<u>Advance Refundings</u>

Section 3602 of the Tax Cuts and Jobs Act (H.R. 1) would amend the Internal Revenue Code to eliminate the ability of state and local governments to execute tax-exempt "advance refundings" of outstanding tax-exempt bonds. Tax-exempt advance refundings provide states and localities with an important tool for refinancing outstanding debt at lower interest rates and have generated many billions of dollars of interest savings over decades, lowering the cost of government. We urge Congress to abandon the proposed prohibition on advance refundings.

Background

State and local governments tend to be conservative borrowers. To preserve the ability to refinance debt when market interest rates fall, most municipal bonds are issued with a "call" feature that allows the issuer to redeem its bonds early at face value, usually after 10 years. It permits state and local governments to refinance their prior borrowings in much the same way a homeowner might refinance a home mortgage. However, unlike home mortgages that can be repaid at any time, the call feature early redemption cannot be exercised earlier than the call date, which for many municipal bonds is 10-years after issuance.

Often, the interest rate environment becomes attractive for refinancing before the call date has arrived. In those cases a local government may choose to execute a refunding in advance of the call date. In these cases the bond issuers sells the new, lower interest rate bonds (the "Refunding Bonds") to investors and deposits the proceeds of the sale in a secure escrow to pay the debt service on the old bonds (the "Refunded Bonds") and redeem those bonds when the call date arrives. When the Refunded Bonds have been redeemed on the call date, only the Refunding Bonds remain outstanding. Transactions where the Refunding Bonds are issued within 90 days of the call date are treated as current, not advance, refundings.

There are already several restrictions on advance refundings under current law. First, advance refundings can be executed only once per new bond issue. Once an issuer has undertaken an advance refunding, those bonds can never be advance refunded again. Second, there are restrictions on the use of the escrow to ensure that the local government cannot spend money from the escrow on general expenses and cannot earn any profit, or "arbitrage," by borrowing at low tax-exempt interest rates and investing the proceeds in higher yielding taxable securities. Advance refunding escrows are prohibited from earning a return higher than the interest rate on the Refunding Bonds that funded the escrow. Moreover, many advance refunding escrows are invested in special Treasury securities known as State and Local Government Series (SLGS) specifically designed for the purpose of tax-exempt bond escrows. SLGS carry a below-market interest rate, and the federal government saves on its own borrowing costs each time new SLGS are issued. Finally, many private activity bond (PAB) borrowers are not eligible to issue advance refunding bonds at all. It is a benefit available only to governmental and qualified 501(c)(3) borrowers.

H.R. 1 Section 3602

H.R. 1 would prohibit any tax-exempt advance refunding bonds after 2017. The Ways and Means Committee argues[1] that "current-law advance refunding bonds provide State and local governments with incentives to issue two sets of Federally subsidized debt to finance the same activity."

Eliminating advance refundings would remove an important financial management tool that lowers the cost of government, allowing state and local governments to respond to market conditions and save billions on interest costs. By reducing their debt service expenses through advance refundings, states and municipalities are able to lower their debt costs which can benefit residents or free up borrowing capacity for new investment in infrastructure and other important facilities, so eliminating advance refundings would likely result in less overall investment in infrastructure.

As described, advance refundings are already highly regulated to protect investors and minimize the cost to the federal government. The current limitation of one advance refunding per bond issue was put in place in 1986 to correct the problem of having too many bonds outstanding at the same time for a single project. Limiting governments to a single advance refunding was a compromise that recognized how important advance refundings are for states and municipalities while respecting the interest of the federal government to limit the number of bonds outstanding. Moreover, many advance refunding bonds are issued within three years or less of the Refunded Bonds' call dates, limiting the period of time when two bond issues are outstanding, and the proceeds are set aside in a secure escrow with restrictions on arbitrage and spending in anticipation of the call date on the Refunded Bonds. Indeed, many advance refundings only make economic sense for the issuer when the call date is relatively close.

Summary

Advance refundings are an important financing tool that allows well managed state and local governments to respond to credit market conditions to reduce the cost of government. They have resulted in many billions of dollars of savings for states and municipalities. Advance refundings are already highly restricted and regulated to prevent abuse, and eliminating them would result in billions of dollars of unnecessarily high borrowing costs for states and localities and less investment in infrastructure. We urge Congress to amend H.R. 1 to continue to permit state and local governments to advance refund their bonds on a tax-exempt basis.

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[1] U.S. House of Representatives, Committee on Ways and Means, "Tax Cuts and Jobs Act—H.R. 1—Section-by-Section Summary," page 48.