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DESCRIPTION OF TAX BILLS (S. 90, S. 150, S. 267, S. 284, S. 649, AND S. 913)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION

OF THE

SENATE COMMITTEE ON FINANCE

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INTRODUCTION

The Subcommittee on Taxation of the Senate Committee on Finance has scheduled a public hearing on June 12, 1991, on six tax bills: (1) S. 90 ("The Environmental Infrastructure Act of 1991"); (2) S. 150 ("The Higher Education Tax-Exempt Bond Reform Act of 1991"); (3) S. 267 (relating to State taxation of pension income of nonresidents); (4) S. 284 (relating to the treatment of payments under life insurance contracts for terminally ill individuals); (5) S. 649 (repeal of the luxury excise tax on boats and yachts); and (6) S. 913 ("The Tax-Exempt Bond Simplification Act of 1991").

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a summary and description of the six tax bills scheduled for the June 12 Subcommittee hearing.

The first part of the pamphlet is a summary of the bills. The second part is a description of each bill, including present law, explanation of the bill and effective date, and the principal issues relating to the bill.

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[1] This pamphlet may be cited as follows: *Description of Tax Bills (S. 90, S. 150, S. 267, S. 284, S. 649, and S. 913)* (JCS-7-91), June 7, 1991.

I. SUMMARY

1. S. 90 (Senators Domenici, Boren, Symms, and Others):

"The Environmental Infrastructure Act of 1991"

Tax-exempt bonds

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103). Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties if (1) the financed activities are specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue are used to finance the specified activity. Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Among the infrastructure-type activities of private businesses for which tax-exempt bonds may be issued are: (1) airports, docks and wharves, mass commuting facilities or high-speed intercity rail facilities; (2) water, sewage, solid waste, or hazardous waste disposal facilities; (3) facilities for the local furnishing of electricity or gas; and (4) local district heating or cooling facilities.

All tax-exempt bonds are subject to arbitrage restrictions, including a requirement that profits on most nonpurpose investments be rebated to the Federal Government.

S. 90 would liberalize several of the tax-exempt bond rules. First, the bill would create a new type of tax-exempt bond between governmental and private activity bonds, called "infrastructure facility bonds." Bonds for infrastructure facilities (largely facilities currently eligible for private activity bond financing) would not be subject to the restrictions currently applicable only to private activity bonds. Among the restrictions that would not apply are: (1) State volume limitations; (2) treatment of interest on such bonds as a preference item under the individual and corporate alternative minimum taxes; (3) prohibition of the advance refunding of these bonds; (4) application of the change-in-use restrictions on such facilities; (5) limitation on bond-financed issuance costs; (6) maturity limits; and (7) public hearing and approval requirements applicable to private activity bonds.

Second, the bill would create an exception from the arbitrage rebate requirement for all governmental and infrastructure facility bonds, if prescribed percentages of the gross proceeds are spent within specified time limits. To qualify for this exception, at least 20 percent of the gross proceeds of the issue must be spent within one year after issuance, at least 50 percent within two years after issuance, and at least 95 percent within three years of issuance.

Capital cost recovery

Present law generally prescribes accelerated cost recovery periods and methods for most tangible property.

The bill would assign a seven-year ACRS recovery period, and a 10-year ADR midpoint, to all infrastructure facility property which does not already have a shorter recovery period and ADR midpoint, and would make other changes to the cost recovery rules.

Effective dates

The tax-exempt bond provisions of the bill would apply to bonds issued after December 31, 1991. The capital cost recovery provisions of the bill would apply to property placed in service after December 31, 1991.

2. S. 150 (Senators Moynihan, Danforth, Boren, Chafee, Pryor, Daschle, Symms, and Others):

"The Higher Education Tax-Exempt Bond Reform Act of 1991"

Present law generally excludes from income interest on State and local government bonds if the bonds are issued to finance direct activities of these governments (sec. 103). Interest on bonds issued by States and local governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of charitable organizations described in section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business (sec. 141(e)(1)(G)).

Before enactment of the Tax Reform Act of 1986, State and local governments and section 501(c)(3) organizations were defined as "exempt persons" under the Code, and their bonds generally were subject to the same requirements. As exempt persons, section 501(c)(3) organizations were not treated as "private" persons, and their bonds were not "industrial development bonds" or "private loan bonds" (the predecessor categories to current private activity bonds).

Section 501(c)(3) organizations also may not benefit from more than $150 million per institution of outstanding tax-exempt bonds.

S. 150 would amend the tax-exempt bond provisions of the Code to conform generally the treatment of section 501(c)(3) organization bonds to that provided for bonds issued to finance direct State or local government activities. The principal substantive effect of the bill would be the repeal of the $150 million per institution limit on outstanding nonhospital bonds for 501(c)(3) organizations.

Effective date.—The bill would apply generally to bonds issued after the date of enactment.

3. S. 267 (Senators Reid, Bryan, Symms, and Others):

State Taxation of Pension Income of Nonresidents

Under present law, State taxation of retirement income varies from State to State. Effective for taxable years beginning after December 31, 1991, S. 267 would prohibit any State from imposing income tax on the pension or retirement income of nonresidents of the State.

4. S. 284 (Senators Bradley, Symms, Grassley, Chafee, Danforth, Baucus, Breaux, Packwood, Roth, and Others):

Treatment of Payments Under Life Insurance Contracts for Terminally Ill Individuals

Under present law, amounts received under a life insurance contract prior to the death of the insured generally are includible in the gross income of the recipient to the extent that the amount received exceeds the recipient's investment in the contract. Effective for taxable years beginning after December 31, 1989, S. 284 would exclude from gross income amounts received by an individual under a life insurance contract if the insured under the contract is terminally ill.

In addition, in determining whether a contract qualifies as a life insurance contract for Federal income tax purposes, S. 284 would treat a qualified terminal illness rider as a qualified additional benefit. The bill would also provide that the addition of a qualified terminal illness rider to a life insurance contract would not be treated as a modification of, or material change to, the contract for purposes of the definition of a life insurance contract and the definition of a modified endowment contract. Further, for purposes of the rules that apply to life insurance companies, a qualified terminal illness rider would be treated as life insurance. These provisions of the bill would be effective for taxable years beginning before, on, or after December 31, 1989.

Finally, effective on January 1, 1990, the bill would provide that applicants for, and recipients of, benefits under certain public assistance programs would not be required to take into account the right to receive an accelerated death benefit in determining eligibility for the public assistance benefits.

5. S. 649 (Senators Breaux, Chafee, Pell, and Others):

Repeal of the Luxury Excise Tax on Boats and Yachts

S. 649 would repeal the 10-percent luxury excise tax applicable to boats and yachts. The excise tax currently applies to the portion of the retail price that exceeds $100,000. The repeal would be effective retroactive to January 1, 1991 (the effective date of the tax under the Omnibus Budget Reconciliation Act of 1990).

6. S. 913 (Senators Baucus, Dodd, Riegle, and Boren):

"The Tax-Exempt Bond Simplification Act of 1991"

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (sec. 103). Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Code. Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage restrictions on investment of their bond proceeds. These restrictions are a yield restriction requirement, and a requirement that certain profits on nonpurpose investments be rebated to the Federal Government.

S. 913 makes numerous changes to the requirements governing issuance of tax-exempt bonds. Among the changes are: (1) repeal of a limit on unrelated and disproportionate private business use; (2) liberalization of the arbitrage yield restriction and rebate requirement; and (3) expansion of an exception from a financial institution interest deduction disallowance for smaller governmental units.

Effective date.—The bill generally would be effective for bonds issued after December 31, 1990.

II. DESCRIPTION OF THE BILLS

1. S. 90 (Senators Domenici, Boren, Symms, and Others): "The Environmental Infrastructure Act of 1991"

Present Law

a. Tax-exempt bonds

In general

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103). Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties if (1) the financed activities are specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue are used to finance the specified activity. Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Private activity bonds are bonds (1) more than 10 percent of the proceeds of which satisfy a private business use and payment test, or (2) more than five percent ($5 million, if less) of the proceeds are used to finance loans to persons other than State or local government units. A special restriction limits to no more than five percent the amount of bond proceeds that may be used in a private business use that is unrelated to direct governmental activities also being financed with a bond issue. This five-percent restriction is known as the "unrelated and disproportionate private business use limit."

Interest on the following private activity bonds qualifies for exclusion:

(1) Exempt-facility bonds;

(2) Qualified mortgage and qualified veterans' mortgage bonds;

(3) Qualified small-issue bonds;

(4) Qualified student loan bonds;

(5) Qualified redevelopment bonds; and

(6) Qualified 501(c)(3) bonds.

Exempt-facility bonds are bonds the proceeds of which are used to finance the following: airports, docks and wharves, mass commuting facilities, or high-speed intercity rail facilities; water, sewage, solid waste, or hazardous waste disposal facilities; facilities for the local furnishing of electricity or gas; local district heating or cooling facilities; and certain low-income rental housing projects.

Additional restrictions on private activity bonds

The Code imposes several restrictions on private activity bonds that generally do not apply to bonds issued to finance direct activities of States and local governments. The more significant of these private activity bond restrictions are described below.

State volume limitations

States are subject to annual issuance limits of the greater of $50 per resident or $150 million on the volume of private activity bonds they may issue. These volume limitations do not apply to qualified 501(c)(3) bonds and to exempt-facility bonds for airports, docks and wharves, and governmentally owned solid waste disposal facilities. Additionally, only 25 percent of exempt-facility bonds for qualified high-speed intercity rail facilities are subject to the volume limits, and qualified veterans' mortgage bonds are subject to separate volume limitations based on historical issuance by the five States authorized to issue such bonds.

Alternative minimum tax treatment

Interest on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for both the individual and corporate alternative minimum taxes.

No advance refundings

Most private activity bonds may not be advance refunded. An advance refunding is the issuance of refunding bonds without redemption of the refunded (original) bonds within 90 days. Governmental bonds and qualified 501(c)(3) private activity bonds may be advance refunded one time.

Change-in-use restrictions

Beneficiaries of private activity bonds are subject to special interest deduction disallowance rules if the use of the property financed with the bonds is changed to a use not qualifying for tax-exempt financing while the bonds remain outstanding.

Bond-financed costs of issuance

No more than two percent of the net proceeds of a private activity bond issue may be used to finance the cost of issuing the bonds, and these amounts are not counted in determining whether the bonds satisfy the requirement that at least 95 percent of the net proceeds of each bond issue be used for the activity qualifying the bonds for tax exemption.

Maturity limit

The weighted average maturity of private activity bonds may not exceed 120 percent of the average economic life of the property financed with the bonds. (Unlike governmental bonds, private activity bonds other than qualified 501(c)(3) bonds may only be used to finance property as opposed to operating expenses or working capital.)

Public approval

A public hearing must be held and an elected public official must approve private activity bonds before they are issued (or the bonds must be approved by voter referendum).

Additional restrictions on all tax-exempt bonds

Arbitrage restrictions

In general, issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds. As explained more fully below, the two sets of restrictions generally apply with respect to different time periods following issuance of the bonds.

Yield restriction requirement.—Tax-exempt bonds proceeds generally may not be invested at a yield materially higher than the bond yield, i.e., only limited arbitrage profits may be earned. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds (generally prescribed in Treasury Department regulations). Additional exceptions are provided throughout the term of the issue for bond proceeds invested as part of a reasonably required reserve or replacement fund and for a "minor" portion of the issue proceeds.

Unlike the rebate requirement, described below, the yield restriction requirement applies both to investments unrelated to the purpose of the borrowing ("nonpurpose investments") and to investments such as a loan to the ultimate borrower of the bond proceeds in the case of private activity bonds ("purpose investments").

Rebate requirement.—Generally, all arbitrage profits earned on nonpurpose investments of bond proceeds during periods when such earnings are permitted (e.g., temporary periods) must be rebated to the Federal Government. Permitted arbitrage profits on purpose investments (limited by the yield restriction requirement described above) are not subject to the rebate requirement. Present law also includes three principal exceptions to the rebate requirement on nonpurpose arbitrage profits.

First, if all gross proceeds of an issue are spent for the purpose of the borrowing within six months after the bonds are issued, no rebate is required. This exception may be satisfied notwithstanding the presence of a reasonably required reserve or replacement fund if all proceeds other than those invested as part of that fund are so spent and arbitrage profits on the reserve fund (and any bona fide debt service fund subject to rebate) are rebated.

Second, no rebate is due in the case of certain construction bond issues if the available construction proceeds are spent for the purpose of the borrowing at least at specified rates during the 24-month period after the bonds are issued. Construction bonds eligible for this exception include all governmental bonds, qualified 501(c)(3) bonds, and private activity bonds the proceeds of which are used to finance property owned by a governmental unit.

Third, bonds, other than private activity bonds, issued by governmental units having general taxing powers are not subject to the rebate requirement if the governmental unit (and all subordinate units) issues $5 million or less of governmental bonds during a calendar year.

Tax treatment of financial institutions investing in tax-exempt bonds

Banks and other financial institutions generally are denied a deduction for the portion of their interest expense (e.g., interest paid to depositors) that is attributable to investments in tax-exempt bonds acquired after August 7, 1986. This disallowance is computed using a prorata formula that compares the institution's average adjusted basis in tax-exempt bonds acquired after that date with the average adjusted basis of all assets of the institution.

An exception to this prorata disallowance rule is permitted for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that issue no more than $10 million of such bonds during a calendar year.

b. Capital cost recovery

In general

Accelerated cost recovery system

For regular income tax purposes, present law generally allows accelerated cost recovery deductions for tangible personal property and for real property (other than land) that is used in a trade or business or for the production of income (sec. 168). Personal property generally is classified according to its present class life (or "ADR midpoint") and assigned to one of seven cost recovery classes: three-year, five-year, seven-year, 10-year, 15-year, and 20-year classes. Real property is assigned to a 27.5-year (residential rental) or a 31.5-year (nonresidential rental) class. These classes generally are shorter than the applicable ADR midpoint for the property included in the class.

The method used to calculate cost recovery deductions likewise is accelerated for personal property. The cost recovery method applicable to property included in classes having recovery periods under 15 years is the double declining balance method, switching to the straight-line method at the time that maximizes the cost recovery allowance. For property in the 15-year and 20-year classes, the applicable method is the 150-percent declining balance method switching to the straight-line method at the time that maximizes the cost recovery allowance. The cost of real property is recovered using the straight-line method.

Alternative cost recovery system

An alternative cost recovery system is provided for property that is (1) leased to or otherwise used by a tax-exempt entity ("tax-exempt use" property), (2) financed with the proceeds of tax-exempt bonds, (3) predominately used outside the United States, or (4) imported from a foreign country with respect to which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts. Additionally, taxpayers may elect to decelerate cost recovery deductions on other property through use of the alternative cost recovery system. The alternative system also is used for computing a corporation's earnings and profits.

The recovery period under the alternative system generally is equal to the property's ADR midpoint life (12 years for personal property with no ADR midpoint life and 40 years for real property). The recovery method under the alternative system is the straight-line method.

Explanation of the Bill

a. Tax-exempt bonds

In general

S. 90 would create a new type of tax-exempt bond between governmental and private activity bonds, called "infrastructure facility bonds". Bonds for infrastructure facilities would not be subject to the restrictions currently applicable only to private activity bonds.

Further, the bill would substitute a three-year spending requirement for the arbitrage rebate requirement in the case of governmental bonds and the new infrastructure facility bonds.

Expanded financing eligibility and elimination of present private activity bond restrictions

Under the bill, certain facilities for which private activity exempt-facility bonds currently may be issued would be eligible for financing with the new category of infrastructure facility bonds. These facilities would include sewage and solid waste disposal facilities, hazardous waste disposal facilities, and facilities for the furnishing of water. In addition, infrastructure facility bonds could be issued to finance any other facility that was "constructed, reconstructed, rehabilitated, or acquired" to assist a State or local government in complying with any Federal statute or regulation administered by the U.S. Environmental Protection Agency. This authorization is not restricted to existing statutes or EPA regulations.

Because the facilities eligible for financing with infrastructure facility bonds (other than the unspecified facilities for EPA compliance activities) generally may be financed under present law, the principal substantive effect of the bill would be to eliminate application of the following private activity bond restrictions to these financings:

(1) Application of State volume limitations on the issuance of these bonds, other than for governmentally owned solid waste disposal facilities which are exempt under present law;

(2) Treatment of the interest on such bonds as a preference item under the individual and corporate alternative minimum taxes;

(3) Prohibition of advance refundings of the bonds;

(4) Application of the change-in-use restrictions on the facilities; and

(5) Application of the limitation on the amounts of issuance costs that may be bond financed, the maturity limits on the bond issues, and the public hearing and approval requirements applicable to private activity bonds.

Arbitrage rebate restriction

The bill would create a new exception to the requirement that arbitrage profits on nonpurpose investments be rebated to the Federal Government for governmental bonds (other than tax and revenue anticipation notes) and infrastructure facility bonds. Arbitrage profits on these bonds could be retained by the issuers if prescribed percentages of the gross proceeds of the bond issue were spent before set intervals during the three-year period following issuance. The set intervals and required percentages would be as follows:

(1) 20 percent within one year after issuance;

(2) 50 percent within two years after issuance; and

(3) 95 percent within three years after issuance.

Expenditures for soft costs such as costs of issuance made during the first year following issuance would be included in determining if these requirements were satisfied; however, such expenditures would not be treated as qualifying expenditures if made more than one year after the date the bonds were issued.

b. Capital cost recovery

The bill would assign a seven-year ACRS recovery period, and a 10-year ADR midpoint, to all infrastructure facility property for which a shorter recovery period and ADR midpoint is not currently prescribed. Infrastructure facility property would be defined as property eligible for financing with tax-exempt infrastructure facility bonds (as provided for in the bill, described above).

For infrastructure facility property, the bill also would override the present restriction requiring that the cost of tax-exempt use property be recovered using the decelerated alternative cost recovery system. That restriction as applied to property financed with tax-exempt bonds would be retained.

Effective Dates

The tax-exempt bond provisions of the bill would apply to bonds issued after December 31, 1991.

The capital cost recovery provisions of the bill would apply to property placed in service after December 31, 1991.

Issues

Pros

1. Projects funded using infrastructure facility bonds are sufficiently similar to governmental projects that they should be granted the same tax treatment as governmental projects. Under present law, the projects which are the subject of the infrastructure facility bonds proposal may be financed using private activity bonds. However, the restrictions placed on private activity bonds may, to some extent, hinder the utilization of these bonds since the restrictions impose some burdens (e.g., the requirement to receive a State volume limit allocation) on the issuer which would be removed under the proposal.

2. Governmental construction and infrastructure facility projects may require longer lead times than the two-year construction period implicit in the present-law spend-down requirement for pur-

poses of determining arbitrage rebate payments by issuers of tax-exempt bonds. Accordingly, a longer spend-down period than is provided in present law during which arbitrage profits may be earned by the issuer without being rebated to the Federal Government may be required to ensure that issuers may undertake construction projects without being subject to arbitrage rebate requirements.

3. Many projects that are defined as infrastructure facility bond projects are required by Federal regulations; providing a tax subsidy to these projects is a reasonable response to the need for equitable cost sharing.

4. Infrastructure facility projects tend to be large projects that require large amounts of capital to support them. The State private activity volume limits imposed under present law hamper the ability of State and local governments to finance infrastructure projects along with other projects that benefit private parties.

5. Shorter depreciation lives combined with faster depreciation schedules for property financed by infrastructure bonds would encourage businesses to invest in these projects by increasing the present value of the depreciation deductions available to the taxpayer.

Cons

1. Infrastructure facility bond projects provide subsidized financing for private business capital. The Federal tax subsidy provided to private entities through tax-exempt bonds are generally subject to the requirements imposed on private activity bonds (e.g., State volume limitations, alternative minimum tax preference treatment, etc.). Singling out infrastructure facility projects for more favorable treatment would be inequitable.

2. Infrastructure facility projects are often subsidized through governmental grants (e.g., through various direct spending programs); added Federal tax subsidies may be excessive.

3. Given large Federal budget deficits, Federal tax subsidies should be targeted to benefit those most in need. The infrastructure facility bond program does not consider the social desirability of individual projects eligible for low-cost financing through the use of tax-exempt bonds.

4. The removal of the advance refunding prohibition on infrastructure bonds could result in more than one tax-exempt bond issue being outstanding simultaneously for a single infrastructure project. This results in issuers being able effectively to hedge changes in interest rates with Federally subsidized financing.

5. Removal of the tax-exempt property leasing rules for infrastructure facility projects could result in tax-exempt entities receiving much of the benefit of the Federal subsidy inherent in depreciation. Moreover, prescribing faster depreciation schedules for this property may result in an indirect arbitrage opportunity where governmental entities lease facilities from a taxable entity that can make use of depreciation deductions for tax purposes that far exceed the decline in the economic value of the infrastructure assets.

6. The category of infrastructure is so broad that use of a single ADR life will result in depreciable lives that are totally unrelated to the economic life of the asset.

2. S. 150 (Senators Moynihan, Danforth, Boren, Chafee, Pryor, Daschle, Symms, and Others):

"The Higher Education Tax-Exempt Bond Reform Act of 1991"

Present Law

In general

Present law generally excludes from income interest on State and local government bonds if the bonds are issued to finance direct activities of these governments (sec. 103). Interest on bonds issued by States and local governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of charitable organizations described in section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business (sec. 141(e)(1)(G)).

Classification of section 501(c)(3) organization bonds as private activity bonds

Before enactment of the Tax Reform Act of 1986, State and local governments and section 501(c)(3) organizations were defined as "exempt persons," and their bonds generally were subject to the same requirements. As exempt persons, section 501(c)(3) organizations were not treated as "private" persons, and their bonds were not "industrial development bonds" or "private loan bonds" (the predecessor categories to current private activity bonds).

Under present law, a bond is a private activity bond if its proceeds are used in a manner violating either (1) a private business test or (2) a private loan test. The private business test is a two-pronged test. First, the test limits private business use of governmental bonds to no more than 10 percent of the bond proceeds.[2] Second, no more than 10 percent of the debt service on the bonds may be derived from private business users of the proceeds. The private loan test limits to the lesser of five percent or $5 million the amount of governmental bond proceeds that may be used to finance loans to persons other than governmental units.

Special restrictions on tax-exemption for section 501(c)(3) organization bonds

As stated above, present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as

[2] No more than five percent of bond proceeds may be used in a private business use that is unrelated to the governmental purpose of the bond issue. The 10-percent debt service test, described below, likewise is reduced to five percent in the case of such "unrelated and disproportionate" private business use.

private activity "qualified 501(c)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this $150 million limit, all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations. A second restriction limits to no more than five percent the amount of the net proceeds of a bond issue that may be used to finance any activities (including all costs of issuing the bonds) other than the exempt purposes of the section 501(c)(3) organization.

The Technical and Miscellaneous Revenue Act of 1988 imposed low-income tenant occupancy requirements on existing residential rental property that is acquired by section 501(c)(3) organizations in tax-exempt bond-financed transactions. Under these requirements, a minimum number of the housing units comprising the property must be continuously occupied by tenants having family incomes of 50 percent (60 percent in certain cases) or less of area median income for periods of up to 15 years. These same low-income tenant occupancy requirements apply to for-profit developers receiving tax-exempt private activity bond financing.

Other restrictions

The Code imposes several restrictions on private activity bonds that generally do not apply to bonds used to finance direct State and local government activities. Many of these restrictions also apply to qualified 501(c)(3) bonds.

(1) No more than two percent of the net proceeds of a bond issue may be used to finance the costs of issuing the bonds, and these amounts are not counted in determining whether the bonds satisfy a requirement that at least 95 percent of the net proceeds of each bond issue be used for the exempt activities qualifying the bonds for tax exemption.

(2) The weighted average maturity of a bond issue may not exceed 120 percent of the average economic life of the property financed with the proceeds.

(3) A public hearing must be held and an elected public official must approve the bonds before they are issued (or the bonds must be approved by voter referendum).

(4) If property financed with private activity bonds is converted to a use not qualifying for tax-exempt financing, certain loan interest penalties are imposed (the "change in use" restrictions).

Both governmental and private activity bonds are subject to numerous other Code restrictions, including the following:

(1) The amount of arbitrage profits that may be earned on investments of tax-exempt bond proceeds is limited, and most such profits on investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government; and

(2) Banks and other financial institutions may not deduct interest they pay to the extent of their investments in most tax-exempt bonds.

Finally, interest on private activity bonds, other than qualified 501(c)(3) bonds, is a preference item in calculating the alternative minimum tax for individuals and corporations.

Explanation of the Bill

Subject to certain exceptions described below, S. 150 would amend the tax-exempt bond provisions of the Code to conform the treatment of section 501(c)(3) organization bonds generally to that provided for bonds issued to finance direct State or local government activities.

Repeal of private activity bond classification for section 501(c)(3) organization bonds

The concept of an "exempt person," that existed under the Code bond provisions before 1986, would be reenacted. An exempt person would be defined as (1) a State or local governmental unit or (2) a section 501(c)(3) organization, when carrying out its exempt activities under section 501(a). Thus, bonds for section 501(c)(3) organizations would no longer be classified as private activity bonds. Financing for unrelated business activities of such organizations would continue to be treated as a private business use for which tax-exempt financing is not authorized.

As exempt persons, section 501(c)(3) organizations would be subject to the same limits as State and local governments on using their bond proceeds to finance private business activities or to make private loans. Thus, no more than 10 percent of the bond proceeds [3] could be used in a business use by a person other than an exempt person if the Code security interest test were satisfied, and no more than five percent ($5 million, if less) could be used to make loans to such "nonexempt" persons.

Repeal of most additional restrictions on section 501(c)(3) organization bonds

Present section 145, which establishes additional restrictions on qualified 501(c)(3) bonds, would be repealed, along with the restriction on bond-financed costs of issuance for section 501(c)(3) organization bonds (sec. 147(h)). This repeal of section 145 would eliminate the $150 million per institution limit on outstanding nonhospital bonds for section 501(c)(3) organizations.

Retention of certain requirements for section 501(c)(3) organization bonds

As stated above, certain special restrictions on bonds for section 501(c)(3) organizations would be retained. First, the bill would retain the requirement that existing residential rental property acquired by a section 501(c)(3) organization in a tax-exempt bond-financed transaction satisfy the same low-income tenant requirements as similar housing financed for for-profit developers. Second, the bill would retain the present-law maturity limitations applicable to bonds for section 501(c)(3) organizations, and the public ap-

[3] This limit would be reduced to five percent in the case of unrelated and disproportionate private business use as under the present-law governmental bond limit on such use.

proval requirements applicable generally to private activity bonds. Third, the bill would continue to apply the penalties on changes in use of tax-exempt bond-financed section 501(c)(3) organization property to a use not qualified for such financing.

Finally, the bill would make no amendments, other than technical conforming amendments, to the present-law arbitrage restrictions, the alternative minimum tax tax-exempt bond preference, or the provisions generally disallowing interest paid by banks and other financial institutions on amounts used to acquire or carry tax-exempt bonds.

Effective Date

Subject to two exceptions, the bill would apply generally to bonds issued after the date of the bill's enactment.

The first exception would exempt bonds issued pursuant to transitional exceptions included in the Tax Reform Act of 1986, unless the issuers elected to be subject to the bill's provisions.

Second, for purposes of the special arbitrage rebate exception for small governmental issuers (a calendar year exception), the bill would apply in calendar years beginning after its enactment.

Issues

Pros

1. The principal beneficiaries of the bill would be private, nonprofit colleges and universities. These institutions provide substantially identical educational services to those provided by governmental higher education institutions. Consistent with the general tax policy goal of providing like treatment for similarly situated persons, the tax-exempt bond rules should recognize this fact and provide comparable access to tax-exempt financing for these entities.

2. In general, private activity tax-exempt bonds are of two types: those used to provide financing for service providers (airports, rental housing developers, charitable organizations) and for service recipients (mortgage revenue bond and student loan bond borrowers). Service-recipient bonds typically are subject to Federal wealth targeting rules like direct Federal spending programs. Service provider bonds on the other hand, generally are targeted by reference to the ultimate beneficiary of the financing, not the service provider. In fact, section 501(c)(3) organizations are the only service-provider beneficiaries of tax-exempt bonds that are subject to wealth targeting (i.e., a limit on outstanding bonds). In the case of service-provider bond beneficiaries, the service provided, not the provider, is the appropriate measure for determining availability of tax-exempt financing.

3. The $150 million per-institution limit on outstanding nonhospital qualified 501(c)(3) tax-exempt bonds was intended as a limit on tax arbitraging of college and university endowments. Other present-law tax-exempt bond restrictions, e.g., the arbitrage rebate requirement and public approval, bond maturity, hedge bond, and advance refunding restrictions, adequately address this concern.

4. The argument that private colleges and universities engage in tax arbitraging of their endowments reflects a misunderstanding of the restrictions governing endowments. Most State laws prohibit depletion of endowment corpus. Further, approximately 65 percent of endowment funds nationally is subject to donor-imposed restrictions on the uses for which even the income may be used.

Cons

1. The present-law tax-exempt bond rules appropriately distinguish between States and local governments and all other permitted beneficiaries of these bonds. Nonprofit colleges and universities are not legally governmental entities or accountable as such. Accordingly, it is appropriate to classify bonds for their benefit as private activity bonds.

2. In the short run, repeal of the $150 million limit would primarily benefit a relatively small number of private, nonprofit universities having endowments among the largest of any in the United States. Such nonprofit institutions with large endowments may use tax-exempt bonds to engage in economic, if not direct tax, arbitrage activities by borrowing at tax-exempt rates instead of spending other available funds. It is appropriate in light of high Federal budget deficits to limit such activities. The $150 million per institution limit on nonhospital qualified 501(c)(3) bonds achieves this objective in a way that is administratively simpler than direct taxes or yield restrictions on these universities' endowment investments.

3. Notwithstanding donor-imposed restrictions on the use of some endowment funds, nonprofit colleges and universities also benefit from substantial amounts of restricted endowment funds available for activities being bond-financed, unrestricted endowment investments, and quasi-endowment funds ("funds functioning as" endowments) which are available for bond-financed activities. Tax-exempt bond financing should not be available to these institutions until such available funds are exhausted.

3. S. 267 (Senators Reid, Bryan, Symms, and Others): State Taxation of Pension Income of Nonresidents

Present Law

Certain State laws provide that some or all retirement income is included in income for State income tax purposes if the income was earned within the State, even though the individual resides outside the State when the retirement income is actually received. Some States achieve this result through general rules that tax income earned within the State, whereas others have explicit provisions regarding retirement income.

Explanation of the Bill

S. 267 would prohibit any State, including any political subdivision of a State, the District of Columbia, and the possessions of the United States, from imposing income tax on the pension or retirement income of any individual who is not a resident or domiciliary of the State.

Effective Date

The bill would apply to taxable years beginning after December 31, 1991.

Issues

Pros

1. The bill would eliminate what may be perceived as an unfair imposition of State tax on individuals who have little current contact with the State.

2. If a large number of States were to tax pension benefits earned in the State when received, then a retiree who worked in several different States would have complex State income tax filing responsibilities.

Cons

1. The bill will likely be viewed by States with income tax laws as an unwarranted intrusion on their ability to tax income derived from the State and an unjustified erosion of their tax base. Some States enacted laws taxing nonresident retirement income to prevent avoidance of State tax. For example, in the absence of such laws, individuals can avoid State taxation of income by structuring compensation agreements to characterize what otherwise would be current compensation as pension income. The proposal would make it more difficult for States to prevent such abuses.

2. The ability of the Federal Government to enforce the bill is unclear. While the Constitution gives the Federal Government some authority to regulate State tax laws in particular circumstances, it is unclear whether that authority would extend to this bill.

4. S. 284 (Senators Bradley, Symms, Grassley, Chafee, Danforth, Baucus, Breaux, Packwood, Roth, and Others):

Treatment of Payments Under Life Insurance Contracts for Terminally Ill Individuals

Present Law

In general

The undistributed investment income ("inside buildup") earned on premiums credited under a contract that satisfies a statutory definition of life insurance is not includible in the gross income of the owner of the contract. In addition, death benefits paid under a contract that satisfies the statutory definition are excluded from the gross income of the recipient, so that neither the owner of the contract nor the beneficiary of the contract is ever taxed on the inside buildup if the proceeds are paid to the beneficiary by reason of the death of the insured. Amounts received under a life insurance contract (other than a modified endowment contract) prior to the death of the insured are includible in the gross income of the recipient to the extent that the amount received exceeds the recipient's investment in the contract (generally, the aggregate amount of premiums paid less amounts previously received that were excluded from gross income).

Definition of a life insurance contract

In order to qualify as a life insurance contract for Federal income tax purposes, a contract must be a life insurance contract under the applicable State or foreign law and must satisfy either of two alternative tests: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. A contract satisfies the cash value accumulation test if the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the contract. A contract satisfies the guideline premium/cash value corridor test if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and the death benefit under the contract is not less than a varying statutory percentage of the cash surrender value of the contract.

The net single premium for purposes of the cash value accumulation test and the guideline single premium or guideline level premiums for purposes of the guideline premium/cash value corridor test are the amounts necessary to fund the future benefits under the contract. For this purpose, the term "future benefits" means death benefits and endowment benefits. In addition, the charge stated in a contract for any qualified additional benefit is treated as a future benefit, thereby increasing the applicable limitation by the discounted value of the charge. The term "qualified additional benefit" means guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefit prescribed under Treasury regulations.

Explanation of the Bill

S. 284 would provide an exclusion from gross income for amounts received by an individual under a life insurance contract if the insured under the contract is terminally ill. For this purpose, an individual would be considered terminally ill if the individual has been certified by a licensed physician as having an illness or physical condition that can reasonably be expected to result in death in 12 months or less.

In addition, in determining whether a contract qualifies as a life insurance contract for Federal income tax purposes, the bill would treat a qualified terminal illness rider (i.e., a provision in the contract that provides for the payment of a benefit to an individual upon the insured becoming terminally ill) as a qualified additional benefit. Consequently, the applicable limitations for purposes of the definition of a life insurance contract would be increased by the discounted value of the charge for the qualified terminal illness rider.

Under the bill, the addition of a qualified terminal illness rider to a contract would not be treated as a modification of, or a material change to, the contract for purposes of the definition of a life insurance contract and the definition of a modified endowment contract. Further, for purposes of the rules that apply to life insurance companies, a qualified terminal illness rider would be treated as life insurance.

Finally, under the bill, applicants for, and recipients of, benefits under certain public assistance programs (for example, Medicaid) would not be required to take into account the right to receive an accelerated death benefit in determining eligibility for the public assistance benefits. For this purpose, an accelerated death benefit would be defined as any payment made under a life insurance contract while the insured is alive as a result of a recalculation of the life expectancy of the insured.

Effective Dates

The provision of the bill that provides an exclusion from gross income for certain amounts received under a life insurance contract would apply to taxable years beginning after December 31, 1989. The other Federal income tax provisions of the bill would apply to taxable years beginning before, on, or after December 31, 1989. The provision of the bill that relates to public assistance benefits would be effective on January 1, 1990.

Issues

Pros

1. The bill would ease the financial burden of many terminally ill individuals and their families by not imposing Federal income tax on benefits received under life insurance contracts prior to death. The amount of Federal income tax that would otherwise be paid could be used to pay the medical bills and other living expenses of the terminally ill individual.

2. The bill may reduce the amount that would otherwise be paid under Federal or State public assistance programs (such as Medicaid) by encouraging terminally ill individuals to elect to accelerate the receipt of death benefit payments.

3. Certain noninsurance companies currently purchase life insurance contracts from terminally ill policyholders. These companies may not pay policyholders the present value of the death benefit under the contract. The bill would encourage policyholders to elect to accelerate the death benefit payment from the issuing insurance company, which is subject to State regulation and, therefore, is more likely to pay the policyholder the present value of the death benefit under the contract.

Cons

1. The bill would result in the unequal treatment of terminally ill individuals because it would provide a tax benefit only for those who own life insurance at the time of their terminal illness. In addition, the bill would primarily benefit higher-income individuals who are able to afford greater amounts of life insurance. A more efficient and equitable tax subsidy could be developed if the goal is to assist the terminally ill.

2. The treatment of inside buildup under present law favors life insurance as an investment over other investment vehicles thereby distorting the flow of savings and investment in the economy. The bill would provide an additional incentive for individuals to purchase life insurance and would exacerbate the inefficiencies of present law.

3. If the purpose of the bill is to encourage individuals to purchase insurance that covers the expenses of a terminal illness, the bill is inefficient because it requires the purchase of life insurance in order to obtain the favorable tax treatment. A more efficient approach would be to provide a tax subsidy for the purchase of terminal illness insurance.

4. The certification requirement contained in the bill may be difficult to administer and may result in the receipt of tax-free benefits in certain cases where the insured is not reasonably expected to die within 12 months. The life insurance company may be indifferent to the payment of benefits where the insured is not reasonably expected to die within 12 months if the amount paid is discounted sufficiently to compensate the insurance company for the early payment of the benefit.

5. S. 649 (Senators Breaux, Chafee, Pell, and Others):

Repeal of the Luxury Excise Tax on Boats and Yachts

Present Law

General rules

Present law imposes a 10-percent excise tax on the portion of the retail price of boats and yachts that exceeds $100,000.

Boats and yachts that are used exclusively (other than a de minimis amount) in a trade or business (except for entertainment or recreation purposes, including the trade or business of providing entertainment or recreation) are exempt from this tax. In addition, boats and yachts that are used exclusively in the trade or business of commercial fishing or of transporting persons or property for compensation or hire are exempt from this tax. The transporting of persons or property for compensation or hire includes transportation by a cruise ship (regardless of destination) or by a boat chartered with a pilot. These may be exempt from the tax provided that the other conditions for exemption are met.

In addition, present law imposes a 10-percent excise tax on the portion of the retail price of the following items that exceeds the thresholds specified:

(1) *Automobiles above $30,000.*—The tax applies to passenger automobiles, which includes trucks and vans with a loaded gross vehicle weight of 6,000 pounds or less. Limousines are subject to this tax regardless of weight. The tax does not apply to the sale or leasing of any passenger vehicle for use by the purchaser or lessee exclusively (other than a de minimis amount) in the active conduct of a trade or business of transporting persons or property for compensation or hire.

(2) *Aircraft above $250,000.*—The tax applies to aircraft above $250,000, with exceptions for aircraft 80 percent of the use of which is in a trade or business, and certain other uses.

(3) *Jewelry above $10,000.*—The tax applies on an item-by-item basis. Custom fabrication of jewelry (from new or used materials) also is subject to this tax. Repairs and slight modifications to jewelry are not subject to this tax.

(4) *Furs above $10,000.*—The tax applies to items made from fur or in which fur is a major component. The tax does not apply to leather or to artificial fur.

Special rules

Tax applicable only to newly manufactured items.—The tax applies only to the first retail sale (for a purpose other than resale) after manufacture, production or importation of items subject to the tax. It does not apply to subsequent sales of these items. Thus, for example, if a boat dealer sells a new boat for $150,000, that item is subject to this tax. If, however, the boat dealer sells a used boat for $150,000, that sale is not subject to this tax.

If a sale is voided, the tax is refunded. Thus, for example, if a taxpayer purchases a boat subject to the tax and pays the tax, but later returns the boat to the dealer for a refund of the purchase price, the tax would also be refunded at that time.

Collection and deposit of tax.—In general, the retailer must collect the tax and remit it to the IRS in accordance with the rules generally applicable to excise taxes.

Anti-abuse rules.—An anti-abuse rule prevents businesses from briefly using boats subject to tax in their trade or business and then selling them (or converting them to personal use) a short time thereafter as a way of avoiding tax. An additional rule prevents the avoidance of the tax on boats and yachts through separate purchases of major component parts. Thus, for example, if the taxpayer purchases a sailboat from a distant boatyard without an inboard motor or mast, and purchases and has installed locally the inboard motor and mast, those purchases would be aggregated for purposes of this tax. The installer must collect the tax due and remit it to the IRS.

Special rule for leases.—A special rule applies to the leasing of boats and yachts by a person in the trade or business of leasing. These lessors do not pay the tax on their purchase of these items; instead, their leasing of these items is treated as a sale. Thus, a pro rata portion of the tax is due on each lease payment, unless the lease payment is being made by a person who would be exempt from the tax (because of the nature of the use of the item) if the person owned the item.

Exemptions.—In addition to the other exemptions from this tax, the tax does not apply to boats used exclusively by the Federal Government or a State or local government for public works purposes. Thus, a State ferry boat would not be subject to the tax. The use must be directly and integrally related to the public works purpose.

Determination of price.—The retail sales price is the price paid by the retail customer, including any charge incident to placing the article in condition ready for use (such as preparation charges, dealer add-ons, and delivery charges). Retail sales taxes (if separately stated) are excluded. The retail sales price is determined without subtraction for any trade in. Thus, the total price paid (whether paid in cash, in a trade in, or otherwise) is the retail sale price. The manufacturer's suggested retail price (if any) is not the basis on which the price is computed. Significant variation from general retail market prices of comparable items may, however, be considered by IRS to be an indication of an attempt to avoid the tax. Rebates that are fixed at the time of sale and that go directly to the customer reduce the sales price for purposes of computing this tax.

Tax applicable to imports.—This tax applies to all boats and yachts subject to the tax upon their importation into the United States (regardless of whether the boat or yacht was used outside the United States prior to importation), unless the item is being imported by someone in the trade or business for subsequent retail sale or leasing (in which instance the subsequent retail sale or lease would be subject to tax). Thus, for example, the tax is imposed on the retail value of a boat (whether new or used) that an individual imports for personal use. The tax does not apply to any use of a boat or yacht after import if the user establishes to the satisfaction of the Secretary that the first sale or use occurred outside the United States prior to January 1, 1991.

Tax inapplicable to exports.—This tax does not apply to exported boats and yachts.

Effective date of tax.

The luxury excise tax on boats and yachts and the other luxury excise taxes were enacted as part of the Omnibus Budget Reconciliation Act of 1990, which included increases in the rates of several existing excise taxes. The tax on boats and yachts applies after December 31, 1990, and before January 1, 2000. The tax does not apply to a boat or yacht purchased pursuant to a contract that was binding on the purchaser on September 30, 1990, and at all times thereafter and before January 1, 1991.

Explanation of the Bill

S. 649 would repeal the luxury excise tax applicable to boats and yachts.

Effective Date

The bill would be effective as if included in the Omnibus Budget Reconciliation Act of 1990 (retroactive to January 1, 1991).

Issues

Pros

1. The luxury excise tax on boats and yachts may be difficult and potentially costly to administer relative to the revenue raised from the tax.
2. The luxury excise tax on boats and yachts may reduce the demand for boats and yachts costing in excess of $100,000, which may lead to a reduction in employment in the boat and yacht industry.

Cons

1. By imposing luxury excise taxes upon many of the luxury items that higher income persons might purchase, the burden of these taxes is more likely to fall on the higher income individual. This increases the progressivity of the overall Federal tax system.
2. The demand for luxury goods may be relatively price insensitive, in which case the demand for luxury goods and employment in those industries is more likely to be determined by general economic conditions than by taxes imposed upon such goods.
3. Taxes on consumption generally discourage consumption and promote saving, which is important to future economic growth.
4. Repeal of the luxury excise tax on boats and yachts would increase the comparative advantage of boats and yachts over several other taxed luxury goods.

5. The luxury excise taxes were included in the Omnibus Budget Reconciliation Act of 1990 as a partial offset for the perceived regressivity of increases in other excise taxes (e.g., motor fuels, alcohol, tobacco). Repealing the luxury excise tax on boats and yachts may be viewed as counter to the 1990 budget agreement.

6. S. 913 (Senators Baucus, Dodd, Boren, and Riegle): "The Tax-Exempt Bond Simplification Act of 1991"

Present Law

In general

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (sec. 103). Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Code. Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Private activity bonds are bonds (1) more than 10 percent of the proceeds of which satisfy a private business use and payment test, or (2) more than five percent ($5 million, if less) of the proceeds are used to finance loans to persons other than State or local governmental units. A special restriction limits to no more than five percent the amount of bond proceeds that may be used in a private business use that is unrelated to direct governmental activities also being financed with a bond issue. This five-percent restriction is known as the "unrelated and disproportionate private business use limit."

Interest on the following private activity bonds qualifies for exclusion:

(1) Exempt-facility bonds;

(2) Qualified mortgage and qualified veterans' mortgage bonds;

(3) Qualified small-issue bonds;

(4) Qualified student loan bonds;

(5) Qualified redevelopment bonds; and

(6) Qualified 501(c)(3) bonds.

Exempt-facility bonds are bonds the proceeds of which are used to finance the following: airports, docks and wharves, mass commuting facilities or high-speed intercity rail facilities; water, sewage, solid waste, or hazardous waste disposal facilities; facilities for the local furnishing of electricity or gas; local district heating or cooling facilities; and certain low-income rental housing projects.

Arbitrage restrictions

Issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds. As explained more fully below, the two sets of restrictions generally apply with respect to different time periods following issuance of the bonds.

Yield restriction requirement

In general, tax-exempt bond proceeds may not be invested at a yield materially higher than the bond yield, i.e., only limited arbitrage profits may be earned. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds (generally prescribed in Treasury Department regulations). Additional exceptions are provided for bond proceeds invested as part of a reasonably required reserve or replacement fund and for a "minor" portion of the issue proceeds, both throughout the term of the issue.

Unlike the rebate requirement described below, the yield restriction requirement applies both to investments unrelated to the purpose of the borrowing ("nonpurpose investments") and to investments such as a loan to the ultimate borrower of the bond proceeds in the case of private activity bonds ("purpose investments").

Rebate requirement

Generally, all arbitrage profits earned on nonpurpose investments of bond proceeds during periods when such earnings are permitted (e.g., temporary periods) must be rebated to the Federal Government. Permitted arbitrage profits on purpose investments (limited by the yield restriction requirement described above) are not subject to the rebate requirement. Present law includes three principal exceptions to the rebate requirement on nonpurpose arbitrage profits.

Six-month expenditure exception.—First, if all gross proceeds of an issue are spent for the purpose of the borrowing within six months after the bonds are issued, no rebate is required. This exception may be satisfied notwithstanding the presence of a reasonably required reserve or replacement fund if all proceeds other than those invested as part of the reserve fund are so spent and arbitrage profits on the reserve fund (and any bona fide debt service fund subject to rebate) are rebated.

24-month construction bond expenditure exception.—Second, no rebate is required for certain construction bond issues if the available construction proceeds are spent for the purpose of the borrowing at least at specified rates during the 24-month period after the bonds are issued. A construction bond issue is an issue at least 75 percent of the net proceeds of which are to be used to finance construction (as opposed to acquisition) expenses. Construction bonds eligible for this exception include all governmental bonds, qualified 501(c)(3) bonds, and private activity bonds the proceeds of which are used to finance property owned by a governmental unit.

The minimum spending rates are as follows: (1) at least 10 percent spent within six months after the bonds are issued, (2) at least 45 percent spent within 12 months, (3) at least 75 percent spent within 18 months, and (4) 100 percent spent within 24 months. Amounts of reasonable retainage (not exceeding five percent of the available construction proceeds) that remain unspent after 24 months, and which are spent no later than 36 months after issuance do not preclude eligibility for this exception.

Issuers of construction bonds with respect to which these spending requirements are not satisfied may elect to pay a special penalty equal to 1.5 percent of shortfall in spending at each six-month interval in lieu of complying with the general rebate requirement. Additionally, these issuers may elect to terminate these 1.5-percent penalties by payment of an additional 3-percent penalty on the earlier of (1) expiration of the initial temporary period when proceeds may be invested without regard to yield or (2) substantial completion of the spending purposes of the borrowing.

The construction bond exception applies to bonds issued after December 19, 1989.

Small-issuer exception.—Bonds other than private activity bonds issued by governmental units having general taxing powers are not subject to the rebate requirement if the governmental unit (and all of its subordinate units) issues $5 million or less in such governmental bonds during a calendar year.

Restrictions on advance refundings

The Code restricts authority to advance refund tax-exempt bonds to bonds other than private activity bonds and to private activity qualified 501(c)(3) bonds. An advance refunding is a refunding where the refunded bonds are not redeemed within 90 days after the refunding bonds are issued. Except for certain bonds originally issued before 1986, each issue of new money governmental and qualified 501(c)(3) bonds may be advance refunded only one time.

In addition, the Code prohibits the advance refunding of any bond if the transaction involves the use of a "device" to obtain a material financial advantage (based on arbitrage) other than the savings received from lower interest rates on the refunding bonds. The Treasury Department is authorized to identify prohibited devices by regulation.

Tax treatment of financial institutions investing in tax-exempt bonds

Banks and other financial institutions generally are denied a deduction for the portion of their interest expense (e.g., interest paid to depositors) that is attributable to investments in tax-exempt bonds acquired after August 7, 1986. This disallowance is computed using a prorata formula that compares the institution's average adjusted basis in tax-exempt bonds acquired after that date with the average adjusted basis of all assets of the institution.

An exception to this prorata disallowance rule is permitted for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that issue no more than $10 million of such bonds during a calendar year.

Explanation of the Bill

S. 913 would make numerous changes to requirements governing issuance of tax-exempt bonds.

Unrelated and disproportionate private business use limit

The bill would repeal the unrelated and disproportionate private business use limit, effective for bonds issued after the date of the bill's enactment. Allowable private business use of governmental bond proceeds would continue to be restricted by the general private business use and payments test and the private loan bond restriction.

Liberalization of arbitrage restrictions

Elimination of yield restriction requirement in certain cases

The bill would eliminate the present-law arbitrage yield restrictions for all bonds other than advance refunding bonds except where the Treasury Department by regulation identified the yield restriction requirement as existing for a purpose other than preventing the earning of arbitrage profits. This provision would apply to bonds issued after the effective dates of the bond provisions in the Tax Reform Act of 1986, but only with respect to earnings accruing after the date of the bill's enactment.

Reduction of arbitrage profits subject to rebate

The bill would permit issuers to retain 10 percent of the arbitrage profits they earn on nonpurpose investments, effective for bonds issued after the date of the bill's enactment.

Expansion of small-issuer rebate exception

The bill would increase the $5 million annual issuance limit for small issuers whose governmental bonds are not subject to rebate to $25 million, and would expand the exception to apply to governmental bonds issued (1) by governmental units without taxing powers and (2) by "on behalf of" authorities that are not themselves governmental units.

This provision would be effective for bonds issued after December 31, 1990.

Retroactive relief for certain construction bond issues

The bill would make retroactive the present 24-month expenditure exception to the arbitrage rebate requirement for certain construction bonds. Thus, issuers of such bonds issued after August 15, 1986 (August 31, 1986 for governmental bonds) would be exempt from rebate on a prospective basis if they satisfied the 24-month expenditure schedule. Additionally, issuers of bonds issued after those dates could elect to comply with the exception's penalty regime on unexpended proceeds in lieu of further rebate.

Identification of prohibited device

The bill would treat as a prohibited device the issuance of advance refunding bonds in conjunction with the investment of existing bond funds (released from bond indenture restrictions) in investment contracts having materially higher and substantially guaranteed yields, if such an investment occurred within 90 days before or after issuance of advance refunding bonds.

This provision would apply to advance refunding bonds issued after February 26, 1990.

Expansion of financial institution small-issuer exception

The bill would increase from $10 million to $25 million the small-issuer exception to the interest expense deduction prorata disallowance rule applicable to banks and other financial institutions, effective for bonds issued after December 31, 1990.

Issues

Pros

1. Whether a private business use is "related" to a governmental activity also being financed with a bond issue is a complex facts and circumstances determination. In light of the general 10-percent limit on private business use, the private loan restriction, and the State volume limit requirement for larger governmental bond issues, the complexity associated with this determination outweighs any marginal benefit (maximum of $7.5 million per issue) derived by limiting tax-exempt financing for unapproved private activities.

2. The arbitrage rebate and yield restriction requirements serve the same policy objective—elimination of earlier and larger than necessary issuance of tax-exempt bonds. The ability to earn—but not retain—arbitrage profits does not create an incentive to violate this Federal policy.

3. Requiring issuers of tax-exempt bonds to rebate all arbitrage profits to the Federal Government encourages investments that nominally produce no such profit, but may in fact, represent creation of an indirect profit for suppliers of investment vehicles such as guaranteed investment contracts. Such an indirect profit is prohibited under present law as a deflection of arbitrage, but factually the activity is difficult to police. Repealing the yield restriction requirement could reduce the incentive to engage in this "yield burning" investment activity. Further allowing these issuers to retain a portion of any profit earned will encourage more efficient investment, with the Federal Government sharing the benefit of these investments.

4. The exception from the arbitrage rebate requirement for bonds of smaller governmental units reflects a balancing of the policy of preventing arbitrage-motivated bond issuance and the administrative responsibilities necessary to comply. Increasing the current $5 million annual issuance limit defining eligible governments may be appropriate if administrative complexity is shown to outweigh the threat of potential arbitrage-motivated issuance.

5. The 24-month construction bond exception applies to bonds issued after December 19, 1989. Making this exception retroactive to the effective dates of the Tax Reform Act of 1986 will relieve additional issuers of the administrative complexities associated with rebate, while not encouraging issuance of additional bonds.

6. Bonds of smaller governmental units are exempt from general restrictions on banks and other financial institutions deducting costs of acquiring and carrying tax-exempt investments because the small size of their bond issues may render other markets unavailable. Increasing the current $10 million annual issuance limit for eligible governments may be appropriate if non-financial institution markets are demonstrated to be unavailable for bonds of the additional issuers.

Cons

1. The five-percent unrelated and disproportionate private business use limit is the effective limit on private business use for many tax-exempt bonds. Repealing this limit will increase the private activities for which tax-exempt financing may be provided outside of restrictions (e.g., State volume limits) generally applicable to such private, conduit financing without ensuring the Congressional review generally accompanying the allowance of this Federal subsidy.

2. Issuers of tax-exempt bonds have been subject to yield restriction requirements since 1969, with rebate having been required for all bonds only since 1986. Except for reasonably required reserve funds, the rebate and yield restriction requirements generally apply to different time periods. An administratively simpler approach to the problem of duplicative requirements might be to limit the rebate requirement to prescribed temporary periods and to reserve funds because issuers have been accustomed to complying with the yield restriction requirement for over 20 years.

3. While allowing issuers to retain a portion of arbitrage profits may discourage yield-burning transactions, it also could lead to earlier and larger issuance of tax-exempt bonds—at an increased Federal revenue cost—if issuers attempted to maximize the arbitrage profits they could retain. This would be particularly true if the present-law yield restriction requirement also were repealed, thereby allowing issuers to earn profits and to retain a percentage of them over extended periods.

4. The small-issuer arbitrage rebate exception is intended to relieve the smallest governmental units from the administrative complexity of compliance with that requirement because they may lack in-house accounting personnel and is premised in part, on the limited incentives for arbitrage-motivated transactions with smaller bond issues. Increasing the annual issuance limit on this exception to $25 million is inconsistent with these objectives because of (1) greater availability of in-house accounting staff to these larger issuers, (2) ready access to computer programs for performing rebate calculations, and (3) greater incentive for arbitrage-motivated transactions due to larger dollar volumes of eligible bonds.

5. Issuers of bonds issued before December 20, 1989, are unlikely to have complied with the spending requirements of the 24-month construction bond exception to the rebate requirement because the rule did not exist when their bonds were issued. Retroactive application of this provision, therefore, merely creates a financial planning opportunity in that the issuers will choose to terminate their current rebate liability in cases where substitution of the 1.5-percent penalty regime of the 24-month exception is more financially advantageous to them.

6. The growth since 1986 of individual investors in tax-exempt bonds, primarily through investment in mutual funds, has eliminated the marketing difficulties historically addressed by bank and

million per issuer provides an unnecessary tax subsidy to these financial institutions.
financial institution purchases. In light of these market changes, allowing banks an exception from the prohibition on deducting interest incurred to acquire or carry tax-exempt bonds of up to $25

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