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Expiring Tax Provisions Dramatically Change Municipal Finance Landscape

What the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Act") did not authorize-rather than what it did-will more dramatically affect the municipal finance market and the borrowing practices of state and local governments. This alert highlights briefly the municipal finance provisions of the Act.

Publicly viewed as extending the "Bush tax cuts" and further extending unemployment benefits, the Act failed to reauthorize many municipal finance provisions that therefore expired on December 31, 2010, including the Build America Bond ("BAB") program, the increased small-issuer limit for bank-qualified bonds, and other provisions created by the American Recovery and Reinvestment Act ("ARRA").

Expiration of BAB Program

After nearly $180 billion in debt had been issued since its introduction in ARRA, the BAB program and its popular direct-pay interest subsidy feature expired on December 31, 2010. The BAB program had appealed to many governmental issuers because of the federal government's commitment to directly subsidize 35% of the issuer's interest payments on BABs, and because these *taxable* municipal obligations had attracted to the long-term municipal market numerous investors who had previously been absent because of their lack of appetite for tax-exempt debt.

Bank Qualification Changes

ARRA had changed the requirements for a bond to be considered "bank qualified"-*i.e.,* exempt from the automatic cost-of-carry deduction disallowance for financial institution holders. Prior to ARRA, banks had been restricted to deducting 80% of the cost of buying and carrying tax-exempt bonds sold by small issuers whose annual bond issuance was less than $10 million. ARRA had both increased that annual limitation to $30 million and treated 501(c)(3) conduit borrowers and individual borrowers in a pooled issue as separate issuers for purposes of the bank qualification requirements. These provisions were not extended by the Act, and the bank qualification requirements have reverted to the old rule ($10 million annual limitation at municipal-issuer level).

Loss of *De Minimis* Rule for Financial Institutions

Under a *de minimis* safe harbor tax provision, most corporations are allowed to deduct their cost of borrowing to buy tax-exempt bonds as long as such bonds comprise no more than 2% of their total assets. ARRA had extended a limited version of this safe harbor to financial institutions (which previously had not been covered) by authorizing them to deduct 80% of their interest expense in 2009 and 2010 to the extent that their holdings in tax-exempt bonds were less than 2% of their total investments. This limited extension of the safe harbor to financial institutions was also allowed to expire.

Loss of Alternative Minimum Tax "Holiday"

Prior to ARRA, interest on tax-exempt, non-housing and non-501(c)(3) private activity bonds had been subject to the individual alternative minimum tax ("AMT"), and interest on all tax-exempt private activity bonds except housing bonds had been subject to the corporate AMT. ARRA had repealed application of both the individual and corporate AMT for all tax-exempt bonds issued in 2009 and 2010 except for refundings of bonds originally issued before 2004, providing a tax "holiday" for interest on these private activity bonds from treatment as a preference item for purposes of the AMT. This alternative minimum tax "holiday" was also allowed to expire.

Loss of Additional New ARRA Bonds

ARRA had created several new categories of tax credit bonds and tax-exempt bonds, including Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds, the former of which could have been used for infrastructure, job training, education, and economic development in areas hit hard by unemployment, and the latter of which could have been used to finance any activity (other than housing and certain standard prohibited uses) of a "qualified business" in a "recovery zone." As with BABs, authorization for these bonds is no longer available.

Some Programs Continue

The Act did extend through December 31, 2012, two school-bond-related provisions that otherwise would have expired: first, the increase in the "small issuer" exception from arbitrage rebate requirements to include issuers that issue $15 million or less of bonds in a year so long as bonds exceeding the prior $5 million limit are used to finance public school construction expenditures, and second, the exemption from state volume cap limitations for tax-exempt private-activity bonds issued for public school facilities owned by private, for-profit corporations but operated by public entities, in amounts up to $10 per capita or $5 million.

The Act also extended Qualified Zone Academy Bonds through 2011, and provided for a $400 million increase in authority, but only as tax-credit bonds without a direct-pay interest subsidy option for 2011 allocations (including carryforwards of unused 2011 allocations). The Act did not, however, affect bonds issued under carryforwards of 2009 or 2010 allocations. New York Liberty Zone Bonds, Gulf Opportunity Zone Bonds, and District of Columbia Empowerment Zone Bonds were also extended through 2011.

Impact

It is possible that legislation could be introduced in the future to reinstate some or all of the expired bond provisions described above. Even if this were to occur, the issuance of municipal debt remains in the spotlight of tax and securities regulators. Nonetheless, governmental issuers continue to operate under significant financial stress and continue to have borrowing needs. The Day Pitney municipal finance attorneys listed to the right of this alert are available to assist you in understanding the impact of the expiration of the programs discussed above, and otherwise to address your financing needs in this challenging environment. Please feel free to call on us.