

**DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO  
H.R. 3930, THE "WATER QUALITY FINANCING ACT OF 2002,"  
AS INTRODUCED AND ORDERED REPORTED BY THE COMMITTEE  
ON TRANSPORTATION AND INFRASTRUCTURE**

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## INTRODUCTION

This document,<sup>1</sup> provides a description of present law and of the Chairman's Modification to H.R. 3930, the "Water Quality Financing Act of 2002", as introduced and ordered reported by the Committee on Transportation and Infrastructure. H.R. 3930 would authorize appropriations for State water pollution control revolving funds. Title III of the bill would liberalize certain rules regarding issuance of tax-exempt bonds for water facilities.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to H.R. 3930, the "Water Quality Financing Act of 2002", as Introduced and Ordered Reported by the Committee on Transportation and Infrastructure* (JCX-26-02), April 16, 2002.

# I. OVERVIEW OF RULES GOVERNING ISSUANCE OF TAX-EXEMPT BONDS FOR WATER FACILITIES AND OF TITLE III OF H.R. 3930

## A. Present Law

### In general

Interest on debt<sup>2</sup> incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds. Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public water systems is an activity eligible for financing with the proceeds of these governmental tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

### Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, water, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers, local redevelopment activities, and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing.

Private activity bonds can be issued for water facilities only if --

- (1) the water is or will be made available to members of the general public; and

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<sup>2</sup> Hereinafter referred to as "State or local government bonds."

- (2) either the facility is operated by a governmental unit or rates for the sale of the water have been established or approved by a State or political subdivision, a Federal agency, or a public service or public utility commission of a State or political subdivision.

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. These annual volume limits are equal to \$75 per resident of the State, or \$225 million if greater. After 2002, the volume limits will be indexed annually for inflation. Private activity bonds for water facilities are subject to these volume limitations.

#### Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. The arbitrage restrictions apply both to actual amounts received from the sale of bonds and to other amounts (from whatever source derived) that are used to secure repayment of tax-exempt bonds (i.e., to "replacement proceeds") because, e.g., those other funds could be used for the purpose of the borrowing thereby reducing issuance of tax-exempt bonds. Under these rules, grant monies set aside by the recipient in an investment account that is used as security for repayment of tax-exempt bonds are subject to the arbitrage restrictions in the same way as proceeds from the sale of the bonds.

In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Reserve funds (including replacement proceeds) are subject to these yield restrictions.

Additionally, subject to limited exceptions, profits that are earned during these periods or on such investments (e.g., on reserve funds or replacement proceeds) must be rebated to the Federal Government. Present law includes two general exceptions to the arbitrage rebate requirements.<sup>3</sup> First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six

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<sup>3</sup> A third exception exempts governmental bonds issued by "small" governments from the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$10 million if at least \$5 million of the bonds are used to finance public schools.

months after issuance.<sup>4</sup> Second, in the case of bonds to finance certain construction activities, the six-month period is extended to 24 months for available construction proceeds. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.<sup>5</sup> Issuers qualifying for this “construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements. Replacement funds and amounts deposited in reserve funds are not treated as spent or as available construction proceeds. Therefore, these exceptions from the arbitrage rebate requirement do not apply.

**B. Title III of H.R. 3930, as Introduced and as Ordered Reported by the Committee on Transportation and Infrastructure**

Title III of H.R. 3930 would liberalize the rules governing issuance of tax-exempt bonds for water facilities in two respects. First, bonds for private water facilities would be exempted from the State private activity bond volume limits that apply to most private activity bonds.

Second, the Code arbitrage restrictions would be liberalized to allow the investment of Federal and State grant monies received in connection with State clean water revolving pools and used as security for repayment of tax-exempt bonds without regard to the Code arbitrage restrictions. Thus, these funds could be used to secure tax-exempt bonds without regard to the general Code restrictions on investing funds used to secure such bonds for profit.

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<sup>4</sup> In the case of governmental bonds, the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

<sup>5</sup> Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued.

## **II. DESCRIPTION OF A CHAIRMAN'S MODIFICATION TO H.R. 3930**

The Chairman's Modification would strike Title III of H.R. 3930 from the bill.