FEB 03 1986

FAGIN, BROWN, BUSH, TINNEY, KISER & ROGERS
A PROFESSIONAL CORPORATION
ATTORNEYS & COUNSELORS AT LAW
SUITE 1900 WEST
FIRST NATIONAL CENTER
OKLAHOMA CITY, OKLAHOMA 73102

TELEPHONE 405-235-3413
TELEPHONE 405-235-7436

January 30, 1986

Representative Mickey Edwards
U.S. House of Representatives
2434 Rayburn Building
Washington, D.C. 20515

Re: Memorandum on 1985 Tax Reform Act

Dear Representative Edwards:

Enclosed for your information is a memorandum prepared by our firm regarding the proposed 1985 Tax Reform Act, H.R. 3838, currently pending in Congress, as it pertains to tax-exempt bonds, and its impact on economic development in Oklahoma if enacted in its present form.

We trust this memorandum will be helpful to you in assessing the impact of the Bill. If we may assist you in further analyzing the Bill, or provide any additional information, please contact us and we will assist in any way we can.

Respectfully submitted,

FAGIN, BROWN, BUSH, TINNEY, KISER & ROGERS

Lynn C. Rogers

Lynn C. Rogers
For the Firm

LCR:kg
Enclosure

D35666

FAGIN, BROWN, BUSH, TINNEY, KISER & ROGERS
A PROFESSIONAL CORPORTION
ATTORNEYS & COUNSELORS AT LAW
SUITE 1900 WEST
FIRST NATIONAL CENTER
OKLAHOMA CITY, OKLAHOMA 73102
TELEPHONE 405-235-3413
TELEPHONE 405-235-7436

January, 30 1986

MEMORANDUM

RE: Impact of the proposed Tax Reform Act of 1985 on economic recovery in Oklahoma

INTRODUCTION

On December 17, 1985, the United States House of Representatives passed and sent to the Senate a bill, H.R. 3838 (the "Tax Reform Act of 1985" or the "Bill") which, if enacted by the Senate and approved by the President in its present form, will, among other things, alter or amend many of the provisions of Section 103 of the Internal Revenue Code regarding tax-exempt bonds issued by states and local governmental entities. The Bill, in its present form, has an effective date of January 1, 1986. This memorandum is intended to present a brief overview of the Bill as it pertains to tax-exempt bonds, and the impact of the pending Bill upon economic recovery efforts in Oklahoma.

For over two years, Oklahoma has been gripped by an economic recession. This slowdown in the State's economy has, to a great extent, been related to serious problems within the agriculture and oil industries. Strong efforts have been made to promote economic recovery within the State by encouraging other types of industry and commerce to locate or expand here, thus achieving a much-needed diversification of our economic base. At the same time, the State and its citizens have continued to do everything possible to help the recovery of agriculture and oil businesses.

A key element in Oklahoma's efforts to promote industrial development and economic recovery is the infusion of resources from outside the State. Industrial development authorities, mainly organized as public trusts acting on behalf of the State or local governmental agencies, have successfully utilized industrial development bonds ("IDB's") to induce new industries to locate within the State, or to encourage existing industries to expand. A large share of these bonds have been sold to out-of-state investors, resulting in a flow of capital into our economy from sources outside of the State. In addition to IDB's, State and local government entities have issued both general obligation ("G.O.") bonds and revenue bonds to finance much-needed expansion, repair and improvement of streets, libraries, schools, water and sewer systems and other public facilities to serve the continuing needs of our citizens, and at the same time, to further encourage the location or growth of new industry here.

The proposed Tax Reform Act of 1985, if enacted in its present form, would have a widespread, negative impact on the issuance of tax-exempt bonds of all kinds in Oklahoma, and on the continuing efforts of the Governor, the Legislature and many others to achieve economic recovery for the State. In particular, the January 1, 1986, effective date of the Bill is already stifling efforts to issue tax-exempt bonds in Oklahoma for worthy purposes.

THE BILL

If enacted in its present form, the Tax Reform Act of 1985, H.R. 3838, would make the following changes in the federal laws regulating the issuance of tax-exempt bonds by State and local governmental issuers and the purchase of these obligations by investors:

* Creates a distinction between

  "essential function bonds" and "nonessential function bonds" depending on the ultimate user of the bond proceeds.

  > A bond is a "nonessential function bond if:

  - 10% or more of its proceeds or $10 million, whichever is less, is used in the trade or business of a person other than a qualified governmental unit, or
  - 5% of its proceeds or $5 million, whichever is less, is used for a loan to such a person.

  > Thus, bonds traditionally used to finance a wide range of projects benefiting the public such as hospitals, airports, public transportation, waste disposal and multifamily rental housing would now become "nonessential function bonds".

* Provides that the exemption from federal income taxation does not apply to interest on "nonessential function bonds", except as further provided in the Bill.

* Provides that an exemption from federal income taxation will still apply to interest on certain types of "qualified nonessential function bonds"

  > These "qualified bonds" may include bonds for:

  - "exempt facilities", which include

    (i) airports ‡
    (ii) docks and wharves ‡
    (iii) mass commuting facilities ‡
    (iv) water facilities (other than irrigation) ‡
    (v) sewage disposal facilities
    (vi) solid waste disposal facilities
    (vii) qualified multifamily housing

    ‡ must be governmentally owned

- qualified single family mortgage revenue bonds
- certain "small issue" IDB's
- 501(c)(3) organization bonds, such as bonds issued for the benefit of hospitals, colleges and certain rental housing facilities
- qualified student loan bonds
- certain "redevelopment" projects under "tax increment" financing

> The Bill restricts those types of bonds that are "qualified bonds" in comparison to present law, particularly where the facilities acquired with bond proceeds are used or operated by the private sector.

* Total annual nongovernmental issuance in each state is subject to a volume cap of $175 per capita or $200 million, whichever is larger. Of this, $25 per capita, or $30 million, is reserved for nonprofit institutions - mostly hospitals and universities. Half of the remainder is reserved for housing and the other half for other nongovernmental financing. State legislatures are authorized, within limits, to reallocate financing authority under these caps among different purposes.

> Oklahoma's total allocation for all "nongovernmental" bonds under this formula is approximately $560 million, based upon a population of 3.2 million.

> Under present law, up to $150 per capita may be utilized annually for IDB's. For Oklahoma, this amounts to approximately $480 million for IDB's alone.

> Under present law, up to $200 million per year may be used for single family mortgage revenue bonds.

> Under present law, there are no limitations on the dollar volume of bonds that may be utilized each year by nonprofit institutions such as hospitals for qualified projects.

> Under present law, no dollar volume limit applies to the amount of bonds that may be used for multifamily rental housing.

* Increased restrictions are placed on bond programs for housing.

> In single family mortgage revenue bond programs, there are increased restrictions on annual family income of qualified borrowers, the acquisition cost of eligible residences, and the number of borrowers that must be first time homebuyers in both target and non-target areas.

> In multifamily rental housing programs, there are increased restrictions on the use of bond proceeds for functionally related and subordinate facilities, the percentage of units held available for low income persons and the income of eligible tenants. In addition, there are increased reporting duties to prove compliance with low income set-aside requirements by the developer.

* New arbitrage regulations sharply curtail the ability of issuers to invest bond proceeds at yields materially higher than the bond yield and retain the earnings.

  > As a general proposition, all arbitrage earnings from investment of bond proceeds must now be rebated to the federal government.

  > These restrictions apply not only to IDB's, but also to "essential purpose bonds" where the governmental issuer is the owner and operator of the facilities financed with bond proceeds.

  > Limited exceptions apply:

    - In the case of "essential purpose bonds" such as general obligation or revenue bonds of governmental entities for schools, streets or utility system improvements, arbitrage profits may be retained if:

      (i) at least 5% of the proceeds are utilized for "bricks and mortar" within 30 days of issuance of the bonds; and

      (ii) all of the gross proceeds of the bonds are spent on the project within 6 months.

      Otherwise, arbitrage earnings must be rebated to the federal government.

    - Certain limited "temporary periods" still apply to reserve funds or debt service funds during which time arbitrage profits may be earned and retained.

* The Bill prohibits advance refundings of any issue of "nonessential function" bonds and sharply restricts the conditions under which "essential function" bonds may be advance refunded.

* Substantial changes are made in the way depreciation or cost recovery may be taken on property financed by "nonessential function" bonds by the tax-owner of the property.

* Top-bracket marginal individual and corporate tax rates are reduced, thus having the likely effect of lowering the demand for tax-exempt bonds.

* Taxpayers using tax-exempt "nonessential function" bonds as tax shelters will be subject to a stiff alternative minimum tax.

* Interest on tax-exempt bonds purchased by property/casualty insurance companies (one of the traditional high volume investors in tax-exempt bonds) will be subject to an increase in their effective tax rate.

* Commercial banks will not be allowed to deduct the cost of carrying tax-exempt bonds purchased after December 31, 1985.

* The Bill, in its present form, has an effective date of January 1, 1986, although nonbinding resolutions have been passed by both the House and the Senate expressing a preference for a later effective date.

THE EFFECT ON OKLAHOMA TAX-EXEMPT BONDS

The existence of the pending legislation is severely restricting issuance and delivery of most types of municipal bonds in Oklahoma, just as it is in the rest of the country. Recent articles from various financial publications, attached as Exhibits A, B and C, indicate the chilling effect the Bill, with its onerous provisions and uncertain effective date, has had on both the issuers and purchasers of tax-exempt bonds.

For example, within the past week, the offering of revenue bond issues of the Claremore Industrial and Redevelopment Authority and of the Latimer County Industrial Authority to finance construction of Veteran's nursing home facilities had to be suspended because of a general lack of market interest, attributed primarily to market uncertainty over the Bill and its effect on pending bond issues.

Even such "plain vanilla" bond issues as general obligation bonds of school districts or cities for such items as construction of classroom buildings or fire stations will be affected by the Bill.

Under the present language of H.R. 3838, in the section apparently intended to discourage the "early issuance" of bonds (according to the Staff Report of the House Ways and Means Committee), unless (i) at least 5% of the bond proceeds are expended for the governmental purpose of the borrowing within 30 days after the date the bonds are issued, and (ii) an amount equal to all bond proceeds (other than amounts invested in a reasonably required reserve or replacement fund) is expended for that purpose within 3 years of the date of issuance, then income from interest on the bonds will be taxable, retroactive to the date of issue.

The requirement that 5% of the gross bond proceeds be spent on "bricks and mortar" within 30 days of the closing of the bond issue is a particularly onerous one, especially in view of Oklahoma laws on competitive bidding of construction projects. Title 61 O.S. 1981 Section 104, a part of the Public Competitive Bidding Act of 1974, requires that a notice for bids on construction of improvements to real property must be published at least 20 days prior to the opening of bids. Section 111 provides that the contract must be awarded within 30 days of the opening of bids. Thereafter, the successful bidder is entitled to a reasonable time in which to execute the contract, provide the necessary surety bonds and proof of insurance, and commence work on the project, all in accordance with the provisions of the bid documents. After construction is commenced, the first progress payment may not be made to the contractor for 30 days or more.

Thus, in the normal course of events, 60 days or more may well elapse between the time notice for bids is published and payment of any amount is made to the contractor for project materials or labor costs. Assuming bids are not invited until bond proceeds are in hand, then it is obvious that 5% of the proceeds will not ordinarily be spent for tangible project improvements within 30 days of bond issuance, thus denying tax-exempt status to the bonds under the provisions of the Bill.

It may be theoretically possible for a local governmental unit to structure the bidding and awarding of a contract on a public construction project in a manner so as to comply technically with the Bill's requirements. However, the wisdom or practicality of such measures must be seriously questioned. If a school board or city council, for example, is willing to take a calculated risk and receive bids on a project prior to receipt of bond proceeds, providing in the bid documents that awarding of the contract to the successful bidder is contingent upon the closing of the bond issue and the delivery of bond proceeds, and further providing that work under the contract must proceed immediately and that the contractor must provide invoices evidencing that payment is due for at least 5% of the contract amount within 30 days of closing of the bond issue, then it might be possible to successfully comply with the requirements of the Bill, as well as applicable requirements of Oklahoma law on competitive bidding. But as previously mentioned, the wisdom and practicality of such a convoluted procedure is subject to serious question, and in some situations, issuers may be unable or unwilling to use such unconventional bidding procedures.

It is submitted that, unless the section of the Bill pertaining to the 5% requirement is amended, many construction projects for Oklahoma governmental entities cannot be financed with tax-exempt bonds, or if they are able to be financed, widespread and substantial changes in bidding procedures will be required.

This is but one example of the potentially damaging consequences of the Bill on Oklahoma issuers of tax-exempt bonds. Similar, and equally harmful, problems will be created for most issuers of revenue bonds to finance construction of utility improvements or to induce industrial development. If this were not enough, even in the limited instances where issuers are willing to proceed with the issuance of bonds, it is already clear that the January 1, 1986, effective date is seriously hampering efforts of Oklahoma issuers to market the securities and have the proceeds available for the needed projects.

An additional aspect of the Bill that further hampers the ability of municipal bond issues in Oklahoma to sell bonds for public improvement projects is the denial to banks of the ability to deduct the cost of "carrying" municipal bond portfolios.

Under Oklahoma law, commercial banks and other depositories of public monies are required to retain certain government obligations as security to collateralize these deposits. Traditionally, one of the primary sources of such collateral in Oklahoma has been general obligation bonds of school districts, municipalities, counties, or subdivisions of the State. However, it is sometimes necessary for a bank to borrow money with which to purchase and hold these securities, in order to remain eligible as a depository. Under present law, banks are permitted to deduct approximately 80% of the cost of "carrying" such securities as a business expense. Under the 1985 Tax Reform Act, this deduction is eliminated (with minor exceptions), making it costly and in some instances, unfeasible for banks to purchase or maintain large inventories of tax-exempt bonds.

Since commercial banks are and have been one of the primary markets for bonds of Oklahoma school districts and municipalities, the Bill's impact on the ability of such institutions to finance the purchase of local bonds is bound to have a significant effect on the ability of the issuers to sell their bonds, and when sold, on the interest rate. We must not lose sight of the fact that any increase in interest rate on bonds of such local issuers will be directly borne by the tax payers and residents of the school district or municipality. Thus, the local tax payer or utility rate payer in Oklahoma will, in effect, be penalized for the federal government's denial of this legitimate business deduction to banking institutions.

WHAT WE CAN DO ABOUT IT

The United States Senate has not yet taken action on the Bill. Obviously, then, one of the most important actions to be taken is for persons concerned about the impact of the Bill to write Senators Boren and Nickles, as well as Senators from other states, expressing opposition to the Bill in its present form, and urging amendments to allow State and local governments some breathing room.

In particular, it is urgent that efforts be made to modify or eliminate at least these three portions of the Bill: (1) the 5% - 30 day expenditure test for bond proceeds; (2) the denial of deductibility of carrying costs to banks as purchasers of tax-exempt bonds; and (3) the January 1, 1986 effective date.

The addresses and telephone numbers of Oklahoma's United States Senators and Representatives are included in the attachment at the end of this memorandum.

The participation of all concerned in expressing to our congressional delegation our alarm over the potential impact of the Bill is vitally needed. If Oklahoma is to successfully continue its efforts to encourage economic development and maintain or increase the level of local government services, we must act without delay in doing everything we can to eliminate or modify these harmful provisions of the Bill.