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Tax and Jobs Act of 2017 and How It Will Affect Nonprofits.

When the first version of the bill that would eventually become the Tax and Jobs Act of 2017 emerged, bond professionals were alarmed. The original House bill took several shots at tax-exempt bonds, most notably eliminating the ability to issue "private activity bonds" on a tax-exempt basis. These bonds are generally issued by municipal authorities to finance projects on behalf of hospitals and other health care providers, colleges and universities, as well as to finance low-income housing projects, among others. While this segment of the tax-exempt market is dwarfed by the much larger market for bonds issued by states, towns and municipalities, it is nonetheless an extremely important tool for nonprofits.

Issuers and beneficiaries of private activity bonds were given a reprieve as the ability to issue private activity bonds on a tax-exempt basis survived the Tax Act. However, institutions are beginning to realize that it was not a complete win for this segment of the market. What most market participants did not initially account for was the negative effect the reduction in the federal corporate income tax rate would have on the borrowing cost of many small nonprofits.

Historically, many smaller nonprofits have had difficulty accessing the tax-exempt market. This may have been because the amount of their borrowing was not large enough to justify the added expense of accessing the general tax-exempt market or the nonprofit may not have had a credit rating, making access to the public market difficult and expensive. In recent years, banks stepped into this void by using a "direct placement" structure. In this structure, a municipal authority issues a bond on behalf of an institution and sells it directly to a bank, often the nonprofit's existing bank. For the bank, it is an opportunity to create or enhance a relationship with an institution. The amount of the bond, which may have been too small to create interest in the public market, is well within the bank's credit profile. The bank could also spend the time necessary to understand the credit and would often secure its loan with a real estate mortgage, a structure within most bank's comfort zone. The rates were often fixed for a period of time (7-10 years) and were comparable to rates for publicly traded bonds with the same maturity. In fact, the structure was so efficient, it attracted many larger nonprofits and other municipal issuers like school districts.

Once the Tax Act was passed, however, the value of these bonds to banks diminished considerably as the banks' nominal tax rate decreased from 35 percent to 21 percent. Many banks anticipated this development and included yield maintenance language in their documents, which gave them the right to increase the interest rate should the corporate income tax rate decline. In one typical formula, the rate increases by a fraction, the numerator of which is 79 (one minus the new tax rate) and the denominator of which is 65 (one minus the old tax rate), or 122 percent, expressed as a decimal. So, if the borrower's old interest rate was 4.00 percent, the bank could now increase that to approximately 4.88 percent. An interest cost increase of over 20 percent could have significant budget impacts on many small nonprofits.

Whether and by how much the rate can increase depends on each borrower's loan documents. In many cases, the nonprofit borrower will simply have to absorb the rate increase. Refunding the bond will often carry prepayment penalties and even if they could refund, the rates for a new bond will likely not be any better unless they are able to access the public market (where the effect on the decrease in the corporate rate has been negligible).

The other headwind nonprofits will face is the possible negative effect of the increase in the standard deduction to $24,000. With the new $10,000 limit on deductibility of state and local taxes is taken into consideration, it is possible there will be fewer people itemizing deductions. If that is the case, one of the incentives for making charitable gifts disappears, which may lead to revenue losses across the board for nonprofits.

Most nonprofits are in the process of their budget discussions and it looks like this budget year could be all the more challenging given the expected effects of the Tax Act.

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