Bloomberg Law

Health Law & Business News

Trump Tax Law Has Nonprofit Hospitals Juggling Bond Debts

By Meg McEvoy

Posted June 20, 2018, 3:42 PM

- Tax Cuts and Jobs Act eliminated tool for nonprofit hospitals to refinance billions of dollars in bond debt
- Nonprofit hospital systems are eyeing substitutes to adapt to market changes

Nonprofit hospital systems like Ascension Health and Catholic Health Initiatives, some of the largest nonprofit entities in the country, rely on bond issues to finance their capital expenditures, and President Donald Trump's new tax law has made those bonds more expensive.

The Tax Cuts and Jobs Act eliminated advance refunding bonds, which are bonds that nonprofit hospitals and other tax-exempt entities could use to effectively refinance outstanding bond issues on a tax-exempt basis. Nonprofits can still issue bonds for "new money" to finance projects, but the rule change means they could be stuck paying set interest rates on bonds for 10 years, or until the "call" date. It also makes nonprofit borrowing pricier as the tax-exempt bonds become less attractive to investors.

The rule change hurts nonprofits' ability to respond nimbly to market changes and has a "pretty significant adverse financial impact on nonprofit hospitals," Robert L. Capizzi, a partner at Chapman and Cutler LLP in Chicago who advises nonprofit hospitals on bond issues, told Bloomberg Law.

The provision was changed suddenly at the end of 2017, with no transition period. But tax and bond attorneys are exploring ways to counteract the effects of the rule change.

Attorneys say it is another example of how nonprofits are being asked to pay for the Tax Cuts and Jobs Act's cut to the corporate tax rate.

Billions in Outstanding Bonds

"Nonprofit hospitals and universities are likely to be the most adversely affected by the change in law," Alexander Reid, a tax partner with Morgan Lewis in Washington who advises nonprofit hospitals, told Bloomberg Law.

Hospitals and universities are nonprofits with "large physical facilities and steady revenues from the performance of their charitable and educational activities," and are more likely to issue tax-exempt bonds than other types of nonprofits, Reid said.

Ascension Health, the largest nonprofit health system, has nearly $4.5 billion in outstanding bond debt according to its 2014 form 990 filing, the most recent filing for which full data is available.

Catholic Health Initiatives, the second-largest nonprofit health system, has about $3.2 billion in bonds outstanding, according to its 2014 filing.

Ascension's largest outstanding bond issue reported in its 2014 filings was more than $870 million in bonds, issued in 2010 through the Michigan State Hospital Finance Authority.

Nonprofit bonds are "conduit financing" that is issued through municipalities, which confer their tax-exempt status.

Bad Timing

As of the 1986 tax reform act, nonprofit organizations had one opportunity to use advance refunding bonds to respond to market changes, Antonio Martini, a partner with Hinckley Allen in Boston who advises on bond issues, told Bloomberg Law.

Congress changed the rule in 2017 because it "perceived that this was a very inefficient use of the tax-exempt bond subsidy," Martini said. This is because when bonds get "advance refunded," the original bonds remain, so every $1 in capital investment was tied to $2 in the bond market.

"I was not surprised when [revoking the tax exemption for advance refunding bonds] became part of the 2017 enactment," Martini said. "Part of the drill was they were going to spend a lot of money in terms of the tax cuts in that bill, and they had to find some pay-fors."

"The timing couldn't be worse," Reid said. "Just as nonprofits struggle to fill the revenue gap from decreased charitable giving, corporate sponsorship, and bequests, they must also struggle to contain costs from new taxes on fringe benefits, executive compensation, and higher costs to refinance their debt."

Meanwhile, taxable stock corporations, including insurance companies, have benefited from the tax law's reduced 21 percent corporate income tax rate. Blue Cross Blue Shield companies saved $2.3 billion in taxes due to the TCJA, insurance ratings service A.M. Best reported this week.

"The sales pitch for the tax bill is that the benefits of the reduced 21 percent corporate income tax rate justify the cost of sacrificing a wide variety of tax incentives," Reid said. "That may well be true for taxable corporations—including those that compete with nonprofits in the health-care and education space—however, it was all squeeze and no juice for the nonprofit sector, leaving few good options to help them make ends meet."

Market Effects

Not only are nonprofit hospitals left holding the bag on billions in bond debt obligations with set interest rates, they are also contending with the market effects of tax-exempt bonds being less attractive to investors.

"Interest rates are rising, which means that the value of outstanding bonds will decrease, and stocks are reaching the end of a long bull run," Reid said.

"We are seeing banks and other corporate [investors] such as insurance companies saying '[tax-exempt bonds] are not as attractive to us, because the corporate tax rates have dropped from 34 percent to 21 percent, so now we need a higher interest rate,'" Capizzi said. "It's a higher borrowing cost to the hospital."

It may be later in the year before the full effects of the change are reflected in the markets, because lots of nonprofit entities completed bond issues in late 2017.

"We were having a flurry of deals at the end of last year, and numerous advance refundings because of the anticipated repeal," Capizzi said. "We did billions of dollars of deals that closed within the last couple of weeks in December."

"So far this year has been a very slow market, and new bond issuance has been down significantly," Capizzi said.

How Nonprofits Are Adapting

"Lawyers and advisers are collectively putting their heads together as to what substitutes there could be to [advance refunding bonds]," Martini said. "Advance refunding substitutes, if they don't get you the full value of the savings you could have achieved, maybe it will at least get you part of the way there."

The National Association of Bond Lawyers discussed advance refunding bond alternatives in a teleconference last month. Among the suggestions were taxable bonds, which can be used if the taxable rate is less than the rate applicable to the refunded bonds. Bond issuers could also make a tender offer to buy back some or all of their outstanding bonds to adapt to interest rates. "Rate locks" can be used, but are not typically seen until a bond is two years to 18 months away from its call date.

A "Cinderella bond" is an instrument that is issued as a taxable bond first, but which converts to tax-exempt status within 90 days of the redemption date, the date at which tax-exempt refunding of bonds is still allowed under the new tax law.

The financial gymnastics could get even more complex, including "forward delivery bonds," "forward-starting swaps," and "sales of optional redemption rights" and other bond lawyer cocktail party conversation fodder.

"There are a number of techniques being proposed to try to deal with this loss, but it's a significant problem going forward," Capizzi said.

"If I were a CFO of a hospital I would be saying, with my next substantial new money borrowing, what do I do to avoid this phenomenon where I feel like I'm shut out of a window of opportunity?" Martini said.

"There will be a new equilibrium that people will be looking for in this market," Martini said. "So far in the first couple of months of 2018, I haven't seen a lot on any of these substitutes. But the mainstream of thought in the market will coalesce over one of these solutions in the next several months."

© 2018 The Bureau of National Affairs, Inc.
All Rights Reserved