FEATURE

Tax Reform and its Impact on Health Care and Senior Living Finance

Tax reform had a wild ride in 2017. Reform advocates were bullish as the year began, citing one-party control of Washington, a president willing to take risks, and a speaker of the house with a detailed plan as reasons why a package would pass by March. By mid-year, following multiple failed attempts to repeal Obamacare and a litany of oxygen-sucking scandals, tax reform passing in 2017 suddenly seemed far-fetched. That outlook changed again, however, as the year ended with a mad dash by the GOP to notch a legislative win. The result was a comprehensive tax reform bill on the president's desk by Christmas. Below, we take a look at key provisions in the bill and detail how seniors housing and health care providers looking for capital financing in 2018 can be prepared for the impending changes.

On December 22, the president signed into law the "Tax Cuts and Jobs Act," a $1.5 trillion package of changes that reduces the majority of tax rates and modifies a wide array of policies, credits and deductions. The bill has major implications for the health care industry, notably the elimination of the Obamacare mandate and the retention of tax-exempt, private activity bonds (PABs). Key elements of the bill include:

- Corporate tax rate reduction
    - From 35% to 21%
    - Permanent
- Individual income tax rate reduction
    - Tax bracket rates decrease one to four percentage points
    - Temporary (expire in 2025)
- State and local tax (SALT) deduction limitation (capped $10,000)
- Eliminates Obamacare mandate that all Americans have health insurance.
    - The Congressional Budget Office (CBO) projects this will increase the uninsured by 13 million in 10 years and will increase health care costs by an average of 10%.
- The CBO predicts the legislation will increase the federal budget deficit by $1.4 trillion over the next decade.
- Medical expense tax deduction retained
- Tax-exempt, PABs retained

As those in the health care industry are well aware, the House of Representatives version of the tax reform bill eliminated both the medical expense deduction and PABs. Industry groups such as LeadingAge and the American Health Care Association/National Center for Assisted Living (AHCA/NCAL) advocated for retaining both provisions in the final bill and their efforts proved successful.

PABs have historically served as an important capital source for nonprofit organizations seeking to finance acquisitions, renovations or new construction projects. PABs have several benefits for nonprofits, including the ability to structure draw-down bonds which eliminates negative arbitrage. Had the PABs been eliminated, it likely would have widened the credit gap between the "haves" and the "have-nots." Larger, and typically more highly-rated, organizations would likely have been able to access the taxable bond market whereas smaller and/or lower-rated organizations may not have access. Thus, their retention is a significant win for nonprofit providers, big and small. It should be noted, however, that even though PABs are safe for now, that does not mean they are safe forever. The elimination of PABs is a conversation that has reared its head several times before. Accordingly, nonprofit organizations should include annual board education on potential financing alternatives before a potential crisis arises.

While PABs were saved, the bill unfortunately eliminates advance refundings of existing tax-exempt bonds with new tax-exempt bonds, which are traditionally used by nonprofits to lower their overall cost of capital. Going forward, obligors still retain the ability to execute current refundings with new tax-exempt debt within 90 days of the call date. Alternatively, obligors could issue taxable debt to effectuate an advance refunding.

In addition, the corporate tax rate reduction could have negative ramifications for organizations that use privately-placed, tax-exempt bonds (privately-placed bonds). When banks purchase privately-placed bonds, they often include corporate tax gross-up provisions in the bond documents. This gives them the ability to increase interest rates on the tax-exempt bonds

if their corporate tax rate declines, with tax-exempt bonds becoming less attractive as a result. This change can impact both fixed- and variable-rate privately-placed bonds. All privately-placed bond documents and existing terms should be reviewed in light of the new legislation, with special attention paid to terms like adjusted tax-exempt rate, interest rate, federal corporate tax rate, and margin rate factor. When in question, nonprofit organizations should reach out to either their placement agent or bond counsel.

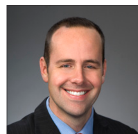
Going forward, there remain a variety of viable financing options for health care and senior living providers. For example, tax-exempt revenue bonds (revenue bonds), either sold into the public capital markets or privately placed, can be used for refinance, acquisition, new construction and expansion financing for both hospitals and seniors housing and care facilities. This option gives providers the ability to access capital based solely on their credit profile. On the plus side, revenue bonds offer speed of execution (typically three months from start to closing), and the fact that it is a fully-amortizing structure with no refinance or interest rate risk for bonds sold into the public capital markets. However, potential considerations include the fact that there is an inherent market bias against low- and non-investment grade health care credits, as community hospitals and senior living organizations not rated above the 'BBB' category will face additional pricing and covenant pressures. Additionally, most privately-placed revenue bonds will have differing terms and amortization periods which introduces both refinance and interest rate risk.

Another financing option for both hospitals and senior living organizations in areas with a population less than 20,000 is the U.S. Department of Agriculture's Rural Development Community Facilities (USDA CF Program) Direct and Guaranteed loan programs. The USDA CF Program offers permanent financing with a 40-year term and amortization, low, fixed interest rates, and minimal financial covenants. Considerations include the long lead time (12 to 18 months from start to closing), limitation on the ability to refinance existing debt, and the requirement of a one-year debt service reserve funded from cash flow over a period of ten years.

For hospitals, the U.S. Department of Housing and Urban Development (HUD)/Federal Housing Administration's (FHA) Section 242 program and its various alternatives provide mortgage insurance for new or existing hospitals in connection with new construction, expansion, substantial rehabilitation, modernization, remodeling, and refinance. Because the mortgage insurance provides most hospitals the opportunity to issue AAA-rated debt, the 242 program allows borrowers to experience substantial debt service savings when compared to unrated tax-exempt bonds. Considerations of this approach include the longer lead time (nine to 12 months from start to closing) and the annual credit enhancement fee. Further, critical access hospitals may have a hard time qualifying given the operating margin and acute care patient day requirements.

Senior living providers have the FHA Section 232 and Fannie Mae Seniors Housing programs as attractive financing options. The 232 program has several benefits, including low interest rates, long terms with matching amortization and prepayment flexibility. Like revenue bonds sold into the public capital markets, the 232 program offers permanent financing for refinance, acquisition, expansion, renovation, and new construction. The 232 program, however, is not open to entrance fee communities and has a limitation on the number of unlicensed units. As for Fannie Mae, one of its key features is timeliness. Rate lock can typically be achieved in less than 45 days from loan application, with early rate lock options also available.

The end of 2017 should serve as an important reminder to nonprofit organizations. These organizations cannot take existing financing alternatives for granted as they may not exist in the future, especially organizations with non-permanent debt. Yields still remaining below historic lows. In combination with a flat yield curve, it may make sense to consider a longer term, fixed-rate debt structure in order to eliminate "stroke of pen risk" in the future. At a minimum, nonprofit organizations should include board education on financing alternatives as part of their annual training. After all, just because tax reform was done in 2017, doesn't mean it won't be "undone" in the future.



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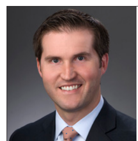

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