Technology

Internal Revenue Service

The Internal Revenue Service (IRS) regulates the use of tax free municipal bonds. If a bond is issued that does not comply with the IRS provisions, then the bond becomes taxable and has a higher interest rate to recognize the investor costs for taxable bond interest compared to tax free interest revenue. The IRS regulations provide a safeguard against the use of long-term tax free municipal bonds for short-lifespan equipment.

Under Federal tax code housed in the Code of Federal Regulations, school districts and others issuing tax-exempt bonds must strive to match the maturity of the bond with the life of the item being purchased with bond proceeds. Governmental entities must ensure that the "weighted average maturity […] does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects" [Treasury Regulation 1.148-1(c)(4)(i)B)(2)]. Failure to do so may subject them to penalties for the creation of "replacement proceeds."

Bond Counsel

Bond counsel is responsible for ensuring compliance with IRS requirements and certifying to purchasers that the bond interest will be tax free. Bond counsel is liable to the issuer and purchaser if an issued bond that is certified as tax free later becomes taxable. No bond counsel can afford the risk of being wrong on this fact.

State School Bonds

The apportionment of state bond funds does not come with a certification of the bonds' redemption terms for the bond(s) sold to fund the state matching apportionment. Consequently, the state bond funds need to be spent for long-term purposes such as site acquisition, facility construction and long-life equipment, such as heating, ventilation, and air-conditioning (HVAC) equipment. This ensures the state bond funds are not used for short-term equipment purchases.

Local School Bonds

Local school bonds can be matched to issuance and redemption terms (1 year, 3 years, 5 years, up to 25 to 40 years) and expenditure purposes. The local bonds, however, also need to comply with IRS requirements and have bond counsel certification to be a tax free municipal bond.

Why Not Just Use Taxable Bonds?

Fiscal Reasons Why School Districts Do Not Issue Taxable Bonds

School districts have tax rate control regarding most bond issuances. Because taxable bonds have significantly higher interest rates, the effect of the tax rate limitation is to reduce the principal amount for bonds that can be issued. Less principal means fewer projects can be funded compared to the bond principal amount that can be issued if the bond has tax free interest. School districts would bear significant local anger if the projects proposed for bond financing are not done because taxable bonds were used.

Political Controls

Any school district that caused local taxpayers to pay more interest than the minimum possible would be a school district where the elected school board would face significant local opposition.

Because of IRS regulations and for both fiscal and political reasons, school districts do not use long-term bonds for short life equipment expenditures.