Municipal Securities Rulemaking Board

Municipal Securities Provisions of the "Tax Cut and Jobs Act"

The following is an overview of municipal securities provisions of the House and Senate comprehensive tax reform proposals entitled the "Tax Cut and Jobs Act" that are currently being considered in Congress.

1. REPEAL OF ADVANCE REFUNDING BONDS

Both the House- and Senate-proposed tax reform measures essentially eliminate advance refunding for municipal bonds issued after 2017 by making interest on advance refunding bonds taxable. Interest on current refunding bonds would remain tax-exempt.

About Advance Refunding

A refunding is a new borrowing that pays off an old borrowing.

A refunding is a new borrowing that pays off an old borrowing. The purpose of refundings is to achieve debt service savings, restructure debt service or free up existing funds. A refunding is similar to refinancing a mortgage to obtain a better interest rate or to restructure payment amounts and dates for budget flexibility.

Two types of refundings common to the municipal marketplace are *advance refundings* and *current refundings*. In an advance refunding, the issuer is able to refund or pay off a prior bond issue more than 90 days in advance of its first call date.[1] In a current refunding, the prior bonds are refunded within 90 days of the first call date.

Proceeds from the sale of refunding bonds are deposited into escrow accounts pending use to pay debt service on the prior bond issue. The deposited proceeds are irrevocably pledged to pay off the prior bonds and invested in government securities for the sole benefit of bondholders, subject to arbitrage restrictions, until prior bonds are called.[2] Bonds issued after the Tax Reform Act of 1986 may be advance refunded only once.

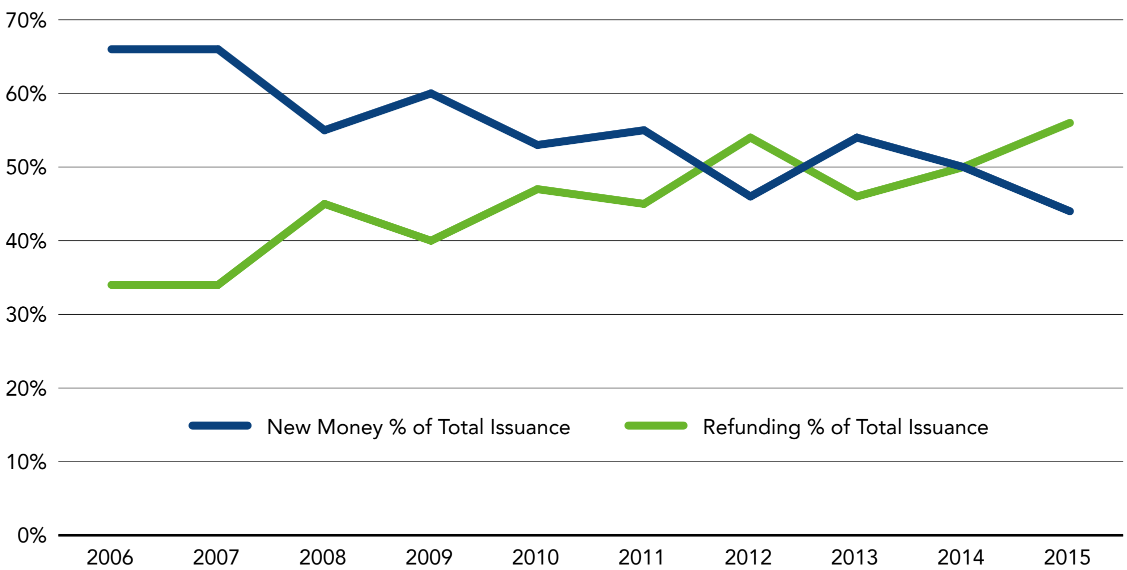
Given the financial flexibility they offer municipal securities issuers, advance refundings make up a significant portion of municipal bonds issued each year. The volume of bonds issued for new projects ("new money") has, in recent years, roughly matched the volume representing refundings that often replace existing debt with lower interest rate debt.

1 A call date is a date after which the issuer has the opportunity to redeem the bond prior to maturity.

2 Under arbitrage restrictions, if the yield on securities purchased with bond proceeds exceeds the yield on the refunding bonds, the excess interest earnings would generally be rebated to the IRS to avoid taxation on the interest on the refunding bonds.

Due to a variety of economic conditions, the recent volume for new projects has lagged significantly behind the volume seen prior to the fiscal crisis of 2008, as reflected in Figure A.[3]

Figure A: Issuance of Tax-Exempt Municipal Securities: New Money vs. Refunding



Source: Internal Revenue Service Statistics of Income (SOI) studies

2. TAXATION OF PRIVATE ACTIVITY BONDS

The House tax reform bill provides that interest on all newly issued private activity bonds (PABs) would be included in income and thus subject to taxation for bonds issued after 2017.

Private activity bonds finance public infrastructure that also involves private business use.

About Private Activity Bonds

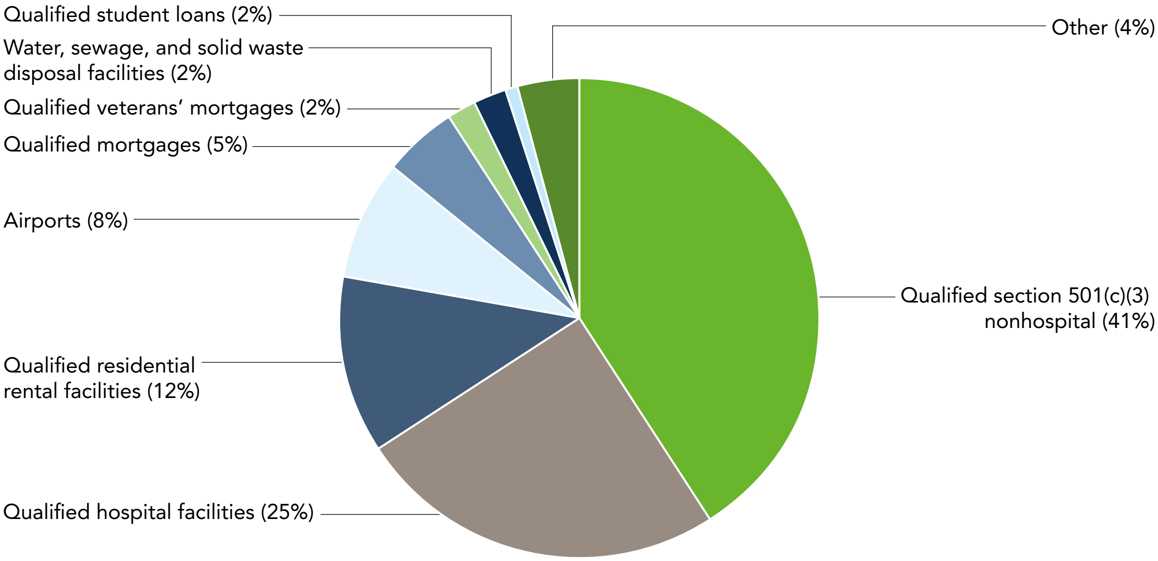
PABs finance public infrastructure projects that also involve private business use. For these securities, a state and local government or other municipal entity issues the debt, while a private business receives some benefits from the project. This transfer of benefits to the private sector can occur for a governmental project that has a private operator and/or involves leases, management contracts, loans and other arrangements with a private entity. Certain private activity bonds are issued as taxable bonds given the level of private involvement. Most are issued as tax-exempt, or "qualified" private activity bonds. Investors do not pay tax on the interest for qualified PABs, although for certain of these bonds, the interest income is used to calculate the alternative minimum tax. To be issued on a tax-exempt basis, private activity bonds must be used for qualified public works.[4] For many of these bonds, the amount or volume cap that can be issued is limited on a state-by-state basis.

[3] All charts are derived from IRS Statistics of Income (SOI) studies of tax-exempt bonds that include data on "public purpose" (governmental) bonds and tax-exempt "private-activity" bonds. This data is obtained from the Forms 8038-G, *Information Return for Tax-Exempt Governmental Obligations*, and Forms 8038, *Information Return for Tax-Exempt Private Activity Bonds*, filed and processed by the Internal Revenue Service after the bonds are issued.

[4] Internal Revenue Service Office of Tax Exempt Bonds. Publication 4078: Tax-Exempt Private Activity Bonds. https://www.irs.gov/pub/irs-pdf/p4078.pdf.

Common examples of projects financed with PABs include airports, water and sewer systems, transportation systems, low-income housing, hospital facilities, universities and other nonprofit 501(c)(3) organizations. Figure B shows the types of projects financed with tax-exempt private activity bonds in 2015.

Figure B: Long-Term Tax-Exempt Private Activity Bonds, by Bond Purpose and Type of Issue, 2015

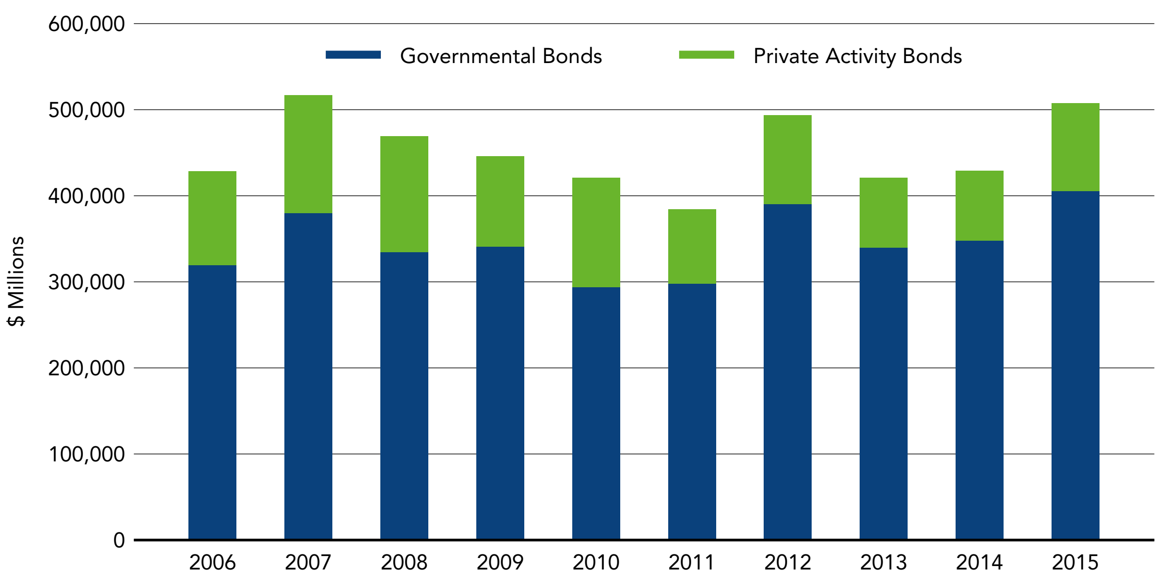


Source: Internal Revenue Service Statistics of Income (SOI) studies

Qualified PABs represent an average of 24 percent of the tax-exempt bonds issued since 2006.

Qualified PABs represent a substantial portion of the tax-exempt municipal market, as demonstrated in Figure C. These bonds represent an average of 24 percent of the tax-exempt bonds issued since 2006. The issuance of taxable bonds, including taxable PABs, represents less than 12 percent of municipal bonds issued in this same time period.

Figure C: Issuance of Government Bonds vs. PABs



Source: Internal Revenue Service Statistics of Income (SOI) studies

3. TAXATION OF BONDS ISSUED TO FINANCE A PROFESSIONAL SPORTS STADIUM

The House tax reform bill provides that interest on bonds issued to finance the construction of or capital expenditures for a professional sports stadium would be subject to federal income tax for bonds issued after November 2, 2017.

About Stadium Bonds

"Stadium bonds" refer to governmental bonds used to finance professional sports stadiums, which are not eligible to be financed with tax-exempt PABs. Governmental bonds are generally eligible to be issued on a tax-exempt basis for sports stadiums when structured such that no more than 10 percent of the debt service is used directly or indirectly in a private business. To achieve this, state and local governments must be willing to finance at least 90 percent of the debt service for the bonds, and cannot rely on stadium-generated revenue such as a tax on tickets or rent collected from the team as tenants. Repayment for the bonds may come from a variety of sources, including portions of instituted hotel-motel taxes, car rental taxes, parking taxes or other user fees.

Tax credit bonds generally provide investors with tax credits in lieu of interest payments from the issuer.

4. REPEAL OF TAX CREDIT BONDS

The House tax reform bill would prohibit the issuance of new tax credit bonds.

About Tax Credit Bonds

Tax credit bonds generally provide investors with tax credits in lieu of interest payments from the issuer, or can be issued as bonds that are taxable to the investor while a direct federal subsidy is paid to the issuer to offset a portion of the interest paid to the investor. These programs generally included a cap on the amount of bonds that could be issued. While the authority to issue some types of tax credit bonds has expired and the volume caps have generally been expended, there remains outstanding volume cap and issuance authority for certain tax credit bonds, such as New Clean Renewable Energy Bonds.

For more information and data about the municipal securities market, contact the MSRB at 202-838-1330 or MSRBSupport@msrb.org.