

DESCRIPTION OF TAX BILLS
(S. 425, S. 608, S. 1348, S. 1479, S. 1580, and S. 1656)
SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
ON OCTOBER 16, 1981

PREPARED FOR THE USE OF THE
COMMITTEE ON FINANCE
BY THE STAFF OF THE
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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on October 16, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are six bills scheduled for the hearing: S. 425, S. 1348, and S. 1656 (relating to mortgage revenue bonds) and S. 608, S. 1479, and S. 1580 (generally relating to adoption expenses).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation, effective dates, and revenue effects.

I. SUMMARY

1. S. 425—Senators Packwood and Hatfield

Additional Transitional Rule to Mortgage Subsidy Bond Tax Act

The bill would provide an additional transitional rule to the Mortgage Subsidy Bond Tax Act of 1980, for \$500 million of general obligation bonds of the State of Oregon for financing housing for veterans.

2. S. 608—Senator Baucus

Expanded Deduction for Certain Adoption Expenses

Present law provides an itemized deduction for up to \$1,500 of expenses paid by an individual in adopting a "child with special needs" (sec. 222). The deduction applies where the child, because of a specific factor such as age, ethnic background, medical condition, or handicap, cannot reasonably be expected to be adopted unless adoption assistance is provided. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies in 1981 and subsequent years.

The bill would expand the adoption expense deduction by extending it to all individual taxpayers, whether or not they itemize deductions; by allowing the deduction for expenses of adopting any child, whether or not the child is considered to have "special needs"; and by allowing an unlimited amount of deductible adoption expenses. In general, this "above-the-line" deduction would be available for reasonable and necessary expenses of a legal adoption arranged by a public welfare department or a nonprofit voluntary adoption agency.

The provisions of the bill would apply to taxable years beginning after 1981.

3. S. 1348—Senators Sasser, Baker, Bumpers, Pryor, Packwood, Pell, Danforth, Chafee, Durenberger, Baucus, Bradley, Mitchell, and others

Amendments to the Mortgage Subsidy Bond Tax Act

The bill would make a number of amendments to the Mortgage Subsidy Bond Tax Act of 1980.

First, the bill would provide that certain targeting provisions of the Act would be considered satisfied if the issuer attempts to enforce compliance with those provisions in good faith and corrects any failures within a reasonable time after discovery of the failure. In addition, bondholders would be able to rely upon a covenant by the issuer that the issuer attempted to comply with the targeting provisions in good faith.

Second, the bill would modify the rule of present law that prohibits an individual from being eligible to receive a mortgage financed by a mortgage subsidy bond if he owned a residence within three years, by providing that the requirement is met if the mortgagor certifies that he has met the three-year rule. In addition, the bill would provide exceptions to the three-year rule in the case of individuals who lived in residences that were either (1) made uninhabitable by disaster or governmental action or (2) certified by an appropriate State or local official as not meeting certain minimum housing standards.

Under present law, the three-year rule does not apply to targeted area residences. The bill would enlarge the definition of targeted area residences to include residences in energy-impacted areas. In addition, the bill would modify the present definition of areas of chronic economic distress, to provide that a State has complete discretion in determining the areas covered by such definition so long as such areas do not cover more than 25 percent of the geographical area of the State.

Third, the bill would modify the purchase price limitation by (1) clarifying that the average purchase price need not be determined more than twice during any 12-month period, and (2) permitting the exclusion from the computation of the average purchase price of those residences which are not typically financed through a normal real estate mortgage loan (e.g., mobile homes). In addition, the bill would permit the computation of the average area purchase price by combining two or more statistical areas.

Fourth, the bill would modify the arbitrage limitations of the Mortgage Subsidy Bond Tax Act of 1980 in several respects. First, it would increase the allowable arbitrage on mortgage investments from one percentage point to one and a half percentage points. Second, it would modify the computation of yield on the bonds to permit relending of bond proceeds for new additional loans. Third, it would permit unlimited arbitrage on nonmortgage investments for a temporary period until the excess funds are reloaned in new mortgages. Fourth, it would provide an exception to the restrictions on arbitrage on nonmortgage investments so that no investment would have to be sold at a loss. Fifth, with respect to arbitrage that must be paid to mortgagors or the Federal Government, the bill would permit the withholding of amounts for a reasonable reserve against losses on investments, would permit the issuer to determine when such payments would be made, and would permit the issuer to modify at any time its rules as to which mortgagors would receive the payments. Finally, the bill would modify the arbitrage rules to permit their application to two or more issues on a combined basis.

Fifth, the bill would provide an exception to the rule of present law that the targeting provisions must also be met in the case of mortgage assumptions in the case of mortgages which are FHA-insured or VA-guaranteed.

Sixth, the bill would repeal the registration requirements as they apply to mortgage subsidy bonds and to industrial development bonds that are used to provide rental housing.

The provisions of the bill would be effective as if they had been included in the Mortgage Subsidy Bond Tax Act of 1980.

4. S. 1479—Senators Metzenbaum, Tsongas, and Williams

Tax Benefits for Employer Adoption Expense Plans; Expanded Deduction for Certain Adoption Expenses

Present law provides an itemized deduction for up to \$1,500 of expenses paid by an individual in adopting a "child with special needs" (sec. 222). The deduction applies where the child, because of a specific factor such as age, ethnic background, medical condition, or handicap, cannot reasonably be expected to be adopted unless adoption assistance is provided. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies in 1981 and subsequent years.

The bill would exclude from the gross income of an employee amounts received for adoption expenses under a qualified (nondiscriminatory) plan established by the employer. The employer would be permitted to deduct amounts contributed to the adoption expense plan. In general, this rule would apply with respect to reasonable and necessary expenses of a legal adoption arranged by a public welfare department or nonprofit voluntary adoption agency.

In addition, individuals would be permitted under the bill to deduct adoption expenses (other than those provided through an employer plan), whether or not they itemize deductions. The bill would also expand the existing adoption expense deduction by allowing an unlimited amount of deductible adoption expenses and by allowing the deduction for the expenses of legally adopting any child, whether or not the child is considered to have "special needs."

The provisions of the bill would apply to taxable years beginning after 1980.

5. S. 1580—Senator Jepsen

Additional Exemption for Childbirth or Adoption; Deduction or Credit for Certain Adoption Expenses

Present law provides an itemized deduction for up to \$1,500 of expenses paid by an individual in adopting a "child with special needs" (sec. 222). The deduction applies where the child, because of a specific factor such as age, ethnic background, medical condition, or handicap, cannot reasonably be expected to be adopted unless adoption assistance is provided. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies in 1981 and subsequent years.

The bill would provide married taxpayers who give birth to or adopt a child with an additional personal exemption of \$1,000 for the year in which the child is born or adopted. If the child is handicapped, the additional personal exemption would be increased to \$3,000. In addition, married taxpayers who adopt a child who either (1) is age six or over or (2) is a member of a minority race or ethnic group would be entitled to an additional personal exemption of \$3,000.

The bill also would give individuals an election to deduct or take a tax credit for certain expenses of legally adopting a child, whether or not the child is considered to have "special needs." The deduction or credit would be limited to the first \$3,500 (\$4,500 in the case of an

international adoption) of adoption expenses in excess of \$500. The deduction would be available whether or not the taxpayer itemizes.

The provisions of the bill generally would apply with respect to births or adoptions after 1980.

6. S. 1656—Senators Durenberger, Roth, Chafee, Bradley, Heinz, Melcher, Symms, and Stennis

Amendments to the Mortgage Subsidy Bond Tax Act

The bill would amend the Mortgage Subsidy Bond Tax Act of 1980 with respect to both mortgage subsidy bonds for single-family residences and industrial development bonds for multi-family rental housing.

Mortgage subsidy bonds for single-family residences

The bill would provide that certain of the targeting provisions of the Act would be considered satisfied if (1) the issuer attempts to comply with those targeting provisions in good faith, (2) the targeting requirements are met with respect to 95 percent of the financing at the time the bonds are issued, (3) the issuer undertakes periodic, cost-effective audits and prosecutes any person who has committed fraud with respect to such requirements, and (4) any failure to meet the requirements is corrected within a reasonable period of its detection.

The bill would modify the arbitrage limitations of the Act by increasing the allowable arbitrage on mortgage investments from one percentage point to one and a quarter percentage points. Also, the bill would provide that the rule limiting arbitrage on nonmortgage investments that exceed 150 percent of debt service does not apply if it would require disposition of any investment at a loss.

The bill would repeal the registration requirements as they apply to mortgage subsidy bonds.

Industrial development bonds for multi-family rental housing

The bill would provide that the targeted group of tenants who would qualify a project for tax-exempt industrial development bonds would be either (1) those individuals whose incomes do not exceed 80 percent of the area median gross income or (2) those individuals who are classified as individuals of low or moderate income by the Secretary of Housing and Urban Development. Under present law, the targeted group conforms to those individuals who are eligible to receive Section 8 rental housing assistance.

Under present law, the targeted requirement must be met for at least 20 years in order for industrial development bonds for multi-family rental projects to be tax-exempt. The bill would provide that the targeting requirement need not be met until after the later of (1) ten years from the date of first occupancy, (2) a date ending when 50 percent of the maturity of the bond has gone by, or (3) the date on which any Section 8 assistance for the project terminates.

The bill would also repeal the registration requirement as it applies to industrial development bonds for multi-family rental housing.

The provisions of the bill would apply with respect to obligations issued after the date of enactment.

II. DESCRIPTION OF BILLS

1. S. 425—Senators Packwood and Hatfield

Additional Transitional Rule to Mortgage Subsidy Bond Tax Act

Present law

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The Act was intended generally to direct the subsidy from use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing. The Act had numerous transitional rules.

Issue

The issue is whether an additional transitional rule should be added to the Mortgage Subsidy Bond Tax Act of 1980 to exempt from the restrictions of that Act \$500 million of general obligation bonds issued by the State of Oregon for financing housing for veterans.

Explanation of the bill

The bill would add an additional transitional rule to the Mortgage Subsidy Bond Tax Act of 1980. That rule would exempt from the requirements of that Act \$500 million of general obligation bonds issued by the State of Oregon between January 7, 1981, and April, 1981, for mortgage financing for veterans qualified under the Oregon Department of Veterans' Affairs program.

Effective date

The provisions of the bill would be effective as if they had been included in the Mortgage Subsidy Bond Tax Act of 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by \$1 million in 1982 and \$3 million annually for 1983 through 1986.

2. S. 608—Senator Baucus

Expanded Deduction for Certain Adoption Expenses

Present law

Present law provides an itemized deduction for qualified expenses paid or incurred by an individual in adopting a “child with special needs” (Code sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed \$1,500. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies to taxable years beginning after December 31, 1980.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to a legal adoption. The term “child with special needs” means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.¹ In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be placed with adoptive parents unless adoption assistance is provided.

An expense which is allowable as a deduction or credit under any other Code section (for example, medical expenses above the three-percent floor) may not also be deducted as an adoption expense; that is, the same expense cannot give rise to a double tax benefit. No deduction is allowable for expenses that are paid from funds received under a Federal, State, or local program, or that are incurred in violation of Federal or State law.

Issues

The issues presented by the bill include the following:

(1) Whether the newly enacted itemized deduction for certain adoption expenses should also be made available to individuals who do not itemize deductions;

(2) Whether a deduction should be provided for the expenses of adopting any child, including a child who is not considered difficult to place; and

(3) Whether adoption expenses should be deductible without limitation on amount.

¹ Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Explanation of the bill

The bill would provide an "above-the-line" deduction to individuals for adoption expenses paid or incurred during the taxable year. This deduction would be taken from gross income; thus, it would be available whether or not the individual itemizes other personal deductions. There would be no dollar limit on the amount of adoption expenses which could be deducted.

Under the bill, deductible adoption expenses would be reasonable and necessary adoption agency fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of a child by the taxpayer. In order for adoption expenses to be deductible under the bill, the adoption to which the expenses relate must be arranged by a public welfare department (or similar State or local public social service agency with legal responsibility for child placement) or by a not-for-profit voluntary adoption agency that is authorized by a State or local government to place children for adoption.

An amount which is taken into account in computing a deduction or credit under any other Code section could not also be deducted as an adoption expense; that is, the same expense could not give rise to a double tax benefit. No deduction would be allowable for expenses that are incurred in violation of Federal or State law.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1981.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by \$5 million in 1982, \$32 million in 1983, \$32 million in 1984, \$32 million in 1985, and \$34 million in 1986.

3. S. 1348—Senators Sasser, Baker, Bumpers, Pryor, Packwood, Pell, Danforth, Chafee, Durenberger, Baucus, Bradley, Mitchell, and others

Amendments to the Mortgage Subsidy Bond Tax Act

Present law

In general

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The Act was intended generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing.

Targeting mechanism

The Act contains a number of requirements to achieve the goals set forth above. Under the Act, the requirements are divided into two groups.

As to one group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy such requirements before the mortgages were executed. Where such good faith has been exercised, 95 percent or more of the proceeds that are devoted to financing of owner-occupied residences (referred to as lendable proceeds) must have been invested in mortgages which meet all requirements in the group at the time of the execution of the mortgages. In addition, where the good faith and 95 percent requirements are met, failures to meet the first group of requirements in any mortgage must be corrected within a reasonable period after such failure is first discovered.

The requirements that come within this group of requirements are the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement.

With respect to the other group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all of such requirements and any failure to meet such requirements is due to inadvertent error. The requirements included in this group are the market share limitation, the portion of loans in targeted areas requirement, the arbitrage requirement, and the registration requirement.

Three-year requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages financed from the bond proceeds must be provided to mortgagors each of whom did not have a present ownership interest in

a principal residence at any time during the three-year period ending on the date that the mortgage is executed.

The three-year requirement does not apply with respect to mortgagors of residences in three situations. First, it does not apply to mortgagors of residences that are located in a targeted area. Second, it does not apply to mortgagors who receive qualified home improvement loans. Third, it does not apply to mortgagors who receive a qualified rehabilitation loan.

A targeted area residence is defined to mean a residence located in either one of two areas: (1) a qualified census tract or (2) an area of chronic economic distress.

A qualified census tract is a census tract in which 70 percent or more of the families have income which is 80 percent or less of the Statewide median family income. This determination is to be based on the most recent decennial census for which data are available.

An area of chronic economic distress is defined as an area which has been designated as such by the State in accordance with its standards and which designated area has been approved by the Departments of Treasury and Housing and Urban Development as an area of chronic economic distress. The criteria to be used by the Departments in approving an area as an area of chronic economic distress are: (1) the condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units; (2) the need of area residents for owner-financing through tax-exempt bonds, as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates; (3) the potential for use of owner-financing through tax-exempt bonds to improve housing conditions in the area; and (4) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program.

Purchase price requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, must be for the purchase of residences where the acquisition cost of each residence does not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that resident.

The average area purchase price means the average purchase price of all single-family residences in the statistical area in which the residence is located. The average is to be based on sales during the most recent 12-month period for which sufficient statistical information is available.¹ Whether a particular residence meets the purchase price requirement is to be determined on the date that the mortgage originator makes a commitment to provide financing from the bond proceeds (or, if earlier, the date of the purchase of the residence). Separate determinations are to be made for new and used residences.

The term "statistical area" is defined to mean a standard metropolitan statistical area (SMSA) or any county, or portion of a county, which is not within an SMSA. Where an SMSA covers a portion of a county, the portion of the county that is not covered by the SMSA is treated as a separate statistical area. An SMSA is defined to mean those areas so designated by the Secretary of Commerce. If a portion

of a State is in neither an SMSA nor a county (as occurs in the State of Alaska), the statistical area is to be the area designated by the Treasury Department as the equivalent of a county.

Arbitrage

In general

In order for an issue to be a qualified mortgage issue, the issue must meet certain requirements regarding arbitrage as to both mortgage loans and nonmortgage investments.

Under the Act, the effective rate of interest on mortgages provided under the issue cannot exceed the yield on the issue by more than one percentage point. This determination is to be made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than one percentage point above the yield of the issue if other mortgages have a lower effective interest rate.

In general, this requirement imposes a limitation on the amount of costs a mortgagor is required to pay, such as underwriter commissions and other issuance costs, servicing fees, and trustee fees. Under this provision, the total cost of issuing the bonds and providing mortgage financing which may be passed on to the mortgagors may not exceed the yield on the issue by more than one percentage point.

Determination of interest rate, yield

The Act provides three rules for determining the effective rate of interest on any mortgage. The first rule deals with the amount to be taken into account in determining the effective rate of interest on any mortgage. The second rule deals with prepayment assumptions. The third rule deals with actuarial assumptions.

The first rule provides that the effective rate of interest on any mortgage is determined by taking into account all amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue.

The second rule provides that in determining the effective rate of interest on any mortgage, it shall be assumed that the mortgage prepayment rate will be the rate set forth in the most recent mortgage maturity experience table published by the Federal Housing Administration for the State (or, if available, the area within the State) in which the residences are located. This rule addresses the problem of determining the effective rate of interest on a mortgage where prepayment occurs. Generally, where a point or fee is charged upon origination or prepayment of a mortgage, the effective rate of interest on the mortgage will vary depending on whether some or all of the mortgages are prepaid. In addition, the exact pattern of prepayments of the mortgages is not known at the time the bonds are issued. The Act addresses the problem by providing that the FHA maturity experience tables shall be used to determine the mortgage prepayment rate in determining the effective interest rate. Thus, the mortgages are to be treated as prepaying on the basis of 100 percent of FHA tables.

¹Temporary regulations issued by the Treasury Department provide a safe harbor rule under which an issuer may rely on the average purchase price published by the Treasury for an area for the period stated at the time of publication (Temp. Reg. § 6a.103A-2(f)(5)).

The third rule provides that the effective rate of interest on the mortgages is to be determined on an actuarial basis. All amounts that are taken into account in determining the effective rate of interest are discounted, from the time the amount is received, to an amount equal to the "purchase price" of the mortgage. The discount rate which will discount all present and future receipts to the purchase price is the effective rate of interest on the mortgages.

The Act also provides certain rules for determining the yield on the issue. The yield on the bond issue is also to be computed on an actuarial basis.

Restrictions under the Act

The Act also imposes restrictions on the arbitrage on nonmortgage investments. Mortgage subsidy bonds usually have established a reserve of one and one-half times the maximum annual scheduled debt service. The Act provides that the reserve must be reduced as future annual debt service is reduced.

The Act also limits the amount that may be invested at unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year. An exception to the 150-percent debt service rule is provided, however, for proceeds invested for an initial temporary period until such proceeds are needed for mortgages.

Present law also requires that arbitrage earned by the issuer on non-mortgage investments is to be paid or credited to the mortgagors or paid to the Federal Government. While the arbitrage rules do not explicitly so indicate, they appear to contemplate that the arbitrage rules are to be applied on an issue-by-issue basis.

Assumptions

In order for an issue to be a qualified mortgage issue, certain of the requirements for a qualified mortgage bond must be met by every mortgagor who assumes a mortgage that had been made from proceeds of a qualified mortgage issue. Those requirements are the residence requirement, the three-year requirement, and the purchase price requirement. These requirements are to be determined based upon the facts as they exist at the time of the assumption as if the loan were first being made at that time.

Registration

In order for an issue to be a qualified mortgage issue, all of the obligations which are part of the issue must be in registered form. Similarly, the Act requires that tax-exempt industrial development bonds for multi-family rental housing be in registered form.

Issues

The issues presented by the bill include the following:

(1) What standard of care should be imposed upon the issuer to insure that the targeting provisions of the Mortgage Subsidy Bond Tax Act of 1980 are enforced? What should be the enforcement mechanism if the funds are not properly targeted?

(2) What actions should the issuer be required to take to insure compliance with the three-year rule? Should additional exceptions to the three-year rule be provided for individuals owning housing made uninhabitable by a disaster or government action or living in sub-

standard housing? If so, what are the proper standards for determining substandard housing?

(3) Should the definition of targeted area residences be broadened to include "energy-impacted" areas? If so, how are such areas different from other areas where adequate housing is in short supply?

(4) Who should be designated to determine what areas are to be included within the areas of chronic economic distress, and what standards and limitations are appropriate in making such determinations?

(5) How often should the data on average area purchase price be determined? Should mobile homes be included in determining these averages?

(6) What is the appropriate level of arbitrage on mortgage investments? Should such a level be adequate to permit mortgage subsidy bonds to be issued without any contribution by State or local governments?

(7) Should the arbitrage rules be modified to permit the reinvestment in new mortgages of principal payments and prepayments of mortgages already financed with the bonds?

(8) Should an exception be provided to the restrictions on the size of nonmortgage investments where the sale of a nonmortgage investment would result in a loss?

(9) In determining the amount of arbitrage on nonmortgage investments that must be paid to the mortgagor or the Federal Government, should a reserve for loss on investments be permitted and should the issuer have complete discretion as to when such payments are to be made and to which of the mortgagors such payments should be made?

(10) Should an exception to the targeting rules be provided in the case of assumptions of FHA-insured and VA-guaranteed loans?

(11) Should the registration requirements be repealed?

Explanation of the bill

In general

The bill would modify a number of the rules and requirements of the Mortgage Subsidy Bond Tax Act of 1980.

Targeting mechanism

The bill would provide that the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement would be met where (1) the issuer in good faith attempted to meet all such requirements before the mortgages were executed, and (2) any failure to meet those requirements is corrected within a reasonable period after such failure is first discovered.

In addition, the bill would provide that the tax-exempt status of interest on a mortgage subsidy bond would not be lost if issuer covenants that the issuer attempted and will attempt to comply with all of the targeting provisions of the Act unless the Treasury Department has published a notice of the issuer's failure to comply with the requirements prior to the sale of the issue.

Three-year requirement

The bill would modify the three-year rule to require only that the mortgagor certify that he did not have a present ownership interest in

a principal residence within the three-year period prior to the execution of the mortgage. In addition, the bill would provide exceptions to the three-year rule (1) where the mortgagor had an interest in a residence which an appropriate State or local official has certified does not meet the minimum housing standards established for the area by the State or local government with respect to sanitation, heating, major structural deficiencies, or overcrowding, and (2) where the mortgagor had an ownership interest in a prior residence which can no longer be occupied on a permanent basis due to natural disaster or governmental action.

The bill would also modify the definition of targeted area residences in two respects. First, the bill would add a new additional area to targeted area residences for residences located in energy-impacted areas. An energy-impacted area would be defined as an area designated as impacted by increased production of coal, uranium, oil, gas, or other energy-related materials which meet the criteria set forth in section 601(a) of the Powerplant and Industrial Fuel Use Act of 1978 with respect to areas impacted by increased coal or uranium production. Second, the bill would modify the definition of "area of chronic economic distress" to mean an area of chronic economic distress designated by the State as meeting the standards established by the State, provided that areas of chronic economic distress may not exceed 25 percent of the geographic area within the State.¹

Purchase price requirement

The bill would make two modifications to the rules applicable to the purchase price limitation. First, the bill would provide that the average purchase price for an area would not have to be recomputed more than twice during any 12-month period. Second, in determining the average area purchase price, the bill would permit the exclusion of residences which are not typically financed through a normal real estate mortgage loan (such as a residence to be located on land occupied under a lease having a term less than 15 years or a residence which is normally financed as personal property). In addition, the bill would modify the rules for determining the area used for measuring the average purchase price (e.g., the definition of "statistical area") to permit the combination of two or more statistical areas.

Arbitrage

The bill would make a number of modifications to the arbitrage requirements both as to mortgage investments and as to nonmortgage investments.

With respect to mortgage investments, the bill would increase the permissible level of arbitrage from 1.0 percentage points to 1.5 percentage points. The bill would also add a rule to clarify that the yield on the bonds would be computed based upon the assumption that funds could be used both to provide additional mortgages and to redeem bonds.

With respect to nonmortgage investments, the bill would modify the restriction on arbitrage on investments that exceed 150 percent of debt service to allow unlimited arbitrage during any temporary period (as

¹ Because the rule is expressed in terms of geographical area, targeted areas could cover substantially more or less than 25 percent of the State's population.

opposed to the initial temporary period provided under present law) that funds are held for investment in mortgages. This change apparently is intended to aid in the relending of funds within an issue. In addition, the bill would add a rule that the 150 percent of debt service rule would not apply if it would require disposition of any investment at a loss.

The bill would also allow the creation of a reasonable reserve for losses on investments to be taken into account in determining the amount of arbitrage on nonmortgage investments that must be paid to the mortgagors or the Federal Government. With respect to amounts paid to mortgagors, the bill would allow the amounts to be paid at the time of receipt or at the time of distribution and would allow for the change of the formula under which such amounts are distributed to mortgagors.

Finally, the bill would provide a rule intended to permit the application of the arbitrage rules to two or more issues on a combined basis.

Assumptions

The bill would provide exceptions to the present law rule on assumptions in the case of mortgages which are insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

Registration

The bill would repeal the registration requirement for both mortgage subsidy bonds for single-family housing and for industrial development bonds for multi-family rental housing.

Effective date

The amendments made by the bill would apply as if they had been included in the Mortgage Subsidy Bond Tax Act of 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by \$4 million in 1982, \$12 million in 1983, \$18 million in 1984, \$19 million in 1985, and \$18 million in 1986.

4. S. 1479—Senators Metzenbaum, Tsongas, and Williams

Tax Benefits for Employer Adoption Expense Plans; Expanded Deduction for Certain Adoption Expenses

Present law

Present law provides an itemized deduction for qualified expenses paid or incurred by an individual in adopting a "child with special needs" (Code sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed \$1,500. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies to taxable years beginning after December 31, 1980.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to a legal adoption. The term "child with special needs" means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.¹ In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be placed with adoptive parents unless adoption assistance is provided.

An amount which is taken into account in computing a deduction or credit under any other Code section may not also be deducted as an adoption expense; that is the same expense cannot give rise to a double tax benefit. No deduction is allowable for expenses that are paid from funds received under a Federal, State, or local program, or that are incurred in violation of Federal or State law.

Issues

The issues presented by the bill include the following:

(1) Whether an income tax exclusion should be allowed to employees for employer-provided adoption expenses, and whether employers should receive a deduction for contributions to adoption expense plans;

(2) Whether the newly enacted itemized deduction for certain adoption expenses should also be made available to individuals who do not itemize deductions;

(3) Whether a deduction should be provided for the expenses of adopting any child, including a child who is not considered difficult to place; and

(4) Whether adoption expenses should be deductible without limitation on amount.

¹Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Explanation of the bill

Exclusion for employer-provided adoption expenses

The bill would exclude from the gross income of an employee amounts received under an adoption expense plan and amounts contributed by the employer, on behalf of the employee, to the plan. Employer contributions to the plan would be deductible by the employer as trade or business expenses. An adoption expense plan would be a written plan of an employer to reimburse employees for adoption expenses.

Adoption expenses, for this purpose, would be reasonable and necessary expenses (not incurred in violation of State or Federal law) that are directly related to the legal adoption of a child. These expenses would include legal fees, medical expenses, adoption fees, temporary foster care expenses, transportation costs, and expenses related to the pregnancy of the child's natural mother. To qualify, the adoption must be arranged by a public welfare department (or similar State or local public social service agency with legal responsibility for child placement) or by a not-for-profit voluntary adoption agency authorized by the State or local government to place children for adoption.

Adoption expense plans would be subject to the existing requirements for medical expense reimbursement plans (sec. 105(h)). Thus, in order to qualify for favorable tax treatment under the bill, an adoption expense plan could not discriminate in favor of highly compensated individuals with respect to eligibility requirements or benefits.

Expanded deduction for adoption expenses

The bill would provide an "above-the-line" deduction to individuals for adoption expenses, not compensated by insurance or otherwise, paid or incurred during the taxable year. This deduction would be taken from gross income; thus, it would be available whether or not the individual itemizes other personal deductions. There would be no dollar limit on the amount of adoption expenses which could be deducted.

The adoption expenses which would qualify under the bill for the deduction would be the same expenses that would qualify for the income exclusion if provided under an employer adoption expense plan. Thus, qualifying expenses would be reasonable and necessary expenses that are directly related to the legal adoption of a child by the taxpayer, where the adoption is arranged by a public welfare department or nonprofit voluntary adoption agency.

An amount which is taken into account in computing a deduction or credit under any other Code section could not also be deducted as an adoption expense: that is, the same expense could not give rise to a double tax benefit. Also, adoption expenses provided under an employer plan and excluded under the bill from an employee's gross income would not be deductible by the employee.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by \$38 million in 1982, \$33 million in 1983, \$35 million in 1984, \$37 million in 1985, and \$41 million in 1986.

5. S. 1580—Senator Jepsen

Additional Exemption for Childbirth or Adoption; Deduction or Credit for Certain Adoption Expenses

Present law

Adoption expenses

Present law provides an itemized deduction for qualified adoption expenses paid or incurred by an individual in adopting a “child with special needs” (Code sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed \$1,500. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies to taxable years beginning after December 31, 1980.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to a legal adoption. The term “child with special needs” means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.¹ In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be placed with adoptive parents unless adoption assistance is provided.

An expense which is allowable as a deduction or credit under any other Code section (for example, medical expenses above the three-percent floor) may not also be deducted as an adoption expense; that is, the same expense cannot give rise to a double tax benefit. No deduction is allowable for expenses that are paid from funds received under a Federal, State, or local program, or that are incurred in violation of Federal or State law.

Personal exemptions

Present law provides personal exemptions of \$1,000 for a taxpayer and for any dependent of the taxpayer. For a husband and wife filing a joint return, two personal exemptions of \$1,000 are allowed, plus an exemption of \$1,000 for any dependent. An additional exemption of \$1,000 is allowed for a taxpayer age 65 or over and for a blind taxpayer.

¹ Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Issues

The issues presented by the bill include the following:

- (1) Whether an additional personal exemption should be provided to married individuals who give birth to, or adopt, a child, and if so, whether the amount of the exemption should be increased if the child is handicapped or in certain other situations;
- (2) Whether the newly enacted itemized deduction for certain adoption expenses should also be made available to individuals who do not itemize deductions;
- (3) Whether a deduction should be provided for the expenses of adopting any child, including a child who is not considered difficult to place;
- (4) Whether the amount of deductible adoption expenses should be increased; and
- (5) Whether a tax credit for adoption expenses should be provided.

Explanation of the bill

Additional personal exemption

The bill would provide married individuals who give birth to or adopt a child an additional personal exemption of \$1,000 for the year in which the child is born or adopted. If the child is handicapped, the additional personal exemption would be increased to \$3,000. In addition, married individuals who adopt a child who either (1) has attained age six before the first day of the year in which adopted or (2) is a member of a minority race or ethnic group would be entitled to an additional personal exemption of \$3,000. The additional exemption would be provided only for the year of birth or adoption, and would not be available in the next or later years with respect to the child.

For purposes of the additional \$3,000 exemption, a handicapped child would be a child who has a physical or mental disability (including blindness or deafness) which constitutes or results in a functional limitation to employment, or who has any physical or mental impairment (including a sight or hearing impairment) which substantially limits one or more major life activities.

In order to claim the additional personal exemption, the husband and wife must file a joint return for the year of the birth or adoption. If the taxpayers cannot use the exemption fully in one taxable year, any unused amount may be carried over as an exemption amount to the following year. An unmarried individual who adopts a child would not be eligible for the additional exemption.

Deduction for adoption expenses

The bill also would provide an "above-the-line" deduction for adoption expenses, to the extent exceeding \$500, paid or incurred by an individual (including an unmarried individual). This deduction would be taken from gross income; thus, it would be available whether or not the individual itemizes other personal deductions. Deductible adoption expenses would be reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of a child, provided that the expenses are not incurred in violation of State or Federal law.

The first \$500 paid or incurred in adopting any one child would not be deductible. The aggregate amount allowable as a deduction, for all taxable years, with respect to adopting a child generally could not exceed \$3,500.

In the case of an "international adoption," the deduction limit would be increased to \$4,500. An international adoption would be either (1) an adoption under the laws of a foreign country or (2) an adoption of a child who was a citizen of a foreign country and who was brought to the United States for the purpose of adoption or under circumstances making the child's placement for adoption reasonably foreseeable.

An amount which is allowable as a deduction or credit under any other Code section (for example, medical expenses above the three-percent floor) could not also be deducted as an adoption expense; that is, the same expense could not give rise to a double tax benefit. No deduction would be allowable for adoption expenses paid from funds received under Federal, State, or local programs.

Credit for adoption expenses

Instead of deducting adoption expenses, individuals could elect to claim an income tax credit. Under the bill, the credit would be available for up to \$3,500 (\$4,500 in the case of an international adoption) of adoption expenses in excess of \$500.

Effective date

The additional personal exemption would apply to births or adoptions in taxable years beginning after December 31, 1980. The deduction or credit for adoption expenses would be available for amounts paid or incurred in connection with any adoption that becomes final after December 31, 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by \$1,063 million in 1982, \$927 million in 1983, \$884 million in 1984, \$893 million in 1985, and \$908 million in 1986.

6. S. 1656—Senators Durenberger, Roth, Chafee, Bradley, Heinz, Melcher, Symms, and Stennis

Modifications to the Mortgage Subsidy Bond Tax Act

Present law

In general

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The Act was intended generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to housing. The Act provided new restrictions on tax-exempt mortgage subsidy bonds for single-family residences and modified the rules applicable to tax-exempt industrial development bonds for rental housing.

Mortgage subsidy bonds for single-family residences

Targeting mechanism

The Act contains a number of requirements to achieve the goals set forth above in the case of tax-exempt mortgage subsidy bonds to finance single-family residences. Under the Act, the requirements are divided into two groups.

As to one group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all such requirements before the mortgages were executed. Where such good faith has been exercised, 95 percent or more of the proceeds that are devoted to financing of owner-occupied residences (referred to as lendable proceeds) must have been invested in mortgages which meet all requirements in the group at the time of the execution of the mortgages. In addition, where the good faith and 95 percent requirements are met, failures to meet the first group of requirements in any mortgage must be corrected within a reasonable period after such failure is first discovered.

The requirements that come within this group of requirements are the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement.

With respect to the other group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all of such requirements and any failure to meet such requirements is due to inadvertent error. The requirements included in this group are the market share limitation, the portion of loans in targeted areas requirement, the arbitrage requirements, and the registration requirement.

Arbitrage

In order for an issue to be a qualified mortgage issue, the issue must meet certain requirements regarding arbitrage as to both mortgage loans and nonmortgage investments.

Under the Act, the effective rate of interest on mortgages provided under the issue cannot exceed the yield on the issue by more than one percentage point. This determination is to be made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than one percentage point above the yield of the issue if other mortgages have a lower effective interest rate.

In general, this requirement imposes a limitation on the amount of costs a mortgagor is required to pay such as underwriter commissions and other issuance costs, servicing fees, and trustee fees. Under this provision, the total cost of issuing the bonds and providing mortgage financing which may be passed on to the mortgagors may not exceed the yield on the issue by more than one percentage point.

The Act also imposes restrictions on the arbitrage on nonmortgage investments. Mortgage subsidy bonds usually have established a reserve of one and one-half times the maximum annual scheduled debt service. The Act provides that the reserve be reduced as future annual debt service is reduced. The Act also limits the amount that may be invested at unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year.

Registration

In order for an issue to be a qualified mortgage issue, all of the obligations which are part of the issue must be in registered form.

Industrial development bonds for multi-family rental housing

Under the Act, interest on an industrial development bond substantially all the proceeds of which are used to provide a qualifying project for residential rental property is exempt from Federal income taxation. A project will be treated as meeting the requirements of the provision only if 20 percent (15 percent in targeted areas) or more of the units in the project are to be occupied by individuals of low or moderate income.

The term "low or moderate income" has the same meaning as in Code section 167(k)(3)(B). Under that section, low or moderate income is to be determined by the Treasury in a manner consistent with the Leased Housing Program under section 8 of the United States Housing Act of 1937. The current Treasury regulations provide that occupants of a dwelling unit generally are considered families and individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development.¹

In order to qualify under this provision, 20 percent (15 percent in targeted areas) or more of the units in each project must be occupied by qualifying individuals on an ongoing basis. However, where an

¹ These regulations presumably are to be modified to take account of the changes made to the section 8 rules by the Omnibus Budget Reconciliation Act of 1981 (P.L. 97-35).

individual satisfies the low or moderate income test at the time first occupying a unit in a project, that occupant will be treated as a qualifying individual as long as he or she continues to reside in the project, even though the occupant later ceases to be an individual with low or moderate income. Moreover, where a qualifying individual leaves the project, the unoccupied unit will continue as a qualifying unit until it is reoccupied by another tenant, at which time the status of the new tenant as a qualifying individual is to be determined.

The 20 (or 15) percent test generally must be met during the entire time that the bonds are outstanding. However, the Act contains a special rule for bonds issued before January 1, 1984 (and which do not come within the transitional rules) under which the 20 (or 15) percent test need be met only for a period of 20 years. The 20-year period begins on the first date that the project is available for occupancy and that the tax-exempt obligations are outstanding. Under this special rule, the 20-percent test will be met where the developer of the project has entered into a contract with a Federal or State agency that requires that at least 20 (or 15) percent of the units be maintained for persons of low or moderate income for a period of at least 20 years and provides rent subsidies for such persons for that period.

Issues

The issues presented by the bill include the following.

Mortgage subsidy bonds for single-family residences

(1) What standard of care should be imposed upon the issuer to insure that the targeting provisions of the Mortgage Subsidy Bond Tax Act of 1980 are enforced? What should be the enforcement mechanism if the funds are not properly targeted?

(2) What is the appropriate level of arbitrage on mortgage investments? Should such a level be adequate to permit mortgage subsidy bonds to be issued without any contribution by State or local governments?

(3) Should an exception be provided to the restrictions on the size of nonmortgage investments where the sale of a nonmortgage investment would result in a loss?

(4) Should the registration requirement be repealed?

Industrial development bonds for multi-family rental housing

(1) Should the targeted group of tenants which will qualify an industrial development bond for tax-exempt status be permanently established as those individuals whose income is 80 percent of the median gross income for an area or be determined by the Secretary of Housing and Urban Development from time to time, or should the targeted group automatically be limited to those individuals who would be eligible to receive direct rental assistance (under section 8 of the United States Housing Act of 1937)?

(2) How long should the lessor be committed to provide rental housing to the targeted group of tenants in order to be eligible for tax-exempt industrial development bond financing?

(3) Should the registration requirement be repealed?

Explanation of the bill

Mortgage subsidy bonds for single-family residences

Targeting mechanism

The bill would provide that the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement would be met if (1) the issuer in good faith attempted to meet all such requirements before the mortgages were executed, (2) 95 percent or more of the proceeds devoted to owner financing are devoted to residences with respect to which the requirements were met at the time the mortgages were executed, (3) the issuer undertakes periodic, cost-effective audits and prosecutes any person who has committed fraud with respect to such requirements, and (4) any failure to meet those requirements is corrected within a reasonable period after such failure is first discovered. For purposes of ascertaining whether the requirements are met at the time the mortgages were executed, a requirement may be treated as having been met if any failure to meet a requirement is corrected or if diligent efforts are being made to correct such failure.

Arbitrage

The bill would modify the arbitrage requirements both as to mortgage investments and as to nonmortgage investments.

With respect to mortgage investments, the bill would increase the permissible level of arbitrage from 1.0 percentage points to 1.25 percentage points.

With respect to nonmortgage investments, the bill would modify the restriction on arbitrage on investments that exceed 150 percent of debt service to provide that the 150 percent of debt service rule would not apply if it would require disposition of any investment at a loss.

Registration

The bill would repeal the registration requirement for mortgage subsidy bonds for single-family residences.

Industrial development bonds for multi-family rental housing

Targeted group

The bill would modify the provisions of present law to provide that individuals with "low or moderate" income, for whom 20 (or, in targeted areas, 15) percent of the bond-financed units must be targeted, are (1) those individuals whose incomes do not exceed 80 percent of the area median gross income or (2) those individuals who are classified as individuals of low or moderate income by the Secretary of Housing and Urban Development. The bill would provide that the gross income for an area may be determined by the use of estimates by the Secretary of Housing and Urban Development. Also, the bill would provide that the Secretary of Housing and Urban Development may take into consideration, in determining individuals of low or moderate income, (1) the size of the individual's family, (2) construction costs in the area, and (3) any other factor prevailing in the area.

Required period of targeting

The bill would provide that the 20 percent (15 percent in targeted areas) requirement must be met for the period beginning on the first day that the project is occupied until after the later of (1) ten years after the project is first occupied, (2) a date ending when 50 percent of the maturity of the bond has gone by, or (3) the date on which any section 8 assistance terminates.

Registration

The bill would repeal the registration requirement as it applies to tax-exempt industrial development bonds for multi-family housing.

Effective date

The amendments made by the bill would apply to obligations issued after the date of enactment.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by \$1 million in 1982, \$4 million in 1983, \$9 million in 1984, \$15 million in 1985, and \$22 million in 1986.

