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What do Walt Disney World and the 2018 Tax-Exempt Bond Market Have in Common?

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Last week, all of my dreams came true when I had the good fortune of going to Walt Disney World with my family. In addition to watching my kids train to be Jedi Knights, I had the opportunity to meet a number of Disney characters, including Cinderella. In so doing, I was reminded that although tax reform eliminated tax-exempt advance refunding bonds issued after December 31, 2017 (discussed here and here), it did nothing to curb the use of so-called"Cinderella Bonds" to advance refund outstanding tax-exempt bonds. Heartened by this realization, I resolved to write this post to discuss the topic.

During the extended period <sarcasm> that tax reform was discussed, public finance tax practitioners commented on various ways that newly issued tax-exempt bonds could be structured to allow for a redemption that replicates the economic effect of a tax-exempt advance refunding.

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For example, an issue of fixed-rate tax-exempt bonds with a make-whole call that is priced to the notional call date, rather than final maturity, of the issue can be currently refunded before that call date with the same economic effect as an advance refunding. The redemption premium for the early call would equal the greater of a stated percentage of par (usually 102%) or the make-whole premium. The make-whole premium is the present value of the stream of debt service payments that would be owed on the refunded bonds (including the redemption amount) through the notional call date, with current market rates serving as the discount rate. In other words, the make-whole premium is calculated in the same way as the purchase price of the securities that are held in an advance refunding escrow to defease the advance refunded bonds. In the event that market interest rates declined a sufficient amount such that the issuer would generate savings without regard to the make-whole premium priced to the notional call date, the issuer could refund the outstanding tax-exempt bonds by issuing tax-exempt current refunding bonds. These structuring mechanisms, however, do not address outstanding tax-exempt bonds that bear interest at above-market rates.

Since the Tax Reform Act of 1986 curbed the use of tax-exempt advance refunding bonds,[1] issuers that could not issue tax-exempt advance refunding bonds to refund outstanding tax-exempt bonds bearing interest at above-market rates have used different financial instruments to enable the issuer to benefit from reduced interest rates. One such instrument is a “taxable exchangeable bond” or a “Cinderella Bond.” Cinderella Bonds are bonds that are initially issued on a taxable basis but that are reissued as tax-exempt bonds upon the occurrence of a certain event. Cinderella Bonds are similar to forward-delivery bonds[2] except that the issuer bears the interest rate and tax risks with a Cinderella Bond and the purchase bears these risks with a forward delivery bond. Procedurally, the governing documents and the necessary due diligence inquiries would be very similar between forward delivery bonds and Cinderella Bonds

Historically, notwithstanding the limits on advance refundings imposed by the Tax Reform Act of 1986, Cinderella Bonds were not commonly used. This is likely due to the fact that the cost to the issuer is higher with Cinderella Bonds than with tax-exempt advance refunding bonds. The increased cost is attributable to the difference between the prevailing taxable and tax-exempt interest rates.[3] Moreover, the issuer of Cinderella Bonds bears the risk that interest rates might rise and/or tax-exempt bonds are eliminated before the taxable Cinderella Bonds are reissued as tax-exempt bonds. Until recently, this increased cost has reduced (or eliminated) the cost savings that issuers would otherwise realize from refunding outstanding bonds with Cinderella Bonds. However, the economic benefit of issuing Cinderella Bonds has grown over the last few years as the difference between taxable and tax-exempt market interest rates has eroded. This erosion, coupled with interest rates that remain historically low, could make Cinderella Bonds more appealing to issuers seeking to replicate the benefits of a tax-exempt advance refunding of outstanding tax-exempt bonds that bear above-market interest.

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[1] Namely, the prohibition against more than one direct or indirect tax-exempt advance refunding of a tax-exempt bond issued after 1985.

[2] Tax-exempt forward delivery bonds are sold by the issuer more than 90 days before the call date of the bonds that are refunded by the forward delivery bonds, but the forward delivery bonds are not issued until 90 or fewer days before that call date.

[3] The issuer would bear the increased cost of paying interest on the Cinderella Bonds at the taxable rate until the outstanding tax-exempt refunded bonds are eligible to be currently refunded (i.e., within 90 days of the redemption or call date of the refunded bonds).