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Should Hospitals and Universities Be Able to Borrow Tax-Free? A $750 Billion Market Waits for the Answer.

Officials have contemplated ending tax exemption on private-activity bonds for several years to raise revenue

A team of private and public officials prepared a routine offer for investors last week: Buy tax-exempt bonds to pay for the widening of an interstate outside Washington, D.C.

But demand for the debt swelled after Republicans unveiled a proposal to end the tax-free benefits of these so-called private-activity bonds, according to an investor who participated in the offering. Prices on the interstate bonds have jumped 3% since the $353 million offering closed Friday morning, according to Municipal Securities Rulemaking Board data.

It didn't take long for the House Republican tax plan to roil a roughly $750 billion corner of the municipal-debt market.

"Over the last three trading days, the types of bonds that are scheduled for potential elimination are being gobbled up," said John Miller, co-head of Global Fixed Income at Nuveen Asset Management. "People are paying higher prices with some nervousness that these bonds will be very scarce going forward."

For decades, nonprofits and certain for-profit firms have been able to raise money the same way that state and local governments do: by issuing tax-exempt bonds for projects perceived to have a public benefit. The proceeds from these private-activity bonds—which have averaged about $110 billion a year over the past decade—help pay for everything from hospitals, nursing homes, college dorms and lecture halls to charter schools, housing and highways.

Elected officials have been contemplating ending this tax exemption on private-activity bonds for several years as a way of raising additional revenue. Former House Ways and Means Committee Chairman Dave Camp floated the idea in 2014, and the current proposal states that $40 billion in additional tax revenue would be made available over the next decade if the exemption were removed.

It is possible private-activity bonds could remain tax free if changes are made to the Republican House plan as it makes its way through Congress. But now that an actual proposal is on the table, those who follow the municipal-bond market are predicting that market will shrink if the exemption is gone and it will be more difficult to attract private investment to infrastructure—a key goal of President Donald Trump's 2016 campaign.

Analysts also expect a surge of tax-exempt borrowing by private companies and nonprofits rushing to take advantage of the exemption before it is gone.

"The whole thing is quite shocking," said George Friedlander, managing partner at Court Street Group Research and a four-decade municipal-market veteran who has been tracking tax policy since the 1980s.

There was a time when private-activity bonds could be used to fund any project as long as a local-government official approved. Congress first established rules for private-activity bonds in 1968, offering a specific list of approved projects including airports and low-income housing. In the 1980s, Congress added new types of private-activity bonds and capped how much nonprofits could issue, but the cap was lifted in the 1990s.

The use of private-activity bonds has attracted criticism from some who argue that certain borrowers shouldn't be able to benefit from the exemption. A Congressional Budget Office report in December found that some projects financed with private-activity bonds "probably would take place without a subsidy" and others likely would not be worth the cost.

"We should question whether large hospitals and universities that take in hundreds of millions of dollars in revenues should able to borrow at tax-exempt rates," said Greg LeRoy, executive director of Good Jobs First, a research group on economic-development incentives.

Dennis Zimmerman, a former Congressional Budget Office analyst and the author of a book about private-activity bonds, said that having a federal tax benefit largely administered by state and local officials invites waste. If government directly subsidized these projects, he said "it would concentrate the mind of state officials about whether there were real social benefits here."

Others say smaller nonprofits such as museums or charter schools might have trouble accessing the corporate-bond market and have to rely on bank loans. "Or just let the roof leak," said Natalie Cohen, a senior analyst with Wells Fargo Securities,

"If we had to pay any additional interest on debt in the taxable market, that would eat into our pretty slim margins," said Randy Safady, chief financial officer at CHRISTUS Health. The company operates Catholic hospitals in six U.S. states and is hoping to issue more than $250 million in tax-exempt bonds in the coming year to rebuild patient rooms and a cooling system at its hospital in Corpus Christi, Texas.

A letter to the House Ways and Means Committee on Monday, signed by trade associations of hospitals, universities, engineers, airports, bond lawyers and public officials, said ending the tax exemption for private-activity bonds would "undermine vital projects."

Christopher Meister, executive director of the Illinois Finance Authority, which facilitated $3.6 billion in private-activity bonds in fiscal year 2017, said he and other officials are ready to expedite deals for nonprofits and other private-activity borrowers that want to get them done by Dec. 31.

"We are prepared to hold special meetings if there is that need," Mr. Meister said.

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By Heather Gillers

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