Implications for Airport Bonds

Effects of the Tax Cuts and Jobs Act on Airport Financings

May 4, 2018

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Agenda

- Provisions of the Tax Cuts and Jobs Act Relevant to Airport Finance
- Ongoing Risks of Tax Law Change
- Implications of Reduction in Corporate Income Tax Rate
- Rev. Proc. 2018-26 – A New P3 Mechanism?

Provisions of the Tax Cuts and Jobs Act Relevant to Airport Finance

Overview: Provisions of the Tax Cuts and Jobs Act Relevant to Airport Finance

- Repeal of authority to issue tax-exempt advance refunding bonds after 2017
- Advance refunding bonds are bonds issued more than 90 days before the refunded bonds are retired
- Repeal of corporate Alternative Minimum Tax
- 21% maximum federal corporate income tax rate

Effective Dates

- Repeal of authority to issue advance refunding bonds and tax credit bonds applies to bonds issued after 2017
- New federal corporate income tax rates apply to tax years beginning after 2017
- Repeal of corporate Alternative Minimum Tax applies to tax years beginning after 2017; but only applies to corporate tax payers

Brief History of Limitations on Advance Refunding Bonds

- Tax Reform Act of 1986 limited the number of permitted advance refundings to one
- Certain transition rules for bonds issued before the 1986 effective dates
- Many prior legislative proposals to further restrict advance refundings

Advance Refunding Repeal – Effect on Structuring

– May lead some borrowers to consider shorter call protection periods (that is, revisit the common 10-year call protection period)
– Need to separate fixed rate and variable rate financings lessened, but still some reasons to separate (e.g., facilitation of defeasance transactions)
– Experience of other types of qualified private activity bonds, which have long not been eligible for advance refunding, suggests that the structuring effect may be minimal

Advance Refunding Repeal – Consideration of Alternatives

- Forward pricing bonds
- Interest rate swaps
- Taxable advance refunding bonds
- Defeasance transactions
- Shorter call periods
- Couple call period with call premium
- Variable rate demand bonds
- “Cinderella” bond structure
- “Make whole” call for early years of term

Alternatives to Advance Refundings: Forward Pricing Bonds

- Risks of tax law change continues to be a factor
- May result in higher forward rates

Alternatives to Advance Refundings: Swaps

- The IRS has asserted that certain interest rate swaps may result in a “reissuance”
- Accordingly, some swaps may be only suitable if a bond issue has no remaining gross proceeds
- Interest rate swap transactions may be more complex than other alternatives

Advance Refunding Alternatives: Taxable Advance Refundings

- Higher rates and likely greater “negative arbitrage”
- If properly documented, could have the benefit of relieving private business use and ownership compliance
- Note DFW plans to issue primarily taxable new money bonds going forward

Advance Refunding Alternatives: Defeasance Transactions

- A number of issuers have used cash to defease debt, and then a short time later issued new money bonds
- Such transactions have sometimes been described as "synthetic" advance refundings, but must be carefully structured to be certain that the subsequent financing is treated as separate from the defeasance
- Different bond counsel have different standards to separate the transactions

Ongoing Risks of Tax Law Change

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- Leading congressional Republicans have suggested that Congress may revisit legislation affecting qualified private activity bonds in infrastructure legislation
- Statements by House Ways and Means Subcommittee Chair on December 19
- Statements by Senator Toomey in December 2017
- May be used as a "pay for," but contrast 501(c)(3) bonds with airport bonds

Ongoing Risks of Tax Law Change: Possible Infrastructure Legislation

- On January 23, the White House released an "outline" of an anticipated infrastructure plan
- The plan includes expanding use of private activity bonds for infrastructure, including permitting advance refunding bonds
- As the end of 2017 demonstrated, even a credible risk of tax law change could have major market effects

Ongoing Risks of Tax Law Change: Strategies

- The risk appears to be less than in tax legislation, but is real
- Steps to prepare for a second "rush to market"
- Steps to structure, or restructure, bond issues to avoid future reissuance to preserve grandfathered status

Ongoing Risks of Tax Law Change: Reissuance Risk

- Traditional “multimodal” bonds avoid much reissuance risk
- “Direct purchase” bonds are at a higher risk of reissuance
- Should borrowers consider “fixed rate” bonds that are structured as eligible for conversion?

Implications of Reduction in Corporate Income Tax Rate

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- The maximum federal corporate income tax rate is reduced from 35% to 21%
- Banks and other financial institutions may be less competitive purchasers
- If banks are less competitive, more transactions may be publicly offered than in recent years
- Greater use of publicly offered variable rate structures may also result (e.g., transactions using letters of credit) (direct placements were cost-effective substitute)

Reduction in Corporate Income Tax Rate: Interest Rate “Step-Ups”

- Many, but not all, tax-exempt bonds directly purchased by banks have a provision that increases the interest rate if the maximum federal corporate income tax rate is reduced
- A typical step-up would increase the interest rate by a factor of about 1.21%
- Currently, it appears many banks are assessing how to respond

Interest Rate Tax Step Ups

- A common framing of an interest rate tax step-up is a formula increasing the interest rate by a percentage
- The exact wording of the provision, however, may vary from bond issue to bond issue
- Examples:
  - Step-up in the bond itself or in a separate agreement
  - Step-up automatic or only after notice
  - Step-up may be reduced by countervailing federal tax changes

Interest Rate Tax Step-Ups: Reissuance Concerns

- An agreement to modify or waive an interest rate step-up may result in a “reissuance”
- Consequences of reissuance include
  - New tax opinion required, including possible due diligence
  - Issuer must approve in some manner – typically by filing new form 8038
  - Creating additional bond issues or “scrambling” which bond issues are treated as part of the same issue

Interest Rate Step-Ups: Reissuance Concerns

- A modification results in a reissuance if it is "significant" under the tax regulations, which is usually a change in yield of 25 basis points (.25%)
- The test applies over the remaining term, however, so that a waiver for a period of time might not result in reissuance, even though a waiver for the remaining term would result in a reissuance
- The application of this rule could be an important factor in discussions with banks

Revenue Procedure 2018-26: A New P3 Mechanism?

Rev. Proc. 2018-26

- Change of use penalties minimized
- Allows use of lease payments by private user for qualified uses, rather than requiring bond call
- Consistent with Trump Administration’s infrastructure plan

Questions?

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