Final Tax Bill Gives Muni Market the Gift of Continued PABs.

WASHINGTON – The first sweeping tax overhaul bill in three decades brings holiday gifts to the municipal bond market with the full preservation of private activity bonds, after the House has initially proposed terminating them at the end of the year.

The final tax bill, which Republicans negotiated and signed on Friday, also preserves tax-exempt bonds for professional sports stadiums and arenas, which the House bill had proposed to halt Nov. 2, 2017.

But market participants will also get some coal in their stockings in the form of the huge reduction in the corporate tax rate to 21% from 35% as well as the loss of advance refundings and tax credit bonds at the end of this year.

Muni market groups had pushed for a transition rule providing a delay in the effective date for advance refundings, but did not get it.

The bill is the product of House and Senate Republicans who insist it will pay for itself through economic growth, create jobs, and cut taxes for the middle class.

Democrats, however, who are incensed at having been left out of the process, complain the bill was railroaded through Congress and is a give-away to corporations. They say it will mostly benefit the wealthy, hurt the middle class, and increase the federal deficit. The bill is expected to add about $1.5 trillion to the deficit over 10 years.

The bill is to be voted on by the full Senate and House next week, with most Republicans expected to vote yes and most Democrats no. The goal of the GOP is to give the bill to President Trump to sign before Christmas.

Sens. Marco Rubio, R-Fla., and Mike Lee, R-Utah, who had threatened to oppose the bill unless the child tax credit was expanded obtained additional benefits for working families on Friday and said they would support the bill.

Even Sen. Bob Corker, R-Tenn., who had been expected to vote against the bill over deficit concerns, has said he will support it. Sen. Thad Cochran, R-Miss. who was recently hospitalized, is expected to be available to vote for the bill. Sen. John McCain R-Ariz., who was also hospitalized has returned home but has said he will return here if his vote is needed.

Muni market proponents of PABs were elated.

Tim Fisher, legislative and federal affairs coordinator for the Council of Development Finance Agencies, said, “We are thrilled that we were able to convince Congress to do something good for communities and economic development all around the country. We couldn’t have done it without our members, our partners, and everyone else who had a stake in this.”

“I’m relieved and gratified,” said Chuck Samuels, a member of Mintz Levin who is counsel to the National Association of Health & Higher Education Facilities Authorities. Usually “tax bills are like Russian novels: they’re long, boring and at the end everybody dies,” he said, “But we escaped” death.

Samuels said his group told lawmakers that if 501(c)(3) bonds were terminated, “thousands of nonprofits would either have lost access to capital or found it only at a prohibitive cost. We made it clear that some small, rural hospitals wouldn’t survive without tax-exempt financing.”

But market participants, particularly issuers, were unhappy about the year-end halt to tax-exempt advance refundings.

“Obviously the advance refunding elimination is a blow,” said Samuels. “That’s significant and issuers will have to deal with that. They’ll have to restructure their financings.”

Bond Dealers of America said it “commends both House and Senate leadership for preserving the tax-exempt status of private-activity bonds in the conference report, and of governmental municipal bonds during tax reform.”

But the group said, “It is disappointing however, to see the repeal of municipal advance refundings retained in the conference report. The repeal of issuers’ ability to advance refund outstanding debt will result in higher borrowing costs and less flexibility when managing debt for vital capital improvement projects.”

The Government FInance Officers Association was troubled both by the advance refunding halt and the compromise on the federal deduction for state and local taxes.

“We are relieved to see that the conference committee provided $10,000 toward individuals ability to deduct state and local taxes,” said GFOA. “But by mapping the provision to its current use (allowing property and income or sales taxes) this signals an important byline – local tax policies are designed to satisfy the needs of local economies. The cap is a finger on the scale and is unfortunate.”

The group added, ” the conference report signals that Congress does not recognize certain tools, such as advanced refunding of municipal bonds, as a critical method by which issuers achieve cost savings on public infrastructure. We will continue to communicate with our federal elected officials the value these tools bring to our state and local government finance and how they ultimately serve to provide savings for taxpayers until the final vote.”

National Association of Bond Lawyers president Sandy MacLennan said, “NABL is pleased that the importance of preserving private activity bonds was recognized in the final bill, however, the immediate loss of advance refundings is a disappointment.”

She added, “We will continue our collaborative efforts with other organizations to convince Congress of the value of advance refundings as an important financing tool for state and local governments, as well as non-profit organizations.”

The preservation of PABs is in line with the Senate bill and is a victory for the municipal bond market, especially since lawmakers had discussed but did not include elimination of the three year carry-forward in volume cap.

The retention of PABs came after a lobbying campaign by proponents. Reps. Sam Graves, R-Mo., and Randy Hultgren, R-Ill., and 36 other colleagues urged House and Senate Republican leaders and tax-writers earlier this week to retain PABs in the tax bill because they are issued to finance infrastructure and nonprofit hospitals.

Sources say House Ways and Means Committee chair Rep. Kevin Brady, R-Texas, was a key opponent of PABs. He and other lawmakers are upset that PABs are used for projects involving corporations and other private parties, sources said. They claim there are abuses. Brady heard stories of PABs used to help finance a vineyard in California and felt that was a misuse of these bonds, the sources said.

But muni market participants claim that abuses – PABs used for massage parlors, golf courses, and McDonald's — were shut down by the Tax Reform Act of 1986. The majority of PABs currently issued are 501(c)(3) bonds, which are used by nonprofit organizations such as hospitals and universities.

Proponents point out that PABs are a critical financing tool for multifamily and single-family housing and are used for airports, water and sewer projects, and local electric and gas facilities.

Treasury Secretary Steven Mnuchin and other administration officials in past months had proposed expanding the use of PABs so they could be used along with public-private partnerships to finance infrastructure projects. The Treasury Department had put PABs on its priority guidance plan for 2017-2018.

Perhaps the biggest harm to the muni market will come from the 40% or 14 percentage point drop in the corporate tax rate to 21%, tax experts said. The lower corporate rate, which is higher than the 20% rate in the House and Senate bills, will make munis unattractive to banks, property and casualty insurance companies and life insurance companies.

"It's a big deal," said George Friedlander, a managing partner at Court Street Research. "It means the effective net benefit of owning municipals drops," he said.

"It means a shift in the demand curve," he added. "Munis will have to yield more relative to taxables for corporate buyers [like banks] to be willing to add them to their portfolios."

Muni market participants will see far fewer bank loans and private placements, which have been increasingly popular in recent years, sources said. That will especially hurt smaller, less frequent issuers that place bonds with banks so they don't have to worry about credit issues and attracting the big underwriters, they said.

State and local governments are likely to see higher interest rates on their bank loans if their loan documents have corporate tax gross-up provisions that give the banks the right to increase the interest rates on the tax-exempt bonds they've purchased if corporate rates go down and the bonds are aren't worth as much to them.

The termination of tax-exempt advance refundings by year-end is not a surprise because both bills had proposed that. Under current law, issuers of governmental and 501(c (3) bonds can do one advance refunding. PABs cannot be advance refunded.

Terminating advance refundings by the end of the year will eliminate the flexibility that muni issuers have had to take advantage of lower interest rates and free up funds for other projects. It will raise costs for issuers. Ben Watkins, Florida's bond finance director, said recently that his state saved $3 billion over the past 10 years by being able to advance refund its bonds.

Issuers have some alternatives to advance refundings such as shorter or more frequent calls in bond documents, taxable refundings and tax-exempt current refundings. But those alternatives also include derivative products such as forwards, options and forward-starting interest rate swaps, which would increase issuers' their risk as well as their costs.

Muni market groups, particularly issuer groups, have been pushing lawmakers for transition rules that would delay the effective date by six months to a year, but the bill does not provide that.

The final bill includes more a flexible, if more stringent, provision on the federal deduction of state and local taxes. It allows a deduction of up to $10,000 for state and local property taxes as well as income or sales taxes.

This is a nod to states with high income taxes like California as well as those with high sales taxes. The House bill had allowed for a deduction of up to $10,000 of property taxes. But Brady had promised California Republicans he would give them some relief from that provision. The deduction would have been eliminated altogether under the Senate bill.

The individual alternative minimum tax would be retained but would not apply to individuals with taxable income under $500,000 and families under $1 million. The AMT applies to PABs and makes them less attractive, thereby raising their yields.

The corporate AMT would be repealed, as was included in the Senate bill. That would require corporations to pay tax on certain income not paid under the income tax such as tax-exempt bonds. All tax-exempt interest is subject to the corporate AMT, unlike the individual AMT, which just applies to PABs other than 501(c)(3) bonds.

The top individual tax rate will be set at 37%, down from the 39.6% rate in the House bill and from the 38.5% rate in the Senate bill. Brady said this would help offset the loss of state and local tax deductions for high income households.

The mortgage interest deduction would be capped at $750,000, up from $500,000 in the House bill but less than $1 million in the Senate bill.

The bill continues to treat Puerto Rico as a foreign country and is otherwise silent as far as providing relief to it. Brady said he would consider creating opportunity zones for Puerto Rico in an emergency supplemental bill. It was left out of the tax bill because it would not have complied with the Senate's Byrd Rule, which prohibits adding to the deficit after 10 years.

The Bond Buyer

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