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H.R. 1 and Private Activity Draw-down Bonds, Commercial Paper, and the Lack of Transition Rules

In addition to eliminating advance refundings, stadium financings and tax-credit bonds, the tax bill (the "2017 Tax Bill") as proposed the week of Nov. 1, 2017, by the House would eliminate the ability of issuers to issue qualified private activity bonds after Dec. 31, 2017.Qualified private activity bonds include bonds to finance governmentally owned facilities that have private business use, such as most airport facilities and many port facilities, bonds to finance charitable facilities such as hospitals and private colleges , schools, service providers and senior living and care facilities, bonds to finance various privately owned waste disposal projects and other infrastructure projects, and bonds to finance low-income housing as well as first-time home buyer mortgage programs and student loan programs. The bill contains no transition rule. Thus, as currently drafted, it would not be possible to refund on a tax-exempt basis an outstanding qualified private activity bond after such date, and any modification of an outstanding qualified private activity bond that results in a reissuance after Dec. 31, 2017, for federal income tax purposes would cause the interest on such bond to become taxable. In addition, if a draw-down bond issue has not been fully drawn by Dec. 31, 2017, interest on draws after such date would be treated as federally taxable, and interest on commercial paper newly issued or rolled over after such date would also be taxable. Issuers, borrowers and lenders can and should examine what steps can be taken to protect the tax-exemption of existing draw-down issues and commercial paper programs, as well as of certain multimodal issues, especially private placements.

No Transition Rule for Refundings.

The 2017 Tax Bill, as now proposed, would eliminate the ability of issuers to issue qualified private activity bonds after Dec. 31, 2017. Often tax legislation contains transition rules that preserve the ability of issuers to issue refunding bonds after the effective date of the legislation to refund bonds outstanding prior to the effective date. As yet, the 2017 Tax Bill provides no such relief.

Borrowers may wish to consider whether a refunding makes sense now. While in most cases putting together a refunding loan would be difficult, issuers, borrowers and lenders that have outstanding private placements in which the rate is reset periodically should consider consulting bond counsel regarding whether the rate-reset provisions as written result or may result in the bonds being treated as "reissued," that is, "refunded" for federal income tax purposes. For example, if the existing provisions depend upon the agreement of the parties to set the rate, or if one party has an option to modify the rate but the other party has a right to tender or require tender of the bond, a rate change might result in a "reissuance" of the bond in question. If the documents need to be revised to allow future rate changes without causing a reissuance, the parties may wish to consider adding provisions that allow for a remarketing or pricing agent to reset the rate or some other rate-setting mechanism that does not depend on an agreement of the parties, for example. Or they may wish to fix the rate now.

Draw-Down Bonds.

Draw-down private activity bonds are issues of bonds where only a portion of the bonds are issued for federal income tax purposes on the issue date of the issue. Draw-down bonds have been popular for construction issues and other issues where proceeds are needed over a period of time. They are generally privately placed issues for which the parties wish to avoid the negative arbitrage associated with an unspent construction fund earning less than the bond yield. Although the "issue" may be treated as issued for some federal income tax purposes on the date that more than $50,000 of bonds is drawn down, each subsequent draw is treated as a separate bond with its own issue date for purposes of determining whether interest on such draw is tax-exempt. To avoid taxable interest, the borrower should be prepared to draw-down its undrawn balances prior to year-end 2017.

Commercial Paper.

Like draw-down bonds, private activity commercial paper has an "issue date" for the program and separate issue dates for the commercial paper notes not issued on the issue date of the program. Issuers and borrowers with existing programs should be aware that, under the 2017 Tax Bill as proposed, any new draw would be treated for federal income tax purposes as issued on the date of such draw; moreover, each "roll" of outstanding notes is treated as a refunding with a newly issued note of the outstanding note so rolled for federal income tax purposes. Thus, interest on each new draw and on each note as "refunded" upon a roll made after Dec. 31, 2017, would be taxable for federal income tax purposes. Now might be a good time to consider refunding the outstanding paper on a fixed-rate basis.

Conclusion.

While the bill still needs to go through the legislative process (and the Senate seems poised to have its own bill that may differ from the 2017 Tax Bill and will require the two bills go through a reconciliation process) and legislative lobbying may or may not bring about the addition of some transition rules during that process, issuers, borrowers and lenders can and should take steps now to preserve the tax-exemption of existing private-activity debt and programs. To such end, they should review outstanding bond documentation and evaluate how best to maintain the tax-exemption of interest on outstanding private activity bonds, in particular draw-down and commercial paper programs, in the long term.

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