use of bond-financed assets; the school district's only corrective action option would be to file a voluntary closing agreement program request with the Internal Revenue Service. Such filings can be costly and time consuming for school districts. School districts should discuss with their bond counsel any contemplated change in use of assets that were financed with outstanding tax-exempt bonds, even if these bonds are defeased by taxable bonds.

There is another tax-exempt bond law complication to note with taxable advance refundings. Normally, proceeds of a taxable advance refunding are not subject to the arbitrage regulations. For example, in all advance refundings, a school district establishes an escrow to repay principal and interest on the advance refunded bonds when they become due and to call the refunded bonds. The amounts in the escrow are invested in certain securities, such as United States Treasury Securities—State and Local Government Series (SLGs). In tax-exempt advance refundings and cash defeasances, the tax regulations require that the yield on the investments contained in an escrow be restricted not to exceed the yield on the defeased tax-exempt bonds. That is not the case in many taxable advance refundings because the investments in the refunding escrow are treated as purchased with proceeds of the taxable advance refunding bonds.

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However, in certain circumstances where the taxable advance refunding bonds amortize faster than the refunding escrow, a complication can occur that subjects some or all of the escrow to yield restriction based on the defeased tax-exempt bonds. In this scenario, the tax regulations require that, to the extent that the taxable advance refunding bonds amortize faster than the escrow, the escrowed securities originally purchased with proceeds of the taxable advance refunding bonds that have already amortized be re-allocated to the advance refunded tax-exempt bonds. If this occurs, the yield restriction requirements applicable to investments of gross proceeds of the advance refunded tax-exempt bonds extend to the reallocated securities. Plain English translation: this result could leave a school district having to pay an unexpected, sometimes expensive, yield reduction payment to comply with the yield restriction.

With proper planning, including consulting bond counsel and a financial advisor, school districts can avoid this potentially costly, unintended outcome.

Taxable advance refundings are all the rage, and in many instances provide tremendous savings to school districts. However, a few pitfalls need to be recognized and avoided early on. To avert additional costs and to realize the full amount of the savings generated by a taxable advance refunding, school districts should properly plan and consult with their bankers, financial advisors and bond counsel when using this type of transaction structure.

Taylor Kaven, associate at Squire Patton Boggs, also contributed to this article.

Ryan Callender is a partner at Squire Patton Boggs LLP.
216.479.8500 | *ryan.callender@squirepb.com*

Mike Cullers is a partner at Squire Patton Boggs LLP.
216.479.8477 | *michael.cullers@squirepb.com*

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