Tax-Exempt Bond Update: 2018 Year in Review

Tax Reform Hangover

The 2018 municipal bond market was shadowed by the brief but dramatic roller coaster ride that culminated in the enactment of the Tax Cuts and Jobs Act ("Tax Act") in December 2017. Early versions of the Tax Act unpleasantly surprised market participants by proposing to eliminate the tax-exemption for all private activity bonds, advance refunding bonds and certain stadium financings. The uncertainty created by the proposals led many issuers to rush to market at the end of 2017. In the end, after intense efforts by the municipal bond community and others, the final Tax Act preserved the tax-exemption for private activity bonds and stadium bonds but repealed the tax-exemption for advance refunding bonds. This repeal, together with the rush of issuance at the end of 2017, contributed to a downturn in the tax-exempt bond market that persisted throughout 2018.

Advance Refunding Limitations

Under the Internal Revenue Code of 1986, as amended (the "Code"), an advance refunding occurs if the refunding bond proceeds are used to retire or call other bonds more than 90 days after the date of issuance of the refunding bonds. The prohibition on tax-exempt advance refunding bonds means that most issuers with outstanding non-callable bonds will either leave the bonds outstanding until a current refunding is possible (i.e. within 90 days of the call date) or defease the bonds with taxable debt or cash. Options such as forward bond sales or swaps or issuance of convertible (also called "Cinderella") bonds may be available in some circumstances.

The wording of the Tax Act created some concern among bond lawyers that the advance refunding prohibition applied to the refunding of taxable obligations as well as tax-exempt debt; however, Treasury officials repeatedly stated that the intent of the provision was to avoid two federal subsidies (i.e. two series of tax-exempt bonds) from being outstanding at the same time and that the provision was not intended to prohibit a tax-exempt advance refunding of taxable debt. Although it does not constitute official guidance, the IRS concurred in a legal memorandum released in the fall that advised that the provision does not preclude the issuance of tax-exempt bonds to advance refund non-tax-advantaged, taxable bonds. In addition, in its December 2018 General Explanation of Public Law 115-97 (i.e. the Tax Act), the Staff of the Joint Committee on Taxation explained that the advance refunding provision "repeals the exclusion from gross income for interest on a bond issued to advance refund another *tax-exempt* bond."

Possible infrastructure bills and "Tax Act 2.0" legislation made the headlines at various points throughout 2018, but no new tax legislation made its way through Congress this year. Throughout the year, the municipal bond community advocated for the return of advance refunding bonds and provided information regarding the important role that private activity bonds play in financing state and local infrastructure. With Democrats taking control of the House and Republicans remaining in control of the Senate, additional significant tax reform efforts seem unlikely to be successful in 2019.

Opportunity Zones

The Opportunity Zone program, established by Congress in December 2017 as part of the Tax Act, is now up and running. The program is designed to spur private investment in certain economically-distressed communities ("Opportunity Zones") which in 2018 were designated in all 50 states, the District of Columbia and five United States territories. Opportunity Zones retain their designation for 10 years. Investors may defer tax on almost any capital gain up to December 31, 2026 by making a qualifying investment in an Opportunity Zone, making an election after December 21, 2017, and meeting other requirements. Investors may also receive a 15% step-up in the basis of the capital gains by holding their qualifying investment for seven years. And investors may permanently exclude any additional gains on qualifying investments that are held for 10 years. Rules regarding Opportunity Zones are found at Sections 1400Z-1 and 1400Z-2 of the Code, and the IRS and Treasury released proposed regulations and Revenue Ruling 2018-29 regarding Opportunity Zones in October 2018. The IRS has also posted a list of Frequently Asked Questions about Opportunity Zones on the irs.gov website. More guidance is anticipated in 2019.

Remedial Action Guidance

Remedial actions allow an issuer to preserve the tax exemption of bonds that would no longer qualify for federal tax exemption due to the occurrence of certain events. On April 11, 2018, the Internal Revenue Service released Revenue Procedure 2018-26, expanding the availability of certain remedial actions for tax-exempt and tax-advantaged bonds. One remedial action available under previous regulations is expenditure of proceeds of a sale, exchange or other disposition of property ("disposition proceeds") for an alternative use meeting the requirements of the Code. Revenue Procedure 2018-26 expands the availability of this remedial action, with some modifications, to eligible leases. Under the Revenue Procedure, an "eligible lease" consists exclusively of cash lease payments and the term of the lease either (i) is at least equal to the lesser of 20 years or 75% of the economic life of the leased property or (ii) runs through the end of the measurement period (the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property).

Previous regulations did not provide remedial actions for tax credit and direct pay bonds. The Revenue Procedure provides a new remedial action for issuers of direct pay bonds, such as Build America Bonds designated under Section 6431 of the Code. Under the Revenue Procedure, the issuer may cure a nonqualified use simply by reducing the amount of the refundable Federal tax credit to eliminate the amount allocable to the nonqualified bonds and by treating disposition proceeds as proceeds of the bonds for certain purposes. The Revenue Procedure also allows issuers to cure a nonqualified use (including a failure to spend proceeds) of tax credit or direct pay bonds by redeeming or defeasing nonqualified bonds or by using disposition proceeds for an alternative use.

For additional information, see our initial alert on the Revenue Procedure here.

Final TEFRA Regulations

On December 31, 2018, the IRS issued final regulations (the "Final TEFRA Regulations") on the public approval requirement applicable to tax-exempt private activity bonds under Section 147(f) of the Code, commonly known as TEFRA requirements. The Final TEFRA Regulations for the most part adopted the proposed regulations published on September 28, 2017, which were generally welcomed as a much needed update to the temporary regulations that had been in place since 1983.

In general terms, the TEFRA requirements are met when a bond issuance receives "issuer approval" and "host approval" after a public hearing following reasonable public notice. Among the provisions in the Final TEFRA Regulations are the following changes and clarifications:

- A notice of public hearing may be posted on a website (either of the approving governmental unit or the "on-behalf-of" issuer, if applicable).
- A notice of public hearing must be posted at least seven calendar days before the hearing (shortened from 14 days).
- If a bond issue will finance more than one project, each project and the maximum principal amount of bonds expected for each project must be separately identified in the notice of public hearing.
- The public hearing must be held even if no one has indicated that they would like to speak at the hearing.
- Public hearings still cannot be held by teleconference or webinar.

The Final TEFRA Regulations apply to bond issuances where the public approval occurs on or after April 1, 2019.

Proposed Reissuance Regulations

Rounding out the year, on December 31, 2018, Treasury and the IRS also proposed regulations that address when tax-exempt bonds are treated as retired (reissued) for purposes of Section 103 and Sections 141 through 150 of the Code (the "Reissuance Regulations") and conforming amendments to existing reissuance regulations at Section 1.1001-3(a)(2). Although the IRS has previously issued reissuance guidance in the forms of Treasury notices dating back to 1988, the Reissuance Regulations are the first proposed regulations that specifically address the reissuance of tax-exempt bonds.

Reissuance is a significant concern for tax-exempt bonds. If a bond is retired and reissued, the reissued bond is a new debt instrument and must be retested for qualification as a tax-exempt bond on the date of reissuance. Reissuance may also trigger arbitrage and rebate consequences with respect to the bond. As a general rule, a tax-exempt bond is reissued if (1) a significant modification occurs under Treasury Regulation Section 1.1001–3; (2) the issuer or its agent acquires the bond in a manner that liquidates or extinguishes the bondholder's investment in the bond; or (3) the bond is otherwise redeemed (for example, at maturity). The Reissuance Regulations provide certain exceptions to these rules for changes in interest rate modes or

acquisitions pursuant to qualified tender rights for qualified tender bonds (all as defined in the Reissuance Regulations) and for acquisition of bonds by guarantors or liquidity facility providers.

Comments and requests for a public hearing regarding the proposed regulations must be received by March 1, 2019. The Reissuance Regulations would apply mandatorily to events occurring 90 days or more after the date on which the Reissuance Regulations are finalized. They may also be voluntarily applied to events and actions taken with respect to bonds before that date.

2019 IRS Audit Priorities

In its Fiscal Year 2019 Program Letter, the IRS set forth its enforcement priorities for the tax-exempt bond program (now part of the combined Indian Tribal Governments/Tax Exempt Bonds group within the Tax Exempt and Government Entities Division of the IRS). According to the 2019 Program Letter, enforcement will focus on three targeted areas:

- Costs of issuance on private activity bonds that may exceed 2% of the proceeds of the issue.
- Bond issuers that may have taken remedial actions under Treasury Regulations Section 1.141-12 or Section 1.142-2 without meeting all of the applicable requirements.
- Facilities financed with public safety bonds that may have excessive private business use caused by federal government use or management contracts.

Rule 15c2-12 Amendments

On August 20, 2018, the Securities and Exchange Commission (the “SEC”) adopted a final rule amending Rule 15c2-12 (the “Rule”) under the Exchange Act of 1934 (the municipal securities disclosure rule that requires an underwriter to determine, prior to purchasing bonds, that an issuer and/or other obligated person has undertaken to provide continuing disclosure to bondholders in the form of annual financial information and notice of certain listed events via emma.msrb.org). Beginning February 27, 2019, issuers of state and municipal bonds (and other obligated persons) will be required to include two additional notice events in new undertakings to provide continuing disclosure pursuant to the Rule. The two new notice events are as follows:

> “(15) Incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and
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> (16) Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties.”

The amendment also adds a definition of financial obligation for these purposes: “The term financial obligation means a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) guarantee of (i) or (ii).

As a result, in connection with bond issues on and after February 27, 2019, underwriters will be required to determine that an issuer and/or other obligated person has undertaken to provide notice, within 10 business days, of the incurrence of a material financial obligation (such as a bank loan or direct purchase obligation) as well as 10 business days' notice of certain agreements and events involving financial obligations.

Issuers and other obligated persons are beginning to prepare for the amendments by considering whether they have entered into, or plan to enter into, financial obligations that could be subject to reporting, and reviewing continuing disclosure procedures to account for these financial obligations. For more information, our initial alert announcing the amendments is available here, and a discussion of frequently asked questions and answers on the Rule amendments is available here.

SEC Enforcement Actions

The SEC settled a series of 2018 municipal enforcement actions (available here) involving deceptive practices in the sale of bonds, unregistered municipal advisors, and undisclosed conflicts of interest including "pay to play" situations. For example, a recent fraud settlement alleged that a financial advisor placed orders for unregistered brokers using false information to purchase bonds during a priority retail investor period (the brokers then "flipped" the bonds). The SEC also took action against unregistered municipal advisors, enforcing the Dodd-Frank Act requirements that municipal advisors be registered and act consistent with their fiduciary duty to municipal entity clients. For example, the SEC settled an action with an unregistered municipal advisor and its principal for failing to register and to disclose that material fact to their California school district client. Likewise, the SEC settled with a registered municipal advisor for allegedly misrepresenting their municipal advisory experience and failing to disclose conflicts of interests to a Texas school district client. Undisclosed conflicts of interest were a focus – including in a settlement that alleged that a financial advisor failed to disclose to his city client that he had accepted payments from an employee of a municipal underwriter before he recommended that the city hire the underwriting firm.

In a non-municipal action (available here) that provides a reminder that other investor communications, including through social media, are subject to the federal antifraud laws, the SEC settled with Tesla, Inc. and its Chief Executive Officer, Elon Musk, regarding Musk's tweets, including a tweet noting "Am considering taking Tesla private at $420. Funding secured." Tesla and Musk agreed to implement enhanced disclosure procedures including controls over social media disclosure, including pre-approving tweets that reasonably could contain material investor information, as described in Tesla's 8-K filing here.

SEC Municipal Securities Conference

On December 6, 2018, the SEC hosted its first municipal securities conference (available by webcast here). In his opening remarks, Chairman Clayton noted the essential role that the municipal securities market plays in financing infrastructure. Noting a concern that some issuers do not make their annual financial information available in a timely manner, he expressed his view that there are potential steps that the SEC and the Municipal Securities Rulemaking Board could take consistent with the Tower Amendment to improve the timeliness of financial information. The conference included a number of SEC, issuer, NABL and other industry panelists, discussing the state of disclosure in the municipal bond market, emerging trends such as

disclosure on cybersecurity and climate change, technological innovations, and whether there are opportunities for regulatory and industry improvement.

If you have any questions on these tax and securities law topics of interest to state and municipal bond issuers, please contact any of our public finance attorneys.

Alison Benge	Alison.Benge@pacificalawgroup.com	206.602.1210
Deanna Gregory	Deanna.Gregory@pacificalawgroup.com	206.245.1716
Faith Li Pettis	Faith.Pettis@pacificalawgroup.com	206.245.1715
Stacey Lewis	Stacey.Lewis@pacificalawgroup.com	206.245.1714
Jon Jurich	Jon.Jurich@pacificalawgroup.com	206.245.1717
Will Singer	Will.Singer@pacificalawgroup.com	206.602.1216

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To subscribe to our mailing list, please contact Mia Wiltse at Mia.Wiltse@pacificalawgroup.com.

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