Bond Case Briefs

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Tax Cuts & Jobs Act: Tax Reform Implications For Public Finance: Stoll Keenon Ogden

The U.S. Congress kept an anxious corporate sector in suspense over the final weeks of 2017, while efforts by the House and Senate to reach a bipartisan compromise on tax reform left us all guessing as to our financial fates until the very end. Public finance practitioners, including investment specialists, attorneys and other advisors to the municipal bond market, were sent particularly on edge once the news broke that the House Ways and Means committee had proposed the repeal of all tax-exempt private activity bonds.

The relief among public finance attorneys was unanimous when tax-exempt private activity bonds remained intact under the Tax Cuts and Jobs Act (the "Final Bill"), signed into law on December 22, 2017. Some bond lawyers have paused to ask why the House would want to repeal all tax-exempt private activity bonds in the first place (see Johnny Hutchinson's pointed critique on The Public Finance Tax Blog), while others quickly moved to dissect the coming changes and alter their practices accordingly.

As one possible sign of less-than-favorable changes to come for the public finance industry, U.S. Bank recently slashed its long-term municipal bond desks in New York City by half, and cut banking and other positions across its public finance offices nationwide, citing "anticipated market transformation" as the reason for its proactive strategy.

This article provides a forecast overview of how changes to the tax code under the Final Bill could impact public finance, and the possible ripple effects through other parts of the finance industry.

Slashing Corporate and Individual Tax Rates, and Reducing Deductions

The feature of the Final Bill receiving the most attention from the general public, as well as from tax and finance attorneys, is the reduction of the corporate tax rate. Under the Final Bill, corporations will see a drastic reduction in their tax liabilities beginning in tax year 2018, from a maximum rate of 35 percent down to a single flat rate of 21 percent. Individual tax rates will also decrease for most, with a reorganization of the 2018 tax brackets to accommodate a reduction of the top tax rate from 39.6 percent down to 37 percent. The reduction to individual tax rates is set to expire at the end of 2025, and the new corporate tax rate is permanent.

Complementing the reduced tax rates are reduced deductions, the most prominent of which are the capping of the state and local tax deduction at $10,000, and a one-quarter reduction of the mortgage interest deduction. Some experts opine that changes to certain deductions available under current law are significant enough to offset the benefits to taxpayers gained by a reduction in individual tax rates.

Finance practitioners anticipate that these changes in tax rates could negatively impact the public finance industry. Lower corporate and individual tax rates will likely decrease the value of tax-exempt interest on municipal and qualified private activity bonds, leading to increased interest rates across the board on tax-exempt bonds in order to attract buyers, especially in the case of institutional purchasers.

While higher interest rates on bonds may be a boon to purchaser returns on investment, they are a burden to issuers, who would be forced to bear greater costs in connection with their bond debt. Moreover, greater expenses for issuers could translate to higher costs to the end consumer in the fields of healthcare, education, and other major industries populated by non-profits. There also exists a likelihood of slowdown in governmental and non-profit issuance of debt, as the higher interest expense may deter issuance altogether in some cases, and even the postponement of major projects that would have otherwise been financed by tax-advantaged bonds.

Elimination of Tax-Exempt Advance Refundings

Although the Final Bill bestowed gifts upon some, it wielded an axe upon others. Under the Final Bill, as of January 1, 2018 governmental issuers and issuers of qualified 501(c)(3) bonds no longer have tax-exempt advance refunding as a tool in their tax-savings belt.

Advance refunding bonds are issued for the purpose of paying off older bonds already issued and outstanding for a past project. The "advance" element of these bonds refers to the fact that they are issued more than 90 days before the outstanding bonds can be paid. The proceeds from the sale of the advance refunding bonds are then held in an interest-bearing escrow account until the date the outstanding bonds are available for redemption.

Issuers have traditionally used advance refunding bonds as a tool to restructure older debt and to take advantage of a current drop in interest rates, while carrying over the tax-exempt basis of the old bonds to the new advance refunding bonds. The elimination of advance refundings imposes significant limitations going forward on issuer and borrower flexibility, particularly in their ability to lock in debt-service savings at current, more favorable rates, lower periodic payments by restructuring debt service over longer periods of time, or escape unfavorable financing terms.

Again, the effects on public finance are likely to revolve around higher costs for issuers, with results similar to those discussed in the section above. And if you're wondering whether there are any transition rules in place for this advance refundings phase-out, there aren't.

As practitioners, the loss of advance refundings can necessarily mean the loss of valuable work—the legal expertise needed in such a transaction can involve hundreds of hours of billable time—unless alternative tax-saving measures can step in to take their place. There has been recent renewed interest in "Cinderella Bonds" or "taxable exchangeable bonds" (bonds initially issued on a taxable basis that are later reissued as tax-exempt bonds at a specified time or upon the occurrence of a particular event) as a potential alternative arrangement, but this type of debt financing is still likely to result in higher costs to issuers and, moreover, carry appreciable risk for issuers.

Tax-exempt current refundings (bonds issued less than 90 days before the outstanding bonds can be refunded) were not banned by tax law changes for 2018, and will still be available to governmental and qualified 501(c)(3) borrowers who want to eliminate certain unfavorable financial covenants, or simply restructure their existing debt.

Bond practitioners can also explore negotiation as a technique to achieve certain changes to their outstanding bonds, such as lowering the interest rate or waiving terms like call protection. However, because such renegotiation of material terms could trigger a bond reissuance, practitioners must proceed with caution.

A bond reissuance occurs when significant modifications to the terms of a bond are such that the modified bond replaces the original bond in a deemed exchange for federal tax purposes. A reissuance of a tax-exempt bond generally triggers retesting of all the various federal tax requirements that apply to a new issue. The consequences of a reissuance can range from a change in yield affecting arbitrage investment restrictions, to necessitating new public approval requirements for qualified private activity bonds.

Bond counsel can additionally consider structuring new bonds using make-whole calls, declining redemption premiums, forward-starting swaps, or variable rates. Private placement of bonds with banks, while still an option, may be on the decline, as the new tax law's reduction of the corporate rate may increase the interest rates charged by banks on the bonds, or heavily reduce demand altogether.

Tax Credit Bonds

All future issuances of "qualified tax credit bonds" have been eliminated under the Final Bill. These types of bonds include qualified school construction bonds, qualified zone academy bonds, qualified energy conservation bonds, and others, which formerly allowed issuers to lower their capital costs for certain infrastructure projects through receipt of a federal tax credit, or in some cases, direct subsidy payments from the federal government. Issuers and holders of tax credit bonds issued before 2018 will continue to receive these benefits.

Although future issuers who would have qualified for tax credit bonds will no longer have that option, many of their projects will still qualify for financing on a tax-exempt basis through either governmental bonds or private activity bonds. The interest on tax credit bonds is not tax-exempt, so a shift in the way these projects are financed to a tax-exempt basis could potentially mitigate the negative effects of losing the tax credit or subsidy.

Tax-Exempt Bond Financing for Professional Stadiums
Professional stadium financings via tax-exempt bonds have almost always been controversial, as both Democrat and Republican legislators have long debated the propriety of granting such favorable tax treatment to private and government-owned facilities used as stadiums or arenas for professional sports. It was reported early on in the process of Congressional debate on tax reform that proposals from the House and Senate would eliminate the tax advantage for professional stadium bonds, but that cut did not make it into the Final Bill.

Bipartisan support continues, however, for the elimination of tax-exempt stadium bonds, propelling some governmental issuers to accelerate financing for their stadium projects before any change in the law could be enacted in the near future.

Major Changes to the Alternative Minimum Tax (AMT)

Under previous law, interest earned by holders of private activity bonds has been treated as tax-exempt for most purposes except for in the determination of the AMT. This meant that any interest earnings on private activity bonds was treated as an item of tax preference includable in alternative minimum taxable income for purposes of determining the AMT for individuals and corporations. To offset this result, bond purchasers have typically demanded higher interest rates for private activity bonds than they would for governmental bonds.

Significant changes to the AMT could change that interest rate distinction, at least temporarily. Beginning in tax year 2018, the AMT has been repealed in its entirety for corporations. For individuals, temporary increases to AMT exemption amounts and phase-out thresholds have been placed into effect for tax years 2018 to 2025, which amounts will also be indexed for inflation. In light of the repeal of the AMT for corporations and the temporary increased exemptions for individuals, public finance practitioners expect to see a reduction in the typically higher interest rates commanded by purchasers of private activity bonds as compared to bonds not subject to taxability under AMT.

The Uncertain Survival of Tax-Exempt Private Activity Bonds

The Final Bill's greatest gift to bond lawyers and public finance practitioners was that it didn't eliminate tax-exempt private activity bonds. The House proposal would have ended tax advantaged financing for all categories of tax-exempt private activity bonds which include, among others, airports; docks, wharves, and ports; sewage and solid waste facilities; facilities furnishing water; projects owned by 501(c)(3) organizations like non-profit hospitals and non-profit higher education institutions; mass commuting facilities; low-income multifamily housing developments; and single-family mortgage bonds.

As is apparent from their descriptions, the above categories of tax-exempt private activity bonds are available to issuers who serve a public purpose. Private activity bonds make up a large percentage of the bond market, accounting for 27 percent of all bond issuance in 2015, and often serve as a first line of financing for large-scale projects belonging to non-profits. Think of the most recent renovation to an important wing of your local hospital or your university alma mater—those are typical of the kinds of projects backed by tax-exempt private activity bonds. All categories of tax-exempt private activity bonds are retained under the Final Bill.

Although bond lawyers were grateful to see private activity bonds off the chopping block in the Final Bill, that relief could be short lived. As Washington looks towards national infrastructure as its next mission, Congress is still considering the placement of new limitations on private activity bonds, questioning whether the scope of projects financed on a tax-exempt basis by private activity bonds should be narrowed to those supporting infrastructure-related efforts. Municipal and non-profit issuers, along with their bond lawyers, will just have to keep holding their breath.

On the Horizon

All finance practitioners should take Washington's lead and turn their attention towards infrastructure and the municipal and conduit bond issuers operating in that sector. New incentives are expected to emerge this year as part of a national infrastructure plan which could jumpstart related public financings and public-private partnerships. Bond lawyers should also pay close attention to any forthcoming technical corrections in the Final Bill that could impact public finance, with a particular eye on a potential narrowing of permitted tax-exempt private activity bonds.

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April 23 2018

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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.