[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS (S. 137 AND S. 1061)

RELATING TO

MORTGAGE SUBSIDY BONDS AND FEDERAL GUARANTEES OF TAX-EXEMPT BOND INVESTMENTS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON MAY 13, 1983

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

MAY 12, 1983

U.S. GOVERNMENT PRINTING OFFICE

20-069 O WASHINGTON : 1983 JCS-12-83

CONTENTS

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on May 13, 1983, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are two bills scheduled for the hearing: S. 137 ("Housing Finance Opportunity Act of 1983", relating to tax exemption for qualified mortgage bonds) and S. 1061 (relating to denial of tax exemption on obligations where bond proceeds are invested in federally insured deposits).

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

I. SUMMARY

1. S. 137—Senators Roth, Mitchell, Durenberger, Danforth, Packwood, Wallop, and Others

"The Housing Finance Opportunity Act of 1983"

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act") imposed restrictions on the ability of State and local governments to issue tax-exempt bonds to finance owner-occupied residences. The 1980 Act provides that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified mortgage bonds" or "qualified veterans' mortgage bonds". Qualified mortgage bonds must satisfy a number of requirements including a requirement that the bonds be issued before January 1, 1984.

The bill would make permanent the tax exemption presently provided for qualified mortgage bonds.

2. S. 1061—Senator Dole

Denial of Tax Exemption Where Bond Proceeds Are Invested in Federally Insured Deposits

Present law generally permits State and local governments to invest the proceeds of tax-exempt bond issues in certificates of deposit of federally insured financial institutions. The amounts deposited with the financial institutions then may be loaned for projects which qualify for tax-exempt financing. The certificates are pledged as security for repayment of the tax-exempt bonds. Because the certificates are insured by Federal depository insurance agencies in amounts up to $100,000 per bondholder, the repayment of the tax-exempt bonds effectively is guaranteed by those agencies.

The bill would eliminate the tax exemption for any obligation which was part of an issue a significant portion of the principal or interest on which is to be insured (directly or indirectly) by a Federal depository insurance agency as a result of the investment of the proceeds of the issue in deposits or accounts in a federally insured financial institution. However, exceptions are provided for (1) temporary period investments, (2) bona fide debt service reserves, and (3) reasonably required reserves.

II. DESCRIPTION OF BILLS

1. S. 137—Senators Roth, Mitchell, Durenberger, Danforth, Packwood, Wallop, and Others

"The Housing Finance Opportunity Act of 1983"

Present Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act") [1] imposed restrictions on the ability of State or local governments to issue bonds, the interest on which is tax-exempt, for the purpose of making mortgage loans on single family residences.[2] The 1980 Act provides that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified mortgage bonds" or "qualified veterans' mortgage bonds".

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. The tax-exemption for veterans' bonds is permanent.

Qualified mortgage bonds

Qualified mortgage bonds must be issued before January 1, 1984, and must satisfy numerous requirements, discussed below.

Volume limitations

The 1980 Act restricts the aggregate annual volume of qualified mortgage bonds that a State, and local governments within the State, can issue. The State ceiling is equal to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the 3 preceding years for single-family owner-occupied residences located within the State or (2) $200 million.

Limitation to single-family, owner-occupied residences

All proceeds (except issuance costs and reasonably required reserves) of qualified mortgage bonds must be used to finance the purchase of single-family residences [3] located within the jurisdiction of the issuing authority. Additionally, it must be reasonably

[1] Title XI of the Omnibus Reconciliation Act of 1980 (Pub. L. 96-499). The provisions of this Act (i.e., Code sec. 103A) were subsequently amended by section 220 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248) ("TEFRA").

[2] Tax-exempt industrial development bonds also may be issued to finance projects for certain multi-family residential rental housing. Tax exemption for such bonds is permanent.

[3] Generally, the term single-family residence includes 2-, 3-, and 4-family residences if (1) the units in the residence were first occupied at least 5 years before the mortgage is executed and (2) one unit in the residence is occupied by the owner of the units.

expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided.

General limitation to new mortgages

With certain exceptions, all proceeds of qualified mortgage bonds must be used for acquisition of new mortgages rather than existing mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Rehabilitation loans must be made for work begun at least 20 years after the residence is first used and the expenditures must equal 25 percent or more of the mortgagor's adjusted basis in the building. Additionally, at least 75 percent of the existing external walls of the building must be retained as such after the rehabilitation.

Certain mortgage assumptions permitted

Loans financed by qualified mortgage bond proceeds may be assumed if the residence satisfies the location and principal residence requirements, discussed above, and the assuming mortgagor satisfies the three-year and purchase price requirements, discussed below.

Limitation on advance refunding

Qualified mortgage bonds may not be advance refunded.

Targeting requirement

At least 20 percent of the proceeds of each issue must be made available for owner-financing in "targeted areas" for a period of at least one year. The term targeted area means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income, or an area designated as an area of chronic economic distress.

Three-year requirement

In order for an issue to be a qualified mortgage issue, at least 90 percent of the mortgages financed from the bond proceeds are required to be provided to mortgagors, each of whom did not have a present ownership interest in a principal residence at any time during the three-year period ending on the date the mortgage is granted.[4] The three-year requirement does not apply with respect to mortgagors of residences in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans; [5] and (3) mortgagors who receive qualified rehabilitation loans.

[4] Section 220(c) of TEFRA reduced the percentage of bond proceeds that must be used in a manner satisfying the three-year requirement from 100 percent to 90 percent, effective for bonds issued after September 3, 1982.

[5] Qualified home improvement loans are loans, not exceeding $15,000, that finance the alteration or repair of a residence in a manner that substantially protects "the basic livability or energy efficiency of the property" (sec. 103A(l)(6)).

Purchase price requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, are required to be for the purchase of residences where the acquisition cost of each residence does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to that residence.[6]

Arbitrage requirements

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

Mortgage investments.—The effective rate of interest on mortgages provided under an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.[7] This determination is made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than 1.125 percentage points above the yield of the issue if other mortgages have a lower effective interest rate.

Nonmortgage investments.—The 1980 Act also imposed restrictions on the arbitrage permitted to be earned on nonmortgage investments. The amount of qualified mortgage bond proceeds that can be invested at unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. An exception to the 150-percent debt service rule is provided, however, for proceeds invested for an initial temporary period until such proceeds are needed for mortgages. Arbitrage earned by the issuer on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Qualified mortgage bonds usually have established a reserve to secure payment of the debt service on the bonds. This reserve must be reduced as debt service is reduced. However, if the sale of any investment would result in a loss exceeding the amount otherwise required to be paid or credited to mortgagors, the investment may be retained until it can be sold without resulting in such a loss.[8]

Background

State housing agencies began issuing mortgage subsidy bonds 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 bonds issued to provide for single-family housing increased from $36 million in 1971 to $959 million in 1977. During 1978, the last full year before any provisions of the 1980 Act were effective, State and local governments issued $3.3 billion of bonds for owner-occupied residential real property.

---

[6] Section 220(d) of TEFRA increased the maximum purchase price requirement from 90 percent (110 percent in targeted areas) to its present level, effective for bonds issued after September 3, 1982.

[7] Section 220(a) of TEFRA increased the maximum permitted arbitrage from 1 percentage point to 1.125 percentage points, effective for bonds issued after September 3, 1982.

[8] The rule permitting retention of an investment where its disposition would result in a loss was added by section 220(b) of TEFRA, effective for bonds issued after September 3, 1982.

The volume of qualified mortgage bonds issued since 1978, and the percentage of total tax-exempt State and local borrowing comprised of such bonds, are shown in Table 1.

TABLE 1.—VOLUME OF QUALIFIED MORTGAGE BONDS, 1979–83

[Dollars in billions]

Year	State qualified mortgage bonds	Local qualified mortgage bonds	Percent of total State and local bonds
1979	$3.3	$4.5	16.2
1980	5.0	5.5	19.2
1981	1.7	1.2	5.0
1982	5.5	3.5	10.4

As shown in Tables 1 and 2, qualified mortgage bonds represented 10.4 percent of total State and local government borrowing during 1982.

Table 2 shows the relative percentages of borrowing by State and local governments by purpose during 1982.

TABLE 2.—COMPOSITION OF STATE AND LOCAL GOVERNMENT BORROWING IN 1982

Purpose	Percent
Owner-occupied housing	10.4
Veterans' housing	0.6
Education	9.7
Water and sewer	5.3
Highways, bridges, and tunnels	1.3
Gas and electric	11.0
Industrial aid	14.7
Pollution control	7.6
Hospital	11.2
Multi-family rental housing	5.9
Other purposes	22.3
Total	100

Issues

The bill raises several issues in providing for a continuation of the exemption of interest on qualified mortgage bonds:

First, what should be the appropriate level of the total Federal subsidy to owner-occupied housing in light of the demands on the available pool of credit for other purposes, the effect that such subsidies have on the cost of housing, and the cost of the subsidy to the Federal Government?

Second, what should be the role of tax-exempt bonds as a part of this total subsidy in light of the relative efficiencies of tax-exempt bonds and other forms of subsidy?

Third, what is the impact of permitting tax exemption for interest on mortgage bonds on the cost to State and local governments of borrowing for other purposes?

Fourth, if the exemption of interest on qualified mortgage bonds is to be continued, should the length of the exemption be limited by a period of time (i.e., an extension for a specified period of time)?

Fifth, assuming that exemption of interest on qualified mortgage bonds is to be continued, do the existing limitations target the subsidy to those individuals who are most in need of assistance?

Explanation of the Bill

The bill would make permanent the tax exemption presently provided for qualified mortgage bonds.

Effective Date

The bill would be effective on the date of enactment.

Revenue Effect

It is estimated that this bill would reduce fiscal year receipts by $0.1 billion in 1984, $0.2 billion in 1985, $0.5 billion in 1986, $0.8 billion in 1987, and $1.2 billion in 1988.

2. S. 1061—Senator Dole

Denial of Tax Exemption Where Bond Proceeds Are Invested in Federally Insured Deposits

Present Law

Federal income tax rules

State and local obligations

In general.—Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services, including schools, roads, water, sewer, and general improvement projects and the financing of public debt. Additionally, State and local governments may provide tax-exempt financing for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations.

Industrial development bonds.—Under present law, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of the proceeds of which are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business.

One of the exceptions under which interest on IDBs is tax-exempt is where the proceeds of the IDBs are used for certain exempt functions. Under this rule, interest on IDBs is tax-exempt if the bond proceeds are used to finance the following activities: (1) projects for multi-family residential rental housing; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; or (10) local district heating or cooling facilities. In addition, interest on IDBs used to acquire or develop land as the site for an industrial park is exempt from tax.

Present law also provides tax exemption for certain "small issue" IDBs the proceeds of which are used for the acquisition, construction, or improvement of land or depreciable property. This exception applies to issues of $1 million or less without regard to related capital expenditures. Alternatively, the exception applies if the amount of the issue, together with certain related capital expenditures over a 6-year period, does not exceed $10,000,000.

Treasury Regulations provide that whether the proceeds of an obligation are used for exempt facilities is to be determined by the ultimate use of the proceeds (Treas. Reg. § 1.103-8(a)(4)). Those regulations illustrate this principle by indicating that bond proceeds are used for an exempt purpose where the proceeds of the bonds are lent to banks or other financial institutions who then relend those proceeds for exempt functions (referred to as a "loan to lenders" program).

Scholarship funding bonds

In addition to State and local obligations, qualified scholarship funding bonds are exempt from Federal income tax. Qualified scholarship funding bonds are obligations issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loan notes. To qualify for tax exemption, the corporation must be required to use any income (after payment of expenses and debt service) to purchase additional student loan notes, or to pay over any income to the State or a political subdivision.

Federal deposit insurance rules

The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) insure deposits in banks and thrift institutions to a maximum of $100,000 per depositor.[1] Where assets of a trust are deposited in Federally insured institutions, the trust funds are insured up to $100,000 for each beneficial owner of the funds.[2] Additionally, where a public official deposits funds required to be paid to holders of bonds issued by a public unit, the interest of each bondholder is insured up to $100,000.[3]

The FDIC and FSLIC concluded in letter rulings issued in 1982 that, where the proceeds of a tax-exempt bond issue are used to purchase certificates of deposit of insured financial institutions, which may occur in loans to lenders programs, each bondholder's proportionate interest in the deposits would be separately recognized. Thus, if one or more depository banks failed, the interest of each bondholder would be insured up to $100,000 for each depository bank.[4]

Background

Typical structure of FDIC- and FSLIC-insured bonds

In certain recent issues of tax-exempt bonds, the issuing authority has deposited the bond proceeds in bank or savings and loan accounts insured by the FDIC or FSLIC, to be loaned to the user by the depository institution. In the typical arrangement, the issuer transfers the proceeds to a trustee for the bondholders, and the trustee deposits the funds in FDIC- or FSLIC-insured certificates of

[1] The FDIC provides insurance for deposits in commercial banks and State mutual savings banks. The FSLIC insures deposits in savings and loan associations, Federal mutual savings banks, and certain other thrift institutions.

[2] 12 U.S.C. sec. 1817(i) and 12 C.F.R. sec. 331.1(b) (FDIC); 12 U.S.C. sec. 1724(b) and 12 C.F.R. sec. 564.2(c) (FSLIC).

[3] 12 C.F.R. sec. 330.8(b) (FDIC); 12 C.F.R. sec. 564.8(b) (FSLIC).

[4] This insurance would be separate from insurance on any deposits which the bondholder individually maintained in the bank.

deposit. The depository institution agrees to provide the deposited funds to private users for stated tax-exempt purposes. Interest and principal on the bonds are repaid from payments on the certificates of deposit. The repayment of the bonds is secured by the certificates. Because the proceeds of the bonds are used ultimately for exempt purposes, the bonds qualify as tax-exempt obligations under present law. Because the trustee for the bondholders holds a certificate of deposit in an insured institution, the amount of each bondholder's holdings is insured to the extent of $100,000 for each depository institution.

Volume and uses of FDIC- and FSLIC-insured tax-exempt bonds

The first FDIC- and FSLIC-insured tax-exempt bonds appear to have been issued in October 1982. Since then, approximately $2 billion of these bonds have been issued. Most of this amount consists of IDBs used to provide projects for multi-family residential rental property.

Precedents for Federal guarantees of tax-exempt bonds

The Public Debt Act of 1941 [5] prohibits the Federal Government from issuing tax-exempt obligations. Since that time, the Federal Government has generally refrained from guaranteeing tax-exempt State or municipal bonds. However, in certain limited cases, Federal agencies may provide additional security for tax-exempt bonds through (1) guarantee of obligations which are used to secure tax-exempt bonds or (2) subordination of debts owed to the Federal Government to the tax-exempt bonds. In other cases, the law specifically prohibits the guarantee of tax-exempt obligations.

New York City loan guarantees

The New York City Financial Assistance Act of 1978 (Pub. L. 95-339) authorized the Treasury Department to guarantee payment of interest and principal on New York City indebtedness issued to certain public employee pension funds. The Act provided specifically that any guaranteed obligation would be treated as a taxable obligation with respect to interest accrued during the guarantee period. The Conference Report accompanying the Act [6] states that the conferees sought to avoid establishing a precedent for tax-exempt federally guaranteed obligations since obligations which combined a Federal guarantee and tax-exempt interest would be more desirable to investors than United States Treasury obligations (which are taxable) or other obligations issued by State or local governments (which are tax-exempt but not federally guaranteed).

Small Business Administration guarantees

The Small Business Administration (SBA) is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design, or installation of governmentally mandated pollution control facilities.[7] The current

[5] 55 Stat. 7 (1941).
[6] H. Rep. No. 95-1369, accompanying H.R. 12426, 95th Cong., 2d Sess. (July 18, 1978).
[7] Small Business Investment Act of 1958, 15 U.S.C. sec. 694-1.

policy of the SBA is to avoid participation in pollution control projects financed with tax-exempt obligations. However, the Senate Committee on Small Business has reported favorably [8] a bill (S. 499) which would prohibit the SBA from declining to participate in projects because of the presence of tax-exempt financing. In addition, the bill states that it is the declared policy of Congress that the guarantee of payments for pollution control facilities would not cause the interest on tax-exempt obligations used to finance the facilities to be taxable.

Department of Agriculture programs (Farmers Home Administration)

The Farmers Home Administration (FmHA) guarantees loans for various purposes, including emergency loans, farm operating loans, farm ownership loans, soil and water loans, business and industrial loans, economic emergency loans, and guaranteed rural housing loans. The FmHA amended its regulations in 1982 to provide that the FmHA will not guarantee loans made with the proceeds of tax-exempt obligations.[9] Additionally, no FmHA loan may serve as collateral for a tax-exempt issue.

Housing and Urban Development

Low income housing.—Section 11(b) of the Housing Act of 1937 [10] provides a special tax exemption for obligations issued by State and local housing agencies in connection with low-income housing projects. The Act [11] prohibits the Department of Housing and Urban Development (HUD) from guaranteeing any tax-exempt obligation issued by a State or local agency. However, under certain circumstances, an issuer may pledge HUD loans or contributions (which are backed by the full faith and credit of the United States) as security for tax-exempt obligations.

Mortgage insurance.—The Federal Housing Authority (FHA) is authorized to insure mortgages on various properties, including certain owner-occupied housing, rental and cooperative housing, housing for moderate income and displaced families, housing for elderly persons, and hospitals and nursing homes.[12] These may include mortgages on properties constructed with tax-exempt financing. In these situations, FHA-insured mortgages may be pledged as security for tax-exempt bonds.

Energy program guarantees

Under certain energy production or conservation programs, the Federal government may guarantee the payment of principal or interest on IDBs used to finance qualified hydroelectric generating facilities or qualified steam-generating or alcohol-producing facilities. The Internal Revenue Code[13] eliminates the tax exemption for bonds guaranteed under these programs. Additionally, the tax ex-

[8] S. Rep. No. 98-22, 98th Cong., 1st Sess. (March 11, 1983). The House Committee on Small Business has reported similar legislation.
[9] 7 C.F.R. sec. 1980.23.
[10] 42 U.S.C. sec. 1437i(b).
[11] 42 U.S.C. sec. 1437c(g).
[12] National Housing Act of 1934, 12 U.S.C. sec. 1707 *et seq.*
[13] Code sec. 103(h).

emption is eliminated when principal or interest on the bonds is to be paid with funds provided by the Federal government (or by State or local governments) under an energy production or conservation program.

Issues

The guarantee of tax-exempt obligations by Federal deposit insurance agencies raises several policy issues:

First, do such guarantees have a detrimental effect on the market for Federal securities?

Second, do such guarantees increase the volume of tax-exempt bonds and, therefore, have a detrimental effect on the issuance of tax-exempt bonds for traditional public purposes?

Third, does the double benefit from both Federal guarantees and tax exemption distort the proper allocation of capital in the marketplace?

Fourth, is the denial of tax-exemption or denial of Federal guarantee the proper method for dealing with the problem?

Fifth, how can guarantees derived through Federal deposit insurance be distinguished from other Federal guarantees?

Explanation of the Bill

The bill would eliminate the tax exemption for any obligation if a significant portion of the principal or interest required to be paid on the issue of which the obligation is a part is to be insured (directly or indirectly) by a Federal depository insurance agency as a result of the investment of the proceeds of the issue in deposits or accounts in a federally insured financial institution. A federally insured financial institution is defined as a bank, savings institution (including a mutual savings bank, cooperative bank, and domestic building and loan association), or credit union, the deposits or accounts of which are insured under Federal law. The term Federal depository insurance agency means a Federal agency (including the FDIC and FSLIC) that insures deposits in federally insured financial institutions.

Tax exemption would not be denied, under the bill, to the extent that proceeds are invested (1) for a temporary period, until such proceeds are needed for the purpose for which the issue was issued; (2) in a bona fide debt service fund; or (3) in a reasonably required reserve or replacement fund (not exceeding 15 percent of the proceeds of the issue, unless the issuer established that a higher amount is necessary).

The bill would not effect any Federal guarantee (direct or indirect) of tax-exempt bonds other than that resulting from Federal depository insurance.

Effective Date

The bill would apply to obligations issued after April 15, 1983. However, the bill would not apply to any obligation issued after April 15, 1983, pursuant to a written commitment that was binding on March 4, 1983, and at all times thereafter.

Revenue Effect

The exact size of the revenue effect for this bill is indeterminate. However, because there are many potential bond programs that could effectively utilize FSLIC and FDIC guarantees, the revenue gain in future years is likely to be substantial.

O