Bond Case Briefs

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BDA: Chairman Camp's Tax Reform Draft - Analysis of Bond Provisions and Politics.

We wanted to provide an overview prepared for BDA by Urban, Swirski & Associates of the politics and next steps surrounding the release last week of Ways and Means Committee Chairman Dave Camp's tax reform proposal. Note that the proposal is simply a "draft," and not a bill, and is not expected to be considered for passage by the Ways and Means Committee at this time. However, any of the items within the proposal could appear in future tax legislation or proposals designed to raise revenue for either spending cuts or to balance the budget.

Also, the following is a revised summary of the proposal that provides a few additional details regarding the bill's provisions that would affect municipal bonds:

New Surtax for High Earners Includes Tax Exempt Bond Interest

Essentially, a 10 percent "surtax" on municipal bonds. Create new 10 and 25 percent individual tax brackets, plus a 10 percent "surtax" on top of the 25 percent tax bracket that applies to a modified adjusted gross income (MAGI) above $400,000 for singles and $450,000 for married couples that would, among other deductions and exemptions, apply to interest on tax exempt bonds – both new issues and outstanding bonds.

Treatment of Deductible Interest Expense and Tax-Exempt Interest Income

The proposal repeals the special treatment for bank-qualified bonds, eliminating tax relief needed for banks to be able to, economically, purchase tax-exempt bonds from small issuers. This provision could create challenges for BDA's effort to raise from $10 million to $30 million issuance dollar limits that can qualify as bank-qualified bonds.

Related provisions establish somewhat less flexible tax rules for corporate investors in tax-exempt bonds than those applicable under current law. Corporations would now be included in rules that currently apply to financial institutions and dealers in tax-exempt obligations. These rules disallow an interest deduction for investment interest based upon the percentage of the taxpayer's assets comprised of tax-exempt obligations. Moreover, for individual investors in tax-exempt bonds, the proposal would permanently reduce any deductions for investment-interest by the amount of tax-exempt interest received.

Repeal of Interest Exclusions for Tax-Preferred Bonds and Advance Refundings

Repeal the interest exclusion for future issuances of private activity bonds.

Repeal the interest exclusion for future issuances of advance refunding bonds.

Generally repeal tax credit bond programs, such as Qualified Zone Academy Bond, Clean Renewable Energy Bond and other programs. Bondholders and issuers would continue receiving tax credits and payments for tax credit bonds already issued, but no new bonds could be issued (this particularly would affect QZABs as other tax credit bond programs are generally already cancelled).

Repeal the exclusion for interest on United States savings bonds used to pay qualified higher education expenses.

Modify the Tax Treatment of “Market Discount” and Bond Premium

Similar to prior Ways and Means proposals and last year’s Administration buget, the proposal would require purchasers of bonds at a discount on the secondary market to include the discount in taxable income over the post-purchase life of the bond, rather than only upon retirement of the bond or resale of the bond by the purchaser. Any loss that results from the retirement or resale of such a bond would be treated as an ordinary (rather than capital) loss to the extent of previously accrued market discount. The provision would limit taxable secondary market discount to an amount that approximates increases in interest rates since the loan was originally made: the greater of (1) the original yield on the bond plus 5 percentage points, or (2) the applicable Federal rate plus 10 percentage points.

Modify bond premium amortization deductions to be allowed as above-the-line deductions (without regard to whether a taxpayer itemizes deductions); this is primarily a conforming change given the new tax regime established by the bill.

Repeal Tax-Favored Treatment for Specialized Local Infrastructure Programs

Repeal the 4% Low Income Housing Tax Credit and make a variety of changes to the program — beyond the private activity bond repeal.

Repeal a number of expired programs, underscoring the Chairman’s apparent desire to update the Code and also prevent extension or expansion of the programs, including:

Enterprise Communities and Empowerment Zones and the associated special tax benefits (including access to expanded tax-exempt bond eligility and QZABs).

Liberty Zone and GO Zone designations and the associated special tax benefits (including access to QZABs).

DC Zone tax benefits (including access to expanded tax-exempt bond eligibility and QZABs).

Favorable tax treatment for renewal communities, including access to QZABs.

Conclusion

The changes in treatment of bonds should be viewed in the context of other provisions overhauling the tax code and affecting the financial services sector, taxpayers and investors, including favorable treatment for capital gains and dividends, taxing those provisions as ordinary income with 40 percent excluded from taxation; and, a highly controversial quarterly tax of 3.5 basis points on banks and insurance companies with over $500 billion in assets. In addition, state and local governments will be pulled in many directions given the multitude of provisions that affect them in the draft – not the least of which is the repeal of the state and local tax deduction.