TAX REFORM SOLUTIONS FOR YOUR NEXT FINANCING

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With the passage of the Tax Cuts and Jobs Act, our country enters 2018 under the first significantly different tax code in more than 30 years. Not only does this Act concern each of us personally, but the rule changes also have sweeping effects for not-for-profit organizations and the capital markets they access. This Sims Perspective outlines the genesis of the rule changes, the specific changes that were made, and how we have seen, or expect to see, the market respond. This piece also provides strategies for how executive leadership can and should respond to these changes now and in the future.

A Rundown of Late 2017:

NOVEMBER 2:
House version of Tax Cuts & Jobs Act released
Eliminates: Private Activity Bonds, Advance Refundings, Tax Credit Bonds and Stadium Bonds for professional sports

NOVEMBER 9:
Senate version is released
Eliminates: Advance Refundings & Tax Credit Bonds
Maintains: Private Activity Bonds and Stadium Bonds for professional sports

DECEMBER 15:
Conference Bill is released
Adopts Senate Provisions for Municipal Bonds

DECEMBER 21:
Continuing Resolution is passed

DECEMBER 22:
President Signs Tax Cuts & Jobs Act

First introduced by the House of Representatives on November 2, and concluding with the President signing it into law on December 22, the Tax Cuts and Jobs Act ("the Act") is the first substantial tax overhaul since the 1986 Tax Reform Act.

The first version of the Act issued by the U.S. House of Representatives took the municipal market by surprise with the recommended elimination of Private Activity Bonds ("PABs"), advance refundings, tax credit bonds and stadium bonds for professional sports. The elimination of PABs would have forced not-for-profit organizations to borrow money on a taxable basis, considerably increasing organizations' cost of capital.

When the Senate issued its own version of the Act on November 9, the market sighed a faint breath of relief as the Senate version preserved PABs and stadium bonds. Unfortunately, the Senate proposed the same elimination of advance refundings and select tax credit bonds as suggested by the House.

Ultimately, the Conference Bill released on December 15, which was later passed by the House and the Senate and signed by the President, adopted the municipal bond provisions outlined by the Senate, thereby eliminating advance refundings, which represented nearly 27% of total market volume in 2016, according to Thomson Reuters.

While PABs ultimately survived the stroke of Congress's pen this time, the great significance of their proposed elimination by the House should not be overlooked. Negative sentiment concerning the many tax-exempt benefits of 501(c)(3) organizations remains on The Hill, and it is likely that PABs will continue to be scrutinized in forthcoming economic initiatives.

Structured Right: How Financing Terms Will Change

Two major changes that impact financing structures are the elimination of advance refunding bonds and the change in corporate tax rate. As borrowers consider their next financing options, the lens through which bond and bank transactions are viewed is now more nuanced.

Advance Refundings are now a luxury of yesteryear.

The basic reasoning for the elimination of advance refundings from a federal revenue standpoint is: When tax-exempt refunding bonds are issued to refund outstanding bonds that are not currently callable, those "refunded" bonds actually remain outstanding until the call date. As such, during this escrow period when two sets of bonds are outstanding for the same issue, the federal government is, in effect, doubling its tax subsidy.

What happens if an organization has an outstanding bond issue with high interest rates and wants to capitalize on the lower rates of the current market? Or, how can borrowers work with their investment banker to address the elimination of this refinancing option in a forthcoming financing? A variety of market adaptations are being considered or applied in response to the discontinuation of advance refundings, many of which are already employed in other sectors or financial products. While it is difficult to know which adaptations will prevail and attain market acceptance, we at HJ Sims believe it is crucial for borrowers to understand their potential options.

The sidebars that follow detail potential responses to the elimination of advance refundings.

Potential Advance Refunding Alternatives for Outstanding Bond Issues:

Taxable Sandwich Structure:

Assuming current taxable interest rates are lower than the tax-exempt interest rates on the outstanding bonds, taxable refunding bonds are issued in order to advance refund the outstanding bonds. These taxable refunding bonds may be sold publicly or privately placed with a bank or institution. Upon the call date of the "refunded" bonds, or up to 90 days before, a new series of tax-exempt bonds would be issued to refund the taxable refunding bonds. Though the community enjoys interest savings on an interim basis, it would be subject to interest rate risk at the time tax-exempt refunding becomes an option.

"Cinderella" Bonds:

These are similar to a taxable sandwich structure, except that the taxable refunding bonds automatically convert to tax-exempt refunding bonds at the earlier of: (i) the call date of the "refunded" bonds or (ii) the reversal of the advance refunding prohibition. This would eliminate interest rate risk after the escrow period as pricing and terms for the tax-exempt refunding bonds would be agreed to at the time the taxable refunding bonds are executed.

Tender Offer:

The borrower would engage an investment bank to act as its Tender Agent and solicit existing bondholders to surrender their bonds for purchase. Bonds would be tendered at a price that is either: (i) similar to the price at which these bonds are trading or (ii) reflective of their "make-whole" value (see explanation on the following page).

Synthetic Advance Refunding:

The borrower would enter into an interest rate swap agreement with a forward start date that coincides with its existing call date. At the call date, the borrower would issue variable rate current refunding bonds, which together with the swap provide a synthetically fixed rate. Though this option does not permit an organization to realize any immediate interest rate savings, it would still lock-in a lower fixed rate for the future. Complicating this option would be the need for a direct purchaser of the variable-rate bonds or a liquidity facility provider.

Potential Structuring Options for Future Bond Issues:

Shorter Call Periods:

Historically, the standard par call date for non-rated borrowers has been 10 years from issuance. In December of 2017, HJ Sims underwrote and closed several financings that included 5-year premium call options. Fellow underwriters also successfully implemented shorter call options during this time period, signaling that the bond market has already accepted this shift.

Make-Whole Premium Calls:

The concept of a "make-whole provision" is common in bank financing. In essence, a borrower has the right to prepay the debt, but must pay a "penalty" or "premium" that is equivalent to difference between the present value of (i) future interest payments due to the bondholder under the existing agreement and (ii) hypothetical interest payments the bondholder would earn if the par amount of the outstanding bonds were invested in some predetermined way (typically treasuries or other government securities, plus a small premium). ***For the borrower, this option is designed to approximate the economic equivalent of completing an advance refunding.***

The decrease in Corporate Tax Rate means more expensive bank debt.

Since 2011, commercial banks have increasingly purchased tax-exempt municipal bonds directly from conduit issuers as an alternative financing product to pre-recession letters of credit. In order to be competitive with the municipal tax-exempt capital market, banks give their tax savings to the borrower by applying a "tax equivalent yield factor" to the taxable interest rate it charges. This factor generally results in a 20 - 35% discount on the taxable interest rate, depending on a bank's effective tax rate, with the median discount being about 30%.

With the corporate tax rate now a flat 21%, the tax equivalent yield factor is likely to increase, which will translate to a lesser discount. Not only does this impact future financings for 501(c)(3) organizations, but it also potentially impacts the current all-in interest rate on outstanding bank bonds, depending on how the bond documents were written to consider future changes in the corporate tax rate. ***See below for further explanation:***

Outstanding Bank Bond Issues:

It is essential that organizations with outstanding bank bonds work with their finance and legal professionals to review their bond documents and understand the definitions and mechanisms that outline an increase in interest rate. ***In some cases, banks may amend or waive this provision.*** *Any such amendments or waivers require the input of the issuer and bond counsel.*

Organizations should also work with their finance professionals to explore refinancing options. While bank debt may still be the appropriate capital source, even at a higher interest rate, it may be that the increased interest rate is no longer competitive, especially if the community has enjoyed a good track record.

Future Bank Bond Issues:

Unfortunately, an increase in cost of capital always equates to a decrease in borrowing capacity. With banks typically only lending up to 80% loan to value, organizations may be forced to employ equity and/or subordinate debt in order to secure the senior debt at a low interest rate.

Going forward, bank bonds will remain very attractive for interim capital needs that require flexible repayment provisions. However, the use of bank bonds as a long-term capital solution will need to be more judiciously considered in comparison to other financing vehicles, such as long-term, fixed-rate bonds.

Executed Right: The Impact on Distribution

In the same way that the change in corporate tax rate presents an indirect impact on 501(c)(3) organizations looking to borrow with tax-exempt bank bonds, changes in the personal tax rates and standard deductions will have an indirect impact on 501(c)(3) organizations looking to borrow tax-exempt bonds in the public market. However, given the mitigating nature of the personal income tax changes, the likely impact on 501(c)(3) organizations is limited.

For some investors, the need for tax-exempt bonds has DECREASED.

With tax cuts across personal income tax brackets, most Americans will enjoy a lower effective federal income tax rate in 2018. Since investing in tax-exempt bonds is a key tax-burden reduction strategy for many Americans, the changes (not only in tax rates, but also standardized deductions), could leave individual investors with a reduced appetite for tax-exempt bonds. At the time of this publication, however, ***inflows into high-yield municipal funds have continued in 2018,*** and with lower supply, yields have not changed significantly.

Recognizing the potential increase in taxable debt issuance stemming from the elimination of advance refundings, it is important to note that individual investors remain an essential buyer in the municipal market. ***See sidebar about Sims' Private Client Group Bond Distribution on the next page for further explanation.***

The SALT Deduction: One of the most controversial of the new personal income tax changes

For other investors, the need for tax-exempt bonds has INCREASED.

Among the most controversial of the personal tax law changes is the new $10,000 limitation on the State and Local Tax (SALT) deduction. Previously, individuals were permitted to deduct their property, general sales and state income taxes from their federal tax return without limitation. ***As shown in the chart below,*** investors from high-tax states, on average, have deductions in excess of $10,000 and therefore face an increased tax burden as a result of the new limit.

In the municipal market, high-tax states are traditionally termed "specialty states", given that their bonds trade at lower yields. Since residents from these states will need to employ further tax reduction strategies, the potential increased demand for tax-exempt bonds may widen the yield spread between specialty and non-specialty states, thereby making specialty states that much more special.

States with Highest Average SALT Deductions (2015)	
New York	$22,169
Connecticut	$19,664
California	$18,437
New Jersey	$17,850
Washington, DC	$16,442
Massachusetts	$15,571
Minnesota	$12,954
Maryland	$12,931

Source: IRS SOI Tax Stats – 2015

Sims' Private Client Group Bond Distribution: *Why it matters more than ever*

With the elimination of advance refundings and the increasing cost of bank debt, the key to executing the RIGHT financing structure will hinge on an investment bank's ability to offer its clients a variety of financing products. The ability to issue taxable bonds, equity and subordinate bonds will become even more vital as a result of tax reform, but these products have historically generated little interest from traditional institutional investors unless sold at very high interest rates.

At a time when other investment banks have sold off their wealth management divisions, HJ Sims continues to invest heavily in expanding its private client group network. We know that individual investors are essential to offering our investment banking clients the RIGHT products for their unique financing needs.

Beyond the way in which the elimination of the SALT tax break impacts individual investors on a state-specific basis, the rule change has a severe impact on wealthy Americans, in general.

As shown in ***the chart below,*** on average, individuals who earn more than $100,000 claimed SALT deductions in excess of $10,000 in 2015.

Even in states with low, or no, state income tax, high income earners are likely to have still utilized the SALT tax break because of high property taxes.

Since these individuals will now need to implement added tax reduction strategies, the potential increased demand for tax-exempt bonds may reduce yields.

Adjusted Gross Income	Total Number of SALT Deductions	Total Dollars Deducted	Average SALT Deduction (2015)
$100,000 - $200,000	13,915,460	$154,484,401,000	$11,102
$200,000 - $500,000	5,065,480	$115,726,717,000	$22,846
$500,000 - $1,000,000	805,020	$43,921,403,000	$54,559
$1,000,000+	400,420	$109,645,122,000	$273,825

Source: IRS SOI Tax Stats – 2015

Financed Right: Staying Committed to our Can-Do Approach

Without question, tax reform has changed the borrowing landscape for 501(c)(3) organizations. Going forward, the RIGHT financing structure will require even more flexible terms and product choices, while the RIGHT execution will necessitate an even wider network of investors, both institutional and individual. With our established Financed Right approach, HJ Sims is uniquely positioned to best navigate not-for-profit organizations through this new normal. In the weeks and months ahead, HJ Sims will continue to monitor and test market response to these new laws and update the industry of new developments and trends as they unfold.

*For more in-depth conversation on Tax Reform and other hot button topics impacting the Senior Living industry, **join us** in Orlando, February 28 - March 2 for our **15th Annual HJ Sims Late Winter Conference.***

To further discuss how Tax Reform impacts your organization, contact your HJ Sims banker:

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