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Obama's Proposed 2016 Budget Seeks to Address Infrastructure Needs: Ballard Spahr

The Obama administration's proposed 2016 budget, released on February 2, 2015, reflects the administration's commitment to finding ways to finance the country's growing infrastructure requirements. The 2016 budget includes many of the tax-exempt bond proposals previously introduced in the administration's 2014 and 2015 budgets, as well as four new bond proposals.

Highlighted below are the new bond proposals:

Provide a New Category of Qualified Private Activity Bonds for Infrastructure Projects -Qualified Public Infrastructure Bonds

The administration proposes a new category of tax-exempt qualified private activity bonds called Qualified Public Infrastructure Bonds (QPIBs) that are eligible to finance specific categories of facilities financed with exempt facility bonds under current law. A significant aspect of this proposal is that, unlike other categories of qualified private activity bonds (PABs), QPIBs are not subject to the bond volume cap requirement and the alternative minimum tax (AMT) preference for interest on qualified PABs. For years, advocates of qualified PABs have requested that bonds not be subject to AMT, thereby putting them on the same footing as governmental bonds. Also, proponents of qualified PABs have argued that the volume cap requirement hinders the use of these bonds for larger projects such as sewage and water facilities. The QPIB proposal addresses both concerns.

Facilities eligible for QPIB financing include airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, and qualified highway or surface freight transfer facilities. The proposal imposes two core eligibility requirements for QPIBs: a governmental ownership requirement and a public use requirement. The proposal provides a safe harbor for establishing governmental ownership of financed projects so that property leased by a governmental unit is treated as owned by the governmental unit if the lessee makes an irrevocable election (binding on the lessee and all successors in interest under the lease) not to claim depreciation or an investment credit related to such property, the lease term is not more than 80 percent of the reasonably expected economic life, and the lessee has no option to purchase the property other than at fair market value (at the time the option is exercised).

Existing categories of exempt facilities that overlap with QPIBs would be removed on the effective date of the proposal (which applies to bonds issued starting January 1, 2016), subject to a transitional exception for qualified highway or surface freight transfer facilities. Alternatively, the proposal provides that Congress consider continuing the existing categories of exempt facilities that overlap with QPIBs for privately owned projects, subject to the unified annual state bond volume cap.

Qualified highway or surface freight transfer facilities are eligible for QPIBs at the same time as other eligible facilities when QPIBs become available and the existing category of exempt facility bonds also continues to be available until the Secretary of Transportation has allocated the existing

$15 billion of authorization (and the additional $4 billion proposed by the administration in one of its other proposals).

Modify Qualified Private Activity Bonds for Public Educational Facilities

Under existing law, tax-exempt private activity bonds may be issued for “qualified public educational facilities” under section 142(k) that are part of public elementary or secondary schools. The current rules require that a private corporation own the public school facilities under a public-private partnership agreement with a public state or local educational agency and that the private corporation transfer the ownership of the school facilities to the public agency at the end of the term of the bonds for no additional consideration. A special separate annual volume cap (equal to $10 multiplied by the state’s population or $5 million, whichever is greater) applies to these bonds.

The proposal eliminates the private corporation ownership requirement and allows any private person, including private entities organized in ways other than as corporations (such as partnerships, limited liability companies, or sole proprietors) either to own the public school facilities or to operate those school facilities through a lease, concession, or other operating agreement. The aim of the proposal is to encourage use of these types of bonds. To date, no bonds have been issued under this category because of the constraint that only private corporations may own the school facilities. The proposal goes one step further by removing the separate volume cap for qualified public educational facilities and instead including these facilities under the unified annual state bond volume cap for private activity bonds. The proposal is effective for bonds issued after the date of enactment.

Modify Treatment of Banks Investing in Tax-Exempt Bonds

For tax-exempt bonds issued in 2009 and 2010, the American Recovery and Reinvestment Act of 2009 (ARRA) established a temporary rule that lifted the total prohibition on deducting the interest expense allocable to tax-exempt bonds, which permitted the 80 percent deduction. Bonds that benefited from this rule could not exceed 2 percent of the taxpayer financial institution’s total assets. ARRA also modified the definition of “qualified small issuer” to allow up to $30 million of these bonds instead of the previously allowed $10 million. For 501(c)(3) bonds, the $30 million limit, unlike the pre-ARRA $10 million limit, applied at the borrower level rather than the issuer level. For conduit financings and composite or pooled issues where each borrower is a 501(c)(3), each borrower was treated as a separate issuer for the applicable qualified portion borrowed. The administration proposes to permanently expand the qualified small issuer limit in the definition of qualified tax-exempt obligations to include issuers of up to $30 million of tax-exempt bonds annually.

However, the proposal does not appear to expand the limit at the borrower level. During ARRA, increasing the $10 million limit to $30 million proved to be a very successful way to expand the tax-exempt market. The proposal aims to capture the same benefits of that time period on a long-term basis. Beginning with bonds issued in 2016, the proposal permanently implements the ARRA exception that allowed financial institutions to deduct up to 80 percent of interest expenses allocable to any tax-exempt bonds. This exception would continue to be limited to 2 percent of the taxpayer’s assets.

Repeal Tax-Exempt Bond Financing of Professional Sports Facilities

Currently, professional sports stadiums can be financed with tax-exempt governmental bonds, even if use by a professional sports team of a bond financed facility exceeds 10 percent of the facility’s total use, if the debt service is paid from sources other than sports facility revenues or other private payments, such as generally applicable taxes.

For years, there have been public debates (including congressional hearings) on whether sports facilities should be financed with tax-exempt bonds. Opponents argue that tax-exempt bond financing should not be used to benefit private sport team owners but should be available to construct a sports facility for the team. The administration's proposal eliminates the private payment test for professional sports facilities so that bonds issued to finance these facilities would have to be taxable bonds if more than 10 percent of the facility is used for private business. The proposal is effective for bonds issued after December 31, 2015.

28 Percent Cap and other Prior Years' Proposals Included

While the administration continues to show strong support for encouraging the financing of infrastructure projects, the 2016 budget includes the proposal from the prior years' budgets to limit the tax rate where upper-income taxpayers can use itemized deductions and other tax preferences, including interest on tax-exempt bonds to reduce the tax liability to a maximum of 28 percent. This limitation would reduce the value of the specified exclusions and deductions that would otherwise reduce taxable income in the top three individual tax rate brackets of 33 percent, 35 percent, and 39.6 percent to 28 percent.

For the last few years, opponents have strenuously argued that the 28 percent cap proposal would severely limit investor appetite for tax-exempt bonds and should be eliminated. In response, the administration has noted that the proposal should not be viewed as a direct attack on tax-exempt bonds but rather as part of a broader reform of tax expenditures.

Other proposals carried over from the administration's 2014 and 2015 budgets are the America Fast Forward Bond proposal (a broader category of taxable bonds similar to Build America Bonds at a 28 percent subsidy rate), as well as proposals to:

- Allow current refundings of state and local governmental bonds
- Repeal the $150 million non-hospital bond limitation on qualified section 501(c)(3) bonds
- Increase the national limitation amount for qualified highway of surface freight transfer facility bonds
- Allow more flexible research agreements for purposes of private business use limits
- Modify tax-exempt bonds for Indian tribal governments
- Simplify arbitrage investment restrictions and single-family housing mortgage bond targeting requirements
- Streamline private business limits on governmental bonds

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Attorneys in Ballard Spahr's Public Finance Department have participated in every kind of private activity financing, including exempt facility bonds, qualified 501(c)(3) bonds, and exempt facility bonds.

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