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Illinois: Should It Issue Bonds or Sell Tax Credits?

By Paul Fennell
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That may seem like an odd question until you consider that a tax-credit financing could easily be viewed as 'AAA.' That contrasts with Illinois bonds that trade below their 'BBB' benchmarks. The difference represents significant value — perhaps more than 100 basis points of savings on long-term offerings.

Here's a simple example of a proxy financing. Instead of issuing a 1-year note that paid $100 at maturity, Illinois would sell a $100 tax credit that could be applied any time after one year. It's an alternative that produces identical net cash flows.

What's the appeal of the tax-credit alternative? It guarantees that a holder will receive full value as long as he has a matching tax liability. That's true even if the issuing State is in a financial crisis and can't pay its bondholders. Imagine where a State's bonds would trade if it missed a payment. But a tax credit would still be worth 100%. In fact tax credits may be the perfect hedge: as long as taxes are owed, they retain full value.

You might also notice something interesting – using tax credits in this way allows a holder to prepay his taxes at a market discount, which is probably the safest and most efficient way to lend to a municipality.

Still, the ideal solution would be to wrap an ordinary bond around the tax credits, so that a holder has both the convenience of cash pay and the safety of back-up tax credits. That's the thinking behind a proposed GO structure, Tax Offset Municipal Securities (TOMS). In its simplest form it's a cash-pay bond, but in the event the issuer can't pay, bondholders receive equivalent tax credits instead.

In terms of mechanics the Trustee purchases tax credits from the State at the close of the underwriting. This is done under an agreement which acknowledges that the credits are receipts for estimated tax payments. The Trustee would then automatically "put" these tax credits to the State at each payment date for its cash equivalent. If all goes well bondholders would be paid cash as expected and the matching tax credit would expire. But if the State failed to pay, the Trustee would simply distribute the tax credits.

You might ask about the behind-the-scenes machinery. It establishes that a holder's credit is for estimated taxes already paid. That makes it secure. No one has ever suggested that a State could say to a taxpayer, "We've cashed the check for your taxes, but we're not going to allow the deduction."

In the end it's a structure that has the potential to deliver high-grade enhancement without counterparty exposure or credit risk, in effect bond insurance which no traditional insurer can match.

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