

The Background

Representative Dave Camp (R-MI), Chairman of the House Ways & Means Committee, recently released a comprehensive tax reform proposal (Camp Proposal) that would fundamentally reshape the tax-favored bond landscape by eliminating private activity bonds (including qualified 501(c)(3) bonds) and advance refundings, among other changes.

There have been a number of proposals in recent years to change certain tax-favored bond rules that were viewed as having little chance of passage. But the Camp Proposal requires more attention even though most commentators believe it similarly has little chance of passage. The Ways & Means Committee bears the principal responsibility for drafting new tax legislation, so a proposal that comes directly from the Chairman is likely to be given greater consideration than a proposal sponsored by a rank-and-file member of Congress.

Set forth below are the provisions of the Camp Proposal that would affect the tax-favored bond community. Although these provisions will have the force of law only if Congress enacts them, issuers should consult with bond counsel to determine whether the Camp Proposal (or any future variations) might trigger any termination provisions in bond purchase agreements.

Section 3431 of the Camp Proposal Would Eliminate Tax-exempt Private Activity Bonds, Including Qualified 501(c)(3) Bonds

If Congress enacts the Camp Proposal, state and local governments could no longer issue tax-exempt private activity bonds. These bonds include qualified mortgage bonds, qualified redevelopment bonds, exempt facility bonds (e.g., certain airport bonds, water treatment facility bonds, solid waste disposal facility bonds, etc.) and qualified 501(c)(3) bonds, which are often issued for the benefit of nonprofit hospitals and higher education institutions.

This provision would apply to bonds issued after December 31, 2014. This delayed effective date is presumably intended to give the tax-favored bond community an opportunity to make preparations for this drastic change. Apart from this delay, the Camp Proposal offers no "transition" relief. For instance, the Camp Proposal wouldn't allow an issuer to refund an issue of private activity bonds with tax-exempt bonds, even a current refunding resulting in a lower interest rate. Thus, if Congress enacts the Camp Proposal, issuers would need to be very careful not to trigger a deemed "reissuance" after December 31, 2014, of their tax-exempt private activity bonds issued prior to January 1, 2015, or the reissued bonds likely would lose their tax-exempt status.

In addition, the Camp Proposal would eliminate the ability of state and local governments to provide homebuyers a tax credit for interest on certain home mortgages instead of issuing tax-exempt private activity bonds for that purpose. This repeal would apply to tax years ending after December 31, 2014.

Section 3433 of the Camp Proposal Would Eliminate Tax-exempt Advance Refundings

If Congress enacts the Camp Proposal, issuers would no longer be able to issue tax-exempt advance refunding issues. An advance refunding issue is an issue that pays principal or interest on the refunded bonds more than 90 days after the refunding issue is issued. Under current law, governmental bonds and qualified 501(c)(3) bonds (which would be eliminated under the Camp Proposal) may be advance refunded once. Other private activity bonds may not be advance refunded under current law.

As with the repeal of private activity bonds, the repeal of advance refundings would apply to advance refunding bonds issued after December 31, 2014. After that date, outstanding governmental bonds, which commonly become subject to redemption about 10 years after their issuance, could not be refunded to reduce interest costs until no more than 90 days before their redemption date.

Section 3434 of the Camp Proposal Would Eliminate Tax Credit Bonds

If Congress enacts the Camp Proposal, issuers would no longer be able to issue the various types of "tax credit bonds" that did not otherwise expire at the end of 2010 and for which there is still available volume cap (for example, qualified school construction bonds and qualified energy conservation bonds). Importantly, holders of existing tax credit bonds would continue to receive tax credits and issuers would continue to receive direct payments if the issuer elected to receive direct payments instead of giving holders a tax credit.

This provision would apply to bonds issued after the effective date of the Camp Proposal as enacted.

The Camp Proposal Would Require High-income Taxpayers to Pay 10% Tax on Interest on Otherwise Tax-exempt Bond Interest and Would Prohibit Individual Taxpayers From Deducting State and Local Taxes

If Congress enacts the Camp Proposal, taxpayers whose "modified adjusted gross income" exceeds a specified amount (\$450,000 for married-filing-jointly taxpayers and \$400,000 for single-filing taxpayers) would be required to pay income tax at a rate of 10% on their otherwise tax-exempt bond interest. **Importantly, this provision would apply retroactively to bonds issued at any time, including prior to the enactment of the Camp Proposal.**

In addition, individual taxpayers would be prohibited from deducting their state and local taxes (including income, property, and sales taxes) from gross income for federal income tax purposes.

While these provisions do not directly limit the types of bond issues that could be issued on a tax-exempt basis, they would roil the tax-exempt bond markets in a number of ways. Perhaps most importantly, this provision would drive up the borrowing costs of issuers by making tax-exempt bonds less attractive to higher income taxpayers, who are

a large segment of the market for tax-exempt bonds. It likely would raise borrowing costs for governmental issuers even further because it would erode investors' confidence that tax-exempt bonds would not be adversely affected by subsequent legislation once they are issued. Issuers might seek indirectly to compensate for these increased costs by raising income, property and/or sales taxes. But, making matters worse, if an issuer tried to raise taxes, it likely would face more resistance than usual from voters because the Camp Proposal would prohibit the deduction of those taxes on their Federal income tax returns.

These provisions would take effect for tax years beginning after December 31, 2014, if Congress enacts them.

Section 3124 of the Camp Proposal Would Repeal "QTEOs/ Bank-qualified Bonds"

Under current law, certain small issuers can obtain a lower borrowing cost from a bank purchaser by issuing "qualified tax-exempt obligations" (also known as "bank-qualified bonds"). A bank purchaser can ignore most of the interest on these bonds in making a complex calculation that generally prevents the bank from deducting the portion of its interest expense that is considered to be allocable to its tax-exempt bond holdings. For this reason, banks typically will accept a lower interest rate on qualified tax-exempt obligations than on other tax-exempt bonds.

If enacted, the Camp Proposal would eliminate this helpful rule for qualified tax-exempt obligations, which would increase the borrowing cost of small issuers that currently benefit from QTEOs/bank-qualified bonds.

The Camp Proposal Would Modify the Availability of Various Tax Credit Financing Programs by Repealing the Historic Tax Credit, Limiting the New Markets Tax Credit to Currently Available Credit Authority and Modifying Many of the Provisions Pertaining to the Low-income Housing Tax Credit

Although not directly related to tax-favored bonds, various tax credit financing programs, including the historic tax credit, the new markets tax credit and the low-income housing tax credit, are important financing and economic development tools for state and local governments.

If Congress enacts the Camp Proposal, the historic tax credit will be repealed for amounts paid to rehabilitate a historic building after 2014, with a transition rule allowing taxpayers to continue to claim the historic tax credit for rehabilitation expenditures incurred through the end of 2016 to rehabilitate a historic building that was acquired before 2015, so long as the 24-month rehabilitation period for claiming the historic tax credit also begins on or before January 1, 2015.

In addition, the new markets tax credit program will be limited to currently available tax credit authority. Once this currently available authority is fully used, state and local governments will no longer be able to use the new markets tax credit program to finance new projects.

The Camp Proposal contains a number of provisions that are designed to simplify and enhance the low-income housing tax credit. Perhaps the most significant proposed change to the low-income housing tax credit program would be the elimination of the so-called "4% credit," which is the only type of low-income housing tax credit that is available for low-income housing facilities that are also financed with tax-exempt multifamily housing bonds, a type of tax-exempt private activity bonds. Generally speaking, for multifamily housing bonds to be economically viable, the bond-financed project must be paired with the 4% low-income housing tax credit, which the Camp Proposal would eliminate. Thus, even if Congress does not enact the provision of the Camp Proposal that eliminates private activity bonds, if it enacts the low-income housing tax credit provisions of the Camp Proposal, it would likely have the practical effect of eliminating tax-exempt multifamily housing bonds.

The Camp Proposal would also change how state and local housing authorities allocate the national "volume cap" available for low-income housing tax credit projects, a change that is intended to simplify the low-income housing credit financing structures and provide a more transparent benefit. In addition, the Camp Proposal would spread the tax credits from a qualifying project over 15 years rather than 10 years, to align with the credit period with the period over which the low-income housing tax credit project must comply with the program rules.

The changes to the low-income housing tax credit rules would be effective for calendar years after 2014.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

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