OVERVIEW OF SELECTED TAX PROVISIONS RELATING TO THE FINANCING OF SURFACE TRANSPORTATION INFRASTRUCTURE

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on July 10, 2008

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 8, 2008
JCX-56-08

CONTENTS

INTRODUCTION AND SUMMARY

The Senate Committee on Finance has announced a public hearing to examine financing for surface transportation infrastructure. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law provisions relating to Highway Trust Fund and its dedicated taxes, a description of tax-exempt financing that is available for certain transportation infrastructure and a general description of tax credit bonds.

The Highway Trust Fund was established in 1956. It is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs. The Highway Trust Fund is funded by taxes on motor fuels (gasoline, kerosene, diesel fuel, and certain alternative fuels), a tax on heavy vehicle tires, a retail sales tax on certain trucks, trailers and tractors, and an annual use tax for heavy highway vehicles. Although baseline receipts for the Highway Trust Fund are projected to grow each fiscal year, the Congressional Budget Office ("CBO"), the Government Accountability Office, and the Administration have projected that the Highway Account will be unable to meets its obligations at some point during fiscal year 2009. The current expenditure authority for the Highway Trust Fund generally expires October 1, 2009. Expenditures are limited by an internal anti-deficit provision, which requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 48-month period beginning at the close of each fiscal year. If there is an excess, apportionments to the States under the Highway Trust Fund are reduced by that amount.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt, governmental bonds to finance a broad range of transportation infrastructure projects, including highways, railways, airports, etc. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the extent to which private parties may benefit from such financing. State and local governments may issue qualified private activity bonds for certain transportation infrastructure such as airports, port facilities, mass commuting facilities, high-speed intercity rail facilities and qualified highway or surface freight transfer facilities.

Unlike tax-exempt bonds, tax credit bonds are not interest-bearing obligations. Rather the taxpayer holding a tax credit bond on a credit allowance date is entitled to a tax credit. Although there have been several bills seeking to provide tax credit bonds for transportation infrastructure, present law does not authorize the issuance of tax credit bonds for transportation infrastructure.

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Selected Tax Provisions Relating to the Financing of Surface Transportation Infrastructure*, (JCX-56-08), July 8, 2008. This document also can be found on our website at www.jct.gov.

I. OVERVIEW OF HIGHWAY TRUST FUND EXCISE TAXES

Present Law

The Highway Trust Fund

The Highway Trust Fund was established in 1956 to coordinate the Federal role in highway construction and maintenance activities, including the development of the then-new Interstate Highway System. The Highway Trust Fund is divided into two accounts, a Highway Account and a Mass Transit Account, each of which is the funding source for specific programs.[2] Highway Trust Fund expenditure purposes have been revised with the passage of each authorization Act enacted since the establishment of the Highway Trust Fund in 1956. In general, expenditures authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent such authorizing Act) are approved Highway Trust Fund expenditures purposes under the Code. Expenditures from the Highway Trust Fund are authorized through September 29, 2009 (September 30, 2009 in the case of expenditures for administrative expenses).

Most Federal surface transportation programs funded by the Highway Trust Fund span four major areas of investment: highway infrastructure, transit infrastructure and operations, highway safety, and motor carrier safety.[3] The funds are distributed either by formula or on a discretionary basis through several individual grant programs.[4]

Revenue Sources for the Highway Trust Fund

Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. The remaining three are a retail sales tax on heavy highway vehicles (trucks, trailers and certain tractors), a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. As shown in Figure 1 below, a substantial majority of the revenues produced by the Highway Trust Fund excise taxes is derived from the taxes on motor fuels.

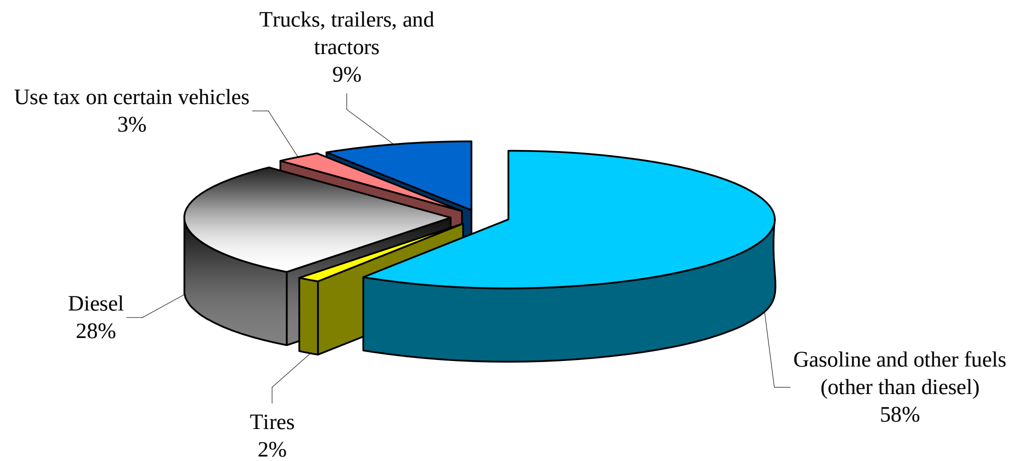
---

[2] Sec. 9503. All section references are to the Internal Revenue Code of 1986 ("the Code") unless otherwise indicated.

[3] Government Accountability Office, *Surface Transportation: Restructured Federal Approach Needed for More Focused, Performance-Based and Sustainable Programs* (GAO-08-400, March 2008) at 6.

[4] *Id*. at 6-7.

Figure 1.–Highway Trust Fund Taxes for Fiscal Year 2007



For fiscal year 2007, the Internal Revenue Service collected $9,919 million in diesel fuel taxes, $25,156 million in taxes on gasoline and other fuels, $2,871 million from the retail sales tax on heavy highway vehicles, $1,076 million from the annual use tax, and $434 million from the tax imposed on heavy vehicle tires. Except for 4.3 cents per gallon of the Highway Trust Fund fuels tax rates, all of these taxes do not apply after September 30, 2011. The 4.3-cents-per-gallon portion of the fuels tax rates is permanent.[5] The taxes dedicated to the Highway Trust Fund are summarized below.

[5] This portion of the tax rates was enacted as a deficit reduction measure in 1993. Receipts from it were retained in the General Fund until 1997 legislation provided for their transfer to the Highway Trust Fund.

Highway motor fuels taxes

The Highway Trust Fund motor fuels tax rates are as follows: [6]

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon[7]
Alternative Fuels	24.3 and 18.3 cents per gallon[8]

The Code imposes tax on gasoline, diesel fuel, and kerosene ("taxable fuels") upon removal from a refinery or on importation, unless the fuel is transferred in bulk by registered pipeline or barge to a registered terminal facility.[9] Typically, these fuels are transferred by pipeline or barge in large quantities ("bulk") to terminal storage facilities that geographically are located closer to destination retail markets. The fuel is then taxed when it "breaks bulk," i.e., when it is removed from the terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The majority of the fuel taxes are imposed upon removal at the terminal. The party liable for payment of the taxes is the "position holder," i.e., the person shown on the records of the terminal facility as controlling the fuel.[10]

All persons controlling taxable fuels before tax is paid must be registered with the IRS.[11] Additionally, terminal facilities must register with the IRS as a condition of storing untaxed (or undyed) taxable fuels. Sale or other transfer of fuel to an unregistered party or removal to an unregistered facility before the fuel breaks bulk results in imposition of tax on that transaction. If the fuel subsequently is entered into and removed from a registered terminal, a second tax is imposed. Refund claims are allowed to prevent double taxation.

---

[6] These fuels are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund (secs. 4041(d) and 4081(a)(2)(B)). That tax is imposed as an "add-on" to other existing taxes.

[7] Diesel-water emulsions are taxed at 19.7 cents per gallon (sec. 4081(a)(2)(D)).

[8] The rate of tax is 24.3 cents per gallon in the case of liquefied natural gas, any liquid fuel (other than ethanol or methanol) derived from coal, and liquid hydrocarbons derived from biomass. For purposes of this pamphlet "alternative fuel" includes compressed natural gas. The rate for compressed natural gas is 18.3 cents per energy equivalent of a gallon of gasoline. *See* sec. 4041(a)(2) and (3).

[9] Sec. 4081(a)(1).

[10] A special rule applies to "two-party exchanges" (sec. 4105). It is common practice for oil companies to serve customers of other oil companies under exchange agreements, e.g., where Company A's terminal is more conveniently located for wholesale or retail customers of Company B. In such cases, the exchange agreement party (Company B in the example) is treated as owning the fuel when sold to B's customer is the requirements of section 4105 are met.

[11] Sec. 4101.

In general, fuel removed from a registered terminal facility is subject to tax, without regard to whether the ultimate use of the fuel is taxable (e.g., non-taxable use for heating or on a farm for farming purposes). Exceptions are provided allowing diesel fuel and kerosene to be removed for a non-taxable use or in a train if the fuel is indelibly dyed at the time of removal.[12]

The tax on alternative fuels accounts for a relatively small portion of the tax on motor fuels. The tax is imposed when the fuels are sold for use or used as a fuel in a motor vehicle or motorboat. The person liable for the tax is either the retailer making the sale or, in some cases, the user of the fuel.

Non-taxable uses of fuel

In general, refunds or income tax credits may be claimed for fuels on which tax has been imposed and which ultimately are used for a non-taxable purpose. Present law includes numerous exemptions (including partial exemptions) for specified uses. Because the fuel taxes generally are imposed before the end use of the fuel is known, many of these exemptions are realized through refunds to end users of tax paid by a party that processed the fuel earlier in the distribution chain. Non-taxable uses of fuel include: (1) use on a farm for farming purposes; (2) off-highway business use; (3) export; (4) use in a boat engaged in commercial fishing; (5) use in certain intercity and local buses; (6) use in a school bus; (7) exclusive use by a qualified blood collector organization; (8) exclusive use by a nonprofit educational organization; (9) exclusive use by a State; (10) in an aircraft or vehicle owned by an aircraft museum; and (11) use other than as a fuel in a propulsion engine of a diesel-powered highway vehicle (e.g., home heating oil).

The rules governing how and by whom a refund is claimed differ by type of fuel, by end use, and by dollar amount of the claim. In general, no more than one claim per quarter may be filed. Refund claims may be filed only if prescribed dollar thresholds are satisfied. If the dollar amounts are not satisfied in a calendar year, refunds must be claimed as credits on income tax returns. Unlike income tax refunds, excise tax refunds generally do not bear interest if they are not paid within set periods. The Highway Trust Fund reimburses the General Fund for refunds and credits related to the non-taxable use of fuel.[13]

Fuel excise tax credits

The Code provides per-gallon tax credits and payments for the following qualified fuels: alcohol (including ethanol), biodiesel (including agri-biodiesel), renewable diesel, and certain alternative fuels.[14] If the qualified fuel is part of a qualified fuel mixture, the incentives apply only to the amount of qualified fuel in the mixture.

[12] However, such fuel generally is still subject to the LUST Trust Fund tax.

[13] Sec. 9503(c)(2).

[14] *See* secs. 40, 40A, 6426, and 6427(e).

The Code provides several mechanisms to obtain the incentives: excise tax credits, direct payments, and income tax credits. The mechanisms are coordinated such that gallons are not double counted.

For qualified fuel mixtures, the excise tax credits are taken against the taxes imposed by section 4081 (relating to the taxes on gasoline, diesel fuel, and kerosene). The alternative fuel excise tax credit are taken against the tax imposed by section 4041 (relating to the back-up tax on diesel fuel and alternative fuels). Although they are taken as credits against excise taxes supporting the Highway Trust Fund, the credits do not reduce the amount of fuel tax transferred to the Highway Trust Fund.[15] Similarly, if a person has insufficient excise tax liability to use the credits, the incentive may be taken as a payment.[16] The Highway Trust Fund does not reimburse the General Fund for these payments.

Non-fuels excise taxes

Manufacturers tax on heavy vehicle tires

The Code imposes a tax on taxable tires sold by the manufacturer, producer or importer of the tire. The rate is 9.45 cents for each 10 pounds of maximum rated load capacity over 3,500 pounds.[17] A "taxable tire" is any tire of the type used on highway vehicles if made of rubber (in whole or in part) and if marked according to Federal regulations for highway use.[18] "Rubber" includes synthetic and substitute rubber. For biasply tires, and super single tires (other than those designed for steering), the rate of tax is half the regular rate, 4.725 cents for each 10 pounds of maximum rated load capacity over 3,500 pounds.[19]

---

[15] Sec. 9503(b)(1).

[16] Sec. 6427(e). These claims for payment may be made on a weekly basis if the claim is for $200 or more (no dollar threshold if filed electronically), and if such claims are not paid within the specified time parameters, the claim is paid with interest. Sec. 6427(i)(3).

[17] Sec. 4071(a). In general, these parameters would exclude tires for passenger automobiles and light trucks.

[18] Sec. 4072(a). "Tires of the type used on highway vehicles" means tires of the type used on motor vehicles that are highway vehicles, or vehicles of the type used in connection with motor vehicles that are highway vehicles (sec. 4072(c)). However, the term does not include the kind of tires used exclusively on mobile machinery vehicles, as defined in section 4053(8) of the Code.

[19] Sec. 4071(a). The term "biasply tire" means a pneumatic tire on which the ply cords that extend to the beads are laid at alternative angles substantially less than 90 degrees to the centerline of the tread. A "super single tire" means a single tire greater than 13 inches in cross section width designed to replace two tires in a dual fitment. It does not include any tire designed for steering.

The tax does not apply to tire carcasses not suitable for commercial use, or to tires for use on qualifying intercity, local and school buses.[20] In addition, tires sold for the exclusive use of the Department of Defense or the Coast Guard are not subject to tax.[21] Nor does the tax apply to tires of a type used exclusively on mobile machinery vehicles. The Code also provides exemptions for tires that have been exported, sold to a State or local government for its exclusive use, sold to a nonprofit educational organization for its exclusive use, sold to a qualified blood collector organization for its exclusive use in connection with a vehicle the organization certifies will be primarily used in the collection, storage or transportation of blood, or used or sold for use as supplies for vessels.[22]

Retail sales tax on tractors, heavy trucks, and heavy trailers

A 12-percent retail sales tax is imposed on the first retail sale of heavy trucks (over 33,000 pounds), trailers (over 26,000 pounds) and certain tractors.[23] The taxable weight is the "gross vehicle weight," which is the maximum total weight of a loaded vehicle (all equipment, fuel body, payload, driver, etc.). The tax is imposed on chassis and bodies. The sale of a truck or trailer is considered a sale of a chassis and a body. However, the price of certain equipment unrelated to the highway transportation function of the vehicle is excluded from the tax base.[24] Additionally, a credit against the tax is allowed for the amount of tire excise tax imposed on manufacturers of new tires installed on the vehicle.

The Code also imposes the 12-percent tax on the price of parts or accessories installed on a taxable vehicle within six months of the date the vehicle was placed in service.[25]

Annual use tax for heavy vehicles

An annual use tax is imposed on heavy highway vehicles, at the rates shown below.[26]

---

[20] Sec. 4221(e)(3). A qualifying intercity or local bus is a bus which is used predominantly in furnishing (for compensation) passenger transportation available to the general public on a schedule with a regular route or has a seating capacity of at least 20 adults (not including the driver) (sec. 4221(d)(7)(B). A school bus is a bus for which substantially all the use of which is to transport students and employees of schools (sec. 4221(d)(7)(C)).

[21] Sec. 4073.

[22] *See* sec. 4221; and Internal Revenue Service, Publication 510, *Excise Taxes (Including Fuel Tax Credits and Refunds)* (2008) at 35.

[23] Sec. 4051. The tax does not apply to tractors weighing 19,500 pounds or less that, in combination with a trailer or semitrailer, has a gross combined weight of 33,000 pounds or less.

[24] Sec. 4053.

[25] A vehicle is treated as placed in service on the date on which the owner of the vehicle took actual possession of the vehicle.

Under 55,000 pounds	No tax
55,000-75,000 pounds	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), logging trucks, mobile machinery and qualified blood collector vehicles.

Baseline projections of Highway Trust Fund excise tax revenue

By statute, the taxes dedicated to the Highway Trust Fund generally do not apply after September 30, 2011. The budget rules provide for an assumption that excise taxes dedicated to a Trust Fund are imposed permanently (even if statutorily they are scheduled to expire).[27] The effect of this rule is that if Trust Fund excise taxes are extended without change before expiration of the taxes, the projected receipts of the Federal government do not change. If a dedicated excise tax is reimposed after the tax has expired (and has been removed from the CBO revenue baseline), the resulting revenue increases may be used under the budget rules to offset the revenue loss from the enactment of other tax provisions or spending.

Table 1 below shows CBO's March baseline forecast for Highway Trust Fund receipts. Table 2 shows CBO's March baseline shortfall projections for the Highway Trust Fund. Since the fuel taxes are levied on a per gallon basis, and since vehicle miles traveled have decreased, revenues to the Highway Trust Fund will likely be lower than CBO projected in March and thus, related shortfalls will likely be higher. Although Table 2 shows negative balances, the Highway Trust Fund is not permitted to borrow to meet its obligations, and therefore cannot incur a negative balance. A negative balance, as shown, represents obligations and the ability of the Trust Fund to pay those obligations. CBO projects that at some point during fiscal year 2009 the Highway Account of the Highway Trust Fund will be unable to meet its obligations.[28]

[26] Sec. 4481.

[27] *See* 2 U.S.C. sec. 907(b)(2)(C). The Balanced Budget and Emergency Deficit Control Act of 1985, which established rules that govern the calculation of the Congressional Budget Office's baseline, expired on September 30, 2006. Nevertheless, the Congressional Budget Office continues to prepare baselines according to the methodology prescribed in that law.

[28] Congressional Budget Office, *Public Spending on Transportation Infrastructure* (October 25, 2007). The Government Accountability Office has noted that recent legislation authorizes spending that is expected to outstrip the growth in Highway Trust Fund receipts. Government Accountability Office, *Surface Transportation: Restructured Federal Approach Needed for More Focused, Performance-Based and Sustainable Programs* (GAO-08, March 2008) at 9.

Table 1.–Projected Fiscal Year Receipts to the Highway Trust Fund
(Millions of Dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Highway Trust Fund Taxes											
Gasoline and other fuels (other than diesel)	25,503	25,689	26,146	26,627	27,011	27,287	27,489	27,632	27,683	27,654	27,601
Tires	538	548	568	590	606	622	638	654	670	686	703
Diesel	9,874	9,994	10,317	10,654	10,866	11,050	11,230	11,405	11,577	11,749	11,923
Use tax on certain vehicles	1,001	1,020	1,057	1,097	1,129	1,158	1,188	1,217	1,247	1,277	1,308
Trucks and trailers	3,251	3,363	3,535	3,722	3,884	4,044	4,208	4,375	4,548	4,726	4,911
Refunds	-1,048	-1,050	-1,057	-1,074	-1,094	-1,110	-1,123	-1,135	-1,146	-1,158	-1,169
Total Highway Trust Fund	39,118	39,563	40,567	41,616	42,402	43,052	43,630	44,149	44,577	44,933	45,277

Source: Congressional Budget Office (March 2008 baseline).

Table 2.–Highway Trust Fund Shortfall Projections
(Billions of Dollars)

	2007*	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Highway Account												
Fed.-Aid Obligation Limit (Gross)	39.1	41.2	41.9	42.7	43.5	44.3	45.2	46.0	46.9	47.8	48.7	49.7
Est. Flexing–Transfer of Cash**	-0.2	-0.7	-0.9	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Beginning of Year Balance	9.0	8.1	4.1	-1.6	-8.7	-16.2	-24.2	-32.9	-41.8	-51.2	-61.1	-71.5
Receipts	34.3	34.1	34.5	35.4	36.4	37.1	37.6	38.2	38.6	39.0	39.4	39.7
Outlays	35.0	37.5	39.4	41.6	43.0	44.1	45.3	46.2	47.0	47.9	48.8	49.1
End of Year Balance***	8.1	4.1	-1.6	-8.7	-16.2	-24.2	-32.9	-41.8	-51.2	-61.1	-71.5	-81.8
Transit Account												
Obligation Limit	7.2	7.8	7.9	8.0	8.2	8.3	8.5	8.7	8.8	9.0	9.2	9.4
Est. Flexing–Transfer of Obligation limit**	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Beginning of Year Balance	6.2	7.3	7.4	6.5	4.7	2.3	-0.3	-3.1	-6.0	-9.0	-12.1	-15.4
Est. Flexing–Transfer of Cash**	0.2	0.7	0.9	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Receipts	5.1	5.0	5.0	5.2	5.3	5.3	5.4	5.5	5.5	5.5	5.5	5.6
Outlays	4.2	5.6	6.8	7.8	8.6	8.9	9.2	9.3	9.5	9.6	9.8	10.0
End of Year Balance**	7.3	7.4	6.5	4.7	2.3	-0.3	-3.1	-6.0	-9.0	-12.1	-15.4	-18.9

* 2007 figures reflect adjustments made to the FY 2006 BOY balance by the Administration. Receipts and End of Year Balances are estimates, and are subject to revision for several months after the close of the Fiscal Year.

**Under the Safe Accountable Flexible Efficient Transportation Equity Act: A Legacy for Users ("SAFETEA-LU") (and TEA-21 before that), States are allowed to use some of their highway funds for transit projects. Therefore, the Highway Account "flexes" or transfers funds to the transit account when States choose to use such flexibility in funds.

***Under current law, the Highway Trust Fund cannot incur negative balances. A negative balance, as shown, represents obligations and the ability of the Trust Fund to pay those obligations. Spending on programs financed by the Highway Trust Fund would continue, although the rate of outlays would likely slow.

Source: Congressional Budget Office (March 2008 baseline).

II. OVERVIEW OF INTERNAL REVENUE CODE PROVISIONS GOVERNING ADMINISTRATION OF THE HIGHWAY TRUST FUND

Section 9503 contains the operative rules for transfer of revenues to, and the expenditure of monies from, the Highway Trust Fund. These rules provide for the transfer of "gross receipts" from the Highway Trust Fund excise taxes to the fund.[29] The transfers are net of refunds for tax overpayments.

In general, the Code requires, with respect to trust funds established by the Code, that the Secretary invest the balances not needed to meet current withdrawals in interest-bearing obligations of the United States. The interest is credited to the respective Trust Fund.[30] However, as of September 30, 1998, the Highway Trust Fund no longer earns interest on its unexpended balances.[31]

Amounts deposited in the Highway Trust Fund are divided between the Mass Transit Account and the Highway Account. The Mass Transit Account generally receives 2.86 cents per gallon of the Highway Trust Fund motor fuels excise taxes.[32] The balance of the motor fuels tax receipts and all receipts from the three non-fuels excise taxes are deposited in the Highway Account.

The Code allows expenditure of Highway Trust Fund monies for the purposes authorized under each of the highway authorization Acts that have been enacted since creation of the Trust Fund in 1956, as those Acts were in effect on the date of enactment of the SAFETEA-LU Technical Corrections Act of 2008.[33] These expenditures are limited by an internal to the Trust Fund anti-deficit provision, the so-called "Byrd Rule." The Byrd Rule requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 48-month period beginning at the close of each fiscal year.[34] If there is an excess, apportionments to the States

---

[29] Sec. 9503(b). Gross receipts do not reflect the effect on actual budget receipts resulting from interaction of the excise taxes with the Federal income tax. Thus, the Highway Trust Fund receives a greater amount than the actual budget gain experienced by the Federal Government from imposition of these taxes.

[30] Sec. 9602(b).

[31] Sec. 9503(f)(2).

[32] Sec. 9503(e)(2). The Mass Transit Account also receives amounts equivalent to 1.86 cents per gallon the case of liquefied natural gas, 2.13 cents per gallon in the case of liquefied petroleum gas, 9.71 cents per MCF in the case of compressed natural gas and 1.43 cents per gallon in the case of partially exempt methanol or ethanol fuel (as defined in section 4041(m)) none of the alcohol in which consists of ethanol.

[33] Sec. 9503(c).

[34] Sec. 9503(d).

under the Highway Trust Fund are reduced by that amount. This rule is applied separately to the Highway Account and to the Mass Transit Account.

The Code further contains a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503 (i.e., not approved by the tax-writing committees of Congress).[35] This provision provides that should such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that may provide for them unless either the legislation providing for the expenditure amends section 9503's expenditure authorization provisions or otherwise authorizes the expenditure as part of a revenue Act.

The structure of the projects financed by the Highway Trust Fund is such that the timing and amount of outlays necessary to reimburse the States for eligible costs vary from year to year. It is possible that the withdrawals required to meet Highway Trust Fund obligations for a given year may exceed the Highway Trust Fund's income for that year. As noted above, the Highway Trust Fund is not authorized to borrow from the General Fund. Thus, the Highway Trust Fund requires a minimum balance to timely meet obligations. It has been recommended that the Highway Account have a safety cushion equal to three months of expenditures to ensure that obligations could be liquidated (funds available to reimburse the States) during an emergency until Congress acted to reduce future commitments or to increase future revenues.[36]

The Transportation Equity Act for the 21st Century ("TEA-21") reduced the balance in Highway Account of the Highway Trust Fund to $8 billion as of October 1, 1998.[37] According to the Federal Highway Administration, at the end of fiscal year 1997, the Highway Account had a closing balance of approximately $12.6 billion.[38] At that time, it was thought that the reduction of the Highway Account balance to $8 billion would leave a sufficient safety cushion.[39] Further, 1998 projections of receipts and expenditures indicated that the three-month safety cushion would be maintained unless an emergency occurred.[40]

---

[35] Sec. 9503(b)(5).

[36] Federal Highway Administration, Office of Policy Development, *Primer: Highway Trust Fund* <http://www.fhwa.dot.gov/aap/PRIMER98.PDF> (November 1998) at 8.

[37] Sec. 9503(f)(1).

[38] Federal Highway Administration, Office of Policy Development, *Primer: Highway Trust Fund* <http://www.fhwa.dot.gov/aap/PRIMER98.PDF> (November 1998) at 8.

[39] *Id.*

[40] *Id.*

III. TAX EXEMPT FINANCING FOR TRANSPORTATION INFRASTRUCTURE

Overview

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Because of the income exclusion, investors generally are willing to accept a lower rate on tax-exempt bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the borrowing cost for the beneficiaries of such financing.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of governmental transportation infrastructure projects such as public highways or governmental mass commuting systems (e.g., rail and bus) are eligible for financing with the proceeds of governmental bonds. In addition, certain privately-used transportation infrastructure projects may be financed with qualified private activity bonds.

Tax-exempt governmental bonds

In general

Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt, governmental bonds to finance a broad range of transportation infrastructure projects, including highways, railways, airports, etc. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the parties that may benefit from such financing. For example, present law limits the amount of governmental bond proceeds that can be used by nongovernmental persons. Use of bond proceeds by nongovernmental persons in excess of amounts permitted by present law may result in such bonds being treated as taxable private activity bonds, rather than governmental bonds. The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[41] Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

---

[41] Sec. 141.

Generally, governmental bonds are not subject to restrictions that apply to bonds used to finance private activities. For example, governmental bonds are not subject to issuance cost, maturity, and annual volume limitations that generally apply to qualified private activity bonds.

Private business test

Under the private business test, a bond is a private activity bond if it is part of an issue in which:

1. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit ("private business use"); and

2. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[42]

A bond is not a private activity bond unless both parts of the private business test (i.e., the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not paid by the factory owner or other private parties.

A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use depending on the terms of the contract.[43] In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits. For example, a management contract with respect to a commuter rail facility that compensates the management company based on the profits of such facility would result in private use. Contracts for service incidental to the facility's primary functions, such as janitorial, office equipment repair and similar services, are not considered management contracts.

For purposes of the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary

---

[42] The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.

[43] Treas. Reg. sec. 1.141-3(b)(4).

expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.[44]

Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

Qualified private activity bonds

Qualified private activity bonds are tax-exempt bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[45]

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[46] Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); privately owned and/or operated public works facilities (sewage, solid waste disposal, water, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated residential rental housing; and certain private facilities for the local furnishing of electricity or gas. Bonds issued to finance "environmental enhancements of hydro-electric generating facilities," qualified public educational facilities, and qualified green building and sustainable design projects also may qualify as exempt facility bonds.

Generally, qualified private activity bonds are subject to a number of restrictions that do not apply to governmental bonds. For example, the aggregate volume of most qualified private activity bonds is restricted by annual State volume limitations (the "State volume cap").[47] For

---

[44] Treas. Reg. sec. 1.141-4(c)(3).

[45] Sec. 141(e).

[46] Sec. 142(a).

[47] The following private activity bonds are not subject to the State volume cap: qualified 501(c)(3) bonds, exempt facility bonds for airports, docks and wharves, environmental enhancements for hydroelectric generating facilities, and exempt facility bonds for solid waste disposal facilities that is to be owned by a governmental unit. The State volume cap does not apply to 75 percent of exempt facility bonds issued for high speed intercity rail facilities, 100 percent if the high speed intercity rail facility is to be owned by a governmental unit. Qualified veterans mortgage bonds, qualified public educational facility bonds, qualified green building and sustainable project design bonds, and qualified highway or

calendar year 2008, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $262.09 million, if greater.

Qualified private activity bonds also are subject to additional limitations on issuance cost and length of maturity. In addition, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[48]

Rules governing private activity bonds for transportation infrastructure

Airports

Exempt facility bonds may be issued to finance airports. Exempt facility bonds for airports are not subject to the State volume cap. However, all tax-exempt-bond-financed airport property must be governmentally owned. Property eligible for this financing includes land, terminals, runways, public parking facilities, and related equipment. Airplanes are not eligible for tax-exempt financing. Additionally, certain real property facilities (and related equipment) are excluded from this financing:

1. Hotels and other lodging facilities;

2. Retail facilities (including food and beverage facilities) located in a terminal, if the facilities are in excess of a size necessary to serve passengers and employees at the airport;

3. Retail facilities for passengers or the general public (including, but not limited to, rental car lots) located outside the terminal;

4. Office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority; and

5. Industrial parks or manufacturing facilities.

Port facilities

Exempt-facility bonds may be issued to finance port ("dock and wharf") facilities and related storage and training facilities. Facilities that are specifically ineligible for financing with airport bonds may not be financed with port bonds. Further, ships and other vessels are not eligible for private activity tax-exempt bond financing. All property financed with these bonds

---

surface freight transfer facility bonds also are not subject to the State volume cap, but the Code subjects such bonds to volume limitations specific to the category of bonds.

[48] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and to certain bonds issued before September 1, 1986.

must be governmentally owned. Exempt facility bonds issued for ports are not subject to the State volume cap.

Mass commuting facilities

Exempt facility bond financing for mass commuting facilities is subject to similar restrictions as those which apply to such bonds for airports and ports. All property financed with these bonds must be governmentally owned. Further, "rolling stock" (e.g., buses and rail cars) are not eligible for financing with exempt facility bonds.

High-speed intercity rail facilities

The definition of an exempt facility bond includes bonds issued to finance high-speed intercity rail facilities.[49] A facility qualifies as a high-speed intercity rail facility if it is a facility (other than rolling stock) for fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas.[50] The facilities must use vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops, and the facilities must be made available to members of the general public as passengers.

Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned. However, if the bonds are to be issued for a nongovernmental owner of the facility, such owner must irrevocably elect not to claim depreciation or credits with respect to the property financed by the net proceeds of the issue.[51]

The Code imposes a special redemption requirement for these types of bonds. Any proceeds not used within three years of the date of issuance of the bonds must be used within the following six months to redeem such bonds.[52]

Seventy-five percent of the principal amount of the bonds issued for high-speed rail facilities is exempt from the volume limit.[53] If all the property to be financed by the net proceeds of the issue is to be owned by a governmental unit, then such bonds are completely exempt from the volume limit.

---

[49] Sec. 142(a)(11) and sec. 142(i).

[50] A metropolitan statistical area for this purpose is defined by reference to section 143(k)(2)(B). Under that provision, the term metropolitan statistical area includes the area defined as such by the Secretary of Commerce.

[51] Sec. 142(i)(2).

[52] Sec. 142(i)(3).

[53] Sec. 146(g)(4).

Qualified highway or surface freight transfer facility bonds

Present law authorizes the issuance tax-exempt private activity bonds to finance qualified highway or surface freight transfer facilities. A qualified highway facility or surface freight transfer facility is any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code or any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Qualified highway or surface freight transfer facility bonds are not subject to the State volume limitations. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.

Similar to the requirement for high-speed intercity rail facilities, the Code imposes a special redemption requirement for qualified highway or surface freight transfer facility bonds. Under present law, the proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds.

IV. TAX-CREDIT BONDS

There have been several bills to provide for tax credit bonds for surface transportation (e.g., high speed rail and "Build America Bonds") but none have been enacted.[54] In the Code, there are currently tax credit bonds for qualified zone academies ("QZABs"), tax credit bonds for capital expenditures relating to certain renewable energy facilities (clean renewable energy bonds or "CREBs") and Gulf Tax Credit bonds.[55]

Tax-credit bonds are not interest-bearing obligations. Rather, the taxpayer holding a tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount[56] on the holder's bond. For the present law categories of tax-credit bonds, the credit rate on the bonds is determined by the Secretary of the Treasury and is an estimate of the rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

Under present law, the subsidy provided by tax-credit bonds is deeper vis-à-vis the subsidy for tax-exempt bonds. This is because (if the bonds are not issued at discount) the issuer of tax-credit bonds pays no interest, only principal.[57] The "interest" is paid by the Federal Government in the form of tax credits. Thus, the issuer theoretically has an interest-free loan. In comparison, issuers of tax-exempt bonds pay both interest and principal on such obligations

---

[54] *See e.g.,* sec. 305 of S. 2345, the American Infrastructure and Improvement Act of 2007, S. 2021, the "Build America Bonds Act of 2007," and H.R. 6004, the "Rail Infrastructure and Development Act for the 21st Century."

[55] The proceeds of Gulf Tax Credit bonds are used to assist States affected by Hurricane Katrina (Alabama, Louisiana, Mississippi, or political subdivisions thereof) in making debt service on certain obligations outstanding on August 28, 2005. All three tax credit bond provisions are temporary. The authority to issue Gulf Tax Credit bonds expired January 1, 2007. For CREBS, the authority to issue expires after December 31, 2008. For QZABs, a national allocation of $400,000 was provided for 2007, but the program has not yet been renewed.

[56] The "face amount" (or par value) represents the value of a bond at maturity as stated on the bond certificate.

[57] On the other hand, if tax-credit bonds are issued at discount, i.e., less than par value, the issuer incurs interest cost to the extent its debt service payments will exceed the amount of proceeds received from the sale of the bonds. This may occur because the rate on a prospective issue of tax-credit bonds is set lower than what investors are willing to accept to purchase the bonds at par value. To illustrate, assume the credit rate on tax-credit bonds with a face amount of $100 is set at five percent. If investors do not view the five percent credit rate as an acceptable return given the riskiness of the investment, they will purchase the bonds for something less than $100, e.g., $90. Because the credit is determined by reference to the face amount of bonds ($100), the investor purchasing tax-credit bonds at a discount ($90) receives a higher yield than the stated credit rate. However, the issuer must repay the full face value of the bonds, $100 in this example, even though it received less than $100 in proceeds.

albeit less interest than if the debt was taxable. As noted above, the Federal subsidy provided to issuers of tax-exempt bonds is limited to the difference between the tax-exempt interest rate paid and the taxable bond rate that otherwise would be paid.

Though called a tax credit, the Federal subsidy for tax-credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or local government benefiting from the bond proceeds.[58] For example, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax-credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax-credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 of interest income by holding the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal Government would make outlays of $100 in interest payments, but would recoup $28 of that in tax receipts, for a net budgetary cost of $72, as before. Similarly, the bondholder/taxpayer would receive a taxable $100 in interest, and would owe $28 in taxes, for a net gain of $72, as before. The State or local government also would be in the same situation in both cases.

---

[58] This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.