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INSIGHT

Advance Refunding Bonds and P.L. 115-97

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On January 29, 2020, the chairs of the House Transportation and Infrastructure, Energy and Commerce, and Ways and Means Committees released the Moving Forward Framework, which would invest roughly $760 billion in infrastructure projects over a five-year period. Among other things, the draft would reinstate the ability to issue federally tax-exempt advance refunding bonds, whose issuance authority was repealed by the 2017 tax revision (P.L. 115-97; sometimes referred to as the Tax Cuts and Jobs Act, or TCJA). This Insight briefly describes advance refunding bonds, summarizes recently enacted changes, and discusses policy arguments and new proposals to modify advance refunding capabilities.

What Are Advance Refunding Bonds?

Refunding bonds are bonds that are issued to replace existing (outstanding) bonds previously issued for a given purpose. Refunding bonds are used by the issuer (borrower) to take advantage of borrowing terms that are more favorable than those present at the time the existing bonds were issued, which may be realized through lower interest rates or more attractive agreements related to the project (known as covenants) funded by the bond.

Current refunding describes cases where the existing bond is redeemed within 90 days of the refunding bond issue date. *Advance refunding* describes cases where the existing bond and refunding bond are both outstanding for a period of longer than 90 days. Advance refunding is typically used when the existing bond has a call protection, or safeguard against a bond being paid off earlier than its maturity date, that does not allow for immediate redemption of the existing bond. The *Internal Revenue Code* (26 U.S.C. §149) stipulates that all bonds issued after 1985 must be redeemed at the earliest date possible if an advance refunding results in present value savings to the borrower.

Federal Tax Law and Changes Made by P.L. 115-97

Generally, interest income earned from state and local bonds issued for a public (governmental) purpose is exempted from federal income taxation. The tax exemption serves to reduce interest rates and subsequent borrowing costs on such tax-exempt (municipal) bonds. Bonds that are not issued for a public purpose but which have been deemed by Congress to have substantive public benefits may also be exempted from federal income taxation if they are classified as qualified private activity bonds.

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Prior to the passage of P.L. 115-97, advance refunding bonds could generally be issued for public purpose bonds one time with interest income still exempt from federal income taxation—allowing for two federally tax-exempt bonds to be outstanding for a single project at the same time. Qualified private activity bonds were generally not eligible for advance refunding with a federal tax exemption, though certain temporary exceptions had been granted in areas receiving government assistance following federal disasters.

P.L. 115-97 eliminated the federal tax exemption for interest income earned on advance refunding bonds for any municipal bond issued after tax year 2017. A December 2017 estimate from the Joint Committee on Taxation projected that the repeal of this exemption in P.L. 115-97 would increase federal revenues by $17.4 billion over the FY2018-FY2027 period.

Recent Legislative Developments

Efforts to reinstate the federal tax exemption for interest income earned on advance refunding bonds have been undertaken since the enactment of P.L. 115-97. Restoration of advance refunding issuing authority was included in the January 2020 Moving Forward Framework released by the chairs of multiple House committees. The discussion draft did not specify if advancing refunding bonds would receive the same restrictions and tax status granted prior to passage of P.L. 115-97 or if other modifications would be considered under the proposal.

The framework would make additional changes to other types of federal bond subsidies, including reinstating the ability to issue certain tax credit bonds and raising the national volume cap for qualified private activity bonds. For general information on these subsidies, see CRS Report RL30638, Tax-Exempt Bonds: A Description of State and Local Government Debt. H.R. 2772, introduced in May 2019, would also reinstate the federal tax exemption for advance refunding bonds. In the 115th Congress, H.R. 5003 (introduced in February 2018) would have reinstated the exemption for the first advance refunding bond issued for public purpose bonds.

Policy Arguments

All else equal, borrowers may be more likely to issue advance refunding bonds after a decline in interest rates, as new borrowing terms may be more favorable than existing arrangements in that scenario. Some supporters of the federal tax exemption for advance refunding bonds argue that state and local government investment in the sorts of infrastructure projects typically financed by bond issuances may otherwise be underprovided if there are benefits that accrue to tourists and other nonresidents who may not pay state and local taxes. An October 2018 study by the Congressional Budget Office (CBO) found that the share of total government infrastructure spending attributable to state and local governments has increased in recent years.

Opponents of federally tax-exempt advance refunding bonds may argue that the federal subsidy is an inefficient way to encourage investment, as most of the additional benefit provided by the tax exemption typically flows to the creditor instead of the state and local governments (or borrower). Although the exemption for advance refunding bonds may have a small effect on the general market for tax-exempt bonds, the decision to issue any individual advance refunding bond will typically be made well after a project has been agreed to, which could reduce the effect of the advance refunding exemption on total infrastructure investment.

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