



## Issue Brief: TAX-EXEMPT BONDS

*Updated February 2009*

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### **Background**

The recently passed *American Recovery and Reinvestment Tax Act of 2009* contains many tax-exempt bond provisions of interest to state and local governments. The *Act* is the largest piece of legislation passed by Congress and includes more bond provisions than any other legislative initiative in recent history. We expect that the municipal bond market will continue to receive attention by Congress, the Department of the Treasury, the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC) throughout 2009. These include Treasury and IRS proposed regulations related to the bond provisions passed in the stimulus bill, an IRS effort on post-issuance compliance procedures, and likely significant reforms to the financial services sector that will affect municipal securities. GFOA members are advised to keep apprised of Congressional and regulatory action through the GFOA's newsletter and Web site.

### **Legislative Initiatives**

#### STIMULUS PACKAGE - *The American Recovery and Reinvestment Tax Act of 2009*

President Obama signed the \$787 billion *American Recovery and Reinvestment Act of 2009* on February 17. The *Act* provides significant direct funding to state and local governments and contains various tax provisions of interest to GFOA members. Below is a summary of the tax-exempt bond provisions in the legislation. Please note that each provision is only in effect for 2009 and 2010:

- Increases Bank Qualified Debt Limit to \$30 Million. The *Act* increases the small issuer exception to \$30 million from its current \$10 million level. This will allow smaller governments to place their debt directly with community or other banks and the banks can then deduct 80% of the purchasing costs for the bonds.
- 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 *Act* allows banks to deduct 80 percent 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 were initially issued after 2003.
- New Taxable Bond Option (Build America Bonds). Under the *Act* issuers can elect to issue either taxable tax-credit or tax-exempt bonds for governmental purposes. The taxable tax-credit bond option would allow issuers to receive a 35 percent reimbursement of interest paid from the federal government OR provide a 35 percent tax credit to investors. All of the tax laws applicable to tax-exempt bonds would apply to the taxable tax credit governmental bonds. If the tax credit to investors option is taken, the tax credit may be stripped from the underlying bonds.
- 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. \$15 billion in private activity bonds, Recovery Zone Facility Bonds, would be allocated based on a proportion of a jurisdiction's unemployment rate versus that of the nation's. The bonds need to be issued by Jan. 1, 2011. The legislation also authorizes \$10 billion in taxable bonds, Recovery Zone Economic Development Bonds to be used to promote economic development in a Recovery Zone, and the state or local government would receive a 45 percent reimbursement of interest paid, with no option to apply the credit to investors.

- Creates New Tax Credit Bonds: Qualified School Construction Bonds. These tax credit bonds may be used to finance new construction, rehabilitation or repair of public school facilities. The *Act* authorizes \$11 billion annually for 2009 and 2010. 40% of the allocation is dedicated to large school districts
- Expands Qualified Zone Academy Bond Authority. Congress has routinely reauthorized \$400 million for this program, however, the *Act* gives an additional \$1.4 billion in 2009 and 2010.
- Increases New Clean Energy Bond Limits. The *Act* authorizes a total of \$1.6 billion for Clean Renewable Energy Bonds used to finance renewable energy facilities. The \$1.6 billion authorization is subdivided into thirds: 1/3 for state/local/tribal governments; 1/3 for qualifying projects of public power providers; and 1/3 for qualifying projects of electric cooperatives.
- Increases Qualified Energy Conservation Bonds Limits. The *Act* provides for \$2.4 billion of tax credit bonds to be issued for green community programs, including allowing bonds to be issued to finance loans to individual homeowners to retrofit existing houses with energy conservation products.
- Expands Definition of Industrial Revenue Bonds. Expands definition of industrial revenue bonds to include facilities used for the manufacturing, creation or production of intangible property.

### Regulatory Reform of the Financial Services Sector

As the country continues to respond to the economic crisis spurred by the global credit crisis, Congress, the Treasury Department, the SEC and other federal agencies will be looking to draft comprehensive regulatory reform measures in all corners of the financial services sector. The Federal Liaison Center will monitor these activities to determine what effect that may have on governmental accounting and investment practices, as well as to the municipal debt market. GFOA will continue to oppose 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.

### Credit Rating Agencies

In the last Congress House Financial Services Chairman Barney Frank introduced legislation that mandates credit rating agencies recalibrate the way they rate securities so that the same criteria is used for all types of securities (municipal and corporate). The Chairman stated many times throughout the year that municipal securities ratings have often been underrated, even though their default rate is less than one tenth of one percent, especially compared to their corporate counterparts. GFOA supports having the legislation reintroduced this Congress, or having the rating agencies act on their own to implement recalibration.

### Regulatory Initiatives – Department of the Treasury

TARP. In 2008, the Congress enacted the Emergency Economic Stabilization Act of 2008 which included the Troubled Assets Relief Program (TARP). TARP was designed to purchase challenged assets, but much of the first tranche of dollars has been used to infuse capital directly into financial institutions, the insurer AIG and the auto industry, and to support consumer loans. The previous administration and the Federal Reserve refused to act to assist the ailing tax-exempt bond market in part because they believe the legislation did not extend to that purpose. However, President Obama and Chairman Frank believe that TARP funds could be used to support the municipal bond market by purchasing municipal securities and providing credit enhancement in connection with municipal securities. A House-passed bill clarified this authority, but it is thought that the new Administration may take regulatory action without any change in the law.

TEFRA. Recently, the IRS issued proposed regulations on how to more efficiently conduct TEFRA hearings before the issuance of some tax-exempt bonds, including private activity, 501(c)3, mortgage revenue and student loan bonds. The proposed regulations are mostly reasonable, streamline the hearing process and are suitable for finalization.

## **Regulatory Efforts – Internal Revenue Service**

The largest initiative for the IRS Tax-Exempt Bond enforcement office will be the dissemination of hundreds of post-issuance compliance questionnaires to governmental issuers. GFOA and the issuer community have expressed some concern both as to the scope and purpose of the questionnaire and what the IRS will do with the collected information. Some issuers will see the questionnaire in their mailbox by the end of January.

## **Regulatory Efforts – Securities and Exchange Commission**

**New System for Disclosure Filings - EMMA.** The SEC announced last year that they will replace the existing four Nationally Recognized Municipal Securities Information Repositories (NRMSIRs) with one central NRMSIR/filing location at the Municipal Securities Rulemaking Board (MSRB), called the Electronic Municipal Market Access (EMMA) system. The SEC decision also provides free public access to continuing disclosure documents filed by issuers. Beginning on July 1, 2009, issuers must make electronic filings in accordance with their continuing disclosure agreements (CDAs) at EMMA, including annual financial information and material event notices. The rule change does not create additional disclosure obligations, and there are no costs associated with making EMMA filings. GFOA supports EMMA and the ability for issuers to file in one location. An EMMA pilot program will be available this spring for issuers to create their accounts and test the system. More information can be accessed at [www.emma.msrb.org](http://www.emma.msrb.org).

**Regulatory Reform Measures.** GFOA will be paying close attention to any attempts by the SEC to directly regulate issuers and governmental accounting standards or propose other regulatory actions that would have an adverse effect on state and local governments. Additionally, the SEC will be focusing on restructuring the agency to provide greater oversight of capital markets. GFOA will need to be vigilant that this new activism does not improperly extend to state and local governments.

## **2008 Activities - Highlights**

The tax-exempt bond market has been on a roller coaster ride for the past year, as the global credit crisis has significantly reduced liquidity in our market, and caused the demise of the bond insurers and the auction rate securities market. Congress held hearings that looked at municipal market conditions; concerns about the credit agencies; and the possible need for additional disclosure and regulatory standards for issuers of municipal securities. While hearings were held, no legislative effort got off the ground.

One of the most significant Supreme Court decisions affecting tax-exempt bonds was the decision last year in *Davis v Kentucky*. The Court held that it is not a violation of the Commerce Clause of the Constitution for states to tax out-of-state bonds while leaving in-state bonds tax-exempt. GFOA, along with a dozen other state and local government association, filed an amicus brief on behalf of Kentucky.

Legislation was enacted to allow Federal Home Loan Banks to support its members' letters of credit for tax-exempt bonds without running afoul of federal guarantee prohibitions.

## **Related Public Policy Statements (see [www.GFOA.org](http://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)