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Proposed Tax Reform Act of 2014: Changes Affecting Tax-Exempt Bond Related Provisions

Federal income tax reform has been the subject of numerous congressional discussions and committee hearings over the last year. On February 26, 2014, Representative David Camp, chair of the House Ways and Means Committee, released draft legislation referred to as the Tax Reform Act of 2014 that proposes to amend major portions of the Internal Revenue Code to provide for comprehensive tax reform. An overarching goal of the proposed legislation is to reduce both corporate and individual tax rates and to pay for those rate reductions by eliminating many tax breaks.

The following is a summary of significant proposed changes affecting the tax-exempt bond provisions of the Internal Revenue Code included in the draft legislation. We have also prepared summaries of other provisions relevant to other topical areas - please check our website for those. Although the Tax Reform Act of 2014 has not yet been formally introduced as a bill, and its prospects for passage are uncertain at this point, given the significant nature of the proposed reforms, we will monitor their progress and provide updates as warranted.

Inclusion of Tax-Exempt Interest in the Calculation of the Tax Base for Certain Higher Income Taxpayers

The proposal would replace the individual income tax rate structure with a new rate structure that generally includes three tax rates: a 10 percent rate, a 25 percent rate and a 35 percent rate. The 35 percent rate is composed of the 25 percent rate imposed on taxable income in excess of the 25 percent rate bracket threshold and an additional 10 percent tax on *modified adjusted gross income* in excess of $450,000 for joint returns ($400,000 for all other taxpayers). Modified adjusted gross income would include, among other things, all tax-exempt interest; therefore, individuals with these incomes would pay a 10 percent federal income tax on their interest income on tax-exempt bonds. This provision would apply to all tax-exempt bond interest, regardless of when the bonds were issued, and would therefore apply to interest on currently outstanding bonds. Additionally, the benefit of the 10 percent rate as measured against the 25 percent rate on taxable income is phased out if an individual's modified adjusted gross income exceeds $300,000 for joint filers (or $250,000 for other taxpayers). The benefit amount is phased out at a 5 percent rate, and is fully phased out at a modified adjusted gross income of $513,600 for joint filers or $356,800 for other taxpayers. Because such phaseout is based on modified adjusted gross income, which includes tax-exempt interest, these individuals would effectively pay a 5 percent federal income tax on their interest income from tax-exempt bonds.

Elimination of Bank Qualified Bonds and Greater Restrictions on Interest Expense Deductions Allocable to Purchasing or Carrying Tax-Exempt Obligations

Current law generally disallows a deduction for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Under current law, absent direct tracing linking an individual taxpayer's indebtedness to the purchase or carrying of tax-exempt obligations, the IRS takes the position that it ordinarily will not infer that a taxpayer's purpose in borrowing money was to purchase or carry tax-exempt obligations if the taxpayer's investment in tax-exempt obligations is insubstantial, *i.e.*, the average adjusted basis of the individual's tax-exempt obligations is two percent or less of the average adjusted basis of the individual's portfolio assets and assets held by the individual in the active conduct of a trade or business. The same substantiality test applies to corporations that are not financial institutions or dealers in tax-exempt obligations.

With respect to financial institutions, current law generally disallows the deduction of a portion of a financial institution's interest expense that is allocable to tax-exempt interest (with certain limited exceptions). The amount of interest expense disallowed is the amount that bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986 bears to the average adjusted bases for all of the financial institution's assets. However, certain tax-exempt obligations issued during 2009 or 2010 and certain bonds issued to refund these bonds, in an amount up to two percent of the average adjusted basis of the financial institution's assets, are not taken into account in determining the portion of the financial institution's interest expense subject to this pro rata interest expense deduction disallowance rule. In addition, a "qualified tax-exempt obligation" (commonly referred to as a "bank qualified bond") is not taken into account in determining the portion of a financial institution's interest expense deduction subject to the pro rata interest expense deduction disallowance rule. Certain requirements must be met for an issuer to issue a bank qualified bond.

The proposal would expand the present rule applicable to financial institutions to all C corporations such that no deduction is allowed for the portion of the taxpayer's interest expense that is allocable (using the pro rata rule currently applicable to financial institutions) to tax-exempt interest for tax years ending on or after February 26, 2014. The proposal would also repeal the exception for bank qualified bonds for obligations issued on or after February 26, 2014 and repeal the special exception for certain bonds issued to refund bonds issued in 2009 or 2010 for obligations issued on or after February 26, 2014.

In the case of a taxpayer other than a corporation, under the proposal, the current rules on disallowing the deduction for interest attributable to tax-exempt interest would be repealed. Instead, the deduction otherwise allowable for investment interest for any taxable year would be reduced by the amount of tax-exempt interest received by the taxpayer during the year. The limitation on investment interest would apply to taxable years beginning after December 31, 2014.

Repeal of the AMT

Under current law, interest on certain private activity bonds is treated as an item of tax preference for purposes of the calculation of the alternative minimum tax for individuals and corporations. In addition, tax-exempt interest (with limited exceptions) is generally included in the calculation of adjusted current earnings, which is used as an adjustment in determining the federal alternative minimum tax for certain corporations.

The proposal would repeal the individual and corporate alternative minimum tax for taxable beginning after December 31, 2014.

Termination of Tax Exemption for Private Activity Bonds, Including 501(c)(3) Bonds

Under current law, the interest on qualified private activity bonds is not included in the gross income of the holders thereof for Federal income tax purposes.

The proposal includes a provision that repeals the exemption from gross income for interest paid on qualified private activity bonds, including exempt facility bonds, qualified mortgage bonds, veterans' mortgage bonds, small issue bonds, redevelopment bonds, qualified 501(c)(3) bonds and student loan bonds. The proposal would apply to bonds issued after December 31, 2014. The proposal would also eliminate the ability to issue mortgage credit certificates after December 31, 2014.

Repeal of Tax Exemption for Advance Refunding Bonds

Under current law, tax-exempt bonds can to be issued to advance refund another bond, with certain limits. An advance refunding bond is a bond that is issued more than 90 days before the redemption of the refunded bond.

The proposal includes a provision that repeals the exemption from gross income for interest on any bond issued to advance refund a bond. The proposal would apply to bonds issued after December 31, 2014.

Repeal of Tax Credit Bonds (Including Direct Pay Tax Credit Bonds)

Under the proposal, the authority for the issuance of tax credit bonds and direct pay tax credit bonds, including new clean renewable energy bonds, qualified energy conservation bonds, qualified school construction bonds and qualified zone academy bonds, would be prospectively repealed. The repeal of the authority would be effective for all bonds issued after the date of enactment of the proposal. Therefore, any unused volume cap for such tax-credit bonds and direct pay tax credit bonds would terminate.

For More Information

For more information, please contact your primary attorney at Chapman and Cutler or visit us online at www.chapman.com.

To the extent that any part of this summary is interpreted as being tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

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