Implications of Recent Tax Reform
What Tax-exempt Borrowers Should Know

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The recent tax-reform known as the Tax Cuts and Jobs Act (tax reform) went through the legislative branch like a hurricane, leaving a trail that is still being sorted out. The legislation was quickly passed in December 2017 and became effective January 2018. While the senior living industry was appropriately focused on the larger items in the bill that would have significant impact on tax-exempt borrowers – such as the potential elimination of private activity bonds (PAB) and the elimination of advanced refundings – there wasn't time to fully digest how the tax reform, in general, would impact several facets of tax-exempt debt.

With one fiscal quarter now behind us, we're seeing that the ripple effects of tax reform on tax-exempt debt are broader than originally thought after seeing that private activity bonds were spared. This article provides an overview of the broader impact tax reform has had on tax-exempt debt and what tax-exempt borrowers should know and do to protect themselves.

THE FIXED RATE, TAX-EXEMPT BOND MARKET

As most bond lawyers, banks and investment bankers will tell you, December 2017 will go down in infamy. There were more tax-exempt deals done than any other prior month, including December 1985, which was the last time major tax-reform was implemented. With the expected elimination of advanced refundings in the tax bill and the potential for the elimination of PAB (which was NOT in the final bill), many issuers rushed to market in November and December of 2017 to issue their debt under the then- current tax laws, before the change took effect Jan. 1, 2018. It is estimated approximately $50 billion of tax-exempt debt was issued at the end of 2017 that might have taken place in 2018[1]. We are continuing to feel the effects of this with the significant decrease in issuance in the first quarter of 2018 when compared to the same time last year. The first quarter of 2018 had issuance of $61.4 billion vs. $92.3 billion for the first quarter of 2017[2]. While issuance volume is expected to pick up, the elimination of tax-exempt advanced refundings will decrease the number of deals completed this year. To put it in perspective, advanced refundings were 44 percent of the municipal market issuances in 2016, 34 percent of the market in 2017 and was expected to be roughly 25 percent of the market in 2018[3].

The decrease in the volume of tax-exempt debt activity could help senior living borrowers by keeping interest rates lower due to lack of supply. However, several aspects of the tax bill could mitigate this advantage. First, with the lowering of the corporate tax rate, municipal securities are not as attractive of an investment for banks or insurance companies. Although they are not a primary buyer of fixed-rate bonds, this could negatively impact demand, causing interest rates to increase. The market is seeing insurance companies, in particular, looking to divest themselves of tax-exempt munis as they change their investment directives. Most of the redirection appears to be going towards taxable municipal securities.

However, because retail buyers (high net-worth individuals) and tax-exempt mutual funds (buyers of tax-exempt securities on behalf of retail buyers) are the primary buyers of fixed-rate, tax-exempt bonds, and because tax rates for individuals changed very little under tax reform, demand from these two investor categories should not drop off. Institutional tax-exempt mutual funds get their money from individuals; therefore, their appetites will be dictated by changes in individual tax rates, not corporate tax rates. With that said, we have seen a decrease in inflows into municipal bond funds in February and March of 2018. Total inflows for the first quarter experienced a 92% drop from the five-year average[4]. In summary, with fewer issuances since tax reform took effect, the sustained impact on the fixed-rate, tax-exempt bond market is still uncertain. However, we've seen several deals get done at interest rates similar to what we saw in 2017. Accordingly, while the type of buyer of this debt may have shifted slightly, the ongoing demand, especially from retail, makes the tax-exempt, fixed-rate bond market a good alternative to consider when creating your capital formation strategy.

[1]Weitzman, Aaron, "February Fallout: Monthly issuance hits 18-year low," *Bond Buyer*, Feb. 28, 2018.
[2]Hallacy, John, "How munis have fared under the new tax law," *Bond Buyer*, March 29, 2018.
[3]Hume, Lynn, "Banks are rethinking munis," *Bond Buyer*, March 22, 2018.
[4]Gillers, Heather, "Municipal Bonds Were Supposed to Get More Expensive in 2018. Why Didn't That Happen?" *The Wall Street Journal*, March 31, 2018.

***Action Item**: Determine if it still makes sense to have a direct tax-exempt bank loan instead of traditional fixed-rate bonds on your balance sheet. Even if it costs a little more to refinance with traditional fixed-rate bonds, it may be a better choice due to:*

(1) elimination of interest rate reset risk at the end of the bank commitment,

(2) ability to stretch the amortization out with traditional fixed-rate bonds, creating additional debt capacity, and

(3) freeing-up bank debt capacity by refinancing with traditional fixed-rate bonds. The freed-up bank capacity can be used for future project needs where bank debt is a more efficient financing vehicle.

While each situation is different, you should at least explore the option of replacing your bank debt with fixed-rate bonds.

TAX EXEMPT BANK DEBT

While the impact of tax reform on the appetite of buyers in the fixed-rate bond market is still unknown, we have seen no slowdown in the appetite for direct tax-exempt loans by banks. **However, tax reform is directly impacting the interest rates for borrowers that have existing tax-exempt bank loans**. The most notable change in the tax bill was the significant decrease in the maximum corporate tax rate from 35- 21%. The after-tax return for banks purchasing tax-exempt debt decreases with the decrease in tax rate. Most tax-exempt bank placements are priced based on a formula similar to: "X% of LIBOR + credit spread." The X% is based on the bank's tax bracket.

For example, if the bank's tax-rate was 35%:

(1 - Tax Rate) = X

(1 – 35%) = 65 %. Hence your all-in rate would be (65% of LIBOR) + credit spread.

Prior to the tax reform, the 'X' ranged from 65–72%. With the decreased corporate tax rates, we're seeing an increase in "X" to 76-85%.

Knowing tax changes have always been a possibility, and to protect their returns in the event of a corporate tax cut, many banks have a "gross-up" or "yield maintenance" provision in the loan documents. This provision requires interest rates to be adjusted for existing debt so the after-tax yield the bank gets on the loan is maintained with the lower tax incentive. Depending on the bank's current tax rate, we've seen borrowers all-in rates increase between 18-22%, which is significant. In addition, sometimes the credit spread is increased as well, increasing the rate by even more.

Tax reform became effective Jan. 1, 2018, so many banks are charging the increase in the rate retro-active to the date of the implementation of tax reform. We have run across this type of language, in various degrees of specificity, in the majority of direct, tax-exempt bank placements in the markets. However, we're facing a wide discrepancy in banks' reactions of how prompt/strict they are at implementing these rate increases. We're also hearing from some bond counsels that if the language is in the documents, and the bank/borrower takes no action to follow what is outlined in the documents, it could trigger what is called a reissuance. Furthermore, if the language in the documents is vague (versus formulaic), and the increase in the rate is greater than 0.25% or 25 basis points, this could also trigger a reissuance. A reissuance occurs strictly for tax reasons and is not as big of a deal as it sounds. It will require a few new legal documents, a new bond counsel opinion and some legal fees. Therefore, the possibility of a reissuance should not influence a borrower to blindly accept the changes that are outlined in the loan documents. As previously stated, if the bank has gross-up language but is willing to waive it, you'll need a reissuance. Paying for a reissuance (one-time legal fee) may be much cheaper than implementing the gross-up language (higher interest rate) that will last through the length of the bank's commitment.

***Action Item**: If you have an existing, direct tax-exempt bank loan, look in your legal documents to see if there is language that describes what happens if/when tax rates change. Talk to bond counsel to explore your options, and bring in an investment banker to help. If there is gross-up language in your documents, you will need to do something. That 'something' could include: 1) adjusting your rate per the language in the document; 2) negotiating a new rate with the bank; 3) getting a waiver of the rate adjustment. The second and third options could trigger a reissuance, so involve your bond counsel in your discussions on this matter.*

SWAPS ON BANK-PLACED TAX-EXEMPT DEBT

Many providers with tax-exempt bank debt have corresponding swaps to mitigate interest rate risk. Most swaps, when done in conjunction with the issuance of debt, are based on a variable-rate factor identical to your variable rate from the bank, hence, in the previous example, (65% of LIBOR) + credit spread. If/as the banks increase the margin rate factor, you will have a swap that is no longer "perfectly hedged." Your swap is a separate legal instrument and would need to be amended to reflect the change in the rate for your debt if you want to continue to be "perfectly hedged."

THINGS TO CONSIDER WHEN TAKING ON FUTURE DEBT

As previously mentioned, there remains a large appetite for tax-exempt, fixed-rate bonds and direct tax-exempt bank placements. However, there are several things to consider when taking on future debt. For example, you may want to explore taxable bank debt as well as tax-exempt bank debt. With the increase in the rates on tax-exempt bank placements, the interest rate difference between taxable and tax-exempt debt is not as significant as it used to be. Often the added flexibility and the lower costs of issuance of taxable debt could override the interest rate differential between taxable and tax-exempt debt, especially on smaller loans.

Another approach investment bankers and counsels have adopted due to the tax reform is the desire to make future debt documents 'multimodal.' This allows debt to switch modes (i.e., from variable-rate to fixed-rate or to variable-rate demand bonds, without having a re-issuance). This would protect borrowers if, in any future tax reform bills, the ability to access tax-exempt debt is further restricted. Bonds, if issued with multimodal documents, can remain outstanding without reissuance in a different mode, thereby remain tax-exempt despite the (then-in-effect) new/more restrictive tax reform rules.

With the elimination of advance refundings for fixed-rate, tax-exempt debt, the debt cannot be refinanced until 90 days before the call date. The industry standard for call dates has been 10 years. Not being able to refund debt for 10 years can feel onerous for borrowers in a decreasing interest rate environment and/or for borrowers who have punitive covenants that need to be restructured to provide operating or strategic flexibility. **Many borrows are exploring the cost-benefit of including shorter call periods in new fixed-rate debt issuances**. Often adding in this extra flexibility with shorter call periods does not materially increase the cost for the borrower, but does provide added flexibility for the unforeseen events in the future. Another alternative being explored is make-whole call-periods. In this structure, the borrower would calculate what the interest rate would be from the proposed early call until the first call date, present-value it back and pay that amount to the bond holder as a 'make-whole' in exchange for being able to refinance/repay the debt early.

Finally, with the elimination of tax-exempt advanced refundings, there are many work-arounds industry participants are exploring. The most common alternative being discussed in the industry, and most likely to get the approval of bond council, is doing a taxable advanced refunding. The tax reform eliminates the ability to advance refund tax-exempt debt with new tax-exempt debt. The common understanding (albeit awaiting official clarification, which is in process as part of the Technical Corrections actions related to this bill)[5] is tax-exempt bonds can be advanced refunded with taxable bonds. So, if a borrower is looking to refund debt due to covenant restrictions, this could be an option to explore. You would issue temporary taxable refunding debt with a maturity of the current call date of the tax-exempt debt you are advance refunding. Once you reach that call date, you can then take out the temporary taxable debt with new tax-exempt debt. Other structures are also being explored, but a discussion of these alternatives is beyond the scope of this paper. In summary, bond counsels are also attempting to adjust to the impact of tax reform and have yet come to a consensus on allowable alternative structures.

***Action Item**: When considering future debt, work with an investment banker who is willing to look at all options on your behalf. With the nuances of the tax reform, its impact on tax-exempt bank placements and demand on the fixed-rate investor side, you want a partner that is willing to explore creative options to achieve the best capital structure for you and is willing to say your current structure remains the best option.*

OTHER RECENT REGULATORY CHANGES IMPACTING TAX-EXEMPT BANK LOANS

The Basel Committee on Banking Supervision (BCBS) sets regulatory standards for many global banking institutions. As a response to the 2008 financial crisis, the Basel III regulatory capital rules introduced a new designation for commercial real estate loans: High Volatility Commercial Real Estate (HVCRE) with stricter capital reserve requirements. These loans pertain to acquisition, development and construction (ADC) loans for commercial real estate projects and carry a higher risk weighting of 150 percent (compared to the typical 100 percent risk weighting prior to January 1, 2015). The impact of these higher capital reserves required for HVCRE loans will most likely increase what banks charge for these loans.

To avoid being designated as a HVCRE loan, three criteria need to be met:

1. The project's loan-to-value ratio must be less than the supervisory maximum

2. The borrower has contributed capital in the form of cash or unencumbered readily marketable assets equivalent to at least 15 percent of the "as completed" appraisal value of the property before any funds are advanced by the bank

[5] Samuels, Chuck. "Washington Advocacy Report." *Wisconsin Health and Educational Facilities Authority Newsletter.* March 14, 2018

3. Funds generated by the project (capital generated by operations) must be kept in the project until the construction loan is converted to permanent financing, the project is sold or the loan is paid off in full (this is in addition to the originally injected cash equity)

It is important to note that unsecured, general revenue pledge, or loans secured by real estate under an abundance of caution can be exempt from the HVCRE regulations.

These HVCRE requirements have been retroactively applied to loans provided prior to the effective date of the regulation, requiring additional capital reserves against these loans. Most banks have responded by raising the interest rate they charge to offset their higher capital costs and decreased profitability. Based on a very limited sample of life plan construction projects, we have seen increases of approximately 30-50 basis points during construction prior to certificate of occupancy and start of principal repayment.

Certain financial institutions believe that the HVCRE regulations are somewhat vague, open to varying interpretations, and proposed adjustments are under discussion.

***Action Item**: When looking at new debt, work with an investment banking partner who understands the restraints banks are working with so they can appropriately formulate capital formation strategies that meet your needs and goals, while reducing the cost of capital. Because banks have added constraints and increased pricing, the best option may no longer be a bank option. You owe it to yourself and your organization to explore all options.*

In summary, when the tax reform hurricane was headed our way, there was a great deal of anxiety and uncertainty. What we're now learning in the wake of the hurricane is despite some uncertainty, the debt capital markets are very resilient. In addition, the tax reform hurricane and its aftermath also highlight the importance of working with an investment banker, advisor or counsel who is willing to explore various capital formation strategies that might not have been considered prior to tax reform.

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