Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS FEBRUARY 14, 2012

Obama Administration Proposes BAB Reinstatement, Other Municipal Bond Changes

The US Department of Treasury has released its general explanation of the tax proposals in the Obama administration's proposed fiscal year 2013 budget. The administration's proposals include provisions that, if enacted, would reinstate and expand the build America bond program and provide various changes to the tax provisions relating to municipal bonds.

Build America Bonds

Build America bonds, which were authorized under the American Recovery and Reinvestment Act of 2009, are federally taxable bonds issued by states and local governmental entities that provide for a federal tax credit equal to 35 percent of the interest payments on the bonds. In the case of certain new money build America bonds for capital projects, the federal government makes direct payments to the issuer equal to this 35 percent credit. The ability to issue build America bonds expired at the end of 2010.

The administration proposal would reinstate and make permanent the ability to issue build America bonds at a reduced credit rate of 30 percent through 2013 and 28 percent thereafter. The proposal would also expand the eligible uses for build America bonds to include the following: (1) original financing for governmental capital projects, as under the initial authorization of build America bonds; (2) current refundings of prior public capital project financings for interest cost savings where the prior bonds are repaid within 90 days of issuance of the refunding bonds; (3) governmental working capital financings, subject to a thirteen-month maturity limitation; and (4) financing for Section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities.

Current Refundings

Generally, tax-exempt bonds may be issued for current refunding purposes, meaning such tax-exempt bonds are used to redeem or retire prior bonds within 90 days of the issuance of such tax-exempt bonds. Certain maturity limitations apply to current refunding bonds issued as private activity bonds. From time to time, the tax law has allowed the issuance of other types of bonds, such as build America bonds and tax credit bonds, providing borrowing subsidies to state and local governments through direct payment subsidies or through tax credits to investors. Certain of these state or local bonds may have volume caps, time deadlines for bond issuance, or transitional provisions for program restrictions. The administration's proposal includes a general statutory provision that sets forth parameters for allowable current refundings of state and local bonds where such state and local bond program or provision does not otherwise allow current refundings or expressly address the treatment of current refundings (including bonds for which volume caps or time deadlines applied to the issuance of the original bonds). Current refundings would be authorized so long as (i) the issue price of the current refunding bonds is no greater than the outstanding principal amount of the refunded bonds or, in the event the refunded bonds were issued with more than a de minimis amount of original issue discount or premium, no greater than the adjusted issue price or the accreted present value of the refunded bonds and (ii) the weighted average maturity of the current refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.

Reducing the Value of Certain Tax Expenditures

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income, and claiming either itemized deductions or a standard deduction. One exclusion from taxable income is the interest income on tax-exempt state and local bonds. The administration's proposal would limit the tax value of specified deductions or exclusions from adjusted gross income and all itemized deductions that would reduce the value to 28 percent of the specified exclusions and deductions that would otherwise reduce taxable income in higher tax brackets. A similar limitation would apply under the alternative minimum tax. The income exclusions and deductions limited by this provision would include, among other things, any tax-exempt state and local bond interest. The proposal would be effective for taxable years beginning after December 31, 2012.

Arbitrage Simplification

Generally, gross proceeds of tax-exempt bonds are subject to an arbitrage rebate requirement. In certain cases, amounts may also be subject to a yield restriction requirement under which amounts may not be invested at a yield greater than the yield on the bonds. The administration's proposal contains three simplification provisions relating to the arbitrage limitations applicable to tax-exempt bonds. First, the proposal would generally repeal this yield restriction requirement, except in the case of advance refunding escrows and other situations to be identified in regulations. Second, there would be a new three-year spending exception to the arbitrage rebate requirement (in addition to the existing six-month, eighteen-month, and two-year exceptions) that would apply to certain fixed rate bonds (including private activity bonds) other than advance refunding bonds. Third, the proposal would expand the small issuer exception to the arbitrage rebate requirement to increase the maximum amount of bonds that a small issuer generally may issue in a year from $5 million to $10 million (indexed for inflation) and to eliminate the requirement that issuers have general taxing power.

Eliminate the 5 Percent Private Use Limit

Generally, to avoid being private activity bonds, no more than 10 percent of the proceeds of a governmental bond issue may be used in a private business use. However, this 10 percent limit is reduced to 5 percent in the case of certain private uses that are not related to, or are disproportionate to, the governmental uses of the issue. The administration is proposing to eliminate this 5 percent limit on unrelated or disproportionate private business use.

Expand Eligible Uses of Single Family Mortgage Bonds

Qualified mortgage bonds are tax-exempt private activity bonds the proceeds of which are used to finance home mortgages. The mortgages must meet numerous requirements. The administration is proposing to eliminate two of those requirements: the requirement that the homes financed by the mortgage loans have a purchase price that is no more than certain maximums and the current prohibition on using qualified mortgage bonds for mortgage refinancings.

Other Provisions

The administration's proposal also includes certain other provisions relating to tax-exempt bonds, including the modification of rules governing the issuance of tax-exempt bonds by Indian tribal governments and, with respect to low income housing tax credits, the provision of a 30-percent basis "boost" to properties that receive an allocation of tax-exempt bond volume cap and that consume that allocation.

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