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Expiration of Certain Municipal Bond Tax Provisions

In the absence of congressional action, many tax laws affecting municipal bonds will change significantly at the end of 2010. This Alert focuses on two of those possible changes: (1) of import to small issuers, the scheduled elimination of the 2001 increase to the small issuer exception to the arbitrage rebate requirement to accommodate certain public school project financings; and (2) of import to small issuers, pooled-financing and 501(c)(3) conduit borrowers, the scheduled expiration of the enhanced bank qualification provisions of the American Recovery and Reinvestment Act ("ARRA").

(1) Small Issuer Arbitrage Rebate Exception

Prior to 1998, bonds issued by a governmental issuer were not subject to the arbitrage rebate requirements if the issuer reasonably expected to issue not more than $5 million in aggregate face amount of tax-exempt bonds (other than private activity bonds) during the calendar year in which such issue was issued and if certain other criteria were satisfied. Legislation passed in 1997 increased the $5 million cap to $10 million, provided that the amount of bonds in excess of $5 million was used to finance public school construction, reconstruction, or rehabilitation expenditures ("public school projects"). Legislation passed in 2001 increased the $5 million cap to $15 million, provided that the amount of bonds in excess of $5 million was used to finance public school projects. That 2001 legislation is scheduled to expire at the end of this year.

If the 2001 legislation is allowed to expire, issuers may still be "small issuers" that may benefit from the arbitrage rebate exception as long as they do not issue more than $10 million of tax-exempt bonds in a calendar year, the amount of bonds in excess of $5 million is used to finance public school projects, and the other required criteria are met. These other criteria are: (a) the issuer must be a governmental unit with general taxing powers, (b) no bond that is part of the issue may be a private activity bond, and (c) 95 percent or more of the net proceeds of the issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer).

(2) Bank Qualification

The ARRA changed the requirements for a bond to be "bank qualified" - i.e., exempt from the disallowance of the "cost of carry" deduction for financial institution bondholders. Bank qualified bonds are attractive to financial institutions and generally bear lower interest rates than do similar non-bank qualified bonds. Prior to the ARRA, banks were restricted to deducting 80 percent of the cost of buying and carrying tax-exempt bonds sold by small issuers whose calendar year bond issuance was not more than $10 million. The ARRA increased the amount of bank qualified bonds available for financial institutions to purchase by (a) increasing the bank qualified issuer calendar year limitation from $10 million to $30 million and (b) allowing 501(c)(3) conduit and pooled-financing borrowers to be treated as the issuers (rather than the actual governmental issuers) for purposes of the bank qualification requirements. Both of these ARRA provisions are scheduled to expire at the end of this year.

The tax law, securities law, and regulatory landscape of municipal finance is changing dramatically. This Alert highlights only two of the possible significant changes. We look forward to providing further Alerts to keep you advised of additional changes. Please contact any of the attorneys listed on the side of this Alert to discuss how these changes might affect you.