Orrick: Tax Issues When Fixing Rate and Fee Adjusters in Tax-Exempt Loans.

The recently enacted reduction of the maximum federal corporate tax rate may trigger contractual provisions that provide for a significant increase in the interest rate on tax-exempt debt privately placed with a bank lender or require issuers or conduit borrowers to pay a significant fee. In each case, this adjustment is meant to compensate a bank lender for the reduction in after-tax return relative to a comparable taxable investment. We advise you to consult bond counsel before amending or allowing the waiver of any contractual provisions providing for interest rate increases or fees resulting from the change in the maximum federal corporate tax rate.

The recently enacted tax bill reduces the maximum federal corporate tax rate from 35% to 21%. This reduction increases the after-tax return on taxable investments currently held by bank lenders but does not affect the after-tax return on their tax-exempt investments. As a result, the change in law reduces the after-tax return on tax-exempt investments relative to the return on comparable taxable investments.

Most tax-exempt bank loans include “gross up” adjustment provisions crafted to deal with the adverse effect of corporate tax rate reductions on the relative return on such loans. The adjustments can take various forms, including a permanent, automatic, formula-based rate increase or a one-time fee determined by the bank lender to be adequate to compensate it for the reduction in the relative value of its tax-exempt investment. See the chart below for examples of two common “gross up” rate adjustment formulas.

Continue reading.

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