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Administration Revenue Proposals: Proposed Changes to Tax-Exempt Bond Related Provisions

In March, 2014, the U.S. Department of the Treasury released its general explanation of the tax proposals in the Obama administration's proposed fiscal year 2015 budget. The following is a summary of significant proposed changes to the tax-exempt bond provisions of the Internal Revenue Code included in the administration's proposals.

Reducing the Value of Certain Tax Expenditures, Including Tax-Exempt Interest

Under current law, individuals 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 the 33-percent, 35-percent or 39.6-percent 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, 2014.

Creation of the America Fast Forward Bond Program

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. However, the credit payments are currently being reduced under the federal budget "sequestration." The ability to issue build America bonds expired at the end of 2010.

Similar to build America bonds, the administration proposal would create the ability to issue America Fast Forward Bonds at a credit rate of 28 percent for bonds issued on or after January 1, 2015. Eligible uses for America Fast Forward Bonds would include the following: (1) original financing for governmental capital projects, as under the 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; (4) financing for Section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities; and (5) financing for the types of projects and programs that can be financed with qualified private activity bonds, subject to the applicable State bond volume caps for the applicable bond category. In addition, the proposal also recommends precluding direct payments on America Fast Forward Bonds from being subject to sequestration.

Expansion of the Authority to Issue Current Refunding Bonds

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.

Repeal of the $150 Million Non-Hospital Bond Limitation on Qualified Section 501(c)(3) Bonds

Under current law, Section 501(c)(3) bonds can be used to finance either capital expenditures or working capital expenditures of Section 501(c)(3) organizations. The Tax Reform Act of 1986 established a $150 million limit on the volume of outstanding, non-hospital, qualified 501(c)(3) bonds. The limit was repealed in 1997 with respect to bonds issued after August 5, 1997, if at least 95 percent of the net proceeds were used to finance capital expenditures incurred after that date. The limitation continues to apply to bonds more than 5 percent of the net proceeds of which finance or refinance (1) working capital expenditures, or (2) capital expenditures incurred on or before August 5, 1997.

The proposal would repeal in its entirety the $150 million limit on the volume of outstanding, non-hospital, tax-exempt bonds for the benefit of any one Section 501(c)(3) organization, effective for bonds issued after the date of enactment.

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 the 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 $5,000,000 to $10,000,000 (indexed for inflation) and to eliminate the requirement that issuers have general taxing power.

Elimination of the 5 percent Unrelated and Disproportionate 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, effective for bonds issued after the date of enactment.

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:

- Increasing volume cap for qualified highway or surface freight transfer facility bonds from $15 billion to $19 billion;
- Eliminating the volume cap requirements for tax-exempt exempt facility bonds for the furnishing of water or sewage facilities;
- Increasing the 25-percent limitation on the financing of land acquisition with bond proceeds to 35 percent for certain qualified private activity bonds;

- Revising the rules related to private business use resulting from research arrangements to allow more flexibility with respect to research arrangements; and
- Repealing the government ownership requirement for certain types of exempt facility bonds; and
- Allowing the conversion of private activity bond volume cap into low income housing tax credits.

For More Information

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