



Issue Brief: TAX-EXEMPT BONDS

Updated April 2010

Background

This is a big year in Washington for the tax-exempt bond market. The *American Recovery and Reinvestment Act of 2009 (ARRA)* is the most expansive piece of legislation passed by Congress and includes more tax-exempt bond provisions -- many of interest to state and local governments -- than any other legislative initiative in recent history. We expect the municipal bond market will continue to receive attention by Congress, the U.S. Treasury Department, the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC) throughout 2010. Additionally, Congress is considering major reforms to the banking sector that will impact municipal securities, and the SEC continues its call for more disclosure requirements. GFOA members are advised to keep apprised of Congressional and regulatory action through the GFOA's newsletter and Web site.

Legislative Initiatives

Regulatory Reform of the Financial Services Sector –

The House of Representatives passed its version of the overhaul legislation last December (H.R. 4173, *The Wall Street Reform and Consumer Protection Act*), and the Senate is set to consider its bill this spring (*Restoring American Financial Stability Act of 2010*). Both the House-passed bill and the Senate bill contain numerous provisions that affect the municipal bond market and issuers of municipal securities. They include:

- **Create uniform ratings for municipal and corporate securities.** Currently, credit rating agencies maintain two separate rating systems for municipal securities and corporate securities. In most cases, the scale used for rating municipal securities is more rigorous than what is used for corporate securities, even though the rating agencies readily acknowledge that the default rate for municipal securities is far less than what exists in the corporate sector. The two separate scales and the criteria used to determine creditworthiness cause municipal bonds to be rated lower than their corporate counterparts, which increases debt issuance costs for state and local governments. Legislation that mandates the use of uniform ratings based on the likelihood of default would create a level playing field for all securities, making it easier for investors to compare different types of securities and significantly assisting state and local governments. Both the House-passed and the Senate versions include language calling for credit rating agencies to use uniform ratings.
- **Mandate the regulation of financial advisors, swap providers and other professionals involved in the issuance of municipal securities.** Currently, financial advisors and most other advisory professionals involved in municipal securities are not regulated by the SEC, Financial Industry Regulatory Authority (FINRA) or the Municipal Securities Rulemaking Board (MSRB). Both the House-passed bill and the Senate bill drafts create a regulatory framework, similar to what exists for broker/dealers, that would ensure that those advising state and local governments meet certain qualifications and adhere to rules that protect their clients from unlawful practices. The GFOA supports such efforts.
- **Mandate the regulation of derivative products.** Currently all derivative products, including those associated with municipal securities, are not regulated. A cornerstone of the reform effort is to ensure that an adequate regulatory framework exists for the entire derivatives market. Both the House and Senate versions would impact state and local governments that enter into these contracts. The House-passed legislation would allow a state or local government to enter into a derivatives contract only if the government has over \$50 million in "discretionary investments" or if the counterparty to the transaction is a regulated party (e.g., a bank). The Senate bill would only allow governments with over "\$50 million in discretionary investments" to enter into these contracts.

- **Studies to review the need for federal intervention in municipal securities issuance, governmental accounting rules and GASB funding.** Senate drafts have included two studies that would affect state and local governments significantly. The first study would have the Government Accountability Office (GAO) examine the effectiveness of the Tower Amendment on municipal securities. The Tower Amendment prohibits the SEC from regulating issuers of municipal securities. The GFOA strongly supports the prohibition of federal government involvement in the issuance of bonds by state and local governments, and we remain vigilant in opposing efforts to change or eliminate this ban. The second study calls on the SEC to review a stable funding source for the GASB. The GFOA continues to oppose any efforts to involve the federal government in the funding or oversight of the GASB and has expressed concern that such a study, especially if conducted by the SEC, would not provide a well-rounded assessment of the potential options for funding GASB nor adequately address the concerns with having the federal government involved in the management of GASB.

Extension of Tax-Exempt Bond Programs Included in the *American Recovery and Reinvestment Act of 2009*

Many of the bond provisions included in the ARRA expire at the end of 2010. GFOA will continue to monitor Congressional action to extend these programs. (See Tax Credit Bond issue brief for additional information).

- Increases Bank Qualified Debt Limit to \$30 Million. The ARRA increases the small issuer exception to \$30 million from its current \$10 million level. This allows smaller governments to place their debt directly with community or other banks, which can then deduct 80% of the purchasing costs for the bonds. Extending this limit past 2010 – or making it permanent – tops GFOA’s 2010 advocacy efforts.
- Provides New Incentives for Banks to Purchase all Types of Bonds. Since 1986, banks have been able to deduct only the carrying costs of bank-qualified bonds. The ARRA allows a bank to deduct 80% of the carrying costs of purchasing all types of newly issued bonds, up to 2% of the bank’s total assets.
- Eliminates application of the AMT on private activity and governmental bonds. The interest on private activity bonds and some governmental bonds is not deductible for individuals and corporations, who must pay the alternative minimum tax (AMT). The legislation eliminates the application of the AMT on all newly issued bonds and the refunding of bonds that initially were issued after 2003. The Small Business and Infrastructure Jobs Act (H.R. 4849), which passed the House in 2010, extends the exemption through 2011. The Senate has not yet acted on the legislation.
- New “Recovery Zone Bonds”. A new category of tax-exempt private activity bonds has been created for use in “recovery zones,” which are designated areas with significant unemployment, poverty and home foreclosure rates. For Recovery Zone Facility Bonds, \$15 billion in private activity bonds would be allocated based on a proportion of a jurisdiction’s unemployment rate versus that of the nation’s unemployment rate.
- Expands Definition of Industrial Revenue Bonds. The ARRA expands the definition of industrial revenue bonds to include facilities used for the manufacturing, creation or production of intangible property.

FHLB Letters of Credit: *The Housing and Economic Recovery Act of 2008* included a provision amending Section 149(b) of the Internal Revenue Code, which added Federal Home Loan Banks (FHLBs) to the list of Government Sponsored Enterprises permitted to provide credit-enhancement for all types of tax-exempt bonds. (Prior to this change the FHLB only had the authority to provide credit enhancement to housing bonds). The authority sunsets on Dec. 31, 2010, and the state and local government community is seeking to have the authority extended or made permanent. This is especially necessary as the lack of credit enhancement in the municipal market remains stifled due to the lack of bond insurance.

Regulatory Initiatives – Securities and Exchange Commission

Municipal Securities and GASB - The Federal Liaison Center will monitor closely the SEC's efforts to further regulate the municipal securities market and state and local governments. SEC officials stated throughout 2009 that they want the agency to have more authority to regulate issuers of municipal securities. GFOA and the state and local government community strongly oppose any such intrusion by the SEC in these areas and will continue to resist any efforts that would give the federal government authority over state and local governmental accounting standards, the issuance of municipal bonds, or other state and local government functions.

Changes to Rule 15c2-12. In July 2009, the SEC proposed additional requirements to SEC Rule 15c2-12, which sets forth obligations on underwriters for ensuring that issuers of municipal bonds have prepared official statements for primary offerings and have agreed to provide continuing disclosure information for the lifetime of the bond, including material event disclosures and annual financial information. The proposed changes would apply continuing disclosure obligations to variable rate demand obligations, increase the number of material events that must be submitted by issuers and require disclosure of certain events even if they are not deemed "material." One of the most significant proposals would require material event notices to be submitted within 10 business days after the event, which the GFOA opposes. Currently Rule 15c2-12 calls for submissions to be made "in a timely manner." In a formal comment letter submitted in September 2009, the GFOA cautioned the SEC against a uniform standard and noted that in some instances an issuer may be made aware of a material event long after 10 days from when it occurs, such as in the case of a downgrade of insurance or letter of credit provider). GFOA also has expressed concern with the elimination of the need to determine "materiality" for some events, especially a new requirement to disclose IRS audits. The SEC is expected to finalize these rules in the spring and may propose additional changes to Rule 15c2-12, this year as well.

Regulatory Initiatives – Department of the Treasury and Internal Revenue Service

The Treasury Department recently released rules and allocations for the various tax credit bond programs, including the necessary forms for issuers to receive BABs subsidy payments. In March, Treasury released guidance on "stripping the tax credits" so that they may be sold to other investors.

In recognition of current credit market constraints, the Treasury in December extended by a year the temporary rules that allow state and local governments to buy and temporarily hold their tax-exempt bonds without being considered reissued for tax purposes. The rules allow issuers to buy and hold tax-exempt auction-rate securities, variable-rate bonds and commercial paper without penalty until Dec. 31, 2010.

Meanwhile, the IRS will continue its focus on post issuance compliance matters. As in past years for both governmental and 501(c)3 bond issuers, the IRS in 2010 plans to send out detailed questions to BABs issuers asking about each entity's compliance standards, in place to ensure compliance with the tax code after the bonds are issued. The surveys and the agency's overall focus on post-issuance compliance practices could lead to additional IRS guidance and procedures.

GFOA is calling upon the IRS and Treasury to provide guidance with regard to the subsidy payments that issuers receive for BABs and other tax credit bonds. Currently, the payments may be "offset" by an amount that a state or local government may owe the federal government – unrelated to the bonds. The GFOA is working to provide guidance to their members about how the offset is applied is seeking to eliminate the IRS's ability to offset these payments, unless the offset is related to the bonds.

Related Public Policy Statements (see www.GFOA.org)

- Disclosure and Federal Regulation of the Market for Municipal Securities (2003)

- Federal Tax Policy and Preserving the Tax-Exempt Status of Municipal Bonds (2005)