
Interest Rate Increase Coming For Many Tax-Exempt Borrowers: Holland & Knight

Many states, local governments and conduit borrowers (e.g., 501(c)(3) not-for-profit corporations) have directly placed tax-exempt loans (secured by the issuance of notes or bonds) with lenders, such as banks and their non-bank affiliates, instead of going to the public markets. Many of these direct placement loans have so called "gross-up" provisions for changes in the marginal corporate tax rates. The gross-up provisions were intended to protect banks' investment return, because as marginal corporate tax rates decrease, the tax-exemption becomes worth less to the lender. Therefore, as corporate tax rates decrease, the gross-up provisions preserve a lender's net rate of return by increasing the interest rate on the loan or bonds. Consequently, as a result of the recent reduction in the marginal corporate tax rate from 35 percent to 21 percent, many borrowers with direct placement tax-exempt loans containing gross-up provisions may see their interest rates increase.

Not all gross-up provisions are written equally, and borrowers, as well as lenders, will need to carefully review the applicable provisions in loan documents. In most instances, the provisions are written as an objective adjustment in which the interest rate is multiplied by a fraction, the numerator of which is equal to 1 minus the Maximum Federal Corporate Tax Rate on the date of calculation and the denominator of which is 0.65. The current factor of 1 (i.e., 1 – 0.35 / 0.65) is increased to a factor of approximately 1.215385 (i.e. 1 – 0.21 / 0.65)1. As demonstrated, this will result in an increase of the interest rate by more than 21 percent.

Considerations for Borrowers and Lenders

The increased interest rate will have a budgetary impact for states, local governments and conduit borrowers. Moreover, additional challenges can arise for borrowers who have entered into variable-to-fixed interest rate swaps, as a basis differential can arise from a change in the rate on the loan without a change in the interest component on the underlying swap. For these borrowers, the variable rate interest rate under the loan will be increased as a result of the "gross up" but the receipt of swap payments received from the swap counterparties will not change. Therefore, a borrower will be paying a higher variable interest rate under the loan than it is receiving from the counterparty under the swap. Consequently, the swap will no longer be perfectly hedged.

Due to the quick implementation of these changes, many lenders are still reviewing their loan documents to determine which of their loans have gross-up provisions, as well as the extent to which they must be implemented. Thus, it may be several months before lenders notify borrowers of the change in rates. In many cases, however, the implementation of the rate increase is automatic, whether or not notice is given, and will become effective as of Jan. 1, 2018. Thus, governmental entities should quickly review their budgets to account for the potential rate increases.

Depending on the way the documents are written, the implementation of these changes may not be automatic and may not be equally applied across a bank's portfolio of loans. For some lenders, the documents provide that the rate "will" be grossed up (i.e., "the rate shall be increased"), but for other loans the provisions give the lender the option of whether or not to increase (i.e., "the rate may be increased at the option of the lender"). In those cases where the rate change under the loan documents is automatic, careful consideration needs to be given by bond counsel if the lender offers to waive the gross-up provision, because the failure to fully implement such a provision – or a delay in implementing its effective date – could cause a reissuance for federal income tax purposes and thus could cause the loan to become taxable. Lenders should consult with counsel prior to formalizing any waivers to ensure that the tax-exempt status is not unknowingly jeopardized.

Footnotes

1 A similar common adjustment factor is reflected as the product of 1 minus the Maximum Federal Corporate Tax Rate on the date of calculation multiplied by 1.53846.

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