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# The tax man cometh

By LORI RAINERI

Taxable municipal bonds: Until recently, that term would have been an oxymoron. Municipal bonds are tax-free — or at least they were, until Congress decided that the federal government was sacrificing too much revenue to tax-exempt municipal bonds.

In order to reduce the overall volume of tax-exempts, Congress has voted to limit the purpose and eligible issuers of tax-exempt bonds. So what do municipalities do when they cannot issue tax-exempts? They issue taxable municipal bonds.

Historically, tax-exempts have traded at interest rates from 1 to 4 percentage points below comparable taxable bonds. Thus public entities have experienced tremendous savings — and even profits — through their ability to borrow at tax-exempt rates.

However, during much of 1986, tax-exempt interest rates have been close to record-high levels relative to taxable rates, because of the uncertainty created by tax reform bills pending in Congress.

When the spread between tax-exempt and taxable rates is narrow, there is less reason for public issuers to do tax-exempt bond issues, particularly when they are faced with the more restrictive regulations on tax-exempt packages.

California recently took a bold step forward in the area of taxable muni bonds by enacting AB 939, sponsored by Assemblyman Pat Johnston of Stockton and signed Sept. 29 by Gov. George Deukmejian. The new law provides a broad range of financing options for issuing taxable debt which might otherwise be unavailable.

Taxable bonds are traded in a different marketplace from tax-exempts. The largest investors are pension funds which — because they are tax-exempt themselves — traditionally did not buy tax-exempt muni bonds. Thus issuers need flexibility to respond to the demands of these new municipal investors.

Additionally, several municipal issuers have found that foreign markets value their debt more highly than domestic markets. Some issuers have experienced interest-rate savings of 20 to 40 basis points by selling taxable bonds overseas.

Roger Davis of Orrick, Herrington & Sutcliffe, the San Francisco law firm, calls the law "a source of authority, not a source of limitation." Issuers could have gone to the taxable market had this bill never passed, Davis says. "(But) with the existence of this bill, now they have an alternative . . . They can use any additional authority that is offered by this (bill) or not, as they choose."

By September, 28 taxable municipal bond issues had been completed in the United States, including three in California. Many of these were prompted by provisions in HR 3838, the House of Representatives' version of tax reform passed last December. During most of this year, state and local governments issued bonds in accordance with the bill, since some of its provisions were to be retroactive. However, many aspects of HR 3838 did not survive in the final bill, the Tax Reform Act of 1986.

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Anticipating an easing of restrictions, the city of Fresno offered one of the most innovative taxable muni-bond issues yet: It sold $9.8 million of taxable bonds (on behalf of the Valley Children's Hospital and Guidance Clinic) with an optional tax-exempt conversion if federal legislation was ultimately favorable.

The financing could not have been done originally with tax-exempt bonds because — at the time of sale in May — proposed legislation subjected the issue to a state tax-exempt bond volume cap, and Fresno would not have been assured of receiving allocation when the final bill was enacted.

However, as anticipated, the final version of the bill did allow this financing to be done tax-exempt. Now bondholders are being notified of the conversion to tax-exempt bonds and an interest rate adjustment, according to Darrell Fischer, vice president of finance for the hospital.

Some state and local governments will continue to issue taxable bonds for projects that cannot be financed with tax-exempt issuances. Illinois was one of the first states to enter the taxable market with a $40 million issue as part of its "Build Illinois" program. "Tax reform won't alter the number of bonds Illinois will issue in the next five years or so," says Mark W. Gallagher, chief of the economic development division of the Illinois Bureau of the Budget. "If we have to go taxable, we will, but we won't abandon the projects we have in the works."

Ironically, some public issuers have found it advantageous to issue taxable bonds, even when there was an option to issue tax-exempts. That's because the restrictions on tax-exempt financings can affect their economic viability, especially in the limits on investment of tax-exempt bond proceeds.

Arbitrage — the practice of investing bond proceeds in higher-yielding securities and profiting from the spread — is severely limited in the new tax bill. However, with taxable bonds, arbitrage is not prohibited. Los Angeles County Treasurer Richard Dixon has estimated that the yield-curve play on a $50 million taxable issue last September (illegal if it had been tax-exempt) will save $400,000 a year over the 19 years of the paper.

It is clear that municipal debt financing will become more complex, with new options to be explored, now that state and local governments are turning to the taxable markets for dollar savings and flexibility.

Through its strict limitations on the tax-exempt bond field, the Tax Reform Act of 1986 will force major changes in the way America's public agencies finance their projects. ■