National Association *of* Bond Lawyers

BAN ON TAX-EXEMPT ADVANCE REFUNDINGS -
NOW WHAT?

The tax reform bill passed by Congress and signed into law on December 22, 2017 (referred to herein as the "Act") prohibits the issuance of tax-exempt advance refunding bonds after December 31, 2017. Previously, federal tax law provided issuers of governmental and 501(c)(3) bonds a single opportunity to advance refund outstanding bonds on a tax-exempt basis. An advance refunding occurs when refunding bonds are issued more than 90 calendar days prior to the call date of the outstanding bonds. The Act does not provide transition rules or an exception for outstanding bonds that would otherwise have been eligible for a tax-exempt advance refunding. As a result, the prohibition on advance refunding bonds applies immediately to outstanding bonds and may affect how call features for new bonds are drafted going forward.

The purpose of this paper is to briefly (1) describe known alternatives to tax-exempt advance refunding bonds[1] and (2) identify issues for consideration when structuring new transactions in light of the advance refunding ban. Given the creativity of investment bankers, municipal advisors, lawyers, and issuers,[2] it is likely that approaches in addition to those identified in this paper will develop over time. Further, as the municipal bond market and investors react to call provisions other than the traditional 10-year par call, alternatives involving shorter and other call features may become more cost-effective in the future. Of course, the viability of any of these approaches will depend on factors including market interest rates, demand for bonds, federal tax issues, and state law considerations.

Advance Refunding Alternatives

Current Refunding. The Act does not affect the ability of issuers to issue tax-exempt refunding bonds within 90 days of the call date of the refunded bonds. Depending on the purpose of the refunding, such as eliminating disadvantageous covenants, waiting until the current refunding window is available may or may not be a viable option.

Taxable Advance Refunding Bonds. For some issuers, issuing taxable advance refunding bonds may be a simple approach to achieving the benefits of an advance refunding. If the motivation for the refunding is (i) eliminating disadvantageous covenants, (ii) achieving interest rate savings and taxable rates are less than the rates on the refunded bonds, or (iii) restructuring existing debt, a taxable advance refunding may be a good alternative.

Negotiate with Existing Bondholders. Where bonds are held by a limited number of investors, it may be possible to negotiate a change in interest rate or a waiver of call protection.

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1 References to bonds in this paper include all types of obligations including bonds, notes, leases, loan agreements and certificates of participation.
2 As used in this paper, issuer refers to bond issuers and obligors in conduit financings.

Because many fixed rate bonds are sold in $5,000 increments and may be traded on a daily basis, it may be challenging to identify the correct pool of bondholders. Even if bonds are widely held, an issuer may offer to purchase outstanding bonds pursuant to a tender offer. Issuers should be mindful of the federal securities laws when communicating with investors. In addition, negotiated changes may result in a reissuance for federal tax purposes. Such a reissuance would be treated as a current refunding, which is still permitted, but bond counsel should also consider whether interim changes in tax law may be applicable to the reissued bonds and whether a new IRS Form 8038 needs to be filed.

Cinderella Bonds. A "Cinderella bond" is initially issued on a taxable basis and converts to tax-exempt status upon the occurrence of some specified event or at a specified time. In the case of a refunding, the conversion could occur within 90 calendar days of the redemption date of the refunded bonds. This locks in the tax-exempt rate at the time the bonds are sold even though the conversion will occur in the future. Investors may demand a higher interest rate for committing to a rate in the future. Further, there are risks that the conversion may not occur. For example, if federal tax law changes between the date of issuance and the conversion date, the tax-exempt conversion may not happen. Practitioners will need to determine what structuring elements, if any, are necessary to ensure that the taxable bond is in fact treated as retired on the "Cinderella date" and replaced with a tax-exempt bond.

Forward Delivery Bonds. Tax-exempt bonds may be sold by an issuer to an underwriter pursuant to a bond purchase agreement with a longer than normal delivery date so that the closing occurs within 90 days prior to the redemption date for the refunded bonds. For example, if the bonds to be refunded are callable on December 1, 2020, the issuer might sell refunding bonds to an underwriter in March 2020, for a closing in September 2020. Like Cinderella bonds, investors may demand a higher interest rate for locking in an interest rate that takes effect in the future and there may be risks that prevent the refunding bonds from being delivered, such as changes in federal tax law.

Forward-Starting Swaps. An interest rate swap may be used to hedge against rising interest rates. An issuer may use a forward-starting swap to effectively "lock in" interest rates at the time current refunding bonds are issued. The swap could be entered into more than 90 days before the call date of the refunded bonds. The hedged bonds would not be issued until within 90 days of the call date. There are at least two fundamental variations of this concept:

> *Swaps Anticipated to be Cash Settled at Time of Issuance of Fixed Rate Bonds*: If rates rise between the date the swap is entered into and the date the fixed rate refunding bonds are issued, the swap counterparty will make a payment to issuer. If rates decrease during that period, the issuer will make a payment to the swap counterparty. These payments will generally reflect the present value of the difference in interest rates between the hedged rate and market rates at the cash settlement date, which is the issuance date of the refunding bonds. If rates have gone up, the issuer will issue a smaller amount of refunding bonds based upon the cash payment from the swap counterparty.

Swaps Anticipated to be Part of Synthetic Fixed Rate Financings: If the issuer issues variable rate bonds contemporaneous with the start date of the swap, the issuer will have entered into a synthetic fixed rate transaction. In this circumstance, it is not anticipated that the swap would be cash settled at the time of issuance.

Sale of Optional Redemption Right. An issuer may sell its right to redeem outstanding bonds or agree to an extension of the date on which it may redeem the bonds. An investor may be willing to pay an issuer an upfront amount in exchange for this sale or extension. Such a sale or extension may give rise to a reissuance and the corresponding change in law risk and the requirements of filing a new IRS Form 8038.

Future Structuring Considerations

Shorter Calls. Issuers may sell new tax-exempt bonds with par call features that allow the bonds to be redeemed sooner than the traditional 10-year par call. This means the current refunding option can be structured to be available sooner than a traditional ten year lock-out would permit.

Shorter Calls with Declining Redemption Premium. Issuers may sell new tax-exempt bonds with shorter calls and/or a declining redemption premium. For example, if the bonds are callable in year seven, the redemption premium may be 3%, then 2% in year eight, 1% in year nine, and no premium in year ten and thereafter. Declining redemption premiums provide issuers the option of calling bonds sooner than with the traditional 10-year par call, and give investors some call protection (and added compensation) from solely a shorter call.

Make-Whole Calls. An issuer may sell bonds that are callable at any time so long as the bondholders are paid an amount equal to the present value of remaining principal and interest payments. A make-whole call is present in many corporate bond issues and was prevalent in many direct-pay taxable bonds issued under the American Recovery and Reinvestment Act of 2009, such as direct-pay Build America Bonds.

Variable Rate Bonds. Issuers may consider selling variable rate bonds rather than fixed rate bonds because they can be callable at any time. This exposes the issuer to the risk of interest rate increases and generally will require a liquidity support feature such as a bank letter of credit.

Bank Loans. Issuers may consider private placements with banks, which may have more flexible repayment terms. The Act, however, lowers the corporate tax rate to a flat rate of 21%, which may significantly affect the market for tax-exempt bonds, including potentially diminishing the appetite for banks for tax-exempt loans, or may increase the interest rate that banks will charge.

Conclusion

This paper briefly summarizes a few of the refunding options available to issuers of municipal bonds after December 31, 2017, and identifies considerations for structuring new financings

allowing issuers to preserve the ability to refinance their debt without the ability to do a tax-exempt advance refunding. Investment bankers, municipal advisors, lawyers, issuers, and other members of the working group will provide advice on these issues and may develop other strategies for dealing with the tax-exempt advance refunding ban. Time will tell what types of call provisions will replace the traditional 10-year par call as the bond market adjusts and adapts to the Act.