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Obama Again Proposes 28% Cap, AFF Bonds in Fiscal 2015 Budget.

WASHINGTON — President's Obama $3.9 trillion fiscal 2015 budget, released Tuesday, proposed capping the value of the tax exemption for municipal bond interest at 28%, which market participants complain would amount to an unprecedented tax on municipal bonds.

The 28% cap, which he has offered in previous budgets, is similar to the 25% cap on the value of the muni exemption proposed by Rep. Dave Camp, R-Mich., in his draft tax reform legislation last week.

The proposal drew disappointment from market participants. "I think something is being lost here," said Susan Collet, senior vice president of government relations for the Bond Dealers of America. "These tax-exempt bonds are standing behind public infrastructure we can all feel good about."

"Municipal bonds play a key role in funding state and local infrastructure projects like hospitals and schools, which are essential to creating jobs and growing our economy," said Michael Decker managing director and co-head of municipal securities for the Securities Industry and Financial Markets Association. "Taxing municipal bonds is counter-productive to the goal of economic growth, as the tax could raise capital costs for state and local governments and discourage investment in job-creating infrastructure projects."

While neither Obama's budget nor Camp's tax-reform draft plan are likely to be enacted this year, market participants are troubled by the similar treatment of the muni exemption in the proposals.

The muni exemption is "out there as a target" for tax reform, said Utah Treasurer Richard Ellis, who is president of the National Association of State Treasurers.

"This will be a continuing issue for years to come," said Chuck Samuels, an attorney at Mintz Levin and counsel to the National Association of Health & Higher Education Facilities Authorities.

The president's budget also would in put in place the so-called Buffett Rule, requiring high-income households to pay at least 30% of their income, after charitable giving, in taxes.

Obama also re-proposed an America Fast Forward Bond program, which would build on the Build America Bond program. AFF bonds would be direct-pay bonds with a 28% subsidy rate that could be used for the same kinds of projects financed by BABs but also for projects that could be financed with qualified private activity bonds.

"The president's America Fast Forward Bonds program might be an option for attracting private investment in infrastructure," said Large Public Power Council Chairman Bill Gaines in a statement. "However, it should not be a replacement for the stable and mature municipal bond market."

Ellis said that the 28% subsidy rate for AFF bonds as opposed to the higher 35% subsidy rate for BABs could make AFF bonds less attractive for issuers.

The budget would shield AFF bond subsidy payments from sequestration cuts, but does not seem to do the same for payments for outstanding BABs.

Bill Daly, director of governmental affairs for the National Association of Bond Lawyers, said that he thinks the Obama administration recognized that if it wants issuers to accept direct-pay bonds, they had to address the sequestration issue. It is “unfortunate” the budget did not address sequestration for BAB payments, he said.

Obama’s proposed budget would boost private investment in infrastructure through a Rebuild America Partnership, establishing an independent National Infrastructure Bank to leverage private and public capital to support infrastructure projects of national and regional significance.

Camp was critical of Obama’s budget, saying it “adds more complexity to the tax code and increases taxes for more Washington spending.”

While Camp’s proposal would end the tax-exemption for private activity bonds after 2014, Obama’s budget eases several current restrictions for PABs. The president would eliminate state volume caps for PABs used for water furnishing and sewage facilities. “These bonds are intended to complement Environmental Protection Agency and local efforts to finance water quality improvement projects in the United States,” Treasury Department officials said in their green book explanation of the president’s tax proposals.

Obama would also allow tax-exempt PABs to be issued to finance airports, docks, wharves and mass commuting facilities even if they are not owned by a governmental unit. “The administration has consistently emphasized the importance of infrastructure investment and the role that private capital can play in enhancing such investment,” Treasury officials said.

The president’s budget would except tax-exempt private activity bonds used for research facilities from the more than 10% private use restriction as long as they were owned by a state, locality or nonprofit entity and the issuer is permitted to enter into a bona fide arm’s length contractual arrangement with a private business sponsor of the research for sharing the economic benefits from any resulting products. Under current tax law PABs are not “qualified” and therefore tax-exempt if more than 10% of the proceeds are for private use and more than 10% of the debt service is paid or secured by private business or property and they do not fall into one of several specific categories.

Obama would also repeal the five percent unrelated or disproportionate private business test use test to simplify the private business limits on tax-exempt PABs. Under current law, the 10% business use test is reduced to 5% if the private use is unrelated or disproportionate to the governmental use of a project. Treasury officials said in the green book that this test “requires difficult factual determinations regarding the relationship of private business use to governmental use in financed projects” and is “difficult to apply, particularly in governmental bond issues that finance multiple projects.”

Obama also would increase to 35% from 25% the land acquisition restriction on certain PABs. Current law generally restricts bonds from being tax-exempt PABs if it is part of an issue where 25% or more of the net proceeds are to be used for the acquisition of land. Treasury officials said the 25% restriction must be eased because land costs have increased steadily over the years.

In addition, the president would repeal to $150 million limit on the volume of outstanding, non-hospital tax-exempt 501(c)(3) bonds. This restriction was created by the 1986 Tax Reform Act but repealed in 1997 with respect to bonds issued after Aug. 5, 1997, if at least 95% of the net proceeds were used to finance capital expenditures incurred after that date. As a result, the limitation continues to apply to bonds where more than five percent of the net proceeds are used to finance or refinance working capital or capital expenditures incurred on or before Aug. 5, 1997. “Repealing the limitation would enable nonprofit universities to utilize tax-exempt financing on a basis comparable to public universities,” Treasury officials said in the green book.

Obama would repeal the purchase price and refinancing limitations on single-family mortgage revenue bonds. Under current law these bonds can only be used when a mortgagor’s income is generally not more than 115% of applicable median family income. The limit is higher in certain high-cost areas. Treasury officials said these targeting requirements “are complex and excessive” and the restriction against refinancing “limits the availability of this lower cost borrowing subsidy as a tool to address needs for affordable mortgage loan refinancing within a needy class of existing low- and moderate-income homeowners.”

The budget would put Indian tribal governments on a par with state and local governments and eliminate the restriction that tribal bonds only be used for projects with an “essential government function.” Tribal governments could issue private-activity bonds under volume caps.

The community development block grant program would receive $2.8 billion in budget authority, which is $230 million less than the enacted level for the current fiscal year. But the budget also proposes reforms designed to improve the program’s performance.

The budget proposes $1.8 billion for the clean and drinking water state revolving loan funds, which is $581 million below the enacted level for fiscal 2014. The reduction was proposed to focus on communities that most need assistance.

BY NAOMI JAGODA

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Lynn Hume and Kyle Glazier contributed to this story.