PACIFICA LAW GROUP

Municipal Finance Update:

Tax Cuts and Jobs Act Proposes Sweeping Changes to Financing Tools for Municipalities, Nonprofits, Housing Agencies, and Others

On November 2, 2017, Chairman Kevin Brady of the House of Representatives Ways & Means Committee introduced the Tax Cuts and Jobs Act (the "Bill"). Although the Bill does not completely eliminate the tax-exemption for municipal bonds provided by the Internal Revenue Code of 1986, as amended (the "Tax Code"), the Bill proposes substantial changes that would eliminate major financing structures for a variety of projects. The provisions include:

- Elimination of Tax-Exempt Private Activity Bonds
- Elimination of Tax-Exempt Advance Refunding Bonds
- Prohibition on Tax-Exempt Financing of Professional Sports Stadiums
- Elimination of Tax Credit Bonds
- Elimination of New Markets Tax Credits
- Elimination of the Historic Tax Credit
- Effective Termination of the 4% Low-Income Housing Tax Credit
- Repeal of the Alternative Minimum Tax
- Reduction of the Corporate Tax Rate

Most of the provisions would be effective as of January 1, 2018. Click here for a link to the section-by-section summary of the Bill from the House Ways and Means Committee.

Private Activity Bonds. Current law provides that certain private activity bonds, such as qualified 501(c)(3) bonds, multifamily housing bonds, qualified mortgage bonds, exempt facility bonds for airports and seaports, solid waste facility bonds, and small issue manufacturing bonds, can be issued on a tax-exempt basis so long as certain requirements are met. For decades, this tax exemption has supported financings for nonprofit universities, hospitals, museums, and social service agencies as well as for low-income housing and senior living facilities, and many airport, seaport and other projects in our community and nationwide. Recent discussions relating to infrastructure spending had led many to believe that the private activity bond provisions might be expanded. Contrary to these expectations, the Bill prohibits the issuance of any tax-exempt private activity bonds after December 31, 2017.

Advance Refunding Bonds. An advance refunding occurs when refunding bonds are issued more than 90 days prior to the call date for the prior bonds (which is typically 10 years from the original issue date). Proceeds of the refunding bonds are placed in an escrow and used to redeem the prior bonds on their call date. Current law allows issuers of governmental and 501(c)(3) bonds a single opportunity to advance refund prior bonds on a tax-exempt basis to take advantage of low interest rates even if the prior bonds are not immediately callable. According to Bloomberg, more than $37 billion in advance refunding bonds have been issued so far in 2017. The Bill would prohibit the tax-exempt advance refunding of any outstanding bonds after December 31, 2017.

Professional Sports Stadiums. Under the Bill, no tax-exempt bonds could be used to finance or refinance a stadium or arena that is used for professional sports exhibitions, games, or training for five or more days in any calendar year. Prohibited facilities could include college or university arenas or public domes or convention centers that also are used occasionally by professional sports teams. Governmental issuers should be aware that this is an absolute prohibition, and if any proceeds from an issue of tax-exempt governmental bonds are spent on a facility that is used for five or more days as a stadium or arena for professional sports events or training, the entire governmental bond issue could be taxable. This provision would be effective for any bonds issued after November 2, 2017.

Tax Credit Bonds. Over the years, the Tax Code has provided for various types of tax-advantaged bonds, such as qualified zone academy bonds, clean renewable energy bonds, qualified energy conservation bonds, and build America bonds (together, "Tax Credit Bonds"). Tax Credit Bonds have typically been limited by volume cap requirements, and most types of Tax Credit Bonds do not currently have volume cap and are, therefore, not an available financing tool. The Bill would eliminate the provisions authorizing the issuance of Tax Credit Bonds, and outstanding Tax Credit Bonds would not be eligible for tax-exempt refinancing after December 31, 2017.

New Markets Tax Credits. The New Markets Tax Credit ("NMTC") program was enacted in 2000 as part of a bipartisan effort to stimulate investment and economic growth in low-income urban neighborhoods and rural communities. The NMTC program has been used to finance a variety of projects including retail, health care and social services, manufacturing and community facilities, and was scheduled to expire in 2019. Under the Bill, no new NMTC allocation would be available after 2017.

Historic Tax Credits. The federal Historic Tax Credit ("HTC") program was enacted by the Reagan administration in 1981 to encourage the redevelopment of historic and abandoned buildings and to fight urban blight. The Bill summary estimates eliminating the HTC will increase revenues by $9.3 billion over 2018-2027. According to analysis from the National Trust for Historic Preservation, however, the HTC program returns $1.20-1.25 in tax revenue for every dollar invested and has been used to renovate more than 42,000 structures and has leveraged more than $131 billion in private investment since its enactment. The Bill repeals the HTC. Under a transition rule, the HTC would continue to apply for a 24-month period for certain projects able to commence within 180 days after enactment of the Bill.

Low-Income Housing Tax Credits. The Tax Code provides for "9%" and "4%" Low-Income Housing Tax Credits ("LIHTCs"), which are available to help finance the acquisition, rehabilitation and new construction of low income housing. Each state receives a limited allocation of 9% LIHTCs based on population, and states use a competitive process to allocate these 9% LIHTCs to developers. In contrast, the 4% LIHTC is not subject to the state ceiling and is available for projects where at least 50% of the project is financed by tax-exempt private activity bonds. Although the Bill technically preserves both the 4% and the 9% LIHTC, the repeal of the private activity bond provisions will result in the inability of developers to access 4% credits. According to the National Council of State Housing Agencies ("NCSHA"), states use tax-exempt bonds to finance approximately 45% of LIHTC rental homes every year. The elimination of tax-exempt multifamily bonds and the related 4% credit could severely undermine state and local efforts to preserve affordable housing.

Alternative Minimum Tax. The Bill would repeal the Alternative Minimum Tax ("AMT") for tax years beginning after December 31, 2017. Currently, interest on certain private activity bonds is treated as a specific preference item for purposes of the AMT, and repeal of the AMT would provide a financial benefit for holders of (but not necessarily issuers of) private activity bonds. Because the Bill eliminates the issuance of tax-exempt private activity bonds after 2017, the repeal of the AMT would only affect existing private activity bonds. The treatment of interest on governmental tax-exempt bonds would not be affected.

Corporate Tax Rate. A cornerstone of the Bill is the proposed reduction in the corporate tax rate from a top rate of 35% to a flat rate of 20%. This reduction could significantly impact the market for tax-exempt bonds. Many publicly sold bonds are held by banks, insurance companies, and other corporations, and a significant number of bonds have been privately placed with banks in recent years. The proposed reduction in the corporate tax rate may reduce demand for tax-exempt bonds and could drive up yields in the municipal markets.

Lack of Transition Rules. The Bill is effective for private activity bonds and advance refunding bonds issued after December 31, 2017, and for professional stadium bonds issued after November 2, 2017. The Bill does not affect the taxation of interest on outstanding private activity bonds, advance refunding bonds or professional stadium bonds; however, the Bill does not include any transition rules to ease implementation of the provisions. The lack of transition rules means that, after December 31, 2017, additional draws on private activity bonds issued on a draw-down basis or any rolls or take-outs of existing private activity commercial paper will not qualify for tax-exemption. This may impact construction projects currently underway.

In addition, there is no transition rule allowing for refunding (current or advance) of outstanding private activity, tax credit, advance refunding or professional stadium bonds on a tax-exempt basis. This means that issuers and conduit borrowers will need to be careful to avoid an inadvertent refunding resulting from "reissuance" of outstanding bonds. Under the Tax Code, certain modifications of bond terms, which can include changes in interest rates or amortization schedules, may result in a reissuance of that bond. Without transition rules, reissuance of outstanding private activity, advance refunding or professional stadium bonds could result in interest on those bonds being declared taxable.

The immediate effective dates and the lack of transition rules may cause problems for the municipal market even if the Bill never becomes law. As long as the proposed tax reform legislation includes these provisions, it is unlikely that bond counsel will be able to give tax opinions regarding private activity bonds or advance refunding bonds after December 31, 2017, because eventual adoption of the Bill would make these bonds retroactively taxable. Financings for facilities meeting the definition of "professional stadium" must be done on a taxable basis starting on the date the Bill was introduced, November 2, 2017. Issuers must immediately address the issue of outstanding private activity draw-down bonds and commercial paper that otherwise would roll or be taken out after December 31, 2017.

We expect to see a high volume of private activity bonds (including 501(c)(3) bonds and multifamily housing bonds) and advance refunding bonds flooding the market before year end in an attempt to lock in the tax-exempt status before December 31, 2017.

Congress's Path. The House Ways and Means Committee is expected to consider the Bill this week. The Committee will revise and amend the Bill, and the full House is expected to consider the Bill the week of November 13. Meanwhile the Senate Finance Committee is considering its own version of tax reform legislation. The Senate bill may be released as early as November 10, and the full Senate could consider the bill before Thanksgiving. The Republican leadership's goal is to send a final tax reform bill to the President by the end of the year.

Republican leadership has been planning to use the budget reconciliation process to pass a tax reform bill with a simple majority vote. However, under the "Byrd Rule," in the Senate, a bill cannot be passed using the reconciliation process if it has revenue losses and an increase in the deficit beyond ten years. The Joint Committee on Taxation estimates that the current House Bill would increase the deficit by over $150 billion in 2027. As a result, the Senate bill may need to make some of the tax cuts temporary or include additional off-sets to reduce the resulting deficit. As the Senate and House propose, revise and then reconcile differences between bills, the Bill may be substantially revised.

Next Steps. In the meantime, organizations such as the National Association of Bond Lawyers, the Governmental Finance Officers Association, the National Council of State Housing Agencies, the Council of Development Finance Agencies, the National Council of Nonprofits, the National Association of College and University Business Officers, the National Association of Health and Educational Facilities Finance Authorities and others are urging legislators to amend provisions of the Bill that affect state, local and nonprofit infrastructure financing and/or urging their members to contact their elected officials in Congress to voice concerns with respect to the Bill.

The Bill raises many questions and concerns for issuers, borrowers and developers, both immediate and long-term. If you have any questions on the Bill or other topics relating to tax-exempt bonds, please contact any of our public finance attorneys, listed below.

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