Tax Cuts and Jobs Act Becomes Law, Terminates Tax-Exempt Advance Refunding Bonds

Hinckley Allen Public Finance Group Client Alert

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On December 22, 2017, H.R. 1, the “Tax Cuts and Jobs Act”, was signed into law. Addressing a wide range of tax policy and revenue matters, starting with a 40% reduction in the corporate income tax rate and significant adjustments to the tax brackets for individual taxpayers, the Act has been described as “generational” in ambition and scope. The Act is likely to affect all sectors of the American economy, including the market for tax-exempt and tax subsidy bonds.

The Act has two provisions directly impacting these bonds. First, the Act repeals tax-exemption for advance refunding bonds issued after December 31, 2017. Refunding bonds are obligations issued to pay debt service on, and typically to retire, outstanding bonds; under federal tax law, a transaction is characterized as an advance refunding if the refunded bonds remain outstanding for more than ninety days after the date on which the refunding bonds are issued. Before passage of the Act, state and local governmental issuers and 501(c)(3) borrowers have been eligible to use tax-exempt advance refunding bonds as a debt management tool, most often to capture interest rate savings. Some policymakers, however, have for many years noted the inefficiency associated with extending tax-exempt treatment to advance refunding bonds. In essence, these policymakers say, advance refunding bonds can be characterized as “overburdening” a valuable tax subsidy—putting two dollars of tax-exempt bonds into the market to provide just a dollar’s worth of assets. Thus, the advance refunding repealer will not be entirely surprising to the bond market, and it is likely that issuers and borrowers will explore transaction substitutes, such as “forward delivery” bonds and so-called bond swaptions, to capture the kind of savings that otherwise would have been available through the direct issuance of tax-exempt advance refunding bonds.

Second, the Act repeals qualified tax credit and direct-pay subsidy bonds such as new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds and qualified school construction bonds. This provision of the Act also is effective for bonds issued after December 31, 2017. Since 2009, most of these bonds have been issued as direct-pay subsidy bonds, permitting issuers and borrowers to receive a payment directly from the United States Treasury for a portion, and in some cases all, of the interest paid on them. Tax credit and direct-pay subsidy bonds issued prior to 2018 are unaffected by this repealer, although direct-pay subsidy payments on eligible bonds continue to be affected by federal budgetary sequestration measures.

Notably, unlike the House of Representatives bill that preceded it, the Act does not include a provision to terminate tax-exempt treatment for private activity bonds issued after 2017. This means that 501(c)(3) organizations and other eligible borrowers can continue to use tax-exempt bonds to finance capital projects such as manufacturing facilities, privately-operated docks and wharves, airport, solid waste and sewage facilities and low- and moderate-income residential rental properties. Tax-exempt bonds to finance certain single family mortgages and student loans also are preserved under the Act.

Bond issuers and borrowers should also note that the Act permanently repeals the corporate alternative minimum tax and substantially raises the income thresholds at which the alternative minimum tax will be applicable to individual taxpayers for tax years ending before 2026. In contrast to the tax bracket revisions that give the Act the first part of its name, these AMT-related provisions should have a stimulative effect on demand for the kinds of tax-exempt private activity bonds that were subject to AMT under prior law (i.e., all qualified private activity bonds other than 501(c)(3) bonds).

Reports indicate that leadership in the House of Representatives may pursue additional tax legislation in 2018, including possibly revisiting the tax-exempt treatment of certain types of private activity bonds. Bond market associations and participants will want to monitor legislative developments in the coming year to ensure that access to tax-exempt bond financing is maintained in the future for projects that appropriately further significant public policy objectives.

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