[JOINT COMMITTEE PRINT]

BACKGROUND AND ISSUES REGARDING H.R. 3712 RELATING TO TAX-EXEMPT BONDS FOR HOUSING

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

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INTRODUCTION

The bill discussed in this pamphlet, H.R. 3712 (introduced by Mr. Ullman and Mr. Conable of the Committee on Ways and Means, and by Mr. Reuss, Mr. Ashley, and Mr. Stanton of the Committee on Banking, Finance and Urban Affairs), is scheduled for markup by the Committee on Ways and Means. The bill relates to the treatment of tax-exempt housing bonds issued by State and local governments.

In connection with the markup, the staff of the Joint Committee on Taxation has prepared a description of the provisions of the bill. There also is included in the pamphlet a description of the present law tax treatment of State and local bonds, and housing bonds in particular. In addition, background information is presented on the issuance of housing bonds by State and local governments as well as the recent growth in the issuance of bonds for home mortgages (called "mortgage subsidy bonds"). Further, there is a discussion of various issues involved in the issuance of such bonds by State and local governments. Finally, the pamphlet discusses alternatives regarding the treatment of these mortgage subsidy bonds for the Committee's consideration, including a specific alternative (H.R. 4030, introduced by Mr. Heftel) that have been suggested to H.R. 3712, as well as a discussion of transitional rule issues.

The Appendix includes data on housing bonds issued by State and local governments and data on costs of major housing assistance programs.

I. SUMMARY OF H.R. 3712

The bill (H.R. 3712) makes two amendments to the provision exempting interest on State and local bonds from Federal income tax. First, with one exception, it removes the exemption for bonds which are used for mortgages on owner-occupied residences. Second, it restricts the existing rule allowing tax exemption for industrial development bonds used in a trade or business of a non-exempt person to bonds which are used for projects for low- or moderate-income rental housing, determined in a manner consistent with the Leased Housing Program under Section 8 of the United States Housing Act of 1937.

II. DESCRIPTION OF H.R. 3712

The bill (H.R. 3712) makes two amendments to the provision exempting interest on State and local bonds from Federal income tax (Code sec. 103). First, with one exception it removes the exemption for State and local government bonds used to provide mortgages for owner-occupied residences. Second, it restricts the exception for tax-exempt industrial development bonds issued in connection with housing programs to bonds whose proceeds are used for projects for low- or moderate-income rental housing.

Under the bill, a mortgage subsidy bond is defined as any obligation that is part of an issue of which all or a significant portion of the proceeds are used, directly or indirectly, for mortgages on (or other owner-financing of) owner-occupied residences. This rule applies regardless of whether the bonds are revenue bonds (secured by mortgage payments) or general obligation bonds (secured by the full faith and credit of the issuing government unit).

The bill contains an exception to the taxable status of interest on mortgage subsidy bonds in the case of certain bonds used to finance residences for veterans. Under the exception, tax-free status would continue to be allowed for general obligation bonds of a State, territory, possession of the United States, or the District of Columbia which are part of an issue substantially all of the proceeds of which are used to provide residences for veterans.

The bill would also modify the exception to the industrial development bond rules for housing by restricting the types of housing for which tax-free industrial development bonds may be issued to projects for low- or moderate-income rental housing. For this purpose, low- or moderate-income housing is to be determined by the Secretary of the Treasury in a manner consistent with the Leased Housing Program under Section 8 of the United States Housing Act of 1937. In general under these rules, occupants of a dwelling unit are considered families and individuals of low or moderate income only if their adjusted income does not exceed 80% of the income limits described by the Secretary of Housing and Urban Development (HUD) for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographic area.

In general, the amendments made by the bill are to apply to obligations issued on or after April 25, 1979 (which is the day that the bill was introduced). However, the amendments made by the bill would not apply to obligations issued before May 25, 1979, pursuant to a binding written agreement to sell between the issuer and the underwriter (or other purchaser of the obligations) which was entered into before April 25, 1979.

III. PRESENT LAW AND BACKGROUND

A. Present Law—State and Local Bonds

1. Tax-exempt bonds generally

Under present law (Code sec. 103), interest on State and local government bonds generally is exempt from Federal income taxation. In contrast, interest on virtually all Federal debt obligations is subject to Federal income taxation. However, in order for the interest on a State or local government bond to qualify for tax exemption, the bond must satisfy certain restrictions placed on the use of its proceeds. One statutory restriction is the arbitrage provision (Code Sec. 103(c)) which denies tax exemption when the proceeds of a bond may reasonably be expected to be used to acquire securities which produce a materially higher yield. This provision (enacted as part of the Tax Reform Act of 1969) was intended to prevent State and local governments from issuing bonds at low tax-exempt interest rates and investing the proceeds in taxable securities paying higher interest rates. Through such transactions, State and local governments were able to gain a profit by virtue of their ability to issue tax-exempt bonds.

2. Industrial development bonds (IDBs)

a. General

In addition to the arbitrage restrictions placed on State and local government bonds, present law also restricts the use of industrial development bonds (IDBs) issued by State and local governments. Prior to 1968, interest on State and local government bonds was exempt from Federal income taxation regardless of the manner in which the governmental unit used the proceeds of its bonds. As a result, State and local governments could issue bonds for the benefit of private industries, that is, industrial development bonds. Such bonds typically were used to finance industrial plants. In the case of an IDB, the State or local government would purchase the facility and either lease or sell (on an installment basis) the facility to a for-profit corporation for the amount needed to pay the interest and amortize the principal on the bond. Usually, the State or local government assumed no liability for payment of the bonds. Instead, payment of the interest and principal was guaranteed from the lease or installment sales contract.

In 1968, in response to the widespread use of industrial development bonds, concern over their potentially adverse effect on interest rates on traditional State and local government obligations, and interstate competition for the location of new industrial plants, Congress substantially restricted the uses for which tax-exempt industrial development bonds could be issued. Under current law (Code sec.

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103(b)), interest on industrial development bonds is taxable,[1] with certain exceptions.

b. IDBs for residential real property for family units

One exception to the general rule of taxability of interest on industrial development bonds is for industrial development bonds used to provide residential real property for family units (Code sec. 103(b)(4)(A)).[2] The explanation of this exception in the legislative history on the Revenue and Expenditure Control Act of 1968 makes no distinction between multi-family rental housing and single-family owner-occupied residences. However, at that time, tax-exempt bonds generally were not being issued for single-family residences.

3. Tax-exempt housing bonds

a. General

Under present law, State and local governments may issue tax-exempt bonds for housing. State and local government bonds for housing in general have been issued for two types of programs: rental housing programs and owner-occupied housing programs.

b. Rental housing

Housing owned by private, non-exempt persons

State and local governments currently are allowed to issue tax-exempt bonds for rental housing if the housing is owned and operated by a private party. Since the bond proceeds are used in the trade or business of a private party, the bonds are industrial development bonds. Nonetheless, interest on these bonds is exempt from Federal income taxation because of the special treatment afforded to industrial development bonds for residential real property for family units. The exemption applies regardless of whether the rental units are leased to low, moderate or high income individuals. The only restriction placed on the use of the bond proceeds is that the rental facilities may not be housing facilities used on a transient basis, such as a hotel.

Housing owned by governmental units and other exempt organizations

State and local governments may also issue tax-exempt bonds for rental housing if the facilities are owned and operated by a governmental unit or a tax-exempt organization. Such bonds are not industrial development bonds because the proceeds are used in a trade or business of an exempt person. As a result, interest on the bonds is exempt from Federal income taxation under the general rule of Code

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[1] Under Code section 103(b), a State or local government obligation is an industrial development bond if all or a major portion of the proceeds are to be used directly or indirectly in a trade or business of a person (other than a government unit or a tax-exempt organization) and payment of principal or interest on the obligation is secured by an interest in, or derived from payment with respect to, property used in a trade or business

[2] In addition to housing, exempt activities include sports facilities, convention or trade show facilities, airports, docks, and wharves, solid waste disposal facilities, air and water pollution control facilities, and several other activities.

section 103(a). As is the case with industrial development bonds for rental housing, the exemption applies regardless of whether the rental units are leased to low, moderate or high income individuals.

c. Owner-occupied housing

State and local governments are also permitted, under current law, to issue tax-exempt bonds for owner-occupied housing. Both tax-exempt industrial development bonds and bonds which some have considered to be tax-exempt under the general rule of Code section 103(a) have been issued under State and local governments' owner-occupied housing programs. In both instances, the State or local government will issue a bond and lend the bond proceeds to private individuals, at a higher interest rate than that on the bonds, for purchase or rehabilitation of homes. In general, the procedure used to funnel the bond proceeds to individual borrowers will determine whether the bond is an industrial development bond. In addition, whether the bond is a tax-exempt industrial development bond or a bond tax exempt under the general rule of Code section 103(a), the exemption applies regardless of whether the mortgage loan recipients are low, moderate, or high income individuals.

B. Background and Growth of the Use of Tax-Exempt Bonds for Owner-Occupied Housing

1. Description of an owner-occupied housing bond program

a. General

In a typical housing bond program, a State or local government will issue a revenue bond for the purpose of making low-interest mortgage loans for single-family homes. The lower tax-exempt interest rates on the bonds allow the State or local government to relend the bond proceeds to individuals at approximately one to two percentage points below conventional home mortgage interest rates. The bonds are repaid from the mortgage payments collected from the individual homeowner-mortgagors.

Generally, the sole security for the bonds is the pool of mortgage loans made with the bond proceeds and reserve accounts established from the bond proceeds.[1] In addition, private insurers and the Federal government, through its VA and FHA programs, may insure repayment of the mortgages and, thus indirectly, the bonds Usually, there is no general obligation for repayment on the part of the issuing State or local government.

Mortgage loans are typically made through lending institutions.[2] These institutions also service the loans. Loan applicants must satisfy the credit criteria established for the program. A commercial trustee will generally act as trustee of the repayment proceeds and make interest and principal payments to bondholders. Usually, the issuing government's primary role is issuing the bonds and establishing guidelines for eligibility for mortgage loans.

Guidelines for eligibility for mortgage loans under existing mortgage subsidy bond programs have differed for each issuing governmental unit. Usually, these programs limit participation to low- and moderate-income individuals. However, the definition of low to moderate income has been subject to different meanings for each issuer. Some jurisdictions have conducted bond-financed urban renewal and community development programs in which no income restrictions were placed upon participants.

b. Certain new construction programs

In addition to making mortgage money available to home purchasers, some State and local governments operate programs that provide low interest loans to single family housing developers. Under such

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[1] Typically 12 to 15 percent of the bond proceeds are placed in a reserve account. For example, for a $100 million bond issue, $15 million of the proceeds would be placed in a reserve account. Under the section 103(c) arbitrage rules, bond proceeds placed in a reasonable reserve account (but generally not more than 15 percent) may be invested at an unlimited yield.

[2] Some State housing agencies and at least one local housing agency originate and service their own loans.

a program, the governmental agency will make construction period loans to developers. Typically, the loan proceeds are obtained through the use for short-term tax exempt notes. In order to qualify for such loans, developers are usually required to construct single family housing which will be sold to individuals meeting the issuer's income eligibility requirements.

The short-term notes used to provide construction period loans are industrial development bonds since the notes proceeds are used in the trade or business of the developers. However, the notes are tax exempt under the exception for industrial development bonds for residential real property for family units.

In certain instances, a program which provides construction period loans to developers has been combined with a program which provides mortgage loans to home purchasers. In such instances the State or local government will also issue long-term tax exempt bonds for owner occupied housing and designate that the bond proceeds are to be used to provide mortgage loans for the particular housing units constructed by the participating developers. Typically, the bond proceeds will be reloaned to home purchasers through one of the procedures described below.

c. Relending procedures

Three procedures are generally used to funnel bond proceeds to individuals under an owner-occupied housing program. Under each procedure, the State or local government will issue a bond and lend the bond proceeds to private individuals for the purchase or rehabilitation of homes. One procedure, commonly called the loan to lenders procedure, involves the use of tax-exempt industrial development bonds and the other two procedures, commonly called the agency procedure and the forward commitment mortgage purchase procedure, involve the use of tax-exempt bonds which are generally not considered to be industrial development bonds.

(1) Loan to lenders procedure

Under the loans to lender procedure, a State or local government issues bonds and lends the bond proceeds to lending institutions which in turn use the proceeds to finance home mortgage loans. The issuing governmental agency typically will require that the lending institutions offer mortgage loans at a stipulated interest rate. Additionally, the governmental agency may establish income eligibility requirements and other restrictions on the loans. The bonds are industrial development bonds since the proceeds are used in the trade or business of the lending institutions. However, the interest on these bonds is exempt from Federal income taxation as a result of the special treatment afforded to industrial development bonds for residential real property for family units.

(2) Agency procedure

Under the agency procedure, bond proceeds are made available for mortgage loans through one or more lending institutions which originate mortgage loans as an agent of the issuer. The issuing governmental agency determines the interest rates that will be paid by the mortgagors on the loans, as well as, the income eligibility criteria, if

any, for obtaining a loan. In addition, other restrictions such as purchase price and mortgage ceilings may be imposed. Since the bond proceeds generally are not considered to be used in a trade or business, but for the purchase of homes by private individuals, the bonds have not been considered to be industrial development bonds.

(3) Forward commitment mortgage purchase procedure

Under the forward commitment mortgage purchase procedure, lending institutions originate mortgage loans and then sell them to the bond issuer under pre-existing purchase commitments. In effect, the issuer uses the bond proceeds to provide a secondary mortgage market for the lending institutions. Typically, the purchase commitment agreement includes criteria as to the type and amount of the mortgages that will be purchased by the issuer. In addition, the issuer may impose income limitations on mortgagors. Since the bond proceeds are generally not considered to be used in a trade or business of a private party, but for the purchase of mortgage loans, the bonds are not considered to be industrial development bonds.

d. Factors relating to marketing the bonds

The effectiveness of an owenr-occupied housing program will depend on the ability of an issuer to effectively market its bonds at a low interest rate. The mortgage rate charged to home borrowers typically will be from 1 to 2 percentage points above the rate the issuer must pay on the bond issue. Thus, to reduce monthly payments for homebuyers, the issuer must obtain a favorable rate on the bonds. The rate will, in turn, depend on two factors: the prevailing overall market rate and the rating the bond receives from a rating agency.

In rating a bond issue, a rating agency is generally concerned with three factors: the quality and composition of the mortgage pool that provides collateral for the bonds, the level of collateralization of the bonds, and the treatment of mortgage prepayments.

The quality and composition of the mortgage pool depends on whether the loans are for single family, one to four family, or condominium type properties. It will also depend on the loan to value ratio and whether the loan is FHA insured, VA guaranteed or is a conventional loan that is privately insured. Additionally, it will depend upon the past record of the lending institutions which originate and service the loans as well as the financial condition of the borrowers.

To obtain a high quality mortgage pool, a program will be structured so that a mortgage pool contains a substantial portion of loans to moderate or high income homebuyers. Additionally, it will require a favorable loan to value ratio which will generally result in a downpayment by the homebuyers in excess of 5 percent.

The level of collateralization of the bonds, i.e., the degree to which the bonds are secured by reserves or mortgages, is generally 95 to 97 percent of the face amount of the bonds. This shortfall results from the underwriting discount and cost of issuance which are paid directly out of bond proceeds. The shortfall will generally be from 3 to 5 percent of the total amount of the bond issue.

One method of making up the shortfall is through the income earned on the reserve accounts established with a portion of the bond pro-

ceeds. These reserves will generally be 12 to 15 percent of the bond proceeds and will be invested in high yield securities. Although the arbitrage rules (Code sec. 103(c)), in general, preclude the investment of bond proceeds in materially higher yielding securities, issuers have been able to invest reserves in materially higher yielding securities as a result of an exception to the arbitrage rules which does not apply those rules to reasonable reserve accounts which are not more than 15 percent of the principal amount of the issue. If arbitrage profits are not ultimately needed to meet debt service charges, they are typically distributed to the issuing government or split in some fashion between the issuing government and participating lendors.

The shortfall may also be made up through the use of participation fees. These fees are paid by the borrowers at the time they close on their home purchases. In some cases, these fees have been as high as 3½ points.

The final consideration in structuring a bond issue is the treatment of mortgage prepayments. Bond issues may either be structured to require the prepayment to be used either to call a portion of the bonds or to reinvest the prepayment in additional mortgages. In addition, one method of decreasing the volume of prepayments is to allow loan assumptions without income limitations on the individuals assuming the loans.

e. Objectives

The owner-occupied housing programs that have been established have had several stated aims. The predominant aim of the programs has been to reduce the costs for homeownership. However, few of the programs have been intended as programs to benefit the poor. An analysis of one of these programs recognized that other types of subsidies are necessary for such a purpose.[3] One of the reasons these programs cannot be used to help the poor is that if the program was tailored in such a direction market acceptance of the bonds would be difficult to obtain. In addition, the amount of the subsidy is generally insufficient to allow the poor to purchase homes.

A further objective of some of the programs has been to attract middle-class homeowners to the central cities. Such homeowners would establish a solid tax base for cities which in turn would aid in establishing a good bond rating for the general obligation bonds of the cities.

Another objective of some of the programs has been to stimulate revitalization of blighted neighborhoods through new construction and rehabilitation of existing structures. Usually, income eligibility limitations for these programs have been substantially higher than those for programs designed exclusively for the purpose of reducing the cost of homeownership.

A further objective of some of these programs has been to increase the housing stock within an area. Programs with such an objective are designed to provide the funds necessary for new construction at a lower cost.

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[3] See the "City of Chicago Mortgage Revenue Bond Program; Advisory Committee's Report on Review of Pilot Program: Finding and Recommendations." (December, 1978)

An objective of some programs has been to provide funds for mortgage loans where the flow of funds from traditional sources was judged to be inadequate because of rapid population growth, the impact of usury laws, or the inability of local lending institutions to meet the demand for mortgage loans.

2. State and local government restrictions on tax-exempt bonds for owner-occupied housing

a. State programs

The first consideration in any mortgage subsidy bond program is whether any State constitutional prohibition prevents the lending of State credit in such programs. In many States, the courts have ruled that the financing of low- and moderate-income housing is a permissible use of State credit. In some States, the financing of housing for any income group has been upheld on the grounds that housing itself is a public purpose. Absent a constitutional prohibition, State programs are generally established under statutes creating a state housing finance agency authorized to issue bonds.

b. Local programs

Whether State law permits a local government to issue housing bonds generally depends on specific statutory authorization; the absence of a law prohibiting the bond issues is not sufficient. Exceptions to this rule include Delaware, Illinois, and Kansas, in which localities have the power under home rule provisions to issue mortgage bonds.

The most common type of State authorizing statute is an industrial or economic development revenue bond law. These have been used in Colorado and West Virginia, among others. In many States, these laws have been amended to specifically include residential real property for family units. In other States, such as Louisiana and Oklahoma, mortgage bonds are issued under the authority of public trust laws. Separate authorities, or public trusts, are set up to issue bonds for the benefit of the city or State involved. Finally, there are a number of miscellaneous laws in various States. The State of Minnesota has authorized several cities, including Minneapolis, to exercise the same powers in housing finance as the Minnesota Housing Finance Agency. In California, bond issues are authorized to finance housing in designated redevelopment areas under new construction and rehabilitation programs. State laws may also restrict the type of program which can be operated.

3. Growth of tax-exempt bonds for owner-occupied housing

Three States—California, Oregon and Wisconsin—have since the end of World War II issued general obligation bonds the proceeds from which are used to provide mortgage financing for veterans. In 1978, $1.2 billion were issued for this purpose.

State housing agencies began to issue some tax-exempt bonds for owner-occupied housing in the early 1970's. However, prior to 1978, most state housing finance agency bonds were issued to provide multi-family rental housing. The volume of their bonds for owner-occupied housing varied between $36 and $680 million from 1971 through 1976 and was $959 million in 1977. In 1978, the amount of tax-exempt bonds for owner-occupied housing issued by State housing finance agencies increased to $2.8 billion. (See table below) In addition, since May 1978, numerous localities have begun issuing such bonds.

During 1978, State and local governments issued $3.4 billion of tax-exempt bonds for owner-occupied housing. This amount represented approximately 7.4 percent of the aggregate of the tax-exempt long-term financing for all purposes by State and local governments during 1978. In the first four months of 1979, State and local governments issued $3.3 billion of tax-exempt bonds for owner-occupied housing. This amount represents 26.4 percent of the aggregate for tax-exempt long-term financing for all purposes by State and local governments during the first 4 months of 1979. The relative portions of all borrowings by State and local governments during 1976, 1977, 1978 and the first 4 months of 1979 were as follows:

Activity	1976	1977	1978	1979 [1]
		(percent)		
Owner-occupied housing	1.8	1.9	7.4	26.4
Multi-family rental housing	4.3	3.4	5.4	4.8
Education	15.3	11.3	13.5	11.6
Water and sewer	9.8	10.0	9.7	7.5
Highways, bridges, and tunnels	4.6	3.1	4.1	3.3
Gas and electric	13.2	12.7	13.0	13.2
Industrial development	1.1	1.1	1.3	1.6
Pollution control	7.9	8.6	7.5	6.0
Hospital	8.1	10.4	6.8	4.9
Various purposes	34.0	37.4	31.2	20.7

[1] Estimate of distribution through April 1979.

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The following table reflects in summary form the amount of tax-exempt housing bonds issued during 1978 and the first 4 months of 1979:

[In billions of dollars]

	State tax-exempt bonds for owner-occupied housing	*Local tax-exempt bonds for owner-occupied housing*	*Total State and local tax-exempt bonds for owner-occupied housing*	*Total long-term State and local tax-exempt bonds*
1978	2.8	0.6	3.4	46.2
First 4 months of 1979	1.7	1.6	3.3	12.5

C. Other Housing-Related Tax Provisions

The Federal Government currently provides several programs that subsidize housing. These programs are either direct subsidies, or indirect subsidies through various tax incentives under the Internal Revenue Code. These programs cover both owner-occupied housing and rental housing. The tax incentives are outlined below, while the various Federal housing subsidy programs are summarized in the next section.

1. Owner-occupied housing

Deduction for interest

Under present law, interest paid on mortgage loans for owner-occupied homes is deductible for individuals who itemize. As a result of the allowance of this deduction, the estimated loss of revenue is $9.3 billion in fiscal 1980.

Deduction for real property taxes

Property taxes paid with respect to owner-occupied homes are also deductible. As a result of the allowance of this deduction, the estimated loss of revenues is $6.6 billion in fiscal 1980.

Exclusion of gain on sale of residence

Individuals who are age 55 or older may exclude from gross income, on a one-time elective basis, up to $100,000 of gain from the sale of their principal residence. As a result of this exclusion, the estimated loss of revenue is $535 million in fiscal 1980.

Rollover of gain on sale of residence

Gain realized on the sale of a taxpayer's principal residence generally is not recognized to the extent the adjusted sales price is reinvested in a new principal residence. As a result of this deferral provision, the estimated loss of revenue is $1 billion in fiscal year 1980.[1]

2. Rental housing

Accelerated depreciation

Under present law, the owner of residential rental property is able to recover his capital investment through annual depreciation deductions over the useful life of the property. In general, real property depreciation deductions must be on a straight-line method under which equal annual amounts may be deducted over the useful life of the property. However, with respect to new and used residential real property, larger depreciation deductions may be claimed in the early years of the property's life under an accelerated depreciation

[1] In addition, the Energy Tax Act of 1978 provides a new tax credit for the installation of insulation and other energy conserving items in a taxpayers' principal residence. The Act also provides a credit for the installation of solar, wind and geothermal energy equipment in a taxpayer's principal residence. As a result of these credits, the revenue loss is estimated at $434 million in fiscal year 1980.

method. In addition, upon the sale or other disposition of residential real property, only depreciation in excess of straight-line depreciation is recaptured. In other words, gain upon sale of residential real property is taxable as ordinary income only to the extent the prior accelerated depreciation deductions exceed the depreciation deduction which would have been allowed under a straight-line method. Further, the recapture rules are phased out for certain low-income housing. As a result of these provisions, the estimated loss of revenue is $350 million in fiscal year 1980.

Rehabilitation of low-income housing

Taxpayers may also amortize expenditures incurred in the rehabilitation of low-income rental housing over a period of five years (Code sec. 167(k)). The aggregate amount of expenditures qualifying for the special deduction may not exceed $20,000 per dwelling unit and the deduction is available only if the taxpayer makes qualifying expenditures for the unit in excess of $3,000 over a period of two consecutive years. Under present law, this provision will expire after December 31, 1981. As a result of this provision, the estimated loss of revenue is $15 million in fiscal year 1980.

D. Federal Government Programs to Assist Housing

1. Programs for single-family housing

Government National Mortgage Association tandem plan

GNMA (Government National Mortgage Association) is a corporation within the Department of Housing and Urban Development HUD that provides a secondary market for FHA, VA and conventional mortgages. Under its tandem plan, GNMA provides an interest subsidy that permits lenders to offer mortgages at a below-market interest rate of 7.5 percent. GNMA purchases these low-interest mortgages from lenders at the market interest rate, absorbing as a subsidy the difference between 7.5 percent and the market rate. Authority to purchase both single family and multifamily mortgages has been given to GNMA. There are no income limits for borrowers under the single family program, although the maximum mortgage is $42,000 per unit.

Section 312 rehabilitation plan program

These loans are available for improvements to residential and commercial structures located in designated economically depressed areas. Loans for improvements on residential property may not exceed $27,000 per unit, nor $50,000 for improvements to nonresidential property. The interest rate is 3 percent for low income individuals and rises to higher levels for middle and upper income individuals.

Section 235 homeownership program

Through this program, HUD pays family housing expenses (mortgage payments, property taxes and insurance premiums) which are greater than 20 percent of adjusted gross income. The program assists low to moderate income families in purchasing newly constructed or substantially rehabilitated homes. The subsidy could bring the effective mortgage interest rate paid by the homeowners to as low as 4 percent.

Eligibility is limited to families with incomes below 95 percent of area median [1] income, which HUD determines annually for each standard Metropolitan Statistical Area and nonurban county. The maximum allowable mortgage ranges from $32,000 to $38,000, depending upon whether the mortgage is placed in low or high cost areas; additional allowances are made for family size. A minimum downpayment of 3 percent is required on purchase, and the subsidy terminates when the family is able to meet its housing costs by spending 20 percent or less of its adjusted gross income.

Farmers Home Administration (Section 502)

The Farmers Home Administration (FmHA) makes direct low interest rate mortgages available to low and moderate income families buying homes in rural areas. The interest rate is 8.75 percent to families

[1] The median is the midpoint of a distribution of families above and below which are 50 percent of the observations of family income.

with adjusted annual incomes below $15,000 ($18,500 in Hawaii and $23,000 in Alaska). Families with low incomes ($10,000 in general, $12,000 in Hawaii and $15,600 in Alaska) are eligible for an additional subsidy which could reduce the mortgage interest rate to as little as 1 percent.

Loans are made for rehabilitation, construction or the purchase of existing homes. The size of the home is restricted but not the mortgage or purchase price of the home.

Insured and guaranteed loans

Federal Housing Administration.—The section 203(b) program of the FHA provides insurance for single-family loans, with maximum interest rates, downpayment requirements and loan amounts which are set periodically by statute and regulation. The insurance is a guarantee to the lender that payments of interest and principal will be made.

Veterans Administration.—VA guarantees and insures privately written mortgages for eligible veterans and servicemen.

Mortgage market interventions

Federal National Mortgage Association (FNMA).—This is a government sponsored private corporation that purchases and resells privately written loans. Because it offers lenders an opportunity to liquidate residential mortgages, FNMA encourages the use of private funds for home loans.

Government National Mortgage Association (GNMA).—GNMA purchases Federal Government insured and Federal Government guaranteed mortgages, which provide the backing for securities sold to the public. GNMA also may buy mortgages with interest rates as low as 7.5 percent under the tandem program.

Federal Home Loan Banks.—These banks advance funds to member savings and loan institutions to cover net withdrawals during tight money periods or to savings and loan associations to expand their lending activities, which are focused mainly on single family homes.

2. Programs for multi-family rental housing

Low-rent public housing

Low-rent public-housing programs fund the construction or the purchase and rehabilitation costs (including financing expenses), and a portion of the operating expenses, of rental projects that are owned and managed by State or local government agencies and that are made available to lower-income tenants at reduced charges. Public housing is generally limited to low- and moderate-income families and to elderly, handicapped, or displaced individuals. Tenant rental and utility charges are limited to a total of not more than 25 percent of adjusted family income.

Section 8 new construction and substantial rehabilitation

Section 8 new construction and substantial rehabilitation programs provide assistance on behalf of lower-income households occupying newly built or significantly rehabilitated units that meet certain criteria as to cost, physical adequacy, and location. Under these programs, public agencies or private sponsors develop housing projects in which a portion of the units are made available to low- and moderate-income renters at reduced costs. The difference between the HUD-established

allowable rent for each unit and the household contribution—limited to 15–25 percent of family income—is made up by regular payments from HUD to the project owner/manager. Assistance contracts between HUD and project sponsors cover five-year periods and are renewable at the owner's discretion for 20 to 40 years, depending on the type of sponsor and the kind of financing used. Income limits for Section 8 assistance recipients are set at approximately 80 percent of the area median family incomes.

Section 8 existing housing

The existing housing component of the Section 8 program provides assistance on behalf of low-income households occupying physically adequate, moderate-cost rental housing of their own choosing in the private market. Public housing agencies under contract to HUD subsidize the housing costs of lower-income families by paying their landlords the difference between the tenants' rental fee and the tenants' contribution of 15 to 25 percent of their monthly income. All housing units must meet standards of physical adequacy, must be located within the jurisdiction served by the local agency, and must rent for an amount equal to or less than a HUD-established maximum. Beyond these restrictions, assisted households are free to select the location and type of housing, so long as the landlord is willing to enter into a lease with the tenant and a participation agreement with the administering agency.

Section 236 rental assistance and rent supplements

The Section 236 program, authorized in 1968, provides mortgage interest subsidies to developers of rental projects in which a portion of the housing units are made available to low-income persons at reduced rates. The interest subsidy alone is sufficient to reduce tenant rental payments to an average of about 30 percent of family income. Additional subsidies are provided on behalf of the occupants of some of the units through rent supplement payments, Section 8 assistance, or deep subsidy payments specifically authorized for use in conjunction with Section 236. This piggybacking of those subsidies, which are paid to the project owner, permits tenants' rents for some units to be reduced to 25 percent of their income without jeopardizing the financial viability of the projects.

The rent supplement program was authorized to provide payments to the owners of private rental housing on behalf of lower-income tenants, but it has been used primarily to reduce rental charges in Section 236 and other mortgage subsidy projects.

Section 202 housing for the elderly and handicapped

Section 202 provides direct federal loans to nonprofit organizations developing rental housing for the elderly and the handicapped. Since 1974, the interest rates have been slightly higher than the yield on all outstanding Treasury obligations—an interest rate more nearly approximating that of conventional financing. Projects developed under the Section 202 program also carry a Section 8 subsidy, which enables the rents of low-income families and individuals to be reduced to a maximum of 25 percent of their income.

3. Housing-related community development programs

Several community development programs provide housing benefits to a wider range of income groups than are eligible for housing as-

sistance programs. These grant programs to State and local governments generally are administered by the Department of Housing and Urban Development.

Community Development Block Grants (CDBG)

The CDBG program provides grants to state and local governments to fund projects designed to promote viable urban communities. Most CDBG funds are allocated by means of needs-based formulae among cities within metropolitan areas with populations of 50,000 or more and urban counties with populations of 200,000 or more. Beginning in fiscal year 1978, two formulae are used to distribute these entitlement grants. Both consider the number of persons in the jurisdiction with incomes below the poverty line. One formula also takes into account total population and the number of overcrowded housing units within the jurisdiction; the other formula considers lag in population growth relative to the national rate and the number of pre-1940 housing units. Communities that receive entitlement grants must also submit housing assistance plans that estimate the extent and nature of housing needs among low and moderate income persons residing or expected to reside in the jurisdiction and indicate how federal housing assistance will be used to address those needs. Communities that fail to provide low income housing assistance may forfeit their eligibility for the community development funds.

Urban Development Action Grants (UDAG)

The UDAG program was authorized as an adjunct to block grants. UDAG funds are available only to distressed cities, and they are to be used to support projects involving private investment as well as public funds. Current criteria for determining urban distress include: the proportion of the housing stock constructed before 1940, net increase in per capita income from 1969 to 1974, population growth between 1960 and 1975 relative to the national rate, the level of unemployment, the rate of growth in employment, the percent of the population below the poverty level, and unique local factors. More than 300 localities are eligible for UDAG funding under those criteria.

Section 312 rehabilitation loans

The Section 312 loan program provides direct financing for the rehabilitation of privately owned residential and commercial buildings in designated urban renewal, neighborhood-development, and code-enforcement areas. Loans bear a 3-percent interest rate, with a maximum repayment period of 20 years. Most of the approximately 58,000 Section 312 loans made through the end of fiscal year 1977 financed the rehabilitation of owner-occupied housing. The Section 312 program provides benefits to people with higher incomes than those who receive direct federal housing assistance.

Urban homesteading

A small-scale urban homesteading demonstration program has been enacted, under which federally held single-family properties are deeded to localities and sold by them at nominal cost to persons willing to rehabilitate and occupy them. This program is intended to encourage residential reinvestment in distressed areas and to stimulate economic integration and neighborhood revitalization.

IV. ISSUES

There are two general issues relating to the use of tax exempt bonds to provide subsidies for housing. The first, which must be viewed in the context of total Federal expenditures, is the appropriate level of Federal expenditures to be used to provide subsidies for housing. The second issue is the appropriateness of using the Federal exemption for interest on State and local bonds to provide subsidies for housing.

A. The Appropriate Level of Federal Housing Assistance

1. General

The Federal Government has long pursued programs of housing assistance through direct spending programs, specific provisions of the tax code, and credit policies. Any change in the level of Federal assistance raises issues of both budgetary policy and broader economic policy. Increased direct spending for housing assistance and increased tax expenditures of comparable magnitude have the same impact on the budget deficit. Credit programs, such as mortgage insurance and guarantees, have a minimal impact on the budget but attract a greater portion of the total flow of credit toward the housing sector because the insurance programs substantially reduce the risks of loss associated with the loans. The magnitude of the major Federal spending and tax provisions for housing assistance are projected for fiscal years 1980 through 1984 in Appendix table 2. Continued expansion of tax-exempt housing bonds would add to these amounts.

In an effort to contain future budget outlays for assisted housing programs, new budget authority for that purpose has been reduced from $34 billion in fiscal year 1979 to $26.1 billion in fiscal year 1980 in the first concurrent resolution on the budget agreed to by House and Senate Conferees. A major issue raised by the recent growth of tax-exempt housing bonds is whether this form of housing assistance should be allowed to expand, thereby increasing future budget deficits or diminishing future budget surpluses.

2. Indicators of need for housing assistance

Degree of substandard housing

Over recent years, the percentage of households who have occupied substandard housing has consistently fallen. This trend has resulted both from overall economic growth and the resulting increase in household income and from a variety of Federal spending programs, tax provisions, and credit polices which promote adequate housing. Two broad measures of housing adequacy have traditionally been used—the presence of plumbing facilities and the number of inhabitants per room. In 1960, 13.2 percent of all housing units lacked some or all plumbing facilities. By 1976 this figure had fallen to 3.4 percent. The percent of housing units with more than 1 person per room decreased from 11.5 percent in 1960 to 4.6 percent 1976.

Home ownership

Home ownership has been increasing steadily since the end of World War II. In 1950, 54.9 percent of all dwelling units in the United States were owner-occupied. By 1976, the figure had increased to 64.7 percent. In that same year, the portion of owner-occupied dwellings varied among regions as follows:

Region:	*Percentage of home-ownership*
Northeast	59.9
North Central	69.8
South	59.1
West	62.2

Home ownership is broadly distributed among income classes. The distribution of households, including families and unrelated individuals, and home ownership by income class in 1977 was as follows:

Household income	*Percentage of total households*	*Percentage of home ownership*
$7,000 to $9,999	38.9	48.6
$10,000 to $14,999	18.5	67.1
$15,000 to $19,999	14.7	72.3
$20,000 to $24,999	10.7	80.6
$25,000 to $34,999	10.4	86.4
$35 000 and over	6.9	89.6

In addition to the degree of home ownership, recent data indicates that some persons of all income levels purchase homes. In 1977, the distribution was as follows:

Income level	*Percentage of total homes purchased*
0–$9,999	19.6
$10,000–$14,999	19.4
$15,000–$19,999	19.1
$20,000–$24,999	15.2
$25,000–$35,000	16.1
$35,000 and above	10.5

Finally, the distribution of home ownership varies by age. The following table indicates the percentage of home ownership in 1976 by families where a male wage earner and his spouse are present in the home:

Age bracket	*Percent that own home*	*Percent that rent*
Under 25	32.6	68.4
25 to 29	56.6	43.4
30 to 34	73.6	26.4
35 to 44	81.4	18.6
45 to 64	86.3	13.7
Over 64	83.1	16.9

Family income spent on housing

Another indicator of housing need often used is the percentage of income which families spend on housing. Available data indicate that this percentage has risen in recent years partly because housing costs have increased more than incomes. Those figures do not show whether, or how much, the quantity or quality of housing has been either increased or restrained by these price increases.

A comparison of the median price of new or existing homes to various levels of household income is often used by those who emphasize the importance of homeownership. Unfortunately, these comparisons are not useful for identifying the degree of need for additional housing subsidies. Since the median is merely the midpoint of the distribution of selling prices, it contains no information concerning the 50 percent of houses whose prices were below the median, and, thus, more likely to be suitable for those most in need of housing assistance.

Neighborhood conditions

One of the goals of housing assistance programs has been to promote the upgrading of deteriorating neighborhoods into economically and socially viable ones, or at least, to slow the decline in marginal neighborhoods. Unfortunately, it is difficult to develop indicators of the condition of communities.

B. The Appropriateness of Tax-Exempt Bonds for Housing

1. Effect of tax-exempt housing bonds on capital markets

An increase in Federal housing assistance raises an issue of broad economic policy the Committee may wish to consider. Such an increase directs a larger fraction of total investment into housing and away from other forms of investment. In 1978, 32 percent of total fixed investment was devoted to residential purposes, a higher fraction than is found in most other developed countries. Any further increase in the share of total investment devoted to housing must come at the expense of other types of capital formation in a period of approximately full resource utilization such as the present.

Most economists conclude that the current tax structure favors housing over most other kinds of investment. Homeowners receive deductions for mortgage interest and property taxes. They do not include in taxable income the value of the income they would have received had they rented their home instead of living in it themselves, but they do not depreciate the declining value of their asset. Capital gains on principal residences can be deferred when one home is sold and another purchased and are eligible for a specific, one-time $100,000 exclusion from tax. Rapid amortization is allowed on interest and taxes incurred during construction. Financial institutions are allowed special deductions for bad debt reserves if they invest a high proportion of their assets in housing mortgages.

In contrast, income from corporate investment is subject to tax under the corporate income tax and then is taxed under the individual income tax on receipt of dividends. While the impact of corporate double taxation is mitigated by the investment credit, capital gains and other tax code provisions, the tax burden on most kinds of corporate investment is considerably greater than that on both owner-occupied and rental housing. In addition, there are large direct housing subsidy programs operated by the Department of Housing and Urban Development, and the system of financial institutions is structured to encourage mortgage lending by ceilings on interest rates paid on savings deposits in savings and loan associations and other mortgage lending banks.

On balance, the combinations of tax, spending and credit market provisions encourage a greater amount of investment in housing than in plant and equipment. The increment to GNP from housing investment is smaller than from plant and equipment investment because the latter investment is used to produce additional income. Most economists have concluded that further diversion of investment from plant and equipment to housing would decrease the efficiency of the economy and reduce the overall rate of economic growth.

2. Effect of tax-exempt housing bonds on Federal monetary policy

During periods of restrictive monetary policy, high interest rates contribute to increased costs in housing as well as in other sectors of

the economy. Policies which attempt to insulate housing from the impact of generally restrictive monetary policy transfer a greater share of the constractionary impact of the restrictive policy to other sectors of the economy, such as, investment in industrial plant and equipment. As a result, monetary authorities may be forced to seek even higher interest rates in an attempt to achieve the desired reduction in inflationary pressures.

3. Effect of tax-exempt housing bonds on other tax-exempt bonds

Both the absolute amount of these housing bonds and their growth in relation to the total tax-exempt bond market have the tendency of increasing the rates of interest for all tax-exempt bond issues, both general obligation and industrial development bonds. The amount of the increase is not easily verified, but estimates suggest that in otherwise stable municipal bond and money markets, the interest rate on tax-exempt bonds will rise by 4 to 7 basis points for each additional $1 billion in issues. In addition, the superior ratings usually earned by mortgage subsidy bonds may make them more attractive then general obligation bonds that are less highly rated thus adding to upward pressure on general obligation interest rates.

The resulting increase in interest costs affects all tax-exempt bond issues, including general obligation bonds for traditional State and local government purposes, such as, schools, fire houses, police stations, water and sewer facilities, and streets and highways. Many local government jurisdictions are very sensitive to the interest costs on bonds because their ability to finance the costs of servicing the bonds is limited by inflexible revenue bases.

4. Efficiency of tax-exempt housing bonds

The use of tax-exempt bonds to provide housing assistance raises the question whether the resulting loss of tax revenue is being used efficiently. This involves a comparison of the amount of subsidy received to the cost to taxpayers of providing that assistance.

As a rough approximation, it is useful to analyze what happens to taxpayers when an additional $1 billion of tax-exempt bonds is issued. These additional bonds will be sold only if their yields are sufficiently attractive to compete with the after tax yields of other investments. As the supply of tax-exempt bonds grows, the issuers must offer higher and higher interest rates to make the bonds attractive to investors in progressively lower tax brackets, because there are only a limited number of taxpayers in the very high tax brackets for whom tax-exempt bonds are an attractive investment at any interest rate. Thus, as the supply of tax-exempt bonds goes up and the interest rate on them rises, the interest rate subsidy provided to any single governmental issuer declines. In addition to the revenue loss to the Federal Government, there is the increased cost to State and local governments which results from the higher interest rates for the other tax-exempt bonds they choose to issue.

Furthermore, there is some evidence from recent issues of mortgage subsidy bonds that the process of financing home mortgages through the use of tax-exempt bonds involves relatively large fees and administrative costs, resulting in substantially less assistance to the homebuyer than its cost to the Federal government. This is

illustrated in the following example, developed from data on ten specific offerings issued in late 1978 and early 1979, which reflects the typical mortgage subsidy bond program.

Typical owner-occupied program

In a typical program, a bond offering of $100,000,000 at a net interest cost of 7.30 percent would yield $96,400,000 available for use in the program after payment of the market and underwriter's discounts. From this $96,400,000, capital reserves and accumulation reserves totalling $12,650,000 would be set aside. This reserve account would usually be invested in U.S. Treasury notes at 8¼ to 8½ percent.

The remaining $83,750,000 would be reloaned to individuals through commercial lending institutions at 8.50 percent plus the fees described below.

Generally, the lending institutions would be compensated for placing the loans and servicing the mortgages by an origination fee charged to borrowers. The lending institutions would also be entitled to collect annually from the mortgage payments a service fee of .5 percent on the outstanding balance of the mortgages.

The mortgagors who borrow the $83,750,000 from the lending institutions will pay interest at the rate of 8.50 percent plus 3 points in origination fees and participation fees. As was previously noted, the origination fee would be paid to the lending institution for originating the loan. The participation fee would be paid to the issuer to defray, in part, the costs of issuing the bond, including underwriting fees. In this case, the points charged would amount to $2,512,500. Together, these fees would raise the effective rate of interest on the mortgage to 8.988 percent.[1] In the case of mortgages not guaranteed by FHA or VA, periodic commercial insurance charges also will be imposed on the borrower.

Reduced to terms of a single borrower, this transaction might be viewed as follows: A principal amount of bonds of $50,000 would yield $48,200. $6,325 of this would be placed in reserve. The remaining $41,875 would be loaned to the mortgagor at 8.50 percent upon payment of $1,256.25 in points. The monthly principal and interest payment would be approximately $323. The national average stated interest for conventional home mortgage loans during the period in which the 10 specific issues considered above were issued was 10 percent; in addition, 1½ points were typically charged. At this rate, a 95 percent conventional mortgage of $41,875 insured by a private mortgage insurer would require payment of approximately $376 a month, and $963 [2] in points. The $50,000 invested in tax-exempt bonds would have produced $125 a month in Federal income tax revenues, if it had been invested in a 10 percent investment by a taxpayer in the 30 percent bracket.

5. Characteristics of housing assistance provided with tax-exempt bonds

In considering whether to impose limits on the issuance of tax-exempt housing bonds, the committee may wish to discuss the limita-

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[1] Assuming the actual life of the mortgage is 10 years.

[2] This figure represents $628 in points paid to the lender plus $335 in points paid for mortgage insurance.

tions inherent in any program which uses tax-exempt bonds to provide housing funds. These limitations involve standards of eligibility for assistance, control over the amount of subsidy provided to each eligible household, control over the aggregate amount of subsidy, and control over the administration of the subsidy.

Eligibility for subsidy

The use of tax-exempt bonds to provide housing assistance imposes several important constraints on the determination of which households are eligible for the subsidy.

In considering whether to adopt income limits, there are several problems inherent in using income limitations. First, the determination of eligibility must depend on the level of family income determined at the time the mortgage loan is made. However, the subsidy continues during the entire life of the mortgage loan (typically 10 years). It is not practical to terminate the subsidy if the income of the person increases beyond the income limit established for initial eligibility.[1]

A second problem inherent in this approach is that income in any given year may not be representative of a person's overall economic status. For example, the income of a family could be low during a particular year because one spouse ceases employment during a portion of the year. Likewise, a year when a person is temporarily unemployed may not be representative of that person's need for a subsidy.

A third feature of the use of tax-exempt housing bonds involves their use for rental housing. Because they provide a subsidy to the owner of the housing, not the tenants, there is no guarantee, unless the arrangement is closely regulated by the State or local government, that the tenants will benefit from the subsidy through lower rents. Even if they do, the subsidy necessarily goes to all the tenants in the subsidized buildings. Thus, unless the State or local government regulates the rent in each apartment, this form of subsidy cannot be used to provide assistance only to those tenants who meet certain specified conditions, unless all tenants are required to meet these conditions. However, such a requirement may tend to prevent the owner from renting to the broad spectrum of tenants, which experience has demonstrated is desirable housing and social policy.

Relationship of subsidy to need of recipients

The nature of the assistance granted through the use of tax-exempt bonds for owner-occupied residences makes it impossible to scale the amount of assistance to the income of the recipient households. The subsidy consists of a reduction in the mortgage interest rate, a reduction which would not be under the control of the Committee, but, rather, would depend on the state of the economy and overall supply and demand factors in the market for tax-exempt bonds. At any given time, the amount of the subsidy varies only with the size of the mort-

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[1] It would be possible to require that a person refinance his mortgage with conventional financing after his income level had increased above the income limit. However, this is expensive for the mortgagor, since refinancing may involve a new title search, new mortgage insurance, etc. Moreover, a change of a few dollars of income would result in a substantial loss of subsidy. In addition, bondholders may be reluctant to invest in bonds used to provide mortgages having a termination provision.

gage. Thus, to the extent that the least needy families are able to purchase a more expensive house because of the subsidy they also have a larger mortgage and receive a larger amount of subsidy.

Because the amount of assistance granted by tax-exempt bonds can not be scaled to income, those families who participate in the program might be the least needy within the eligible group. For the most needy, the reduction in interest costs granted by tax exempt bonds for owner-occupied residences would be insufficient to result in a significant change in housing expenditure patterns. In addition, because the marketability of the bonds depends partly on the probability that recipient households default on these payments, local agencies may be reluctant to specify that a high proportion of the funds be loaned to low-income families. Furthermore, a "notch" would be created with respect to any eligibility ceilings; a family whose income is $100 under the ceiling could receive a substantial subsidy leaving it better off than a family whose income is $100 over the ceiling.

Relationship of number of eligible families to amount of aid provided

Many of the eligibility standards which have been suggested in connection with the housing assistance which could be provided by tax-exempt bonds for owner-occupied residences would result in eligibility for a very large proportion of households in the United States. However, State and local governments are limited in the ability to provide this subsidy by the capacity of the bond market to absorb these bond issues without significant increases in the interest cost of other bonds which these governments may wish to issue.

Previous experience suggests that the available assistance would be provided on a first-come, first-served basis. Providing assistance on a first-come, first-served basis is generally not what is done in other assistance programs under the Committee's jurisdiction. In the cases of the AFDC, SSI, and unemployment compensation programs and the earned income tax credit, the Federal or State government specifies the standards of eligibility for, and the amount of, assistance, and then provides that all persons eligible for such assistance receive the amount to which they are entitled.

Administrative control over assistance provided

The use of tax-exempt bonds to grant housing assistance has specific implications for the administrative relationships between the provider of the subsidy funds (the Federal Government) and the administrators of eligibility for the subsidy (State and local governments).

Although the Committee might specify eligibility and other standards which must be met for the tax exemption to be granted, the Internal Revenue Service would have no direct control over the administration of those standards. In addition, it would be difficult for the Service to monitor a local agency's compliance. Even if it were determined that a local agency, for example, made many errors in the determination of eligibility or granted mortgages larger in size than a limit which may be specified by the committee, the only recourse which the Service would have would be to declare the bonds taxable. Because this would penalize the bondholders, it would be only an in-

direct sanction against the administering agency. Furthermore, since this is an "all-or-nothing" sanction, the Service might be reluctant to take such a step unless the degree of noncompliance by the administering agency were extreme.

On the other hand, the threat that an agency's bonds could be taxable is equivalent to a threat that its subsidy program would be terminated for the indefinite future, since investors would be extremely reluctant to invest in that agency's securities for an extended period after such an enforcement action. This threat may be sufficiently severe that State and local agencies would be careful to comply with whatever standards the Committee might prescribe.

V. ALTERNATIVES

A. Owner-Occupied Residences

The Committee may choose among several alternatives in dealing with tax-exempt bonds used to finance mortgages on owner-occupied residences. First, they could adopt the position of H.R. 3712 to prohibit all tax-exempt financing of owner-occupied residences. Alternatively, the Committee could decide to do nothing and leave unrestricted the use of tax-exempt financing of mortgages on owner-occupied residences. Finally, the Committee could permit limited use of tax-exempt financing for mortgages on owner-occupied residences. These limitations include:

1. Directing the subsidy towards particular person (e.g., income limitations, first purchaser limitations);
2. Directing the subsidy towards certain types of residences, by placing a ceiling on the size of the mortgage or purchase price, or restricting the mortgages to new or used residences or rehabilitation of existing residences;
3. Directing the subsidy toward certain narrowly defined geographic areas (e.g., rehabilitation or redevelopment areas);
4. Requiring a greater degree of State government involvement (e.g., limitation restricting local issuance, limitations requiring appropriations), and
5. Assuring that the bonds are used more efficiently (e.g., limitations requiring a minimum amount of proceeds be used to finance mortgages).

1. Prohibition of tax-exempt financing of owner-occupied residences

H.R. 3712, as introduced, would prohibit the issuance of tax-exempt bonds if all or a significant portion of the proceeds are used, directly or indirectly, for mortgages on (or other owner financing of) owner-occupied residences. Those who favor this approach base their conclusion on a number of considerations.

First, tax-exempt financing of owner-occupied residences involves a very significant revenue loss which will substantially reduce the ability of the Federal Government to balance its budget and to control inflation.

Second, in addition to budgetary restraints, the anti-inflation program has relied upon monetary policy to decrease economic activity generally through the effects of increased interest rates. The use of tax-exempt housing bonds substantially frustrates this procedure. Thus, allowing tax-exempt housing bonds to continue is at cross purposes with other governmental policies.

Third, Congress has specifically reduced the level of direct Federal expenditures for housing, and it is inconsistent with this action to allow additional expenditures through the tax laws.

Fourth, even if a subsidy for home ownership is appropriate, use of tax-exempt financing is a very inefficient method of providing that subsidy. Studies indicate that it costs the Federal Government at least $3 of lost revenue to provide $2 of benefit in the form of tax-exempt financing. In the case of housing bonds, the subsidy is even more inefficient because of large contingency (or security) reserves and high issuance and administrative costs.

Fifth, tax-exempt financing diverts a substantial portion of the country's capital toward housing and away from highly productive use in industrial plant and equipment. Most experts agree that presently there is insufficient investment in industrial plant and equipment which has resulted in our inability (i) to increase the productivity of our industrial facilities, (ii) to stimulate and sustain a higher rate of real economic growth, and (iii) to compete with other countries. Allowance of tax-exempt financing would further worsen an already unfavorable situation.

Sixth, tax-exempt financing of owner-occupied residences has adverse effects on the tax-exempt bond market. Substantial increases in the amounts of such bonds will increase all tax-exempt interest rates and also increase the costs which State and local governments will have to bear in order to provide traditional services to their citizens.

Seventh, tax-exempt financing of residences puts governments into direct competition with banks and savings and loan associations in providing mortgage financing. Because of tax exemption, State and local governments have an undeniable and unsurmountable competitive advantage.

Finally, the use of tax-exempt financing generally does considerable injury to the fairness of the tax system. Higher income individuals are the major purchasers of tax-exempt bonds. As a result, when large amounts of income escape taxation, it makes others who are not able to use tax-exempt bonds or tax shelters dissatisfied with our tax system and, thus, produces a direct threat to our self-assessment system of taxation.

2. Unrestricted use of tax-exempt financing of mortgages on owner-occupied residences

One of the alternatives available to the Committee is to retain present law and, thereby, permit unrestricted use of tax-exempt financing of mortgages on owner-occupied residences. There are several points that are made to support this position.

First, proponents of present law argue that State and local governments have a valid public purpose to aid their citizens in being able to afford home ownership. They argue that the promotion of home ownership is at least as valid a use of tax-exempt financing as other uses which are already specifically allowed in the Code (such as sports facilities or parking lots).

Second, tax-exempt financing would just be another form of tax subsidy for home ownership. The Code already allows owners to deduct interest and property taxes for Federal income tax purposes. It also allows the tax-free rollover of the gain on the sale of principal residences. Moreover, it exempts up to $100,000 of the gain from the sale of a principal residence if the owner is age 55 or older. Thus, a tax subsidy for housing is nothing new.

Further, proponents of present law argue that this form of tax subsidy is needed more than other types of tax subsidy. For the deduction for interest and property taxes to be sufficiently valuable to make home ownership affordable, the owner must be in a relatively high income tax bracket. Furthermore, to take advantage of the deferral and exclusions of gain on principal residences, the owner must have been able to afford home ownership. Tax-exempt financing is particularly effective in helping persons of relatively modest means to afford home ownership, often for the first time.

Third, there is some evidence that large segments of our society are no longer able to afford home ownership. While a fairly large segment of the existing population may own their homes, that is little consolation to those persons who are presently unable to afford the cost. This problem has become particularly acute with the recent increases in the interest rates, resulting in a larger percentage of a family's income having to be spent for housing. Thus, tax-exempt financing which reduces the interest cost of home ownership is one way of permitting persons to purchase homes who could not do so otherwise.

Fourth, while there may arguably have been abuses of the subsidy in the past, State and local governments are taking steps to correct these abuses. Retention of present law permits the State and local governments flexibility to direct the subsidy in the directions it believes most appropriate to its situation.

Fifth, proponents of present law believe that there is no indication that the existence of tax-exempt housing bonds has had an adverse impact on the tax-exempt bond market. The difference in interest rates between taxable and tax-exempt issues has not significantly changed

despite the issuance of a relatively large amount of tax-exempt housing bonds during recent months.

Sixth, although higher income individuals receive substantial income tax advantages through the tax-exempt interest, they are contributing to a useful public purpose by helping finance home ownership by lower income individuals. If any of the higher income individuals shift from other, less socially desirable tax shelters to tax-exempt housing bonds, the country as a whole benefits.

Finally, proponents of present law argue that financing for home ownership is not presently available in many communities regardless of the interest rate. Tax-exempt housing bonds is one way by which a community can make sure that funds are available in its community to finance mortgages on owner-occupied residences.

3. Possible limitations on the use of tax-exempt financing for owner-occupied residences

a. Limitations directing the subsidy at particular persons

(1) Income limitations

One alternative often mentioned as a way of limiting the use of tax-exempt housing bonds to finance mortgages on owner-occupied residences is to restrict the eligibility to receive such mortgages to persons with less than a designated level of income. Those who favor this approach argue that the snbsidy should be targeted to persons to whom conventional financing is not available. In addition, depending upon the income level selected, income limits could substantially reduce the revenue cost. Under this approach, the income limitation would be expressed as a percentage of the median area income. In addition, various refinements would vary the income limitation depending upon family size or upon other circumstances (e.g., high medical expenses, etc.).

In considering whether to adopt income limits, there are several problems inherent in income limitations. First, even though the determination of eligibility must depend on income determined at the time the mortgage loan is made, the subsidy continues during the entire life of the mortgage loan (typically 10 years). Thus, there is no way to terminate the subsidy if the income of the person increases beyond the income limit established for initial eligibility.

A second problem with income limitations is that income in any given year may not be representative of a person's overall economic status. One restriction that the Committee may wish to consider is to require that persons eligible for the loans be self-supporting for several years prior to the home purchase. One way to lessen this effect is to use an average of several years.

If the Committee decides to impose income limitations, it may want to decide whether the loan can be assumed, and if so, under what circumstances. Mortgage subsidy programs typically allow the assumption of the loan in order to keep the funds invested so that bonds need not be redeemed prior to their maturity. Other programs use the proceeds from early prepayments of the loans to place new mortgages. It has been suggested that if assumptions are to be permitted, they should be allowed only for persons who also meet the eligible income limitations at the time of the assumption.

(2) Directing the subsidy to first time purchasers of homes

Another limitation that has been discussed would limit the use of tax-exempt housing bonds to persons who have not previously purchased a home. It has been stated that high interest rates and high home prices have had their largest effect on persons who have not previously owned a home. If a person has previously owned a home, there is often sufficient equity in that home to permit that person to finance the purchase of another home under conventional financing methods.

One of the problems with this limitation is that it does not account for the large differences in housing costs by geographic region. A person who owned a home in a low-cost area may not have sufficient equity in that home to permit him to purchase a home in a high-cost area.

(3) *Limitations restricting refinancing of existing debt*

Another limitation that has been suggested would prohibit tax-exempt financing for refinancing of an existing mortgage on the residence. The argument in favor of such a limitation is that tax-exempt financing is appropriate only as a means of allowing a person to afford to purchase a particular residence. It is not appropriate to reduce the living expenses of persons who are already able to afford the purchase of a particular residence.

On the other hand, it could be argued that it would be unfair for two identically situated persons to be treated differently just because one of the persons purchased his home at a time and place where tax-exempt financing was available. The person receiving tax-exempt financing would receive a substantially higher standard of living even though he may have the same income, family size, size and value of home, etc., as the person who did not receive tax-exempt financing.

If the Committee decides to provide a restriction on the use of tax-exempt financing for refinancing existing mortgages, it may also wish to provide a limited exception in the case of rehabilitation loans. For example, it has been suggested that at least 50 percent of the loan proceeds be required to be used for rehabilitation, thus allowing up to 50 percent of the tax-exempt financing to be used for refinancing an existing mortgage.

(4) *Limitations directing the subsidy to persons of limited wealth*

Another limitation that has been suggested would restrict the persons who are eligible to receive mortgages according to net worth. Those who favor this limitation state that the amount of a person's income may not provide a good indication of the need of that person for an interest subsidy because that person may have substantial amounts of wealth even though his income is not substantial. A person who derives all of his income from passive investments may have relatively modest amounts of income and yet have substantial amounts of wealth.

The major problem with this limitation is that it is often very difficult to determine the value of a person's net worth. These types of problems have caused much litigation in the estate tax area. The administrative cost of making such a determination would be substantial and would decrease the amount of the benefit to the person for whom the benefit is intended. Also, it has been argued that to require a person to invest a substantial amount of his wealth in his home may remove his sole source of support.

(5) *Limiting the use of tax-exempt financing by disallowing the income tax deduction for interest*

Another limitation that has been proposed would provide that any interest paid by the borrower which is financed with tax-exempt bonds is not deductible in determining his Federal income tax. Those who

favor this limitation state that it would restrict the subsidy to persons in relatively low marginal income tax brackets.

However, before financing his home purchase, a person would have to determine whether the tax benefits from tax deductibility of interest would exceed the reduced amount of interest that he would have to pay if tax-exempt financing were used. The determination of whether tax deductibility or tax-exempt financing were the better arrangement would require a rather complicated computation involving projections of the future income of the person, existence of other itemized deductions, and the use of present value concepts. These computations would be beyond the ability of the typical home buyer.

Also, when the homeowner's income reaches the level that the tax deduction is worth more than the tax-exempt financing, the home owner presumably could refinance his mortgage using conventional financing. However, refinancing often involves substantial costs such as retitling, title search, new mortgage insurance, etc.

b. Limitation directing the subsidy towards certain types of residences

(1) Directing the subsidy to mortgages below a designated amount

Another often-mentioned limitation would limit the size of the mortgage that could be financed with tax-exempt bonds. Compared with an income limitation, a mortgage limitation might be easier to administer because the originator of the mortgage loan need not determine the income of the mortgagor. It has been suggested that, since the median housing prices differ substantially between used and new residences, it might be appropriate to adopt separate limitations for new and used residences.

One of the problems with a mortgage ceiling is that the cost of housing varies substantially by a geographic region within the country. As a result, a fixed dollar limitation would provide more than adequate financing in some parts of the country and inadequate financing in other parts of the country. One way to solve this objection is to adopt a limitation based on a multiple of area median income. However, the ratio of housing costs to income also varies significantly by geographic region.

Another problem with a mortgage limitation is that it will result in the subsidy being available to persons of relatively high income, unless it was combined with an income limitation. In addition, it permits the subsidy to be used by wealthy persons who can make larger down payments than required.

(2) Directing the subsidy to homes below a certain purchase cost

Another limitation that has been suggested would allow financing only when the purchase price of the residence is below some designated limit. The major advantage of a purchase price limitation over a mortgage limitation is that it appears to better insure that the subsidy does not finance luxury housing.

One problem that arises with a purchase price limitation is that the cost of housing varies substantially by geographic region and by whether the residence is new or used. One method of compensating for the regional differences in housing costs would be to express the lim-

itation as a multiple of area median income. The problem with this approach is that the ratio of income to housing costs is not uniform throughout the country.

(3) Limitation on the subsidy to use of housing for personal residence

Under present law, there is no requirement that the house purchased with tax-exempt financing be used as the principal residence of the owner. Thus, it is possible for the subsidy to be used for the purchase of a second home or for the purchase of rental housing. It has been suggested that, in order to be eligible, a purchaser must certify that he intends to use the home as his primary residence. However, this certification may not be too meaningful.

Another problem with this limitation relates to duplexes or four-unit flats. It is common in these types of buildings for the purchaser to own the entire building, live in one of the units, and rent the other units. Several of the housing bonds issued to date permit the financing of multi-family units (typically limited to four-unit dwellings) if the purchaser intends to use one of the units as his principal residence. Accordingly, it has been suggested that only multi-family dwellings of limited size be eligible, and then only if the owner intends to use one of the units as his principal residence. On the other hand, it has been argued that the eligibility be limited to just the purchase of the principal residence of the purchaser since it would be an unwarranted extension of the subsidy to provide an investment asset to the purchaser which goes beyond the basic family need of housing.

c. Limitation on the subsidy for use in certain geographic areas

Another alternative that has been proposed would target the subsidy to certain geographic areas, such as economically depressed areas, blighted areas, areas of substantial population growth, areas with substandard housing stocks, etc. This targeting could be accomplished by providing that the subsidy could be used only in the targeted area or that any other limitations (such as income, mortgage or purchase price limitations) would be less restrictive when applied to housing in targeted areas.

There are a number of problems with the concept of geographic targeting. First, it is very difficult to establish exactly what criteria will be used in determining the targeted area. For example, it is very difficult to determine what is blight. One method of solving this problem is to tie the subsidy to the existence of other subsidy programs. For example, the Housing and Urban Development Agency (HUD) administers a program for blighted areas called the Urban Development Action Grants (UDAG).

d. Limitations on veterans mortgage programs

H.R. 3712 permits tax-exempt bond proceeds to be used to provide mortgage funds for veterans when general obligation bonds are used. It has been suggested that this provision of H.R. 3712 be stricken since the issues raised by programs for veterans are essentially similar to the issues raised by other tax exempt bonds for owner-occu-

pied housing. Alternatively, limitations could be imposed on the veterans programs, including restricting such mortgage subsidies to first-time home buyers, imposing income restrictions, or limiting the exception in H.R. 3712 only to programs which were in existence before April 25, 1979.

e. Limitations designed to require more State involvement in providing a subsidy to financing mortgages on owner-occupied residences

(1) Restriction of subsidy to general obligation bonds

Another limitation that has been discussed would limit the subsidy for housing bonds to bonds that are secured by the full faith and credit of the State or local governmental unit (commonly called general obligation bonds). Those favoring this limitation argue that States and local governmental units are more likely to limit the subsidy to the most meritorious cases if their own credit (or monies that they have appropriated) is subject to liabilities to finance the mortgages on owner-occupied residences.

However, if full faith and credit is required only of the issuing authority instead of a State or governmental unit possessing a taxing authority, the limitation may not provide a meaningful restriction. In many states, governmental units are created solely to issue bonds and these governmental units typically do not possess any power to tax. In these situations, extension of the full faith and credit of such a governmental unit might not provide a very meaningful restriction. Consequently, if the Committee were to adopt such a limitation, it may wish to require the full faith and credit of a governmental unit with general taxing authority.

In some States, there is no constitutional or statutory authority to issue general obligation bonds for housing because housing does not fall within the defined meaning of public purpose for which general obligation bonds may be issued. Moreover, the governmental units most able to issue general obligation bonds would be those which are in relatively secure financial positions. Thus, this limitation could discriminate against some of the urban areas where housing needs are greatest.

(2) Restricting the subsidy to bonds issued by States housing authorities

It has been proposed that the use of tax-exempt housing bonds be limited to bonds that are issued by States or State agencies (such as State housing agencies). Some persons argue that States are more inclined to limit the use of the subsidy to the most meritorious cases and control issuance and administration costs. In addition, States are more likely to respond to the effect that tax-exempt housing bonds have on the interest rates commanded by all tax-exempt bonds.

However, it has been pointed out that political pressure on State housing agencies may be sufficient to force those agencies to issue housing bonds to the same extent local governmental units have issued housing bonds. If this is true, the restriction will not provide a meaningful limitation on the issuance of tax-exempt mortgage subsidy bonds for owner-occupied residences.

(3) Limitation requiring State or local governmental unit to contribute to the subsidy

One of the alternatives that has been suggested would require that the State or local governmental unit contribute to the subsidy for financing mortgage on owner-occupied residences. Those favoring this requirement argue that the State or local government would be more responsive and provide a more careful review before issuing bonds.

There are a variety of methods that can be used to require contribution by State or local governmental units. One method would be to require the State or local governmental unit to pay for the costs of issuing the bonds. This can be done by requiring that all of the gross proceeds from the sale of the bonds must be used to finance mortgages on owner-occupied residences. This would have the effect of requiring the State or local governmental unit to provide funds for the issuance costs (including underwriting commissions), and to provide any reserves in the event that there are insufficient mortgage prepayments to retire series bonds as they mature.

f. Limitations designed to make the subsidy more efficient

As indicated above, the issuance of tax-exempt housing bonds has involved substantial issuance costs. Moreover, most of the arrangements require that between 12 and 15 percent of the bond proceeds be held in reserves. Because of these costs and reserves and the general inefficiency of tax-exempt financing, it has been argued that the benefit to the home purchaser is substantially less than the cost in foregone revenues on the tax-exempt bonds. As a result, it has been proposed that housing bonds be permitted only when a substantial portion of the cost of the subsidy is passed on to the home purchaser.

One method of restricting the amount of the issuance costs is to place a restriction on the amount of arbitrage that the reserve fund may earn. Under present rules, the arbitrage rules do not apply to reasonable amounts of reserves (up to 15 percent). Under existing practice, these reserve funds are invested in high yield taxable securities and the arbitrage profit is used to pay certain costs, such as the bond discount.

B. Rental Housing

As indicated above, present law contains an exception to the industrial development bond rules that permits tax-exempt financing of "residential real property for family units." Thus, present law does not restrict tax-exempt bond financing to rental housing for a particular class of persons.

As introduced, H.R. 3712 narrows the exception to the industrial development bond rule so that tax-exempt financing is permitted only if substantially all of the proceeds (90 percent) of the bonds are used to provide rental housing for persons of moderate or low incomes. For this purpose, low or moderate income is to be determined by the Secretary of the Treasury in a manner consistent with the Leased Housing Program under section 8 of the United States Housing Act of 1937. In general, this test will be met if their adjusted gross income does not exceed 80 percent of the median area income.

1. Unrestricted use of tax-exempt financing of rental housing

One alternative would be to retain present law and, thereby, permit unrestricted use of tax-exempt financing of rental housing. Persons supporting this position argue that, unlike tax-exempt bonds for owner-occupied residences, there have not been any substantial abuses of present law and, consequently, there is no need for legislation in this area. Supporters of this position state that rental housing generally is not a very attractive investment and that any further restrictions on rental housing will reduce the production of this type of housing below an already depressed state. Moreover, tax-exempt financing of rental housing has been used by governmental housing agencies as a creative and flexible way of achieving redevelopment in blighted areas where redevelopment would not otherwise be possible.

2. Limited use of tax-exempt financing of rental housing

It has been argued that, while unrestricted use of tax-exempt financing may not be appropriate, H.R. 3712 does not permit rental projects with mixed income tenants. One alternative that has been proposed would require that a lower percentage of families with "section 8" incomes be required. The suggested percentages vary from 20 to 80 percent.

Another alternative that has been proposed would allow tax-exempt housing bonds only if the rate of return on the investment that the landlord could earn on the project is restricted. Those favoring this restriction argue that it would insure that a substantial portion of the subsidy passes through to the tenants in the form of lower rents.

C. H.R. 4030 (Mr. Heftel)

H.R. 4030, (introduced by Mr. Heftel) would allow tax-exempt bonds to be issued by a qualified housing agency in connection with owner-occupied housing programs with certain limitations. As in H.R. 3712, the proposal would continue to allow general obligation bonds to be tax-exempt if substantially all of the proceeds are used to provide residences for veterans.

In addition, the proposal would allow tax exempt bonds to be issued in connection with owner-occupied housing if substantially all of the proceeds are used to provide qualified residences for low and moderate income families. Under this exception, housing subsidy bonds would be tax-exempt if the placement of mortgage loans which are financed by the proceeds of the bonds was limited to owner-occupants with incomes (at the time of receiving the commitment for the loan) of 120 percent of the median income or less. Owner-occupants with incomes of 200 percent or less of the median income would be allowed if the area in which the residence is situated is either (i) designated as an urban development action grant area, (ii) determined to be economically distressed or energy impacted, or (iii) designated as a redevelopment area or as substandard or blighted.

In addition to the income limitations, the proposal would place a limitation on the purchase price of the home. The limitation would require that the total cost of the residence (excluding closing costs and taxes) not exceed 3 times the applicable income limitation.

Under this proposal, median income means the higher of the median family income within the area in which the residence is located or the national median family income. Also, a qualified housing agency includes any political subdivision, a department, agency, or other entity established by or pursuant to State law and acting on behalf of a State or local political subdivision authorized to issue mortgage subsidy bonds.

H.R. 4030 would also allow tax-exempt industrial development bonds to be issued to finance the construction or rehabilitation of rental housing and cooperative housing, provided the housing is eligible for occupancy pursuant to the express provisions of State law.

Finally, under this proposal, the amendments would apply to obligations issued after April 24, 1979. However, the amendments would not apply to obligations with respect to which any official resolution or other similar authorization declaring the issuer's intent to issue such obligations had occurred before April 25, 1979.

D. Transitional Rules

1. In general

In general, H.R. 3712, as introduced, would provide that the amendments made therein are to apply to obligations issued on or after April 25, 1979 (which is the day that the bill was introduced). However, the amendments made by the bill would not apply to obligations issued before May 25, 1979, pursuant to a binding written agreement to sell between the issuer and the underwriter (or other purchaser of the obligations) which was entered into before April 25, 1979.

Most of the proposed tax exempt bonds for owner-occupied residences pending on April 25, 1979 do not meet the transitional rule provided in H.R. 3712, although substantial effort or money may have been expended on those issues prior to April 25, 1979.

A typical sequence of events in issuing bonds for owner-occupied residences

Once a jurisdiction posseses the requisite statutory authority to issue tax exempt bonds for owner-occupied residences it must pursue a number of actions before bonds will in fact be sold. Generally, the first of these steps will be the creation of a bond issuing authority. The steps that follow will not occur in any fixed order, but generally will include most of those described below. Once an authority exists, the authority may adopt a resolution authorizing the issuance of bonds and retain underwriters, a bond counsel, and a market analyst. Bond counsel will prepare the loan agreements and servicing agreements, and the authority will begin requesting participation offers from lending institutions. When lenders make participation offers they may or may not pay a commitment fee.

Generally, the underwriter will be engaged in preparing a preliminary official statement reflecting the results of the market analysis and the effort to obtain participation commitments. When sufficient data are available, the preliminary official statement is printed and issued. The underwriter and authority will also set the size of the offering, receive a rating on the bonds, and price the bond.

Once the preliminary statement is issued, the underwriter will obtain firm purchase comitments from investors, and the authority will begin execution of participation agreements with the lending institutions.

A final resolution permitting issuance of the bonds will normally be adopted by the authority before execution of the agreement of sale with the underwriters. The execution of this sales agreement is the critical date in the transitional rule contained in H.R. 3712 as introduced.

Execution of the sales agreement is usually followed by printing of the bonds, retention of a trustee, issuance of the official statement, and issuance of the bonds.

The authority may expend funds on retention of bond counsel and market analysts, on retention of a rating agency, and upon printing of the bonds.

The underwriters, who look to the actual issuance and sale of bonds for their income, expend funds in preparation and printing of the preliminary official statement and the official statement, in the marketing of the bonds and in the sizing, and pricing processes.

To summarize, the following steps would normally occur during the process of issuing tax exempt bonds for owner-occupied residences. However, the order of these steps will vary from issue to issue and different procedures will be followed for privately placed or publicly auctioned issues:

1. Passage of enabling legislation.
2. Creation of the bond issuing authority.
3. Adoption of bond resolution authorizing issuance of bonds.
4. Retention of underwriters.
5. Retention of bond counsel.
6. Retention of market analyst.
7. Preparation of loan agreement and servicing agreements.
8. Requests for participation from loan originators.
9. Receipt of participation offers from loan originators.
10. Preparation of Preliminary Official Statement.
11. Issuance of Preliminary Official Statement.
12. Setting of the size of the issue.
13. Receipt of bond rating.
14. Pricing of the bonds.
15. Execution of participation agreements with loan originators.
16. Final resolution permitting issuance of the bonds.
17. Execution of agreement of sale with underwriters.
18. Printing of bonds.
19. Retention of debenture trustee.
20. Issuance of Official Statement.
21. Closing—issuance of bonds.

Rollover of obligations

The transitional rule of H.R. 3712 would not only affect states and localities in the process of preparing a bond issue, but it would also affect States and localities that had planned to roll over short-term financing into long-term obligations.

Generally, a rollover will be necessary in two situations. First, short-term financing may have been arranged during the construction period with the expectation that the principal and interest on that short-term financing would be refinanced upon completion by a mortgage subsidy offering. Second, if an industrial development bond was brought to market in a period of unfavorable interest rates, the issuer may have issued short-term bonds with the intention of refinancing with long-term obligations when market conditions improved.

Generally, a rollover merely refinances the obligations previously incurred; it does not increase the amount of principal outstanding nor does it extend the term of the issuer's obligation beyond the life of the property financed or the term originally contemplated by the issuer when the short-term obligations were incurred.

2. Transitional rule precedents

In the past, both the Congress and the Treasury have addressed transitional rule issues similar to those raised in consideration of H.R. 3712.

Most recently, the Treasury's proposed regulations on arbitrage bonds provide that as to bonds sold after May 2, 1978, amounts accumulated in a sinking fund for an issue shall be treated as proceeds of the issue unless the bonds were sold before May 16, 1978, and before May 3, 1978, one of the following had occurred:

(1) the sale of the bonds was either authorized or approved by the governing body of the governmental unit issuing the bonds or by the voters of such governmental unit, or

(2) notice of sale of the bonds was given as required by law, or

(3) a bona fide written offering statement (or preliminary offering statement) was circulated to potential purchasers.

In 1968, the Congress amended Code section 103 (effective May 1, 1968) to limit the tax-exemption for industrial development bonds. As would be true if H.R. 3712 were enacted, certain localities were in the course of issuing IDB's that would have been taxable under the 1968 amendments to Code section 103. To address this problem, section 107 (b) of Public Law 90–364 provided that obligations issued before January 1, 1969, but after the general effective date of the 1968 amendments would be exempt, if they would have been exempt under prior law and, if before the general effective date, any one of the following had occurred with respect to the obligations:

(1) the issuance of the obligation (or the project in connection with which the proceeds of the obligations are to be used) was authorized or approved by the governing body of the governmental unit issuing the obligation or by the voters of such governmental unit;

(2) in connection with the issuance of such obligation or with the use of the proceeds to be derived from the sale of such obligation or the property to be acquired or improved with such proceeds, a governmental unit had made a significant financial commitment;

(3) any person (other than a governmental unit) who would use the proceeds to be derived from the sale of such obligation or the property to be acquired or improved with such proceeds had expended (or had entered into a binding contract to expend) for purposes which were related to the use of such proceeds or property, an amount equal to or in excess of 20 percent of such proceeds; or

(4) in the case of an obligation issued in conjunction with a project where financial assistance will be provided by a governmental agency concerned with economic development, such agency has approved the project or an application for financial assistance is pending.

As to rollovers, the Treasury would provide in the proposed regulations on advanced refunding, that a refunding issue is tax exempt, if the prior issue was exempt and the refunding issue matures no later than the prior issue.

3. Possible alternative transitional rules

a. Bonds in progress for owner-occupied residences

H.R. 3712, as introduced, would allow exemption for bonds issued before May 25, 1979, if prior to April 25, 1979, the issuer and the underwriter (or other purchaser) had entered into a binding agreement to sell. This rule would be readily administrable. However, the rule apparently precludes exemption for the bulk of the issues in progress on April 25, 1979.

Numerous possibilities exist for establishing a straight-forward transitional rule by selecting a single event, such as, approval of the issuance of bonds by the governing body of the issuer, retention of underwriters or analysts, or issuance of the preliminary official statement.

Each such proposal would have the advantage of producing a readily administrable rule. However, since the particular point at which any single event occurs varies from issue to issue, a rule focused on a single event may fail to exempt issues more fully developed than some that are exempt.

Further, each of the particular events commonly suggested as the foundation for a transitional rule could be criticized. For example, granting exception to any bond issue that has been authorized or approved by the governmental unit involved, could result in exempting projects that were not past the tentative planning stage and were unsupported by a significant financial commitment on April 25, 1979. Granting exemption to issuances for which counsel or underwriter had been retained could be subject to the same objection. Focus upon a later event, such as issuance of the preliminary official statement or similar documents could fail to exempt issues on which a significant amount of time or money had been expended.

Some of the weaknesses of a single factor transitional rule could be avoided by adopting a multi-factor rule. Such a rule could be conjunctive or disjunctive; each approach creates its own problems. For example, a rule exempting plans for which counsel had been retained, and participation offers obtained, and a resolution of intent adopted, could fail to exempt a substantially completed program because the governmental unit had failed to pass a specific resolution of intent when it authorized planning to commence. In contrast, a rule exempting plans for which counsel had been retained, or participation offers obtained, or a resolution of intent adopted, could exempt plans that were not beyond the tentative planning stage.

Another approach would be to list actions demonstrating a determination to go forward with a bond issue and to require that some minimum number of those actions had been taken before April 25, 1979.

Any of the possible alternative transitional rules described above could result in exempting an issuance that had not been definitely sized as of April 25, 1979. If such an issue was later sized at an artificially high level, a substantial frustration of the effective date limitation could result. This could be avoided by providing that if the transitional rule exempts an unsized offering, the size of the offering will be limited by a dollar per capita limitation.

b. Cutoff date for transitional issues

Once a transitional rule is established so that issues in progress on April 25, 1979, which are to be exempt can be identified, it will be possible to identify a period of time during which all of the transitional offerings must be issued (e.g., a number of days following enactment). Such a period should be long enough to permit the completion of the necessary documents and agreements and to allow for the orderly absorption of the offerings by the bond markets. Too long a period could invite efforts to bring questionable issuances under the transitional rule.

c. Multi-family rental projects in progress

Multi-family rental programs are frequently built in stages. Thus, in addition to the problem of bond issuances affected by the transitional rule in H.R. 3712, there may be projects partially financed or partially constructed for which the issuance of contemplated long-term tax-exempt financing in the future would be precluded by H.R. 3712. It is argued that many of these projects will not be economically and socially viable unless the original plan is carried to completion. Proponents of permitting completion through tax-exempt financing also note that multi-family programs have not represented an area of abuse in the past.

In response to these concerns, the Committee may wish to consider an effective date provision that permits tax-exempt financing to complete projects, if prior to April 25, 1979, a governmental unit had determined to go forward with the project. Such a determination could be reflected in approval of a plan specifying the number and location of units, and by the acquisition and improvement of real property in pursuance of that plan.

d. Rollover of obligations

Two separate types of obligations incurred before April 25, 1979, may need to be rolled-over. First, there may be construction period obligations for which permanent financing was planned. If the Committee wants to exempt such issues, it may wish to consider whether any increase in the amount of principal and interest will be permitted and whether a limitation should be placed on the maturity date of the rollover obligations. As to the amount of the permanent financing permitted upon rollover of the construction financing, it could be argued that any increase in amount above the principal and accrued interest until completion of construction should be permitted.

A limitation on the maturity of the long-term financing, may be desirable to prevent perpetual rollovers. At least two different limits on maturity are possible. The maturity date of the obligation should not be extended beyond the depreciable life of the property. Such a rule could lead to some dispute over the precise property to be examined and its useful life. Alternatively, a specific date could be set by which all rollover obigation would have to mature (e.g., 30 or 40 years after enactment). This alternative, although it provides great certainty, could be criticized as highly artificial or arbitrary.

The second type of obligation that may need to be rolled-over is the short-term obligation incurred to acquire funds while waiting for improved market conditions.

APPENDIX TABLES

Table 1.—Data on State-Local Tax-Exempt Bonds, State Housing Bond Issues, and New Mortgages on Single Family Housing, 1970–84

Years	Total State and local tax-exempt bonds for all purposes (billions)	Tax-exempt bonds issued by State housing finance agencies for single-family housing (billions)	Tax-exempt bonds issued by local housing finance agencies for single-family housing (billions)	Gross new mortgages on single-family housing (billions)
1970	$18	0	0	$36
1971	24	([1])	0	58
1972	23	$0.2	0	76
1973	23	0.3	0	79
1974	23	0.7	0	68
1975	29	0.2	0	78
1976	34	0.5	0	111
1977	45	1.0	0	157
1978	46	2.8	$0.6	177
1979	[2] 12.5	1.7	[2] 1.7	[3] 65
1984				[2] 360–400

[1] Less than $50 million.
[2] The amounts represent tax-exempt bonds issued through Apr. 24, 1979.
[3] Estimated for the period through Apr. 24, 1979.

Table 2.—Cost Projectons for Major Housing Assistance Programs, Fiscal Years 1980–84

[Billions of dollars]

Program	1980	1981	1982	1983	1984
Housing Assistance (HUD) [1]	5.07	5.92	6.80	8.07	9.46
Rural Housing (FmHA)	.72	.82	.92	1.02	1.13
Government National Mortgage Assn. (GNMA)	.52	.40	.18	.11	.11
Housing for the Elderly or Handicapped	.64	.69	.73	.77	.82
Community Development Block Grants [2]	.67	.76	.86	.98	1.11
Tax deduction for interest on owner-occupied homes	9.29	10.97	12.94	15.27	18.01
Tax deduction for property taxes on owner-occupied homes	6.62	7.68	8.91	10.33	11.98
Exclusion and deferral of tax on capital gains of sales on residence	1.55	1.71	1.88	2.06	2.28

[1] Includes section 8 rental assistance, public housing, section 235 homeownership assistance, section 236 and other rental assistance.

[2] These figures are 20 percent of the estimated outlays for community development block grants. This is a rough estimate of the proportion of the funds used for housing assistance.

Source: Joint Committee on Taxation; Congressional Budget Office.

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