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Final Tax Reform Legislation Saves PABs and Stadium Bonds, Kills Advance Refundings and Tax Credit Bonds

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Signaling the end of our six-week ride in a runaway cement mixer, the Conference Committee for the Tax Cuts and Jobs Act has released its Conference Report, which represents a compromise version of the House and Senate-passed versions of the Act. Each chamber has the votes to enact the compromise bill; they'll do it, and the President will sign it early next week. The Conference Report follows the Senate approach by preserving tax-exempt private activity bonds and governmental use bonds that are issued to finance professional sports stadiums, but it eliminates tax-exempt advance refunding bonds and tax credit bonds issued after December 31, 2017 – no transition relief. The Conference Report takes a solomonic approach to the alternative minimum tax, repealing it for corporations but not for individuals (though the exemption amount is increased for individuals). This should increase the attractiveness to corporate bondholders of tax-exempt private activity bonds that presently are subject to AMT.

The fact that this final result is being described by some as good news reflects the whiplash (bordering on low-grade Stockholm Syndrome) that has taken hold after the House proposal blew us all into the next room on November 2, after months of easy reassurances that tax reform wouldn't monkey with tax-advantaged bonds.[1]We were told from the beginning that Congress hoped to move quickly, and indeed they did. Doug Jones's[2] victory on Tuesday over Roy Moore in the special election to fill Attorney General Jeff Sessions's Alabama Senate seat likely sped things up even more. Though the votes to pass the legislation probably would have been there even if Jones were seated, his certain "no" vote would have shrunk the already slim margin in the Senate even further, especially with a few senators (Rubio and Corker, for example) recently making noises about voting "no." Not even 24 hours after the race was called for Jones, the Republican members of Congress announced that they had reached a deal to harmonize the House and Senate bills. This announcement was made before the conference committee met to debate the bill, but the committee held its meetings anyway, providing further evidence of the kabuki-theater nature of conference committees in recent years,[3] if they are used at all.

Though it is welcome news that tax-exempt private activity bonds survived, the case for eliminating tax-exempt advance refundings remains dubious, notwithstanding the JCT's unmitigated success in convincing both houses of Congress that the technique is a substance-less tax dodge that would warm the heart of a Cayman Islands tax advisor from the 1980s. (Even if the case were not so dubious, the Tax Reform Act of 1986 went overboard to brand advance refundings with a scarlet "A," by placing limits on them that went beyond solving the perceived abuses at the time.) As we've noted, it's likely that participants in the tax-exempt markets will turn to "synthetic" structures that attempt to mimic the economic effect of an advance refunding but that are not proscribed. In this regard, it won't be surprising to see tax-exempt bonds issued with a make-whole call premium that is calculated to the call date, rather than final maturity, of the bond issue. This modified make-whole premium would mirror the economic structure of an advance refunding issue but would be a current refunding in which the refunded bonds are called within 90 days after the refunding bonds are issued. We're sure to have more posts on this topic in the near future.

Despite the relentless efforts of many in the tax-exempt bond community, and unlike major shake-ups to the tax-exempt bond world from days of yore, the Conference Report does not include any kind of transition rule for its elimination of advance refunding bonds. This is rather unfair. As our retired partner Jack Browning has reminded us many times over the last few weeks, a fair transition rule would have applied the advance refunding prohibition to the advance refunding of a prior bond issued after 2017 and would have continued to allow one advance refunding (as under current law) for any bond issued before December 31, 2017. That type of rule would put issuers of future new money bonds on notice of the inability to advance refund that bond, which would allow issuers to build in call provisions that might better accommodate a refinancing. Instead, most of the outstanding bonds these days, even most of them that have been issued since November 2, were structured and sold on the premise that they would get their one advance refunding.

Having said all of that, and though we're biased, it is a blessing that Congress came to its senses (again, thanks to your tireless labors to make them do so) and didn't touch private activity bonds. We will have more to say in future posts about the value of private activity bonds, and the fact that current law already recognizes and accounts for the so-called "abuses" that the House Bill cited. It's a shame, though, that it has to be said again, as many times as that question has been litigated across the decades.

We will also concede that when faced with a choice between the loss of tax-exempt advance refunding bonds or tax-exempt private activity bonds, it is preferable (but not at all justified) to lose the former. As noted above, alternative structures can be adopted that replicate the effect of advance refunding bonds, but there would be no way to replicate qualified private activity bonds if they were eliminated.

A final aspect of the Tax Cuts and Jobs Act that does not directly address tax-exempt bonds nevertheless has a significant effect on them. The Act reduces the corporate income tax rate to 21%, which means that future issues of tax-exempt bonds will need to bear rates that much more closely approximate taxable rates to attract banks, insurance companies, and other corporations to hold the bonds. The 21% corporate tax rate will also trigger a spike in the interest rates on outstanding tax-exempt bonds that were privately placed with banks or other corporate holders. These private placements often feature modifications to the interest rate that take effect upon a reduction in the corporate income tax rate. Unless waived, we will see these provisions spring to life in many private placements upon enactment of the Tax Cuts and Jobs Act.

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I confess that I was there, awake, with the "alcoholics, the unemployable, and angry loners" in the dim night hours of December 1, two Fridays ago now, as the Senate finished its deliberations and voted on its version of the tax reform bill. I represented a fourth category of those who couldn't sleep: expectant fathers, and while my wife and I waited for our firstborn son to join us, I spared a thought (may Charlie forgive me) for what the Senate bill would say, because if it followed the House Bill, the family would need him to put together his resume and start looking for work (Strengths: averse to fraternization, single-mindedness bordering on stubbornness; Weaknesses: big (99^{th} percentile) head, tends to sleep all day).

For better or worse (partly both – isn't it always?), we have our answer now. Good luck to you all as the year-end feeding frenzy comes to an end.

[1] As we were exchanging emails this afternoon when the news broke, Bob Eidnier noted that the outcome reminded him of a quote that our retired practice group leader Terry Perris liked to cite, the famous Winston Churchill quip that "[n]othing in life is so exhilarating as to be shot at without result" (something that Terry said to me, for example, after I found out that I passed the Ohio bar exam years ago). I think Winston would consider the "result" in the Conference Report to be more like a nasty, if not-quite-mortal, flesh-wound than a near-miss.

[2] Not this Doug Jones, who was a Cleveland Indians great and is a member of Major League Baseball's 300 Save Club, but this Doug Jones.

[3] See here – note the declining number of Conference Reports from 1986 to today.

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