



Public Corporation Law Quarterly

Brave New World: The Changing World of Municipal Finance

Spring 2010, No. 2

c o n t e n t s

brave new world: the changing world of municipal finance—1	•
chairperson's corner—2	•
the michigan medical marihuana act: a municipal lawyer's perspective—6	•
administrative law section chair gives kudos to msu's ipu and mpac—10	•
announcement!—11	•
opinions of attorney general mike cox—12	•
state law update—13	•
federal law update—16	•
legislative update—20	•
i'll bet you didn't know—22	

By Michael P. McGee, principal in the Public Finance Group, Miller, Canfield, Paddock and Stone, PLC

“Municipal bonds.”

The words conjure images of your grandparents' home in the old days ... you remember, the one with Formica counter tops, black rotary-dial telephones, and avocado green appliances.

Conservative. Predictable. Unchanging.

That may have been true in the “old days,” defined as before September 15, 2008. On that day, however, a market already reeling from the collapse of venerable investment banking firm Bear Stearns learned that Lehman Brothers, a Wall Street behemoth for 158 years, had failed. Across town, Merrill Lynch announced that to save itself from a similar fate, it was being sold to Bank of America.

Thus the most significant upheaval in the financial markets since 1929 took firm hold, and with it a season of change for municipal finance never before seen. The consequences continue reverberating through the municipal market today.

Consider the following:

- As part of what has been called the “largest reorganization of the SEC in 30 years,”¹ the Securities and Exchange Commission appointed a new municipal bond enforcement chief, who immediately stated that the SEC will be “proactive” in looking at municipal bond disclosure and other practices.
- Two U.S. Senators, one from each party, proposed completely *eliminating* the traditional tax-exempt treatment of municipal bonds.
- Local governments sold \$26 billion of a new form of tax credit bond called “Build America Bonds,” a bond type unknown until a year ago, in the first quarter of 2010.

Brave New World. . .

Continued from page 1

- The Internal Revenue Service and the SEC announced a joint compliance effort, to use “all means possible to ensure the municipal bond market operates in accordance with all the laws that govern it,”² reflecting stepped-up municipal bond enforcement efforts by both agencies.

All this just in the first calendar quarter of 2010.

While we will be in this period of change for some time yet, two themes are emerging from the turmoil of the past 18 months: First, the future municipal bond market likely will be more closely linked to and resemble the taxable credit markets. Second, local governments likely will be subject to financial regulations – and potential sanctions – to which private corporations historically have been subject and local governments largely exempt.

The Municipal Bond Market – Then and Now

The most fundamental market change reflects a change in prevailing philosophy about a simple question: How should the federal government, through the tax code, assist local government in accessing capital at the lowest cost?

The traditional means of achieving this objective has been the now-familiar tax-exemption of municipal bonds, more precisely the exclusion of bond interest payments from a bondholder’s federal gross income. (A number of states, including Michigan, extend the exclusion to the state income tax by using federal gross income as a base for state taxable income.) Since the bondholder does not pay income tax on the bond interest payments, the bondholder is willing to accept a lower stated interest rate on the tax-exempt municipal bond compared to a taxable investment. If a taxable instrument, for example, bears interest at 7%, the after-tax return on that instrument will be closer to 4.7%. Put differently, the investor gets the same after-tax return on the 7% taxable instrument as she or he does on the 4.7% tax-exempt bond. The stated interest rates are different, but the after-tax yield is the same. The difference is in effect a federal subsidy of local government cost of capital.

Some economists have long asserted that this form of federal subsidy is inefficient. First, they argue, it is indirect. By conferring the tax benefit on the bond purchaser/holder, it relies upon the market to transmit that benefit to the intended recipients – state and local governments – via lower municipal bond interest rates. But it has always been true that signifi-

cantly less than all of the subsidy was reflected in municipal bond rates; that is, municipal tax-exempt rates were a higher than expected when compared to a perfectly equal-yield taxable instrument. That difference in effect increased the cost of the subsidy to the U.S. Treasury. The credit crisis substantially aggravated that inefficiency.

Second, there are many potential bond purchasers who receive no benefit from the tax-exempt treatment of municipal bonds, including pension funds and foreign investors, because they pay little or no federal income tax. Such purchasers as a result simply do not buy tax-exempt bonds. By excluding this pool of prospective purchasers, it was argued, the municipal market was unnecessarily small. A greater pool of purchasers should result in higher bid prices and lower capital costs.

The 2008 credit crisis provided an opportunity to change the means of providing the federal capital-cost subsidy. The Recovery Act (formally, the American Recovery and Reinvestment Act of 2009) thus included provisions which shifted the subsidy, allowing the local government bond issuer to elect to receive directly a federal payment in exchange for giving up the tax-exemption on a bond.

Bonds which shift the subsidy payment from the purchaser/holder to the issuer are called “direct pay tax credit bonds.” The major types authorized in the Recovery Act are “Build America Bonds” or “BABs” and “Recovery Zone Economic Development Bonds” (“RZEDBs,” sometimes called “Super BABs”). These are state or local governmental bonds that could be issued as tax-exempt bonds, but which the issuer elects to treat as direct pay tax-credit bonds. Interest on direct pay tax-credit bonds is taxable to the bondholder, but interest credit payments are provided to the issuer.³ The municipal issuer of the BABs receives payments from the U.S. Treasury equal to 35% (or, in the case of RZEDBs, 45%) of the interest paid by the issuer. Only new capital expenditures of the issuer presently are eligible for financing via direct pay BABs.

Although BABs are issued as taxable bonds, a condition of receiving the interest subsidy payment from the U.S. Treasury is that *BABs must satisfy all the rules applicable to tax-exempt financing generally, including limits on sale prices, private use, arbitrage limitations and rebate requirements.* The change from a tax-exempt to a taxable form of bond does not relieve the local governmental issuer from meeting the tax law requirements, because the federal subsidy remains, albeit in different form. Since the federal government continues to pay a subsidy, satisfying the federal tax requirements continues to be the ante to participate, just as before. In effect, the issuer structures a

transaction in the manner of a tax-exempt bond, but elects to exchange the tax-exemption for the tax credits paid to the issuer.

Because the credit is paid to the issuer, and BABs are taxable obligations, the purchasers of these bonds need not be taxpayers. As intended, this has successfully opened a new market for state and local government debt to include tax-exempt entities such as pension plans and foreign entities.

While BABs provide a new structure for issuing bonds, the local government issuer must have independent state law authority to issue the BABs; this remains unchanged from current practice.

Recovery Zone Economic Development Bonds take the BABs structure a bit further by increasing the payment subsidy to 45% of the interest payments. The tradeoff for the higher subsidy payment is a restriction on availability: RZEDBs require an allocation from the county (each Michigan county and each city of over 100,000 has received such an allocation), and the project to be financed must be in a “recovery zone.” A “recovery zone” is defined as an area having significant poverty, unemployment, home foreclosures, or general distress; or an area that has already been federally designated as an Empowerment Zone or Renewal Community. In addition to the federally-designated areas, a county or municipality may designate areas within their jurisdiction as recovery zones.

Unless extended, BABs and RZEDBs can be issued only through December 31, 2010. Legislation has passed the U.S. House which would extend the BABs program through 2013 with a somewhat lower payment subsidy, and thus the BABs program (though not the RZEDB program) appears likely to be extended.

The jury remains out on whether the policy change away from tax-exempt bonds in favor of tax credit bonds such as BABs will be permanent. In the first year of their use, BABs have been well received in the marketplace and have achieved some of their proponents’ objectives: BABs are the fastest-growing part of the \$2.8 trillion municipal market; the market is attracting more purchasers, especially foreign investors; and capital costs appear to be lower than under the traditional tax-exempt model. On the other hand, some observers worry that the subsidy-payment nature of the program creates risk that the tax credit payments could be disallowed in the future, depriving governmental borrowers of the intended program benefit. This concern has only been heightened by the IRS’s recent announcement of a BABs “compliance project,”⁴ since the initiation of a compliance project tends to suggest that whatever noncompliance is found will be subject to some further, and presumably punitive, action.

The Changing Regulatory Environment

The second major theme emerging from the 2008 credit crisis is the increased level of federal regulatory scrutiny of the municipal bond market. This is taking the form of greater tax compliance review by the IRS and greater securities regulation enforcement by the SEC.

As noted above, in February of this year the IRS began an effort to verify compliance with the tax code requirements applicable to BABs and RZEDBs. The IRS has begun sending questionnaires to all governmental issuers of BABs and RZEDBs to confirm that the various requirements for the credits paid to issuers were satisfied at closing *and will continue to be satisfied over time*, as well as to confirm that such issuers are *keeping sufficient records to show such compliance*. (The questionnaire and related cover letter are available from the IRS website.) Michigan local governments who have issued BABs or RZEDBs can expect to receive a questionnaire if one has not already been received.

The IRS interest in tax compliance, however, is not limited to BABs and RZEDBs. The IRS has announced more generally a greater interest in compliance review for municipal securities, and has added significant staff in its Tax Exempt Bond (TEB) compliance section over the past 24 months. As part of its compliance effort, the IRS “program goals include a renewed focus toward *improving post-issuance compliance* with the use and payment restrictions found in IRC 141”⁵ and “TEB intends to continue to expand its specialty training programs to allow employees to focus on specialized areas of tax-exempt financing.”⁶ Translation: more compliance officers are being trained for more field audits.

As for the SEC, the new municipal market enforcement attorney, Elaine Greenberg, was quoted this spring by Bloomberg as saying “there’s some very egregious conduct that goes on,” and that “the deterrent effect of the cases the SEC brings in this area has the potential to be high.”⁷ She will direct the SEC’s attention to states and cities as part of a focus on the tax-exempt market announced by SEC Chair Mary Schapiro. In Ms. Greenberg’s sights, according to Bloomberg, are possible bid-rigging for municipal-investment contracts by banks with significant Michigan market participation, public officials who hire advisers based on political contributions, and local governments that fail to disclose their true financial condition.⁸

This latter point – issues surrounding the disclosure of financial information about local governments’ financial condition – is of particular note. It signals a potential “corporatization” of municipal finance disclosure, that is, the application of the corporate disclosure rubric which now applies to publicly reporting companies like GM and Ford to local governments generally.⁹

Significance for the Public Corporation Lawyer

Periods of change present opportunities and risks. This is true presently for our local government clients. On the one hand, the enlargement and evolution of the municipal market to include a larger taxable component and a greater pool of bond purchasers provides opportunities for capital cost savings and greater market access. On the other hand, the changing substance of regulation, coupled with a changing emphasis by the IRS and SEC on more muscular levels of review, is increasing the risk to local governments when they undertake to enter the capital markets.

The upshot for public corporation lawyers is likely to be a need to play a more proactive role in financial transactions, particularly as it relates to disclosure, than has been the case in the past. To the extent that the SEC moves to impose a corporate-like disclosure regimen on local units, that will imply a more frequent legal evaluation of when and what the local unit is saying to the marketplace, rather than disclosure considerations being limited largely to bond offerings. Already questions have been raised about the potential securities law risks posed by inconsistencies between what is available, for example, on the city's website, compared to what is contained in annual financial filings with the Department of Treasury and others. Will more frequent disclosure be required of local governments, similar to corporate 10-Q and 8-K filings? That is a policy question now being hotly debated between regulators, principally at the SEC, and local governments, speaking through entities such as the National League of Cities and the Government Finance Officers Association.

All of this change, of course, is occurring in a fiscal environment in which local governments are under more distress

than at any time since the Great Depression. The outcome of all this is far from certain. What is certain is that we have entered a "Brave New World" of municipal finance, both in Michigan and in the U.S. generally. 🏰

Endnotes

- 1 *The Bond Buyer*, January 14, 2010.
- 2 *IRS and SEC Agree to Work More Closely Regarding Municipal Bond Enforcement*, IR-2010-26, March 2, 2010.
- 3 One form of BAB and certain other types of tax credit bonds provide the bondholder with a non-refundable federal income tax credit, but these bonds have not been well accepted in the market and are excluded from this discussion for simplicity.
- 4 *The Bond Buyer*, February 22, 2010.
- 5 IRS FY2008 Tax Exempt Bonds Enforcement Work Plan. (Emphasis added)
- 6 *Id.*
- 7 *SEC Enforcer Probes 'Egregious Conduct' as Muni Scrutiny Widens*, Bloomberg.com, March 25, 2010.
- 8 *Id.*
- 9 Municipal bond issues historically have been outside the direct scope of the SEC's regulatory power because of what is known as the 1975 "Tower Amendment," so named after its sponsor, Sen. John Tower (R-Tex), to the Securities Exchange Act of 1934. Regulation presently is indirect, through direct regulation of underwriters and municipal bond broker-dealers. The new SEC Chair has indicated an interest in repealing the Tower Amendment. *The Bond Buyer*, May 13, 2009.