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The Impact of Tax Reform on Michigan Municipalities and School Districts

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The U.S. House and Senate have approved the reconciled tax reform bill that was reported out of the House and Senate Conference Committee last week. The bill was passed on Dec. 20, 2017, and has been sent to the President for signing. The major changes under the tax reform bill will mainly affect corporations, businesses and individuals, but there are several provisions regarding the issuance of tax-exempt debt that may impact the future issuance of such debt by municipalities and school districts.

The good news is that the bill does not eliminate the ability of states, municipalities, public schools and governmental authorities to issue tax-exempt debt, but it does propose changes that could negatively impact the future issuance of such debt. Additionally, although the original House proposal would have eliminated private activity bonds (an important tax-exempt financing tool for hospitals and other 501(c)(3) entities, airports, housing authorities, and other types of governmental and non-governmental issuers), the final version of the bill does not eliminate private activity bonds, and they may continue to be issued as in the past.

The following is a summary of the proposed changes under the tax reform bill that may have an impact on the issuance of tax-exempt debt by municipalities, school districts and other governmental issuers:

Higher Interest Costs for Tax-Exempt Debt?: The bill significantly reduces individual and corporate tax rates. These lower rates will reduce the value of the tax exemption for corporations and individuals that invest in tax-exempt debt and could cause a reduction in the demand for such debt. For instance, because the corporate tax rate is reduced from 35% to 21%, many of the traditional corporate investors in tax-exempt debt such as insurance companies, banks and credit unions will receive a reduced benefit from holding tax-exempt debt which presumably will make this debt less attractive to these investors. Any reduced demand would likely result in higher interest rates for tax-exempt debt in order to make this type of debt more attractive to investors. Currently, outstanding fixed-rate debt of municipalities and school districts would not be affected by lower tax rates, but long and short-term interest costs for future borrowings would most likely increase under the tax reform bill.

Elimination of Advance Refunding Bonds: The bill eliminates advance refunding bonds. Most tax-exempt bonds are issued with a 10-year optional redemption call date, and current law allows an issuer to refund/refinance these existing bonds without restriction within 90 days of the optional redemption call date. Bonds issued for this type of refunding/refinancing are called current refunding bonds and are typically issued to lower debt-service payments, thereby reducing future borrowing costs. Under current law, an issuer may also issue advance refunding bonds, which are bonds issued to refund/refinance existing bonds before the 90-day window prior to the designated optional redemption call date. This allows issuers to lower debt-service payments and reduce borrowing costs earlier than with current refunding bonds, but advance refunding bonds can only be issued one time. The elimination of advance-refunding bonds would thus prevent a municipality or school district from establishing a new lower borrowing rate more than 90 days prior to the call date of the existing bonds. Municipalities and school districts would still have the ability to issue current refunding bonds within the 90-day period prior to the designated optional redemption call date (e.g., 10 years from the date of issue). Any negative effect from the elimination of advance refunding bonds may potentially be mitigated by issuing future bonds with shorter optional redemption call dates (e.g., less than 10 years). In addition, it may also be possible for municipalities and school districts to enter into contracts for the future delivery of current refunding bonds

which could accomplish savings similar to an advance refunding.

Elimination of Tax Credit Bonds: The bill also eliminates tax credit bonds. These bonds provide either a tax credit to bondholders in lieu of an interest payment or a direct interest rebate payment to issuers. The purpose of tax credit bonds is to provide a low or zero interest rate financing mechanism for various qualified projects. Tax credit bonds have often been issued to finance energy conservation and renewable energy projects. These bonds currently include Qualified Zone Academy Bonds ("QZAB"), Qualified Energy Conservation Bonds ("QECB") and Clean and Renewable Energy Bonds ("CREB"). For a period after the recession, federal law also allowed the issuance of Qualified School Construction Bonds ("QSCB"), Recovery Zone Bonds ("RZ Bonds") and Build America Bonds ("BAB"). Many municipalities and school districts in Michigan have issued tax credit bonds to take advantage of the lower borrowing costs. These bonds provide a lower cost alternative to tax-exempt bonds and have been a valuable financing tool. Separate from federal sequestration, which has reduced the credit amount on tax credit bonds since 2013, and which may continue into 2018 and later years, the tax reform bill does not affect outstanding tax credit bonds.

Reduction of State and Local Tax Deduction ("SALT"): The tax reform bill caps the deduction for state and local taxes at $10,000 ($5,000 for married couples filing separately). This cap would limit the itemized deduction for state and local property, income and sales taxes. These deductible taxes include the general operating, voted debt and other taxes levied by municipalities and school districts. The capping of the federal tax deduction for these types of taxes will make such taxes more costly to certain taxpayers, which may cause these taxpayers to be less likely to support future municipal and school millage requests.

If you have any questions, please feel free to contact a member of the Miller Canfield Public Finance Practice Group.