Public Finance 2022 Year in Review: New Tools and Other Updates

Municipal bond issuers faced a challenging market in 2022, as the Federal Reserve increased interest rates at its quickest pace in over 40 years in an effort to address inflation. Volatile interest rates, high outflows from municipal bond investors and, for some local governments, the availability of federal stimulus funds caused many bond issuers to pause planned borrowings and, in the case of refundings, set aside issuances altogether. Also in 2022, Congress provided both new tools and new requirements that may affect municipal bond issuers. In addition, the Washington State Legislature provided some new revenue tools for funding infrastructure. The following provides a brief overview of this public-finance related legislation and includes tax updates and a summary of enforcement activity by the Securities and Exchange Commission ("SEC") involving municipal bonds.

Federal Direct Payments for Clean Energy Projects. A key provision in the Inflation Reduction Act of 2022 (the "IRA") makes state and local governments, 501(c)(3) nonprofit organizations, tribal governments and other tax-exempt entities ("tax-exempt entities") eligible to receive a number of clean energy federal tax credits as direct payments. Other provisions allow tax-exempt entities to combine direct payments with tax-exempt bonds to fund clean energy infrastructure projects, with a relatively minor (15%) reduction in the direct payment. State and local governments have not traditionally had access to the various federal tax credits available for clean energy projects, as only entities that pay federal income taxes could claim these tax credits. The extension of the tax credits to tax-exempt entities has the potential to reduce significantly the costs of certain clean energy projects. A more detailed overview of these provisions is available here.

New Corporate AMT. The IRA also created a new corporate alternative minimum tax ("CAMT"). The tax applies to certain corporations with an average of $1 billion or more in profits in any three-year period and is equal to 15% of the adjusted financial statement income of the corporation. For purposes of calculating the CAMT, interest received on municipal bonds is *not* excluded. Thus, for some large corporate bondholders, municipal bond interest may not be federally tax-exempt in tax years beginning after December 31, 2022. Municipal bonds (other than certain private activity bonds) retain their status as a non-preference item for purposes of the alternative minimum tax on individuals.

Financial Data Transparency Act. Congress passed, and President Biden signed into law, the Financial Data Transparency Act of 2022 ("FDTA") in December 2022. The FDTA sets forth a sequence of regulatory steps to implement structured data requirements for the securities markets, including the municipal bond market, with the goal of providing machine-readable, searchable, comparable (e.g. standardized), structured financial data to investors and others. Along with other federal financial regulatory agencies, the SEC is required to adopt data standards, including municipal market data standards for information submitted to the Municipal Securities Rulemaking Board (the "MSRB"). The SEC is required to consult with municipal market participants, and may take into account the burden on smaller issuers, in developing these standards. The sequence of regulatory steps is expected to take place over the next four years, with municipal market data standards adopted in 2026. As the proposed scope and content of these standards become clearer, including through SEC and MSRB rulemaking, state and municipal issuers will have an opportunity to comment directly and through industry groups, and to take steps to be ready to comply with the final standards. Stay tuned for more information and for opportunities to weigh in on the implications for state and municipal issuers.

SEC Enforcement Activity. In 2022, the SEC brought several enforcement actions against municipal bond issuers in connection with alleged fraud in both primary and secondary market disclosure documents. The SEC pursued these actions against municipal entities and individuals, municipal advisors and, notably, an outside auditor. Significantly, some of these cases involved misstatements to intermediaries (as opposed to the bond market only), including to a ratings agency and a state bond approval board. The following briefly summarizes 2022 cases of note brought against municipal issuers.

- The SEC charged Crosby Independent School District in Harris County, Texas, and its former chief financial officer with misleading investors in the sale of $20 million of municipal bonds. The SEC also charged the district's external auditor with failing to perform appropriate audit procedures necessary to form the basis for the auditor's opinion. The charges arose from the district's audited 2017 financial statements, which allegedly understated the district's payroll and construction liabilities, resulting in an overstatement of the district's general fund reserves by $11.7 million. Consequently, the financial statements reported a positive general fund balance (with $5.4 million in general fund reserves) when they should have reported a negative balance. The district included these alleged false and misleading financial statements in its offering documents for a $20 million bond sale in January 2018. Each of the parties ultimately settled the SEC charges, with the former CFO agreeing to pay a $30,000 penalty and not participate in any future municipal securities offerings. The external auditor agreed to be suspended from practice before the SEC (with the right to apply for reinstatement). More information is available here.
- The SEC charged the Town of Sterlington, Louisiana, its former mayor, and the town's unregistered municipal advisor with misleading investors in the sale of $5.8 million of privately placed bonds in 2017 and 2018. As required by Louisiana state law, the town applied to the Louisiana State Bond Commission ("SBC") for approval of the two offerings. According to the SEC's allegations, the town submitted false financial projections (created by the town's municipal advisor with the then-mayor's participation and approval) overstating the number of historical and projected sewer customers, producing misleading revenue projections to satisfy debt service coverage requirements and obtain SBC approval for the proposed bonds. The town and its former mayor did not disclose to investors that the town had obtained SBC approval based on this misinformation, nor did it disclose that the former mayor had directed the misuse of more than $3 million from prior bond offerings. The town agreed to a cease-and-desist order against future violations, and the municipal advisor agreed to financial and other penalties. More information is available here.
- The SEC charged the City of Rochester, New York, its former finance director, its former school district chief financial officer, and the city's municipal advisors with misleading investors in a $119 million bond offering. The charges arose out of the city's sale of bond and revenue anticipation notes to be repaid largely with school district revenues. The city included in its bond offering documents financial statements from the school district that were outdated, and did not reflect the district's overspending on increased salaries and significant decline in cash

position. In addition, in response to the rating analyst's questions, the district's CFO characterized the district's financial decline as due to "accounting treatment and timing issues in the receipt of cash," and the city's finance director and municipal advisor did not correct the misstatement. Shortly after the bond offering, the district's auditors revealed that the district had overspent its budget by $27.6 million, resulting in a downgrade of the city's debt rating, and financial intervention by the State of New York. More information is available here.

- The SEC charged the former city administrator of Johnson City, Texas, with civil fraud for allegedly falsifying the city's financial statements and audit report to conceal his theft of city funds. The city administrator then caused the falsified documents to be posted to the city's website and to EMMA, and an investor alerted the city auditor to the false statements. The city administrator has consented to the entry of a judgment requiring him to pay civil penalties and enjoining him from, among other things, participating in the preparation of certain material relating to municipal bond offerings. He has also pled guilty to a criminal theft charge. More information is available here.

These enforcement actions, and others brought by the SEC in 2022, demonstrate the SEC's continued attention to enforcing the federal antifraud requirements in the municipal market. The cases also serve as a potent reminder of the importance of (i) establishing procedures to ensure careful review of financial and other information provided to intermediaries as well as to the bond market, (ii) including more than one individual in the preparation, review and approval of disclosures to the market, and (iii) practicing awareness and care when disclosing financial information that may be outdated and no longer reflective of current financial conditions. In addition to these cases against municipal issuers, the SEC brought other enforcement actions against underwriters and municipal advisors.

TEFRA Hearings. In April 2022, the IRS released Revenue Procedure 2022-20 regarding the public approval requirement for tax-exempt qualified private activity bonds. Public hearings (also known as "TEFRA" hearings) must be held in a location convenient for residents of the approving governmental unit, and the IRS released guidance in 2020 temporarily deeming the location requirement to be met for hearings held by teleconference. Revenue Procedure 2022-20 makes the guidance on telephonic hearings permanent, which simplifies the TEFRA process for many issuers.

New Washington State Revenue Tools. In 2022, the Washington State Legislature supplemented the taxing authority of transportation benefit districts ("TBDs"), which are independent taxing districts created by cities or counties to fund transportation improvements. The new law, ESSB 5974, increases the maximum sales and use tax a TBD can impose with voter approval from 0.2 percent to 0.3 percent. In addition, ESSB 5974 provides that a TBD's legislative authority may, for the first time, impose a sales and use tax of up 0.1 percent *without* such voter approval, as long as the TBD includes all the territory of the jurisdictions that established the TBD. ESSB 5974 also now permits voters within a TBD to renew multiple extensions of an existing TBD sales tax (as opposed to a single extension only), with each renewal extending the tax for up to 10 years.

In 2021, the Washington Legislature adopted a new tax increment financing statute (ESHB 1189, codified at chapter 39.114 RCW and summarized in our 2021 article). The statute allows counties, cities and port districts to form tax increment areas, and allocates regular property taxes of overlapping local taxing districts (with certain exceptions) generated by increased property tax values within the increment area to the sponsoring entity to finance public improvement costs. Some ports and cities are exploring, or proceeding to form, tax increment areas. On June 29, 2022, the Department of Revenue issued a notice that clarified how county assessors are to allocate revenues generated by increased property values in the increment area. Revisions to the statute are under consideration in the current legislative session. Stay tuned on this topic too.

Looking Forward. If you have questions regarding any of these developments, please contact any of our public finance attorneys.

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