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Tax-Exempt Bond Update: 2017 Year In Review.

Tax Reform

In by far the biggest tax news of the year, the tax reform bill, commonly known as the Tax Cuts and Jobs Act (Tax Act), was passed by Congress and signed by the President on December 22, 2017. Municipal finance participants, who had expected that all tax-exempt bonds would be "safe" under any tax reform legislation, were thrown by the initial version of the Tax Act released on November 2, 2017, which proposed to eliminate the tax-exemption for all private activity bonds, advance refunding bonds and certain stadium financings. What followed was an intense six weeks of hand-wringing, lobbying and rushing to close transactions at risk of losing their tax-exempt status if issued after December 31. In addition, issuers of tax credit bonds (such as build America bonds) were concerned that the projected increase in the federal deficit caused by the Tax Act could trigger a 100% reduction (beyond the now typical, annually announced sequestration levels that already affect direct pay bonds under the Budget Control Act of 2011) in the federal subsidy payments paid with respect to tax credit bonds under the provisions of the "Pay-As-You-Go Act of 2010" (PAYGO Act). In the end, Congress waived the PAYGO Act with respect to the Tax Act and avoided 100% sequestration.

The final version of the Tax Act:

- Repeals the authority to issue tax-exempt advance refunding bonds after December 31, 2017.
- Repeals the authority to issue tax credit bonds such as Qualified Zone Academy and Clean Renewable Energy Bonds after December 31, 2017.
- Retains the authority to issue private activity bonds (PABs), including 501(c)(3) bonds.
- Retains the authority to issue tax-exempt bonds to finance professional sports stadiums, in certain situations.
- Preserves the Low Income Housing Tax Credit (LIHTC).

In addition, the Tax Act:

- Lowers the corporate tax rate to 21%.
- Repeals the corporate alternative minimum tax (AMT).
- Retains seven individual tax brackets but changes both rates and income thresholds.
- Retains the individual AMT but raises the exemption and phase-out levels.
- Limits the deductibility of state and local taxes for individuals to $10,000.
- Lowers mortgage interest deduction cap to $750,000.

Most market participants expect to see a short term decrease in the issuance of tax-exempt bonds resulting from the rush to market that occurred in December 2017 and the elimination of advance refunding bonds (which have typically accounted for approximately 20% of new bond issues). The Tax Act did not provide transition rules for outstanding bonds that would have been eligible for tax-exempt advance refunding. As a result, market participants are exploring alternatives to tax-exempt advance refundings, such as forward delivery bonds or taxable advance refundings. For newly issued bonds, the market may react to the elimination of tax-exempt advance refunding bonds with new financing structures and revised call features, but these potential fixes may not be without cost to issuers. While the long-term effects of the Tax Act on the public finance market are not known at this time, it is possible that the lower corporate tax rate will reduce the appetite of banks and insurance companies for tax-exempt debt, and the number of bond issues directly placed with banks may decrease.

Proposed TEFRA Regulations

On September 28, 2017, the Internal Revenue Service (IRS) published proposed regulations with respect to the public approval requirements for private activity bonds under Section 147(f) of the Internal Revenue Code, commonly known as TEFRA requirements. A 90-day public comment period followed publication of the proposed regulations, but issuers may elect to apply the proposed regulations in whole (but not in part) to bond issues with a public approval that occurs on or after September 28, 2017.

The proposed regulations retain the 14-day notice requirement for a public hearing, but expand the permitted methods of providing notice to include the issuer's website. The proposed regulations also clarified the information required to be included in the public hearing notice. In addition, the proposed regulations provide additional guidance on what constitutes an "insubstantial deviation" and the ability to cure substantial deviations in limited circumstances. The proposed regulations also address where a hearing may occur, and include special rules for mortgage revenue bonds, qualified student loan bonds, qualified 501(c)(3) bonds issued for working capital expenditures, and pooled financings for 501(c)(3) bonds.

Updated Management Contract Guidelines

Although private business use can occur when a service provider uses bond-financed facilities pursuant to a management contract, the IRS has long provided "safe harbors" for management contracts that meet certain conditions. With the release of Revenue Procedure 2017-13 on January 17, 2017, the IRS made the safe harbor conditions more flexible and less formulaic. In general, management contracts must provide for reasonable compensation and must not give the service provider a share of net profits or impose on the service provider the burden of sharing net losses. The safe harbor conditions also limit the deferral of compensation, the term of the contract, transfer of the risk of loss, control over rates and other provisions. The new safe harbor conditions apply for all management contracts entered into (or modified or extended by mutual option) on or after January 17, 2017.

IRS: Reorganization, Audits and Guidance

In May 2017, the Tax Exempt & Government Entities Division of the IRS underwent a major reorganization. The tax-exempt bond (TEB) office was combined with the office of Indian tribal governments (ITG) to form a new ITG/TEB office within the Tax Exempt & Government Entities Division. As of May 1, 2017, there is no longer a TEB director, and the new ITG/TEB office is chaired by Christie Jacobs, who was previously director of ITG. Prior to taking the position, Jacobs did not have any experience with municipal bonds. Field operations, the unit responsible for bond audits, is now led by Telly J. Meier. Meier is also an ITG specialist without previous municipal bond experience. Allyson Belsome, the previous head of field operations for TEB, is now manager of the group that is responsible for the voluntary closing agreement program, technical support, and the development of ongoing outreach programs.

In recent years, staffing for TEB field operations (i.e. audits) has reduced dramatically (from 60 agents in 2009 down to an expected 19 agents in 2018). As a result, the IRS has adopted a more streamlined and data driven approach to tax-exempt bond audits. The 2018 work plan lists five focus areas for audits this year: arbitrage of tax-advantaged bonds with guaranteed investment contracts and/or qualified hedges as well as bonds with investments beyond a temporary period; acquisition financing involving private activity bonds to determine whether the rehabilitation requirement was satisfied; non-qualified use in the disposition of financed facilities and/or excessive private business use; bonds issued with a deep discount; and private activity bonds with excessive weighted average maturities.

Each year, the IRS issues a work plan setting priorities for guidance (in the form of proposed or final regulations, revenue procedures, etc.). For 2017-18, the work plan for ITB/TEB prioritizes: remedial actions for tax-credit bonds, private activity bonds, rebate overpayment, reissuance and TEFRA (as described above, proposed regulations were released in 2017, but have not yet been adopted in final form). Of course, the work plan was prepared before the Tax Act was proposed or signed into law and does not take into account any potential infrastructure legislation. The IRS may have to adjust its priorities to provide for implementation of the Tax Act or a possible infrastructure bill.

Commentary: Continued Risks to Private Activity Bonds

Conduit issuers, and housing issuers in particular, dodged a bullet at year end that would have come near to killing the affordable housing industry. Earlier in the year, the outlook was rosy: there was strong bipartisan support for increasing the low income housing tax credit, and a proposed bill that would have granted the increase and provided numerous improvements to the program. Then, in November, the House proposed a tax cut bill that eliminated private activity bonds, which include housing bonds subject to the state volume cap limits. The magic of those bonds – commonly referred to as “volume cap bonds” – is that their issuance provides an “automatic” housing tax credit, which attracts private investment in affordable housing. The tax credit program has enjoyed strong bipartisan support because of its ability to provide much needed affordable housing infrastructure through a true partnership between government and the private sector. It is a well-regarded and tested program that has produced millions of affordable housing units in its thirty year existence. The charitable view is that the drafters of the tax proposal were unaware of the role volume cap bonds play in the tax credit program. Any other interpretation is frightening because it demonstrates a disregard for the challenges cities across the nation face to address the housing needs of their residents.

The House version of the tax reform bill also threatened 501(c)(3) bonds that are used to finance nonprofit schools, hospitals, social service agencies, universities, museums and art institutions. Elimination of tax-exempt 501(c)(3) bonds would have increased the borrowing costs for institutions, which could result in fewer projects being completed or in increased costs being passed on to nonprofit users and clients.

Fortunately, the Senate version of the tax bill prevailed in this regard and the repeal of private activity bonds did not occur, thanks in significant part to bipartisan support for affordable housing. However, significant risks to this industry sector remain based upon reported statements by Kevin Brady, the chair of the House Ways and Means Committee and a critic of private activity bonds. He has suggested that private activity bonds should be “focused on infrastructure projects that help build and enhance the national infrastructure because they’re receiving national subsidies from every taxpayer in America.” Conduit issuers, nonprofit borrowers and affordable housing developers should brace themselves for the possibility that any upcoming infrastructure legislation could seek to redirect the benefit of private activity bonds to large, national infrastructure projects and away from “local” improvements, such as housing and nonprofit facilities.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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