

Federal Tax and Securities Law Matters Affecting Municipal Bond Issues

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**Federal Tax and Securities Law Matters
Affecting Municipal Bond Issues**

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Overview

- Federal Tax Law
 - Arbitrage and Rebate
 - Private Activity
- Federal Securities Law
 - Primary Disclosure
 - Secondary Disclosure

Federal Income Tax Law

- IRC sections: 103, 141 to 150 and others
- Treasury Regulations
- IRS Revenue Rulings, Revenue Procedures, Private Letter Rulings
- Court cases
- Two Main Areas of Concern
 - Arbitrage and Rebate
 - Private Activity (use of tax-exempt proceeds)

What is Arbitrage?

- In general – the profit from a transaction that exploits difference in yields in two different markets
- Municipal bonds – the profit from:
 - borrowing at tax-exempt yield, and
 - investing bond proceeds at taxable yield that is “materially higher” than the bond yield
- Tax-exempt yield is less than taxable yield



Yield Restriction

- IRC §148(a): If the issuer invests proceeds of a bond issue at a yield that is “*materially higher*” than the yield on the bonds, the bonds are “*arbitrage bonds*.”

Yield on Bond Issue

- Math notation

$$PV = \sum \frac{FV^n}{(1 + i/2)^{n \cdot 2}}$$

- Spreadsheet notation

$$PV = \sum_1^n FV^n / ((1 + i / 2)^{(DAYS360(ID,PD) / 180)})$$



General Arbitrage Rule

- No arbitrage is permitted
(but there are exceptions)

Common Exceptions to the General Rule Against Arbitrage

Even if bond proceeds are invested in investments with a “materially higher” yield, the bonds generally are not “arbitrage bonds” if one of the following exceptions applies:

- Temporary Period exception (3 years for construction bonds)
- Minor Portion exception



Rebate

- Once You Have Earned Arbitrage, Can You Keep It?
 - Maybe not. It may be subject to rebate.

What Is Rebate?

- **IRC §148(f)**: The excess amount earned from the investment of bond proceeds over the amount that would have been earned if the bond proceeds were invested at a rate equal to the bond yield must be paid as “rebate” to the federal government.

Rebate and Exceptions

- General rule: all arbitrage must be rebated to U.S. (100% tax)
- Exceptions to rebate:
 - small issuer exception
 - any of three spending exceptions (6-month, 18-month, 24-month)



Small Issuer Exception

- Available to government bond issuers with taxing powers
- At least 95% of proceeds must be used for local governmental activities
- Issuer reasonably expects as of the issue date to issue not more than \$5 million of governmental tax-exempt bonds in the current calendar year

6-Month Spending Exception

- Available for any expenditure
- 100% of proceeds must be spent at the end of six months

18-Month Spending Exception

- Available for capital expenditures
- Spending schedule:
 - 6 months – 15% of proceeds
 - 12 months – 60% of proceeds
 - 18 months – 100% of proceeds

24-Month Spending Exception

- Available only for “construction issues” – at least 75% of available construction proceeds must be used for construction
- Spending schedule:
 - 6 months – 10% of proceeds
 - 12 months – 45% of proceeds
 - 18 months – 75% of proceeds
 - 24 months – 100% of proceeds

Rebate Calculations

- Should be Done Annually
- Rebate Reports Are Required Every 5 Years

Private Activity

Background

- When bonds or notes are sold by a municipality to finance a capital project, the municipality represents that it will use the proceeds of the borrowing for public purposes and will take no action that would impair the tax-exempt status of the bonds or notes issued to finance said capital project
- Examples of Private use
 - Concession Arrangements
 - Leasing of unused space
 - Non-conforming management agreements
 - Special arrangements

State Law Limitations

- NYS Constitution and Local Finance Law §10.00
 - Local government debt may be issued for any “municipal object or purpose” for which a period of probable usefulness has been established by law

Federal Tax Law Limitations

- Internal Revenue Code §103.00
 - Interest on an “obligation of a State or political subdivision thereof” is exempt from federal income taxation

Private Use of Tax-Exempt Bond-Financed Facilities

- Bond-financed Improvements to Privately-owned Facilities
 - Is there a public purpose and a financeable interest?
- Infrastructure Improvements that Benefit Private Owners
 - Is the benefit substantially the same as the benefit to other properties?

Sale/Lease of Bond-Financed Facilities

- Use of Sale Proceeds
 - Redemption of bonds
 - General Municipal Law §6-1
 - Mandatory reserve fund
 - Escrow of all or part of the sale proceeds until bonds can be redeemed

Consequence of Federal Tax Law Violation

- Interest on the bonds is or becomes taxable to the bond holders
- Voluntary Closing Agreement Program (VCAP) is available as a remedy

Securities Law Matters

Regulatory Framework

- Municipal securities are exempt from registration under the Securities Act of 1933
- Municipal securities are subject to anti-fraud rules of:
 - Section 17(a) of Securities Act of 1933
 - Rule 10b-5 of Securities Exchange Act of 1934
 - General statutory and common law rules
- Subject to indirect regulation by the MSRB

Regulatory Framework (cont.)

- Section 17(a) of the 1933 Act
 - “It shall be unlawful for any person in the offer or sale of any securities by the use of any means . . . of . . . communication in interstate commerce or by the use of the mail, directly or indirectly:
 - to employ any device, scheme or artifice to defraud, or
 - to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
 - to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser”

Regulatory Framework (cont.)

- Rule 10b-5 of the 1934 Act
 - It is “unlawful for any person, directly or indirectly, by the use of any means . . . of interstate commerce, or of the mails . . .
 - to employ any device, scheme, or artifice to defraud,
 - to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - to engage in any act practice or course of business, act, practice, which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security...”

Regulatory Framework (cont.)

- What level of proof is needed to find a securities law violation?
 - Rule 10b-5 – the SEC must prove that the offender intended to commit manipulation or deception or knew he/she was manipulating or deceiving or recklessly disregarded a manipulation or deception
 - Rule 17(a) – the SEC must prove mere negligence
- Who can bring a securities law fraud claim?
 - SEC can bring an enforcement action
 - Private citizen can bring a claim
 - Private citizen must prove material misstatement or omission and reliance

Regulatory Framework (cont.)

- What are the consequences of securities law fraud?
 - Investigation by the SEC
 - Investigation by local district attorney or U.S. Department of Justice
 - Imposition of fines or penalties
 - Civil suits for damages (i.e. investor suits)
 - Expense related to defending an action
 - Negative actions by rating agencies
 - Erosion of investor confidence
 - Harm to issuer's reputation

Regulatory Framework (cont.)

- Who can be found liable?
 - Governing board
 - Officers and staff of issuer
- What are the penalties?
 - Penalties include fines, injunctions or, in extreme cases, incarceration
- Can an issuer rely on professionals?
 - Yes, but reliance must be reasonable
 - Issuers and governing boards must exercise independent judgment
 - Issuer has ultimate responsibility and liability

Regulatory Framework (cont.)

- What is the role of the Municipal Securities Rulemaking Board?
 - Established in 1975 and created in response to growth of the market, market abuses and the increased number of retail investors
 - Responsible for regulation of municipal securities industry, with authority to promulgate rules governing the sale of securities by broker-dealers
 - MSRB rules have indirect impact upon municipal issuers (e.g. Rule 15c2-12)

Regulatory Framework (cont.)

- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
 - Creates stand-alone municipal securities office at the SEC
 - Requires the Governmental Accounting Office to:
 - Compare municipal and corporate disclosure
 - Evaluate costs and benefits of increasing regulation of municipal disclosure
 - Individuals who report wrongdoing can receive 10%-30% of SEC recoveries of more than \$1 million
 - New administrative cease and desist program with authority to levy civil penalties up to \$150,000

Primary Disclosure

- Official Statement (should provide information that an investor would reasonably consider important)
 - Terms of Bonds, Financial Condition, Real Property Tax Collections, Management, Economic and Demographic Information, Employment, Transportation, Legal Matters, Continuing Disclosure Undertaking, Legal Opinion

Potential Problems Are

- Overly Optimistic Statements
- Omissions
- Litigation
- Proposed “one-shots” in Budget

Continuing Disclosure

- Responsibilities Continue Beyond Closing
- “Continuing Disclosure Agreement” Signed at Closing Provides for:
 - Annual Continuing Disclosure
 - Updated financial and operating data
 - Notices of Events
 - Specified events, including defaults, credit rating changes, bond calls and bankruptcy

Municipalities Continuing Disclosure Cooperation Initiative (“MCDC”)

- 2014 SEC Initiative Targeted “Material Misstatements” in Official Statements
- Many Issuers had Incorrectly Stated that They Had Been in Compliance for the Past 5 Years
- Self-Reporting Was Encouraged in Return for Reduced Penalties
- Many issuers adopted procedures covering continuing disclosure

Current Disclosure Issues

- Cybersecurity
 - Existing security controls
 - Recent breaches or attacks?
- Climate Change
 - General concerns
 - Specific local matters
 - Flood risk, storm risk, water supply, etc.

Notable Enforcement Actions

- West Clark Community Schools, IN (2013)
- City of South Miami, FL (2013)
- City of Harrisburg, PA (2013)
- State of Illinois (2013)
- Beaumont, CA (2017)
- Town of Oyster Bay
- City of Rochester

Sample Disclosure Checklist

- Sample checklist for preparing an Official Statement
 - Assemble the appropriate team
 - Define roles and responsibilities of all team members
 - Establish a process for ensuring the accuracy and completeness of the disclosure
 - Conduct due diligence – don't leave it to others
 - Review the Official Statement – it is your document
 - Obtain approval of the Chief Fiscal Officer and preparer
- Post Issuance Disclosure
 - Annual Filing
 - Material Events Notices