Bond Case Briefs

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Federal Tax Reform: House Bill Rewrites Municipal Bond Rules - Ballard Spahr

The proposed Tax Cuts and Jobs Act released yesterday would eliminate the federal tax exemption for interest earned on all private activity bonds—including 501(c)(3) bonds and exempt facility bonds—and advance refunding bonds issued after December 31, 2017. These provisions would have a devastating effect on job creation and the cost of capital projects for tax-exempt entities, developers, hospitals, colleges, universities, and other research institutions and state and local governments for reasons described more fully below.

In addition, Chairman Kevin Brady of the House Ways & Means Committee unveiled the House bill along with a proposed timeline to pass tax reform through the House and into the Senate before Thanksgiving. Last week, House Republicans passed a budget resolution that paves the way for budget reconciliation—a process that would allow passage of the reform package without the threat of Democratic filibuster in the Senate.

Repeal of Tax Exemption for Private Activity Bonds

Historically, Congress has sanctioned public financing of certain privately-run projects on a tax-exempt basis through municipal bonds called industrial development bonds and later private activity bonds under the 1954 and 1986 Internal Revenue Codes, respectively. Since the late 1960s, private activity bonds have become an increasingly-significant part of the municipal bond market, which Republicans in Congress now propose eliminating on less than two months' notice.

The House bill would tax interest on private activity bonds issued on or after January 1, 2018. This sweeping change would strike from the Internal Revenue Code sections 142 (Exempt Facility Bonds), 143 (Qualified Mortgage Bonds and Qualified Veterans' Mortgage Bonds), 144 (Qualified Small Issue Bonds, Qualified Student Loan Bonds and Qualified Redevelopment Bonds), and 145 (501(c)(3) Bonds), as well as 146 and 147, which set forth operating rules for interest on private activity bonds, including 501(c)(3) bonds, to qualify for the exemption from federal income tax under section 103 of the code.

Section 103 encourages investment in state and local governments and non-governmental entities carrying out public projects such as charter schools and low-income housing projects by making it less costly for them to borrow funds. Bondholders will accept a lower interest rate from borrowers when that interest is tax-exempt because after-tax earnings on tax-exempt bonds will be higher by an amount equal to the forgone tax on interest income (currently 35% for public companies).

Taxing interest on qualified private activity bonds, as House Republicans propose, will increase the cost of borrowing for charitable, scientific, literary, educational, and other nonprofit organizations to fund public projects and may prevent many important projects from being funded. The repeal of private activity bonds will negatively affect the financing of colleges and universities, museums, charter schools, charities, independent living facilities, multifamily housing developers, hospitals, other nonprofit health care providers, research institutions, and other nonprofit organizations, as well as public-private partnerships used to finance public education, government utilities, and rehabilitation of blighted areas.

In short, the bill makes it more expensive for nonprofit organizations and private entities undertaking public projects to finance capital projects.

Repeal of Advance Refunding Bonds

The House bill also proposes to prohibit advance refunding of tax-exempt governmental and 501(c)(3) bonds. Advance refunding bonds are issued to refund a prior issue of the obligor more than 90 days before the refunded bonds are redeemed. Sale proceeds from the advance refunding bonds are typically deposited in a defeasance escrow and used to purchase government securities so that principal and interest on the securities can be used to pay debt service on the refunded bonds. Advance refunding allows the issuer to obtain the benefit of lower interest rates when the outstanding bonds are not currently callable.

Low-Income Housing Projects Financed by Tax-Exempt

Although the House bill preserves the Low-Income Housing Tax Credit (LIHTC), its repeal of the private activity bond rules will eliminate the availability of credits for projects where at least 50% is financed by tax-exempt private activity bonds.

In general, each state and the District of Columbia receive an allocation of LIHTCs based on population, which may be allocated on a competitive basis to affordable housing projects in the jurisdiction. Project owners recognize an annual LIHTC allocated through designated housing agencies in an amount equal to 9% of the project's eligible basis over 10 years (9% LIHTC). But for the District of Columbia and other jurisdictions where the annual housing credit ceiling on 9% LIHTCs is insufficient to finance necessary affordable-housing projects, tax-exempt private activity bonds have provided an alternative source of LIHTCs to attract developers—which the House bill would eliminate.

Low-income housing projects automatically qualify for a 4% LIHTC allocation over 10 years without regard to the state housing credit ceiling if at least 50% of the project's aggregate basis is financed by tax-exempt qualified 501(c)(3) bonds under section 145, exempt facility bonds under section 142(d), or qualified redevelopment bonds under section 144(c). The House bill eliminates those provisions without increasing the state housing credit ceiling, which will result in a net decrease in LIHTCs available for affordable housing projects nationwide.

Infrastructure

The proposal to eliminate issuance of private activity bonds after December 31, 2017, would likely have a devastating effect on many aspects of governmental, business, and nonprofit entities. It seems to run contrary to the Trump administration's stated goal of improving American infrastructure. The administration's proposals thus far have focused on increasing funding for the nation's decaying airports, docks and wharves, water facilities, and other categories now being built with tax-exempt bonds. It is unclear how Republicans plan to address the gaps in infrastructure financing likely to result if the House repeals tax-exempt bond rules under section 142 available for infrastructure projects.

No Transition Rule for State and Local Bonds Issued after 2017

Nearly as onerous as the House bill's bond provisions is their effective date of January 1, 2018, which, unlike the 1986 Act, applies with full force to not only new issues of tax-exempt bonds on or after that date, but any refund of bonds that are currently tax exempt. Thus, assuming enactment of the House bill, state and local governments and conduit borrowers must refund eligible tax-exempt bonds before the end of next month or forego potential debt service savings from refunding bonds.

As in the case of advance refunding bonds, tax-exempt private activity bonds issued and outstanding under current law before the end of 2017 would nonetheless lose their tax-exempt status upon a reissuance or deemed reissuance occurring on or after January 1, 2018. Tax-exempt private activity bond issuers will be limited in, if not prevented from, modifying terms of outstanding private activity bonds to reflect economic changes after the effective date because any "significant modification" of the terms of a tax-exempt private activity bond issued before 2018 will lose its tax exemption upon such modification.

Under general tax principals, a modification of a bond is considered significant if there is a change in the yield on the debt instrument of more than 0.25%, a deferral of one or more scheduled payments for a period of more than five years (or, if lesser, 50% of the original term of the instrument), or a change of obligor on the tax-exempt bond if the new obligor is not a related entity of the original obligor.

Under technical tax regulations and guidance, the lack of a refunding transition rule could also take away tax-exempt financing for draw-down loans with respect to any draws after 2017 and for any "reissuance" after 2017 of a pre-2018 tax-exempt private activity bond. This means that for certain private activity draw-down loans that were issued as tax-exempt with the expectation that all of the draws would be tax-exempt, any draws occurring after 2017 would not be tax-exempt if the House bill is enacted.

If enacted, these new rules will impose substantial diligence costs on already-strapped municipalities and, in the interim, may increase the impetus for obligors on tax-exempt bonds to advance refund bonds at current interest rates before the end of 2017. Given House Republicans' interest in stimulating commerce, the disruptive force of their tax-exempt bond proposals (including the lack of transition rules) is surprising and should deeply trouble issuers, investors, underwriters and other parties involved in the municipal bond market.

Attorneys in Ballard Spahr's Public Finance Group have participated in every kind of tax-exempt bond financing. These financings include bond issues for governments, hospitals and health care institutions, universities, colleges, student housing, single- and multifamily housing, airports and other exempt facilities, and public-private partnerships.

This is the latest in an ongoing series of Ballard Spahr advisories on the federal tax reform effort and its potential impact on organizations and people across the American economy. An alert on how the tax plan would affect employee benefits and compensation is available here.

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by the Public Finance Group