

Local Agencies Ability to Buy Their Own Debt – A Digest

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INTRODUCTION

In 2008, both the Internal Revenue Services (IRS) and California Legislature amended their rules to allow local agencies to purchase and hold certain types of their own debt under certain conditions. These changes were intended to counteract the rising disruptions in the municipal bond markets brought on by the financial crisis. The temporary federal exception expired in December of 2010, but the State law allowing local agencies to purchase their own debt remains in effect in California. The historically low interest rate environment since 2008 has prompted many local agencies to look for higher yielding investments, with buying their own debt discussed as a viable alternative.

Investment advisors, tax specialists and bond counsel vary in their opinions on whether local agencies can purchase their own debt. Therefore, it is important for local agencies to consult with their own counsel and advisors. Since the IRS temporary exception allowing local agencies to purchase their own debt expired on December 31, 2010, local agencies should be aware that any purchase after that date may affect the tax-exempt status of their bonds. The purpose of this brief

is to provide a background on local agencies repurchasing or acquiring their own debt and to review State and federal regulations related to this issue.

BACKGROUND

As the financial crisis expanded in 2008, the financial markets, including the tax-exempt bond market, experienced significant disruption. The crisis led to the downgrade and dissolution of several bond insurers and the withdrawal of certain types of buyers from the municipal bond markets. At that time, public agencies had issued variable interest rate bonds in the form of Variable Rate Demand Obligations and Auction Rate Securities.¹ The liquidity crisis froze the market for these instruments causing some issuers to pay exorbitant rates. The situation prompted many municipalities to consider temporarily buying their own bonds as a bridge to either resell or refinance in the future. However, issuers and their bond advisors were concerned that purchasing and holding their own tax-exempt bonds could result in the loss of tax-exempt status of the bonds for federal income tax purposes, or the extinguishment of the bonds altogether under State law.

To address these concerns, the IRS released Notice 2008-41 on March 25, 2008. The Notice outlined certain rules that allowed issuers to purchase and hold certain types of their own tax-exempt bonds temporarily without resulting in extinguishment or retirement for the purpose of Section 103 of the Internal Revenue Code (exclusion of

interest on municipal securities from gross income for federal income tax purposes). Subsequently, the IRS issued Notice 2008-88 in October 2008, expanding the guidance set forth in Notice 2008-41. Under Notice 2008-88, qualified tender bonds and tax-exempt commercial paper purchased by a governmental issuer on a temporary basis were not deemed reissued or extinguished, regardless of when the governmental issuer acquired the debt, so long as the governmental issuer did not hold the debt beyond December 31, 2009. Finally, Notice 2010-7 extended the final date to December 31, 2010.²

In response to the federal temporary exception, on March 26, 2008 the Governor signed Senate Bill 344 (Chapter 3, Statutes of 2008), adding Government Code Section 5925 allowing state or local government issuers to purchase or acquire their own debt. It also specified that the purchase of the tax-exempt bonds by the local agency that issued them does not cancel or otherwise alter the bonds.³ However, unlike the IRS Notices, SB 344 did not include a sunset provision.

SCENARIOS AND CONSEQUENCES OF PURCHASING OWN DEBT

Table 1 summarizes scenarios in which local agencies may issue and subsequently re-purchase their own debt along with the possible accompanying tax impact. The information below is general in nature. Issuers should seek legal advice before mak-

¹ See CDIAC publication "[Auction Rate Securities](#)" for a comprehensive discussion

² See www.irs.gov/pub/irs-drop/n-10-07.pdf. Certain provisions of Notice 2008-41 continue to allow certain variable rate bonds to be acquired and held by the Issuer for up to 90 days in certain circumstances.

³ Ibid [Note: It seems like this is intended to be a citation to Section 5925 rather than to Notice 2010-7]

TABLE 1

SCENARIO	NEGATIVE RESULTS
A local agency or its subdivision (i.e. pension fund) purchases their own taxable Build America Bonds (BAB) in the secondary market. The issuer received the 35 percent federal subsidy and the buyer (pension fund) did not pay federal taxes on interest received.	The IRS may dispute the use of this practice and invalidate the BAB subsidy to the agency.
Local agency sells tax-exempt bonds and the local agency or its subdivision buys them back in the secondary market.	The IRS may consider the debt extinguished or retired. If the local agency decides to sell the bonds at a future date, it may not be able to sell them as tax-exempt bonds unless it completes the requalification process to obtain tax-exempt status.
Local agency sells taxable bonds in the primary market and the local agency or its subdivision buys them back in the secondary market.	No IRS concerns regarding tax-exemption on the bonds. See <i>Additional Considerations</i> below.

ing a decision to purchase their own debt or apply any of these scenarios to their own situation.

ADDITIONAL CONSIDERATIONS

The temporary changes as a result of the IRS Notices and the addition of Section 5925 were intended to help state and local governments deal with the municipal bond market crises of 2008 and 2009 and with the liquidity constraints that many municipalities faced during the crisis. Since 2010, the municipal bond market has improved and the IRS exception has expired. If a public entity now decides to purchase its own bonds in a normal market environment it should consider several factors including:

LEGAL INTERPRETATION. The IRS exception allowing local agencies to purchase their own debt expired on December 31, 2010.⁴ On the other hand, California law allowing local agencies to purchase and own their own tax-exempt debt is still in effect. Given the complexities inherent in coordinating both content and timing of IRS Notices (2008-41, 2008-88, and 2010-7) with California Government Code, it is important for investment staff to seek a legal opinion on any transaction involving the purchase and sale of their own debt. This will ensure that such trans-

actions do not affect the tax exempt status of their bonds or the status of their bonds as Build America Bonds.

MATURITY. Government Code Section 53601, pertaining to authorized public investments, states that local governments are allowed to invest in municipal notes, bonds, and other obligations as long as the final maturity does not exceed five years. However, the legislative body of a public agency can grant approval to invest in government bonds, notes, and other securities with maturities longer than five years. The approval must be issued no less than three months prior to the investment.⁵ Section 53601 applies even when local agencies purchase their own debt exceeding the five year maturity limit.

LIQUIDITY. One of the most important investment objectives for local agencies is to insure that the cash flows from their investment portfolios meet or exceed short-term and/or unanticipated needs. If a local government decides to purchase its own bonds, it may be exposed to liquidity risk and compromise its ability to convert the bonds into cash if there is an unexpected need in the future.

CONFLICT OF INTEREST. Purchasing their own debt raises the question of whether

the local agency is playing the role of an investor concerned with safety, liquidity and yield of its investments or the role of issuer looking to minimize interest cost. This is especially relevant to smaller local agencies which may not have a separate independent treasury division. In addition, local agency investment staff may come under pressure from elected officials to buy their own debt and finance projects which otherwise would not be attractive to outside investors.

SUMMARY

The question of whether a local agency can purchase their debt is a complicated one. Opinions by investment advisors, tax specialists and bond counsel vary. The considerations outlined above provide a framework for discussion. However, local agencies should be aware of the fact that the related IRS exception expired on December 31, 2010, and any purchase after that date may affect the tax-exempt status of their bonds. In addition, the intent of both State and federal rules was not to carve a regulatory exception, but to temporarily allow local agencies to better cope with the liquidity constraints many faced during the 2008-2009 market disruptions.

⁴ As noted above, Notice 2008-41 continues to allow certain variable rate bonds to be acquired and held by the Issuer for up to 90 days in certain circumstances.

⁵ [California Public Fund Investment Primer](#), pg.58