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Unintended consequences of tax reform: Nonprofits pay more for existing bond debt

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While most analyses of the impact of the Tax Cuts and Jobs Act on nonprofits deal with the impact of the increase in the standard deduction and the decrease in the individual tax rates, which reduce the incentive to give to charities, other adverse consequences to nonprofits are just being realized. One of these, the increase in the cash required to service existing tax-free bond obligations, could have a significant impact on the ability of already cash-starved charities to provide the services that comprise their missions.

Because the interest on many tax exempt bonds is based on a tax multiplier, which is the inverse of the holder's tax rate, and because the terms of typical bonds fix the holders' yield (by requiring changes so they receive yield protection from changes in tax laws), the decrease in tax rates results in an increase in the costs to the charity obligated to pay the bonds. For example, assuming the bonds are being held by the lender as the sole purchaser and were calculated at its 35 percent tax rate, the tax multiplier was 65 percent so that the rate charged was 65 percent of Libor, plus a certain amount of points. With the corporate rate being reduced to 21 percent, to preserve the yield the multiplier now moves to 79 percent of Libor plus points, a significant increase in the annual interest costs and the total interest costs over the term of the bonds.

In addition to increasing the amount of required debt service, the foregoing may now expose nonprofits that had protected themselves from increases in interest rates via swaps to the risk of the anticipated coming interest rate increases. The reason for this is that swap coverage was, in many cases, based on the same multiplier. In other words, the charities' existing swap coverage is 65 percent, not 100 percent, of the increase in interest rates. Based upon the example, that now leaves the nonprofit obligor at risk for 14 percent of any increases in interest rates unless it purchases additional swap coverage so that it is covered to 79 percent.

Charities and other nonprofits that are obligated under tax-free bonds need to begin analyzing their bond documents to determine whether their debt service will be increasing and whether they are now exposed to interest rate increases to adjust their planning and preserve the ability to serve their missions.

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