[JOINT COMMITTEE PRINT]

TRENDS IN THE USE OF TAX-EXEMPT BONDS TO FINANCE PRIVATE ACTIVITIES, INCLUDING A DESCRIPTION OF H.R. 1176 AND H.R. 1635

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON JUNE 15 AND 16, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 13, 1983

U.S. GOVERNMENT PRINTING OFFICE

21-535 O WASHINGTON : 1983 JCS-24-83

CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on June 15 and 16, 1983, on trends in the use of tax-exempt bonds for financing private activities. The hearings will focus on two bills: (1) H.R. 1176 (introduced by Messrs. Downey, Frenzel, Heftel, Duncan, Gephardt, Guarini, Anthony, Ford of Tennessee, Mrs. Kennelly, and Messrs. Vander Jagt, Thomas of California, Jenkins, Pease, Campbell, Matsui, Conable, Martin of North Carolina, Dorgan, Flippo, Schulze, Fowler, Rangel, Shannon, Archer, and others); relating to the extension of time to issue mortgage subsidy bonds; and (2) H.R. 1635 (introduced by Messrs. Pickle, Gibbons, Stark, Jacobs, and Bates), relating to additional limitations on industrial development bonds.

The first part of this pamphlet is a summary. The second part provides background information on the use of tax-exempt bonds for financing private activities, including tax-exempt bonds for financing owner-occupied residences (i.e., mortgage subsidy bonds). The third part discusses the issues raised by the use of tax-exempt bonds for financing private activities. The fourth part of the pamphlet provides a description of H.R. 1176 and H.R. 1635, including a description of present law, explanation of the provisions, effective dates, and estimated revenue effects.

I. SUMMARY

1. H.R. 1176—Mr. Downey 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 interest on qualified mortgage bonds.

2. H.R. 1635—Messrs. Pickle, Gibbons, Stark, Jacobs and Bates

"Industrial Development Bond Limitation Act of 1983"

Cost recovery for property financed with tax-exempt bonds

Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), property placed in service on or after January 1, 1983, generally is not eligible for full accelerated cost recovery (ACRS) deductions, to the extent that the property is financed with tax-exempt industrial development bonds (IDBs). In lieu of full ACRS deductions, the cost of IDB-financed property must be recovered using the straight-line method over the applicable ACRS recovery period. Exceptions are provided for (1) certain projects for low-income residential rental property; (2) certain public sewage or solid waste disposal facilities; (3) certain air or water pollution control facilities, which are installed or used in connection with existing facilities; and (4) facilities with respect to which an urban development action grant ("UDAG grant") has been made. These projects may qualify for both tax-exempt financing and full ACRS deductions.

The bill would provide extended straight-line recovery periods for property financed with tax-exempt IDBs. The recovery periods would be 5 years for 3-year property, 8 years for 5-year property, 15 years for 10-year property, and 22 years for 15-year public utility property. 15-year real property would be subject to a 25-year recovery period. An exception would be provided for projects for low-income residential rental property, which would continue to qualify for both tax-exempt financing and full ACRS deductions.

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 IDB if a significant portion of the proceeds of the issue of which the obligation was a part is to be invested (directly or indirectly) in deposits or accounts in a Federally insured financial institution. Exceptions would be provided for (1) temporary period investments, (2) investments related to debt service, and (3) reasonably required reserves.

Limitations on small issue IDBs

Present law provides a tax exemption for interest on certain "small issue" IDBs used for the acquisition, construction, or improvement of land or depreciable property. The exemption applies to issues of $1 million or less without regard to related capital expenditures. Alternatively, the aggregate face amount of the issue, together with certain related capital expenditures over a 6-year period, must not exceed $10 million. The small issue exemption will not apply to obligations issued after December 31, 1986.

The bill would eliminate the tax exemption for interest on small issue IDBs used to finance any facilities the principal user of which is a large business. A large business would be defined as any person (including individuals, corporations, or partnerships) which, together with related persons, incurred capital expenditures in excess of $20 million over the 3-year period prior to the issuance of the bonds. Additionally, the bill would limit any business (together with related persons) to an aggregate of $20 million of outstanding small issue financing at any one time. Finally, the bill would eliminate the tax exemption for small issue IDBs used to finance the acquisition of land. The bill would retain the 1986 "sunset" for other small issue IDBs.

II. BACKGROUND INFORMATION ON THE USE OF TAX-EXEMPT FINANCING FOR PRIVATE ACTIVITIES

A. History Of The Tax Exemption For Industrial Development Bonds and Qualified Mortgage Bonds

Overview

The Federal income tax law has provided an exemption for interest on obligations issued by or on behalf of State or local governments since it was enacted in 1913. General obligation bonds were first issued by State and local governments to provide financing for private business activities in the 1930's. By 1954, the Internal Revenue Service had ruled favorably on the use of revenue bonds to provide financing for private businesses. Rev. Rul. 54-106, 1954-1 C.B. 28.

Limitations on industrial development bonds

1968 proposed regulations and subsequent legislation

The volume of tax-exempt bonds to provide financing for private business activities was relatively small until the mid 1960's. At that time, the volume of such obligations began to grow quickly. In response to this increased volume, on March 22, 1968,[1] the IRS issued proposed regulations stating that, in general, interest on industrial development bonds (IDBs) would thereafter be taxable if an identifiable party other than the governmental unit had the right to use all or a major portion of the bond proceeds or the property acquired with bond proceeds, that party was responsible for all or a major portion of the principal and interest payments, and the payments were secured by a security interest in the financed property.

In response to the increased volume of such bonds and the proposed regulations, Congress included the first statutory provisions limiting the circumstances under which interest on IDBs would be tax-exempt in the Revenue Adjustment Act of 1968.[2] This 1968 Act provided that interest on IDBs is generally taxable. Exceptions were provided, however, in the form of a list of purposes for which tax-exempt IDB financing could be provided (i.e., "exempt purpose IDBs") and a more general exception for certain "small issues" (i.e., the "small issue exception").

The original exempt purposes were—

(1) Residential real property for family units capable of maintaining families on a nontransient basis;

(2) Sport facilities;

(3) Convention or trade show facilities;

---

[1] 33 Fed. Reg. 4950 (March 22, 1968).
[2] P.L. 90-364.

(4) Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities related to one of the above;

(5) Sewage or solid waste disposal facilities, or facilities for local furnishing of electric energy, gas, or water; and

(6) Air or water pollution control facilities.

An additional exemption was provided for bonds issued to finance the acquisition of land for an industrial park, meaning a tract of land suitable for industrial, distribution, or wholesale use, controlled by the government itself.

Finally, an exception to the general limitation on tax-exemption of IDBs was provided for certain small issues. Under this exception, if the aggregate face value of an issue does not exceed $1 million, and substantially all of the proceeds are to be used to acquire or construct, depreciable property or land, the interest on the bonds is not taxable. However, in measuring the $1 million limitation, the face amount of any outstanding prior small issues is included in determining the total amount of the small issue, if the prior issues were issued for the same principal user.

The $1 million small issue limit was modified later in 1968 [3] to permit governmental units to elect to increase the $1 million limit to $5 million if outstanding issues and certain capital expenditures by the principal user of the facilities incurred over a six-year period, beginning three years before the date of the issue and ending three years after the date of the issue, are taken into account. This Act also provided that certain specified capital expenditures are excluded from this computation. Certain of these excluded capital expenditures were limited in 1968 to $250,000. If subsequent capital expenditures, after the date of the issue, caused the issue to be disqualified for tax-exemption because they, when added to the issue and prior related issues, exceed the small issue limitation of $5 million, the loss of tax-exemption only occurs from the date of the disqualifying capital expenditure.

Tax Reform Act of 1969 arbitrage rules

The Tax Reform Act of 1969 [4] provided rules restricting the ability of State and local governments to issue tax-exempt bonds where the proceeds of the bonds are to be invested in investments that provide a yield materially higher than the yield on the tax-exempt bonds (e.g., arbitrage bonds).

1971 increase in excluded capital expenditures

The next amendments to the IDB provisions were made by the Revenue Act of 1971.[5] In the 1971 Act, the limitation on certain subsequent capital expenditures permitted without disqualifying the exempt status of small issue bonds was increased from $250,000 to $1 million (the present level).

---

[3] The Renegotiation Amendments Act of 1968 (P.L. 90-634).
[4] P.L. 91-172.
[5] P.L. 92-178.

Certain dam construction as an exempt purpose

In 1975,[6] Congress added a new exempt purpose, permitting tax-exempt IDB financing for dams which furnish water for irrigation purposes and which have a subordinate use for the generation of electricity. The exception applies only if substantially all of the stored water is contractually available for release from the dam for irrigation purposes upon reasonable demand by and for members of the public.

1978 expansions of exemption for IDBs

The Revenue Act of 1978 [7] increased the elective $5 million limit on small issue IDBs to $10 million and permitted exclusion of up to $10 million of capital expenditures in determining whether the $10 million limitation is exceeded for facilities with respect to which an urban development action (UDAG) grant is made. That Act also defined the "local furnishing" of electricity to include furnishing to an area comprising not more than a city and one contiguous county in addition to the previous interpretation (contained in Treasury regulations) of two contiguous counties. Finally, that Act provided rules clarifying when water facilities are provided to the public and denying advance refunding of industrial development bonds except for certain purposes.

1980 restriction of rental housing as an exempt purpose

In 1980, IDBs for residential housing were limited to bonds used to finance multi-family rental housing and targeting requirements were enacted. These restrictions were added as part of enactment of the Mortgage Subsidy Bond Tax Act, discussed below, which also restricted the use of tax-exempt financing for single-family housing. In general, these restrictions require that at least 20 percent of the units in each project be rented to persons of low or moderate income (i.e., persons with incomes of less than 80 percent of the area median income).

Financing of mass commuting vehicles as an exempt purpose and exemption of certain volunteer fire department bonds

In 1981, the Economic Recovery Tax Act [8] (ERTA) further expanded the "exempt purposes" for which IDBs can be issued to include financing of certain mass community vehicles.

ERTA also provided that obligations of certain volunteer fire departments would be tax-exempt as obligations of a political subdivision if the bond proceeds are used to acquire or improve a firehouse or fire truck to be used by the fire department.

TEFRA restrictions on private activity bonds

The Tax Equity and Fiscal Responsibility Act of 1982 [9] (TEFRA) made the following changes to the IDB rules:

---

[6] The Revenue Adjustment Act of 1975 (P.L. 94-164).
[7] P.L. 95-600.
[8] P.L. 97-34.
[9] P.L. 97-248.

(1) Issuers of all private activity bonds [10] are required to make quarterly information reports to the IRS concerning bonds issued by them;

(2) Issuance of IDBs must be approved by an elected official in the issuing jurisdiction and all jurisdictions where the facilities will be located following a public hearing (or approved pursuant to a voter referendum conducted in lieu of the elected official approval and public hearing);

(3) Cost recovery deductions must be reduced, with certain exceptions, for IDB-financed property;

(4) The average length of time to maturity of IDBs was limited in relation to the economic life of the property financed;

(5) The definition of facilities for the "local furnishing" for gas was expanded to parallel the rules for local furnishing of electric energy (adopted in 1978), and a new exception for local district heating and cooling facilities enacted; and

(6) Special rules were enacted allowing advance refunding of certain port authority bonds and financing the purchase of certain used regional pollution control facilities.

Additionally, the small issue exception was repealed, effective at the end of 1986, and in the interim, new restrictions were placed on that exception. First, use of these bonds to finance certain recreational, auto service, food facilities, and certain private sports facilities was prohibited. The use of small issue bonds issued in conjunction with IDBs for an exempt purpose also was restricted, and new rules were provided for determining when simultaneously issued bonds are a single issue and when such bonds are multiple issues qualifying for exemption under the small issue exception.

Limitations on single-family housing bonds

Overview

The Mortgage Subsidy Bond Tax Act of 1980 [11] imposed the first statutory restrictions on the ability of States and local governments to issue tax-exempt bonds for financing mortgage loans for single-family housing. State housing agencies began issuing some mortgage subsidy bonds in the early 1970s. However, before 1978, most State housing finance agency bonds were issued to provide multi-family rental housing.[12] Dramatic increases in the volume of tax-exempt bonds for single family, owner-occupied housing during the late 1970s led to enactment of the 1980 Act.

The 1980 Act provides that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified veterans' mortgage bonds" or "qualified mortgage bonds."

Qualified mortgage bonds

Qualified mortgage bonds must satisfy several requirements:

---

[10] Private activity bonds include IDBs, scholarship funding bonds, and bonds issued by charitable educational, religious, etc. organizations described in code sec. 501(c)(3).

[11] Title XI of the Omnibus Reconciliation Act of 1980 (P.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 (P.L. 97-248) ("TEFRA"). The description of this provision below reflects these amendments.

[12] The exemption for bonds for multi-family rental housing remains as a permanent exempt purpose under the IDB rules.

(1) Qualified mortgage bonds must be issued before January 1, 1984.

(2) The aggregate annual value of such bonds that a State, and local governments within the State, can issue is limited 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.

(3) The bond proceeds must be used to finance the purchase of single-family residences which are located within the jurisdiction of the issuing authority and which are reasonably expected to become the principal residences of the mortgagors.

(4) With limited exceptions, only new mortgage loans are permitted to be made from the bond proceeds.

(5) At least 20 percent of the proceeds of each issue generally must be available for financing residences in certain low-income "targeted" areas.

(6) At least 90 percent of the mortgage loans made from each issue generally must be made to mortgagors who did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date their mortgage loans are made.

(7) All of the mortgage loans must be made to finance the purchase of residences for which the acquisition cost does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to the residence.

(8) Each issue of qualified mortgage bonds must meet certain limitations regarding arbitrage, both as to mortgage loans and nonmortgage investments.

The rules governing qualified mortgage bonds (including the 1982 amendments thereto) are discussed more fully in the explanation of present law under H.R. 1176, below.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Qualified veterans' mortgage bonds are not subject to the volume, arbitrage, targeting, and sunset limitations of qualified mortgage bonds. When the 1980 Act was passed, three States (Oregon, California, and Wisconsin) issued veterans' mortgage bonds. Since then, Alaska has begun to issue veterans' mortgage bonds.

Qualified scholarship funding bonds

In the early 1970s, some States sought to use tax-exempt bonds to finance student-loan programs for college students. These programs were partly in response to Federal education programs which provided incentive payments to institutions offering student loans. Typically, the programs involved not-for-profit corporations organized by the State to issue the bonds rather than the States doing so themselves. Therefore, a question arose as to whether the bonds were issued "by or on behalf of" the States. Additionally, the use of tax-exempt bond proceeds to acquire student notes bearing non-exempt interest could have violated the arbitrage rules adopted in 1969.

In response to this situation, the Tax Reform Act of 1976 (P.L. 94–455) provided a new exemption for interest on qualified scholarship funding bonds. To be exempt, these bonds must be obligations of not-for-profit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes incurred under the Higher Education Act of 1965. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the State or political subdivision, or be required to be used to purchase additional student loan notes.

Tax exemptions outside the Internal Revenue Code

In addition to the tax exemptions provided under the Internal Revenue Code, certain non-tax statutes provide an exemption for interest on specified obligations. These exemptions generally are not subject to the restrictions on tax-exempt bonds contained in the Internal Revenue Code. The Surface Transportation Assistance Act of 1982, Pub. L. 97–424 (January 6, 1983), would have expanded the exemption provisions of the Internal Revenue Code (sec. 103(a)(1) to include obligations the interest on which was previously tax-exempt under provisions outside the Code. However, this provision was inadvertently repealed by Pub. L. 97–473 (January 14, 1983).

District of Columbia bonds

Under the District of Columbia Self-Government and Governmental Reorganization Act,[13] the District of Columbia is authorized to issue (1) general obligation bonds and (2) revenue bonds and notes for use in the areas of housing, health, transit and utility facilities, recreational facilities, college and university facilities, pollution control facilities, and industrial and commerical development. Under the Act, the obligations are exempt from all Federal and District taxation (except estate and gift taxes).[14]

The Internal Revenue Service has held that interest on bonds and notes issued by the District of Columbia is exempt from Federal income taxes nothwithstanding the industrial development bond provisions of the Internal Revenue Code.[15] Thus, the District may issue bonds for industrial and commercial development without regard to the limitations on small issue IDBs. However, they thereby conclude that the District of Columbia does not have the authority to issue arbitrage bonds.

Puerto Rican bonds

Under the Puerto Rico Federal Relations Act,[16] interest on bonds issued by the Government of Puerto Rico, or by its authority, are exempt from Federal, State or Puerto Rican taxation.

---

[13] 87 Stat. 774 (1973); Pub. L. 93-198.
[14] D.C. Code sec. 47–332.
[15] Rev. Rul. 76–202, 1976–1 C.B. 26.
[16] Laws 1917, c. 145, 39 Stat. 953 (48 U.S.C. sec. 745).

Virgin Islands Bonds

The government of the Virgin Islands may issue general obligation and other bonds for public works, slum clearance, urban redevelopment or to provide low-rent housing. Bonds issued by the Virgin Islands (or any municipality thereof) are exempt from Federal, State or Virgin Islands taxation.[17]

State and local housing agency bonds

Section 11(b) of the Housing Act of 1937[18] provides special tax exemption for interest on certain obligations issued by State and local public housing agencies in connection with low-income housing projects. The exemption is limited to projects developed, acquired, or assisted by the State or local agency. The project units must generally be rented to families whose incomes do not exceed 80 percent of the median income for the area (as determined by the Department of Housing and Urban Development).

B. Statistical Data Relating to Tax-Exempt Bonds Generally

Size and composition of the tax-exempt bond market

Table 1 shows the growth in the volume of the tax-exempt bond market, by function, from 1975 to 1982. The total volume of tax-exempt obligations has increased from $30.1 billion in 1975 to $85.1 billion in 1982. During this period, the volume of bonds that has been identified for private activities (including tax-exempt IDBs, student loan bonds, mortgage bonds, and bonds for use by tax-exempt private hospitals) has increased from $6.2 billion (approximately 21 percent of total State and local borrowing) to $44.0 billion (51.7 percent of State and local borrowing). During this same period, the volume of bonds for traditional public purposes has increased from $23.9 billion (79 percent of State and local borrowing) to $41.1 billion (48 percent of total borrowings).

Table 1.—Volume of Private Activity Purpose Long-Term Tax-Exempt Bonds Issued By Type, 1975–82

[In billions of dollars]

	1975	1976	1977	1978	1979	1980	1981	1982
All tax-exempt bonds	30.1	35.0	46.9	49.1	48.1	54.9	56.5	85.1
Private activity bonds	6.2	8.4	13.1	15.8	24.6	29.4	27.4	44.0
Housing	1.4	2.7	4.4	7.0	12.1	14.6	5.6	14.3
Single family	NA	.7	1.0	3.4	7.8	10.8	3.6	8.6

[17] Pub. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1403).
[18] 42 U.S.C. sec. 1437i(b).

Table 1.—Volume of Private Activity Purpose Long-Term Tax-Exempt Bonds Issued By Type, 1975–82—Continued

[In billions of dollars]

	1975	1976	1977	1978	1979	1980	1981	1982
Multi-family....	.9	1.4	2.5	2.4	2.7	2.2	1.1	5.2
Veterans...	.6	.6	.6	1.2	1.6	1.6	.9	.5
Small issue IDBs	1.3	1.5	2.3	3.5	7.1	9.2	12.6	[2] 13.7
Private hospital.....	1.4	1.9	3.3	2.2	2.3	2.7	3.9	7.8[2]
Student loan	0	.1	.1	.3	0.6	.4	1.4	1.7
Pollution control.......	2.0	2.1	3.0	2.8	2.5	2.5	3.9	6.5

NA—Not available.

[1] Only those types of bonds that could definitely be identified as private purpose are listed here. Other private purpose bonds include, among others, those for ports, airports, sports or convention facilities, industrial parks, and the local furnishing of electrical energy or gas. Preliminary information suggests that these types of bonds account in total for roughly 10 percent of all private purpose bonds.

[2] Includes amount and an additional estimated amount to reflect partial nature of survey counted in partial survey but estimated to be in a complete survey to be conducted in future.

Source: Based on data from: *The Bond Buyer,* and unpublished information from: Office of Financial Management, U.S. Department of Housing and Urban Development; Congressional Budget Office; and Student Loan Marketing Association.

NOTE.—Details may not add to totals because of rounding.

Use of small issue bonds by States

Table 2 sets forth the volume of small issue IDBs for 1980 to 1982 by States. The table indicates that volumes of small issue IDBs vary significantly from State to State. For example, for 1982, Pennsylvania issued $1,569 million of small issue IDBs while Vermont issued only $10.7 million. In addition, Hawaii, Idaho, and the District of Columbia did not issue any small issue IDBs in 1982.

Table 2.—Volume of Small Issue Industrial Development Bonds Issued by State, 1980–82

[In millions of dollars]

State	1980	1981	1982
Alabama..........................	247.6	253.2	248.6
Alaska	0	133.5	129.3
Arizona............................	105.4	129.4	[1]138.6
Arkansas.........................	98.3	182.7	94.1
California........................	0	0	65.7
Colorado..........................	40.3	[1]54.0	[1,2]54.5

Table 2.—Volume of Small Issue Industrial Development Bonds Issued by State, 1980-82—Continued

[In millions of dollars]

State	1980	1981	1982
Connecticut	96.5	158.2	333.2
Delaware	37.4	53.9	158.9
District of Columbia	0	0	0
Florida	124.8	311.9	[1]315.0
Georgia	[1]212.5	[1]225.9	[1]369.8
Hawaii	0	0	0
Idaho	0	0	0
Illinois	196.4	[1]263.2	[1]265.8
Indiana	386.1	309.2	[1]312.3
Iowa	131.3	162.9	[1]164.5
Kansas	179.9	276.8	226.1
Kentucky	99.7	166.6	[1]118.6
Louisiana	[1]30.9	121.3	285.6
Maine	36.8	70.6	40.0
Maryland	[1]137.2	[1]356.2	[2]295.1
Massachusetts	369.2	492.2	373.6
Michigan	374.2	446.7	[1]451.2
Minnesota	415.0	545.4	[2]545.8
Mississippi	112.6	123.3	64.3
Missouri	[1]276.6	[1]390.0	[2]391.4
Montana	7.1	53.2	39.4
Nebraska	29.7	51.5	[2]36.9
Nevada	31.0	33.8	24.8
New Hampshire	54.4	88.0	60.6
New Jersey	578.0	599.5	597.5
New Mexico	33.4	[1]44.8	[1]45.3
New York	382.8	531.0	[2]565.0
North Carolina	200.0	251.1	[1]253.6
North Dakota	38.8	[1]46.1	44.2
Ohio	805.4	1,158.8	712.8
Oklahoma	48.9	40.3	[2]14.4
Oregon	31.0	69.5	30.9
Pennsylvania	1,639.1	1,889.3	1,569.0
Rhode Island	63.1	62.6	55.9
South Carolina	119.2	189.6	[1]225.0
South Dakota	21.9	43.3	[1]43.7
Tennessee	244.5	302.6	481.2
Texas	218.8	642.1	1,248.0
Utah	55.2	299.9	[1]302.9
Vermont	23.9	30.5	[1]10.7
Virginia	380.7	488.7	[2]414.1
Washington	0	0	[1]26.8
West Virginia	[1]169.7	227.4	[2]171.3

Table 2.—Volume of Small Issue Industrial Development Bonds Issued by State, 1980-82—Continued

[In millions of dollars]

State	1980	1981	1982
Wisconsin	195.2	206.5	250.5
Wyoming	37.2	[2]15.1	[1]15.3
Total	9,197.7	[2]12,592.3	[2]12,681.8

[1] CBO estimates or projections based on partial year data.
[2] Data is based on incomplete information and it therefore likely to be lower than final totals.

Source: Congressional Budget Office, *Small Issue Industrial Revenue Bonds, 1980-82.*

Use of tax-exempt financing for certain private activities by States

Table 3 sets forth the volumes of tax-exempt bonds issued in 1982 for pollution control, private hospitals, student loans, and multifamily housing by States. These activities, together with small issue IDBs, are the largest users of tax-exempt financing for private activities.

Table 3.—Volume of Pollution Control, Private Hospital, Student Loan, and Multifamily Housing Bonds Issued by State, 1982

[In millions of dollars]

State	Pollution control	Private hospital	Student loan	Multifamily housing
Alabama	707.0	70.0	0	16.9
Alaska	0	0	0	2.4
Arizona	0	241.9	63.2	85.9
Arkansas	35.6	43.4	20.0	324.7
California	113.8	307.4	121.0	437.1
Colorado	174.0	5.8	110.0	165.5
Connecticut	14.7	71.8	0	183.2
Delaware	2.8	120.0	0	91.7
District of Columbia	0	0	0	64.9
Florida	270.5	468.8	0	228.7
Georgia	461.5	8.4	0	107.5
Hawaii	0	91.4	0	3.8
Idaho	10.0	0	71.0	3.8
Illinois	57.8	62.4	25.0	289.0
Indiana	326.6	33.9	100.0	18.8
Iowa	9.9	26.4	0	23.0
Kansas	7.0	10.4	0	5.5
Kentucky	477.6	170.6	0	82.5
Louisiana	503.5	164.5	0	125.3
Maine	28.9	82.5	0	68.6
Maryland	6.0	38.8	0	195.8
Massachusetts	58.2	248.0	120.0	208.1
Michigan	228.4	260.7	107.0	50.7

Table 3.—Volume of Pollution Control, Private Hospital, Student Loan, and Multifamily Housing Bonds Issued by State, 1982—Continued

[In millions of dollars]

State	Pollution control	Private hospital	Student loan	Multifamily housing
Minnesota	35.1	147.6	37.0	99.6
Mississippi	151.0	0	54.0	25.3
Missouri	140.3	86.0	65.0	16.6
Montana	115.0	5.5	0	0
Nebraska	0	33.0	204.0	2.9
Nevada	0	2.4	0	18.8
New Hampshire	0	2.5	76.5	35.4
New Jersey	153.7	557.4	0	40.0
New Mexico	375.7	28.9	59.1	33.0
New York	229.3	639.3	0	390.9
North Carolina	30.6	30.0	0	72.1
North Dakota	3.6	5.4	0	17.8
Ohio	331.1	495.4	0	154.3
Oklahoma	56.0	84.3	0	128.1
Oregon	47.4	27.0	0	67.0
Pennsylvania	181.4	539.4	0	247.9
Rhode Island	0	42.0	108.0	70.9
South Carolina	167.1	9.0	17.5	38.4
South Dakota	0	0	58.0	13.6
Tennessee	19.6	42.7	0	27.5
Texas	438.2	222.0	137.0	408.6
Utah	139.9	104.1	0	22.6
Vermont	0	0	0	8.3
Virginia	99.6	107.8	100.0	262.4
Washington	10.3	37.6	0	31.0
West Virginia	37.0	18.5	30.0	63.1
Wisconsin	36.7	37.5	29.0	76.7
Wyoming	199.6	6.3	35.0	8.4
Total	6,492.0	5,838.7	1,747.3	5,164.6

[1] Preliminary data based on partial survey of private activity hospital bonds. Final figures will probably include an additional volume of bonds.

Source: Based on data from: *The Daily Bond Buyer,* U.S. Department of the Treasury, Association and Office of Financial Management, U.S. Department of Housing and Urban Development (unpublished data).

Nature of the subsidy provided by tax-exempt financing

Table 4 sets forth the ratio of the average interest rates on municipal tax-exempt bonds to the average interest rate on corporate (taxable) obligations for selected years. This ratio provides a measure of the depth of the subsidy provided by tax-exempt financing. The relationship between this ratio and the marginal tax bracket of the average bondholder of tax-exempt bonds provides a measure of the efficiency of tax-exempt financing as a means of subsidizing activities eligible for tax-exempt financing.

The long-term yield ratio indicates that, in recent years, an increasingly larger portion of the subsidy for long-term tax-exempt bonds has benefitted the holders of the bonds in the form of increased after-tax yields.[19]

Table 4.—Comparison of Yields on Corporate and Municipal Bonds, 1950–82

Year	Average corporate yield [1]	Average municipal bond yield [2]	Ratio of municipal to corporate yields
1950	2.86	1.90	.664
1955	3.25	2.49	.766
1960	4.73	3.51	.742
1965	4.64	3.28	.707
1970	8.51	6.34	.745
1975	9.57	7.05	.737
1976	9.01	6.64	.737
1977	8.43	5.68	.674
1978	9.07	6.03	.665
1979	10.12	6.52	.644
1980	12.75	8.59	.674
1981	15.06	11.33	.752
1982	14.94	11.66	.780

[1] Moody's Investor Service's selected long term bonds.
[2] Bond Buyer's 20 bond index.

Source: Board of Governors of the Federal Reserve System, selected issues of *Federal Reserve Bulletin;* and U.S. Department of Commerce, Bureau of Economic Analysis, *1973 Statistical Supplement to the Survey of Current Business.*

Tax-exempt yields as a percent of taxable yields, 1970–82

Another method that is helpful in determining the subsidy provided by tax-exempt financing is to examine the total present value of the reduced after-tax interest payments over the life of the loan as a percentage of the principal amount of the bonds. Where the principal amount of the bonds is equal to the cost of the facilities financed, the value of the reduced after-tax interest payments is the amount of the cost of the facilities paid by the subsidy. (This can also be thought of as an investment tax credit equal to that value.) That value varies with the average time the bonds are outstanding, the difference in interest rates resulting from tax exemption, and the marginal tax rate of the borrower. The borrower's marginal tax rate is relevant to the value of the subsidy because borrowers are able to deduct interest payments. Table 5 sets forth the values of tax exemption for various differences in interest rates and average duration of bonds. The amounts in the table are the

[19] The effect of yield ratios on the efficiency of tax-exempt bonds is further discussed in the "Issues" section of the pamphlet (Part III).

present value of the interest savings from tax-exempt financing expressed as a percentage of the amount of the loan. The table assumes that the borrower is in a 50-percent marginal tax bracket. If the marginal tax rate is lower than 50 percent (as is typically the case of mortgage subsidy bonds or student loan bonds), the values would be increased proportionately (i.e., the values for a borrower in a 30-percent marginal tax bracket would be 40 percent higher). Tax exemption has typically resulted in reduced interest rates from 2 to 4 percentage points, with the average approximately 3 percentage points in recent years.

Table 5.—Present Value of Tax-Exempt Financing Expressed as a Percentage of the Amount of the Loan

	Difference in interest rates		
	2 percent	3 percent	4 percent
Average duration of loan:			
5 years	3.8	5.7	7.6
15 years	7.6	11.4	15.2
30 years	9.4	14.1	18.9

Source: Joint Committee on Taxation.

Ownership of tax-exempt bonds

Tables 6 and 7 presents data on the major owners of tax-exempt bonds, by dollar amount and as a percentage of total bonds outstanding. During the years 1970 to 1982, the percentage of State and local government bonds held by banks and thrift institutions has decreased from 48.8 percent to 36.1 percent. During this same period, holdings by insurance companies have increased from 14.1 percent to 21.2 percent, and those by mutual funds from 0 percent to 4.7 percent. Private households have held between 25.0 percent (in 1978) and 34.6 percent (in 1982) of municipal bonds during this period.

Table 6.—Ownership of Tax-Exempt State-Local Bonds by Class of Holder, 1970–82:[1] Volume

[In millions of dollars]

Class of holder	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982[2]
Households	46,019	46,116	48,373	53,658	61,860	68,061	70,070	70,148	72,738	82,719	94,559	115,006	155,300
Nonfinancial corporate business	2,175	3,175	4,175	4,038	4,654	4,481	3,419	3,468	3,658	3,687	3,490	3,470	3,500
State and local government	2,384	2,132	1,833	2,062	2,586	4,969	7,341	7,920	7,238	6,788	7,402	7,271	7,500
Commercial banks	70,204	82,811	89,960	95,656	101,148	102,927	105,976	115,155	126,205	135,583	149,199	154,174	158,600
Savings and loan associations	123	150	165	185	500	1,508	1,225	1,200	1,275	1,150	1,190	1,305	800
Mutual savings banks	197	390	873	921	930	1,545	2,417	2,828	3,335	2,930	2,390	2,288	2,500
Mutual funds	0	0	0	0	0	0	525	2,156	2,684	4,040	6,357	9,278	21,100
Life insurance companies	3,306	3,363	3,367	3,412	3,667	4,508	5,594	6,051	6,402	6,428	6,701	7,151	8,100
State and local government retirement funds	2,032	2,152	2,029	1,691	983	1,940	3,360	3,544	3,951	3,910	4,059	4,131	3,900
Other insurance companies	17,021	20,481	24,820	28,462	30,662	33,273	38,679	49,390	62,931	72,811	80,533	84,510	87,000
Brokers and dealers	915	1,028	912	1,130	705	631	901	1,065	864	1,046	1,064	1,220	1,000
Total	144,376	161,798	176,507	191,215	207,695	223,843	239,507	262,925	291,281	321,092	356,944	389,804	449,400

[1] Ownership is as of the end of the calendar year.
[2] Preliminary.

Source: Board of Governors of the Federal Reserve System, unpublished data.

NOTE.—Details may not add to totals because of rounding.

Table 7.—Ownership of Tax-Exempt State-Local Bonds by Class of Holder, 1970–82: [1] Percent

Class of holder	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982 [2]
Households	31.9	28.5	27.4	28.1	29.8	30.4	29.3	26.7	25.0	25.8	26.5	29.5	34.6
Nonfinancial corporate business	1.5	2.0	2.4	2.1	2.2	2.0	1.4	1.3	1.3	1.1	1.0	.9	.8
State and local government	1.7	1.3	1.0	1.1	1.2	2.2	3.1	3.0	2.5	2.1	2.1	1.9	1.7
Commercial banks	48.6	51.2	51.0	50.0	48.7	46.0	44.2	43.8	43.3	42.2	41.8	39.6	35.3
Savings and loan associations	.1	.1	.1	.1	.2	.7	.5	.5	.4	.4	.3	.3	.2
Mutual savings banks	.1	.2	.5	.5	.4	.7	1.0	1.1	1.1	.9	.7	.6	.6
Mutual funds	0	0	0	0	0	0	.2	.8	.9	1.3	1.8	2.4	4.7
Life insurance companies	2.3	2.1	1.9	1.8	1.8	2.0	2.3	2.3	2.2	2.0	1.9	1.8	1.8
State and local government retirement funds	1.4	1.3	1.1	.9	.5	.9	1.4	1.3	1.4	1.2	1.1	1.1	.9
Other insurance companies	11.8	12.7	14.1	14.9	14.8	14.9	16.1	18.8	21.6	22.7	22.6	21.7	19.4
Brokers and dealers	.6	.6	.5	.6	.3	.3	.4	.4	.3	.3	.3	.3	.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[1] Ownership is as of the end of the calendar year.
[2] Preliminary.

Source: Based on Board of Governors of the Federal Reserve System, unpublished data.

NOTE.—Details may not add to totals because of rounding.

Revenue effect

Table 8 indicates the estimated revenue loss for private activity tax-exempt bonds during the next five fiscal years. The total fiscal year revenue loss from identifiable private activity bonds is estimated at $10.1 billion for 1984, $11.5 billion for 1985, $13.0 billion for 1986, $14.3 billion for 1987, and $15.1 billion for 1988. These estimates assume that the present law "sunsets" for qualified mortgage bonds (1983) and small issue IDBs (1986) remain in effect.

Table 8.—Estimated Revenue Loss For Private Activity Tax-Exempt Bonds Under Present Law, Fiscal Years 1984–1988

[In billions of dollars]

Type of bond	1984	1985	1986	1987	1988
Total private activity [1]	10.1	11.5	13.0	14.3	15.1
Housing:	2.8	2.9	3.1	3.3	3.4
Single family [2]	1.4	1.4	1.2	1.1	1.1
Multifamily	1.1	1.3	1.5	1.7	1.9
Veteran	.3	.3	.4	.4	.5
Small issue IDBs [3]	3.7	4.3	5.0	5.5	5.5
Private hospital	1.7	2.0	2.3	2.6	3.0
Student loan	.4	.5	.7	.9	1.2
Pollution control	1.6	1.7	1.9	2.0	2.1

[1] Only those types of bonds that could definitely be identified as private activity are listed here. Other private activity bonds include, among others, those for ports, airports, sports or convention facilities, industrial parks, and the local furnishing of electrical energy or gas. Preliminary information suggests that these types of bonds account in total for roughly 10 percent of all private activity bonds.

[2] Assumes that the ability to issue qualified mortgage bonds terminates on December 31, 1983, as provided in present law.

[3] Assumes that the ability to issue small issue IDBs terminates on December 31, 1986, as provided in present law.

Source: Joint Committee on Taxation

NOTE.—Details may not add to totals because of rounding.

Revenue effects of tax-exempt bonds have traditionally been expressed as the revenue forgone through the issuance of the bonds on a year-by-year basis. However, tax-exempt bonds typically are outstanding for a number of years and, consequently, the issuance of tax-exempt bonds during a year results in revenue losses over a number of years. Since tax-exempt bonds result in tax expenditures over a number of years, it may be helpful to express the revenue effect of tax-exempt bonds in terms of the total value of future revenue losses. Table 9 indicates projected future revenue losses from bonds issued in 1983 and the estimated present value of these losses (discounting for projected interest rates). For example, the $15.2 billion of small issue bonds expected to be issued in 1983 would result in total future revenue losses of $7.9 billion, with a present value of $3.5 billion. The authority to issue these bonds during 1983 would thus be equivalent to a current year authorization of $7.9 billion.

Table 9.—Various Measures of Total Revenue Loss of Private Activity Bonds Issued in 1983 [1]

[In billions of dollars]

	Housing [2]	Small issue	Private hospitals	Student loan	Pollution control
Dollar amount of 1983 estimated bond issues	14.7	15.2	8.9	3.2	5.0
Revenue loss:					
Total revenue loss attributable to bonds issued in 1983	6.3	7.9	4.6	1.1	2.6
Present value of total	3.0	3.5	2.1	.6	1.2

[1] Only those types of bonds that could definitely be identified as private activity bonds are listed here. Other private activity bonds include, among others, those for ports, airports, sports or convention facilities, industrial parks, and the local furnishing of electrical energy or gas. Preliminary information suggests that these types of bonds account in total for roughly 10 percent of all private activity bonds.
[2] Include single family, veterans, and multi-family housing bonds.

Source: Joint Committee on Taxation

C. Statistical Data Relating to Mortgage Subsidy Bonds

Volume of mortgage subsidy bonds

The volume of mortgage subsidy bonds for the period 1980 to 1982 is shown in Table 10. State and local governments issued a total of $8.6 billion of mortgage subsidy bonds (not including veterans' mortgage bonds) in 1982, or approximately 10.1 percent of total State and local government borrowing. For 1980, the volume of mortgage subsidy bonds was $10.8 billion (19.7 percent of State and local government borrowing), while for 1981 (a comparatively depressed year for the housing industry) the volume was $3.6 billion (6.4 percent). During 1978, the last full year before any provisions of the 1980 Act were effective, State and local governments issued $3.4 billion of bonds for owner-occupied residential rental property. In 1982, States issued $.48 billion of qualified veterans' housing bonds, or approximately 0.6 percent of State and local government borrowing. (See Table 11.)

Table 10.—Volume of Single-Family Mortgage Subsidy Bonds Issued by State, 1980–82

[In millions of dollars]

State	1980	1981	1982
Alabama	150	100	200
Alaska	460	200	235
Arizona	133	0	192
Arkansas	196	47	100
California	1,601	446	1,895
Colorado	473	135	163
Connecticut	178	200	200
Delaware	191	0	90
District of Columbia	0	0	0
Florida	612	475	406
Georgia	115	0	157
Hawaii	150	20	60
Idaho	56	30	0
Illinois	52	20	191
Indiana	150	0	75
Iowa	0	0	14
Kansas	433	356	146
Kentucky	55	36	31
Louisiana	496	350	149
Maine	70	0	54
Maryland	210	141	281
Massachusetts	75	0	200
Michigan	114	25	30
Minnesota	326	201	219
Mississippi	150	0	150
Missouri	133	0	200
Montana	50	0	55
Nebraska	200	0	137
Nevada	30	0	60
New Hampshire	60	0	167
New Jersey	130	15	275
New Mexico	75	20	118
New York	125	105	402
North Carolina	58	55	0
North Dakota	0	0	30
Ohio	0	0	0
Oklahoma	739	100	25
Oregon	165	0	125
Pennsylvania	23	85	266
Rhode Island	149	65	72
South Carolina	0	0	82
South Dakota	162	0	24
Tennessee	350	50	150
Texas	1,076	156	622
Utah	150	0	122
Vermont	75	0	35

Table 10.—Volume of Single-Family Mortgage Subsidy Bonds Issued by State, 1980–82—Continued

[In millions of dollars]

State	1980	1981	1982
Virginia	121	100	266
Washington	0	0	0
West Virginia	229	0	25
Wisconsin	125	20	158
Wyoming	150	75	0
Total	10,821	3,628	8,646

Source: Office of Financial Management, U.S. Department of Housing and Urban Development, unpublished data.

Table 11.—Volume of Veterans Housing Bonds Issued by State, 1980–82

[In millions of dollars]

State	1980	1981	1982
California	652	250	150
Oregon	900	620	300
Wisconsin	0	0	30
Total	1,552	870	480

NOTE.—The amounts listed above are for tax-exempt general obligation bonds issued only for veterans' housing purposes. Therefore, the data does not include revenue bond issues, issues for the purchase of land only, or issued primarily for other purposes. These issues are included in other classifications, such as in the single-family mortgage bond group. Several states, such as Texas ($74 million issued in 1982) and Maine ($20 million issued in 1982) have in recent years issued these other types of bonds.

Source: Office of Financial Management, U.S. Department of Housing and Urban Development, unpublished data.

Effect of volume limitations

The effect of the volume limitation on mortgage subsidy bonds may be examined with the data provided in Table 12. This table shows the effect that the annual volume limitation (i.e., the greater of 9 percent of the average mortgage activity or $200 million) has had on the ability of State and local governments to issue mortgage subsidy bonds. Note that, in 1982, the $200 million limit is greater than 9 percent of average mortgage activity in 37 States.

In 1982, the statutory "safe harbor" ceilings on the volume of mortgage subsidy bonds issued in each State varied between 7.5 percent of total mortgage originations (for Texas) to 156.3 percent (for South Dakota). The aggregate statutory ceilings for all 50 States equalled approximately 17.7 percent of total mortgage originations. Thus, if each State had issued the statutory maximum of mortgage subsidy bonds, almost 18 percent of the value of all mortgages could have been financed with tax-exempt financing.

Table 12.—Comparison of Statutory Safe Harbor Ceilings for Single Family Mortgage Subsidy Bonds and Total Mortgage Originations, by State, 1982

State	Millions of dollars		Safe harbor ceiling as a percent of total mortgage originations
	Safe harbor ceiling	Total mortgage originations	
Alabama	200	485	41.2
Alaska	200	1,019	19.6
Arizona	227	1,689	13.4
Arkansas	200	974	20.5
California	1,943	11,560	16.8
Colorado	293	2,478	11.8
Connecticut	200	764	26.2
Delaware	200	152	131.6
District of Columbia	200	432	46.3
Florida	675	4,140	16.3
Georgia	200	1,311	15.3
Hawaii	200	496	40.3
Idaho	200	196	102.0
Illinois	495	3,493	14.2
Indiana	200	1,351	14.8
Iowa	200	575	34.8
Kansas	200	634	31.5
Kentucky	200	621	32.2
Louisiana	200	1,065	18.8
Maine	200	312	64.1
Maryland	229	2,162	10.6
Massachusetts	200	1,322	15.1
Michigan	280	2,419	11.6
Minnesota	200	1,435	13.9
Mississippi	200	359	55.7
Missouri	200	1,041	19.2
Montana	200	225	88.9
Nebraska	200	445	44.9
Nevada	200	653	30.6
New Hampshire	200	298	67.1
New Jersey	304	3,033	10.0
New Mexico	200	417	48.0
New York	443	3,986	11.1
North Carolina	200	1,911	10.5
North Dakota	200	239	83.7
Ohio	438	2,755	15.9
Oklahoma	200	1,315	15.2
Oregon	200	544	36.8
Pennsylvania	381	3,132	12.2
Rhode Island	200	303	66.0

Table 12.—Comparison of Statutory Safe Harbor Ceilings for Single Family Mortgage Subsidy Bonds and Total Mortgage Originations, by State, 1982—Continued

State	Millions of dollars: Safe harbor ceiling	Millions of dollars: Total mortgage originations	Safe harbor ceiling as a percent of total mortgage originations
South Carolina	200	852	23.5
South Dakota	200	128	156.3
Tennessee	200	1,093	18.3
Texas	767	10,279	7.5
Utah	200	484	41.3
Vermont	200	211	94.8
Virginia	299	2,812	10.6
Washington	236	1,480	15.9
West Virginia	200	368	54.3
Wisconsin	200	1,533	13.0
Wyoming	200	285	70.2
Total	14,410	81,266	17.7

Source: Office of Financial Management, U.S. Department of Housing and Urban Development, and Office of Tax Analysis, U.S. Department of the Treasury, unpublished data.

Purchase price levels

Table 13 sets forth data which help evaluate the effect of the purchase price limitation on the residences eligible for financing with qualified mortgage bonds. Of homes sold to first-time buyers in 1979, approximately 85.0 percent (69.6 percent, by value) were sold for prices equal to less than 110 percent of the average national purchase price. Thus, it may be estimated that 85 percent or more of residences would have qualified under the average area purchase price limitations applicable to qualified mortgage bonds.

Table 13.—Percent of Homes Sold to First-Time Buyers at Less Than Selected Percentages of Average Purchase Prices in 1979

Percentage of average purchase price	80	90	100	110	120	130
Percent of homes measured by:						
Number	62.1	71.4	78.6	85.0	89.7	92.8
Value	41.7	52.2	60.0	69.6	77.0	81.9

Source: Based on U.S. Department of Housing and Urban Development, Annual Housing Survey: 1979 (unpublished data).

First-time home-purchasers

Table 14 shows the percentage of home purchasers each year that are first-time purchasers. For purposes of this table, the term "first-time purchaser" means an individual who has never before purchased a residence. (The three-year rule for determining first-time purchasers under the qualified mortgage bond rules would result in slightly higher percentages of person being considered first-time purchasers.) From 1976 to 1981, the percentage of homes purchased by first-time purchasers varied from 44.8 percent in 1976 to 32.9 percent in 1980, with a mean of 39.8 percent.

Table 14.—Percentage of Homes Purchased by First-Time Buyers, 1976–81

Year	1976	1977	1978	1979	1980	1981
Percentage	44.8	48.1	36.7	36.6	32.9	39.4

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1982–83.*

III. ISSUES RAISED BY THE USE OF TAX-EXEMPT FINANCING FOR PRIVATE ACTIVITIES

A. General Issues

The use of tax-exempt bonds for private activities raises several policy issues. These include (1) the effect of tax-exempt private purpose bonds on the ability of State and local governments to finance facilities used for traditional public purposes, (2) the efficiency of tax exemption as a means of providing a subsidy for desired forms of investment, (3) the distortion of market allocation by tax-exempt financing, and (4) the revenue loss from tax-exempt bonds. Additionally, if Congress determines that further limits should be placed on private activity bonds, issues arise concerning the nature and scope of these limits.

Effect on bonds used to finance traditional public purpose facilities

The use of tax-exempt bonds for private activities increases the overall supply of tax-exempt bonds resulting in higher interest rates. This results in increased borrowing costs for States and localities for traditional public purposes (e.g. schools, roads, water and sewer projects, and the financing of public debt).

Efficiency of tax exemption as a means of providing a subsidy

Tax-exempt bonds provide an indirect benefit to borrowers by enabling them to borrow at reduced rates for specified purposes. When the percentage reduction in interest rates is less than the marginal tax rate of the bondholder, a portion of the benefit of tax exemption goes to the holder of the tax-exempt obligation, rather than the borrower.[20] Table 4 above indicates that tax-exempt municipal bonds have exceeded 70 percent of the comparable corporate yields. In these cases, the Federal Government loses significantly more than one dollar in revenues for each dollar of benefits received by the issuing State or local government or other user of the bond proceeds.

Distortion of market allocation by tax-exempt bonds

Distortion between competing investment purposes

Tax-exempt bonds distort the allocation of capital by encouraging projects eligible for tax-exempt financing, at the expense of other investments. To some extent, this distortion is the intended result of tax exemption. However, in certain cases, tax-exempt bonds may encourage projects which serve little or no public purpose. For ex-

[20] For example, if the taxable interest rate is 10 percent and the long-term tax-exempt rate is 8 percent, only 40 percent of the subsidy is received by the issuing government in the form of reduced interest rates. The remaining 60 percent (assuming a 50-percent marginal tax rate) is received by the tax-exempt bondholder in the form of increased yield.

ample, the availability of small issue IDB financing encourages small projects at the expense of larger ones, regardless of economic efficiency. Additionally, the availability of mortgage subsidy bonds may encourage construction of single-family residences at the expense of industrial and commercial facilities.

Effect on ineligible persons

In addition to distorting allocation between competing investment purposes, tax-exempt bonds distort the allocation of funds between entities eligible to receive tax-exempt financing (including tax-exempt religious, charitable, or educational organizations, and businesses eligible for IDB financing) and other, ineligible businesses. This places ineligible persons at a competitive disadvantage in attracting investment funds.

Effect on prices for eligible facilities

By increasing the demand for eligible facilities, tax-exempt bonds may encourage increases in the prices of the facilities. For example, mortgage subsidy bonds, by reducing the effective mortgage interest rate, increase the demand for eligible single-family residences. This may result in higher home prices both for purchasers receiving both tax-exempt and taxable financing.

Revenue loss

The revenue loss from tax-exempt bonds has increased with the increasing use of such bonds for private purposes. (See Tables 8 and 9 above.)

Approaches to limitation of private activity tax-exempt bonds

If Congress determines to place further limits on tax-exempt bonds for private activities, issues arise concerning the nature and scope of these limitations:

First, should Congress tighten the existing restrictions on private activity bonds or, alternatively, place limits on the overall volume of such bonds (e.g., a state-by-state volume limitation).

Second, should any restrictions or limitations apply only to tax-exempt IDBs, or to all private activity bonds (including student loan bonds and bonds for use by tax-exempt religious, charitable, or educational organizations)?

Third, should the restrictions or limitation apply to IDBs generally or to specific types of obligations (e.g. pollution control facilities, small issue IDBs, etc.)?

B. Specific Issues

In addition to the general issues above, the provisions of the bills (H.R. 1176 and H.R. 1635) raise the following specific policy issues:

Mortgage subsidy bonds

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

Assuming that the 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?

Combination of tax exemption with other Federal benefits (ACRS or Federal deposit insurance)

Does the double benefit from tax exemption and other Federal benefits distort the proper allocation of capital in the marketplace?

Is the denial of tax exemption or the denial of related Federal benefits (ACRS or Federal deposit insurance) the proper method for dealing with the problem?

Given the extent of the subsidy provided by ACRS and the investment tax credit, should tax-exempt financing be available for ACRS property?

How can guarantees derived through Federal deposit insurance be distinguished from other Federal guarantees?

Small issue IDBs

Should small issue IDBs qualify for tax exemption generally, or should additional limits be placed on the volume or specific uses of small issue bonds? [21]

Should small issue IDBs be limited to small businesses enterprises?

Should small issue IDBs be available to finance the acquisition of land?

Should small issue IDBs be available only in areas of economic distress?

Should small issue IDBs be limited to a certain dollar amount per firm?

---

[21] The Committee on Ways and Means, Subcommittee on Oversight, held hearings on April 8–10, 1981, on issued surrounding tax-exempt small issue IDBs. In a report filed after the hearings, the Subcommittee recommended several legislative changes concerning small issue IDBs, including (1) a requirement that commercial projects financed with small issue IDBs be located in economically distressed areas; (2) a provision that small issue IDB proceeds not be used to finance the purchase of land; and (3) a provision that small issue IDB proceeds not be used to relocate existing activities from one State to another. Additionally, the report recommended special hearing and reporting requirements for small issue bonds. The report also recommended a January 1, 1984, "sunset" for small issue IDBs. Subcommittee on Oversight of the Committee on Ways and Means, "Report on Tax-Exempt 'Small Issue' Industrial Revenue Bonds," Ways and Means Committee Print No. 97–12, 97th Congress, 1st Session (July 9, 1981).

IV. DESCRIPTION OF THE BILLS

1. H.R. 1176—Messrs. Downey, Frenzel, Heftel, Duncan, Gephardt, Guarini, Anthony, Ford of Tennessee, Mrs. Kennelly, Messrs. Vander Jagt, Thomas of California, Jenkins, Pease, Campbell, Matsui, Conable, Martin of North Carolina, Dorgan, Flippo, Schulze, Fowler, Rangel, Shannon, Archer, and others

"The Housing Finance Opportunity Act of 1983"

Present Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act")[22] 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. The 1980 Act provides that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified veterans' mortgage bonds" or "qualified 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. Unlike qualified mortgage bonds, the tax-exemption for veterans' bonds does not expire after December 31, 1983, and these bonds are not subject to the volume, arbitrage, and most of the targeting rules applicable to qualified mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds must satisfy numerous requirements, discussed below. Also, interest on these bonds is tax-exempt only if the bonds are issued before January 1, 1984.

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.

---

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

Limitation to single-family, owner-occupied residences

All lendable proceeds (i.e., total proceeds less issuance costs and reasonably required reserves) of qualified mortgage bonds must be used to finance the purchase of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must be reasonably expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. 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.

General limitation to new mortgages

With certain exceptions, all lendable 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 lendable proceeds of each issue of qualified mortgage bonds (but not more than 40 percent of the average mortgage activity in the targeted area) 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.[23] 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;[24] and (3) mortgagors who receive qualified rehabilitation loans.

Purchase price restrictions

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.[25]

Arbitrage requirements

In order for a 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.[26] 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 of 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.[27]

---

[23] 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. This amendment was effective for bonds issued after September 3, 1983, and also for bonds issued between April 23, 1979, and September 3, 1983, to the extent that the proceeds of such bonds were not committed on September 3, 1983.

[24] 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)).

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

[26] 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.

[27] 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.

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 for bonds issued after December 31, 1983.

Revenue Effect

It is estimated that the bill would reduce fiscal year budget 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. H.R. 1635—Messrs. Pickle, Gibbons, Stark, Jacobs and Bates

"Industrial Development Bond Limitation Act of 1983"

Present Law

In general

State and local obligations

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 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. A nonexempt person is defined to mean all persons other than State or local governments or tax-exempt charitable, religious, educational, etc. organizations (described in Code sec. 501(c)(3)).

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 in IDBs is tax-exempt if the bonds are used to finance the following activities: (1) certain projects for multifamily residential rental property; (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 interest on certain "small issue" IDBs the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property. The exemption applies to issues of $1 million or less without regard to related capital expenditures. Alternatively, the amount of the issue, together with certain related capital expenditures over a 6-year period, must not exceed $10,000,000. If the facilities financed with the IDBs are ones with respect to which an urban development action grant (UDAG grant) has been made, up to $20,000,000 of capital expenditures can be made.

Cost recovery for property financed with tax-exempt bonds

Accelerated cost recovery (ACRS)

Present law [28] provides for a reasonable depreciation allowance for property used in a taypayer's trade or business or held for the production of income. Under the Economic Recovery Tax Act of 1981, Pub. L. 97-34, cost recovery for tangible property placed in service on or after January 1, 1981, is determined according to the Accelerated Cost Recovery System (ACRS).[29]

ACRS provides for capital cost recovery over predetermined periods that are generally unrelated to, but shorter than, the useful lives of the property as determined under prior law.

Under ACRS, the cost of eligible property is to be recovered over a 3-year, 5-year, 10-year, or 15-year period, depending on the type of property. Most eligible property is in the 5-year class. Cars, light-duty trucks, research and experimentation equipment, and certain other short-lived property are in the 3-year class. The 10-year class includes certain long-lived utility property, railroad tank cars, coal-utilization property, and certain real property. Other long-lived public utility property (including most property in electric utility steam production plants, manufactured gas production plants, and telephone distribution plants, and most water utility property) is in a 15-year class. Most eligible real property is in a separate 15-year real property class.

Recovery of costs under ACRS is determined by using a statutorily accelerated method. The schedules were developed to approximate the benefits of using a 150-percent declining balance method for the early recovery years and the straight-line method for later recovery years.[30] For 15-year real property, the schedules reflect a 175 percent declining balance method (200 percent for low income real property) switching to the straight-line method.

As an alternative to ACRS, a taxpayer may elect to depreciate real or personal property on the straight-line method over the regular or extended recovery periods. For 15-year real or public utility property, the available straight-line recovery periods are 15, 35 and 45 years.

Property financed with tax-exempt bonds

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[31] provides that property placed in service on or after January 1, 1983, generally is not eligible for full ACRS deductions or other accelerated cost recovery deductions, to the extent that the property

---

[28] Code sec. 167(a).
[29] Code sec. 168.
[30] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, repealed more favorable depreciation schedules which had been scheduled to apply to property placed in service in 1985 and thereafter.
[31] Pub. L. 97-248.

is financed with tax-exempt IDBs. In lieu of the full ACRS deductions reflecting the accelerated recovery rates, the cost of personal property financed with IDBs must be recovered using the straight-line method (with a half-year convention and without regard to salvage value) over the applicable ACRS period. For 15-year real property, costs are to be recovered using the straight-line method (with a monthly convention and without regard to salvage value) over a 15-year period.

TEFRA provided several exceptions under which IDB-financed facilities may continue to be eligible for full ACRS deductions. The exceptions include: (1) projects for low-income residential rental property;[32] (2) public sewage or solid waste disposal facilities,[33] where substantially all of the sewage or solid waste (other than recycled waste) processed by the facility is collected from the general public; (3) air or water pollution control facilities[34] which are installed in connection with a facility in existence on July 1, 1982, or which are used in connection with conversion of oil- or gas-fired facilities to coal (but only if the oil- or gas-fired furnace which is converted to coal was in use at the facility before July 1, 1982); and (4) facilities with respect to which an urban development action grant (UDAG grant) has been made.

The limitations on ACRS deductions, where applicable, apply to both the first owner of the property and to any subsequent owners who acquire the property while the tax-exempt IDBs (including any refunding issues) are outstanding.[35] The limitations do not apply if the taxpayer has elected a longer recovery period for the property than that provided by the limitations.

Small issue IDBs

Present law provides a tax exemption for small issue IDBs used for the acquisition, construction, or improvement of land or depreciable property.[36] The exemption applies to issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during the 6-year period beginning 3 years before the date of issue and ending 3 years after that date, must not exceed $10,000,000.[37]

In determining whether an issue meets the requirements above, prior small issues and (in the case of the $10,000,000 limitation) capital expenditures are taken into account if (1) they are used with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with small issue IDBs, and (2) the

[32] Code sec. 103(b)(4)(A). In addition, certain multi-family rental projects are exempt if the project was exempt from the restrictions on the use of IDBs for multi-family housing under the Mortgage Subsidy Bond Tax Act of 1980.

[33] Code sec. 103(b)(4)(E).

[34] Code sec. 103(b)(4)(F).

[35] If tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for the property in prior years.

[36] The small issue exemption does not apply to obligations a signficant portion of the proceeds of which are used to provide residential real property for family units.

[37] In the case of facilities with respect to which as Urban Development Act Grant ("UDAG grant") is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20,000,000 are allowed.

principal users of both facilities are the same or two or more related persons. "Related persons" include family members, fiduciaries, and corporations (or partnerships) subject to common control. Capital expenditures are not taken into account if (1) they are made to replace property destroyed or damaged by fire, storm, or other casualty, (2) are required by a change in Federal, State or local law (or the application of such laws) made after the date of issue, (3) are required by circumstances which could not reasonably be foreseen on the date of issue subject to a $1 million limitation, or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[38] imposed the following new restrictions on small issue IDBs:

(1) TEFRA provided that the small issue exemption will not apply to obligations issued after December 31, 1986.

(2) The Act provided that the $1 million "clean limit" exemption is not available for any IDB issued as part of the same issue as other obligations, the interest on which is tax-exempt under a provision other than the small issue exemption.[39] (The alternative $10,000,000 limitation remains available for combined issues.)

(3) TEFRA eliminated the small issue exemption for bonds issued after December 31, 1982, if (1) more than 25 percent of the proceeds of the issue are used to provide a facility the primary purpose of which is retail food and beverage services (including all eating and drinking establishments but not grocery stores), automobile sales or service, or the provision of recreation or entertainment, or (2) any portion of which is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including any handball or racquetball court), hot tub or sun tan facility, or racetrack. The TEFRA use limitations do not affect bonds issued pursuant to exemptions other than the small issue exemption.[40]

(4) TEFRA provided that multiple lots of small issue IDBs will not be treated as one issue unless the proceeds are used to finance two or more facilities which (1) are located in more than one State or (2) have the same or related principal users.[41] Under this rule, multiple lots of IDBs may qualify as tax exempt as long as such separate issue qualifies as a small issue.

---

[38] Pub. L. 97-248.

[39] For example, if $21 million of IDBs were issued in connection with an airport facility, the interest on $20 million of the bonds being exempt under the exempt purpose exception for airports (Code sec. 103(b)(4)(D)) and the remaining $1 million of bonds being used to finance a related non-exempt facility, the interest on the $1 million of bonds would not be tax-exempt.

[40] For example, bonds used to finance a restaurant which was functionally related to an airport, under the exempt purpose exception for airports (Code sec. 103(b)(4)(D)) would not be subject to the provision.

[41] For purposes of this rule, "principal users" include persons (other than governmental units) which (1) arranges or assists in the issuance or guarantees (directly or indirectly) the repayment of any obligation used to finance the facility, and (2) provides any property, franchise, or trademark to be used in connection with the facility.

Background information relating to federally guaranteed tax-exempt bonds

Applicable Federal tax rules

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. sec. 1.103–8(a)(4). The regulations illustrate this principle by indicating that bond proceeds are used for an exempt purpose where the proceeds of the bond are lent to banks or other financial institutions who then relend those proceeds for exempt functions (referred to as a "loan to lenders" program).

Federal deposit insurance laws

The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) insure deposits to a maximum of $100,000 per depositor.[42] 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.[43] 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.[44]

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 a loan 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.[45]

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 the 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, which deposits the funds in FDIC- or FSLIC-insured certificates of deposit. The depository institution agrees to provide the deposited funds to private users for purposes eligible for tax-exempt IDB financing. 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 IDBs under present law. Because the trustee for the bondholders holds a certificate of deposit in an insured institution, the

---

[42] 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.

[43] 12 U.S.C. sec. 1817(i) and 12 C.F.R. sec. 331(b) (FDIC): 12 U.S.C. sec. 1724(b) and 12 C.F.R. sec. 564.2(c) (FSLIC).

[44] 12 C.F.R. sec. 330.8(b) (FDIC); 12 C.F.R. sec. 564.8(b) (FSLIC).

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

amount of each bondholder's holdings are insured to the extent of $100,000.

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

In general.—The Public Debt Act of 1941 [46] 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, regulations specifically prohibit 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 Financial Assistance 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 [47] 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.—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.[48] The current policy of the SBA is to avoid participation in projects financed with tax-exempt obligations. However, the House Committee on Small Business has reported favorably [49] a bill (H.R. 3020) which would prohibit SBA from declining to participate in projects because of the presence of tax-exempt financing.

Department of Agriculture programs (Farmers Home Administration).—The Farmers Home Administration (FmHA) guarantees loans for various purposes, including emergency loans, farm operat-

---

[46] 55 Stat. 7 (1941).

[47] H. Rep. No. 95-1369, accompanying H.R. 12426, 95th Cong., 2d Sess. (July 18, 1978).

[48] Small Business Investment Act of 1958, 15 U.S.C. sec. 694-1.

[49] H. Rep. No. 98-182, 98th Cong., 1st Sess. (May 16, 1983). The Senate Committee on Small Business has reported a similar bill.

ing 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 FmHA will not guarantee loans made with the proceeds of tax-exempt obligations.[50] Additionally, no FmHA loan may serve as collateral for a tax-exempt issue.

Housing and Urban Development.—Section 11(b) of the Housing Act of 1937 [51] provides a special tax exemption for obligations issued by State and local housing agencies in connection with low-income housing projects. The Act [52] 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.

In addition to the above program, 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.[53] 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 [54] eliminates the tax exemption for bonds guaranteed under these programs. Additionally, the tax exemption 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.

Explanation of the Bill

a. Overview

The bill would provide new limitations on cost recovery for property financed with tax-exempt IDBs, on the use of tax-exempt IDBs in conjunction with federally insured deposits, and on small issue IDBs. The bill would provide that the cost of property financed by tax-exempt IDBs (except low-income residential rental property) must be recovered using the straight line method over specially extended recovery periods. Additionally, the tax exemption would be denied for IDBs the proceeds of which were deposited in federally insured bank or savings institution deposits as part of a loans-to-lenders program. Finally, the bill would limit small issue IDBs by providing (1) that small issue bonds be available only to small businesses, (2) that no business may have outstanding more than

---

[50] 7 CFR sec. 1980.23.
[51] 42 U.S.C. sec. 1437i(b).
[52] 42 U.S.C. sec. 1437c(g).
[53] National Housing Act of 1934, 12 U.S.C. sec. 1707 *et. seq.*
[54] Sec. 103(h).

$20,000,000 of small issue bonds at any time, and (3) that small issue bonds not be available to finance land acquisition.

b. Cost recovery for property financed with tax-exempt bonds

Explanation of provisions

Under the bill, property would remain ineligible for ACRS or other accelerated cost recovery provisions to the extent that the property is financed with tax-exempt IDBs. Additionally, the bill would provide extended cost recovery periods for property financed with tax-exempt IDBs. For property other than 15-year real property, the cost of property financed with tax-exempt IDBs would be recovered using the straight line method (with a half-year convention and without regard to salvage value) over the following recovery periods:

Property	*Recovery period*
3-year property	5 years
5-year property	8 years
10-year property	15 years
15-year public utility property	22 years

In the case of 15-year real property, cost recovery would be determined using the straight line method (on a monthly basis and without regard to salvage value) over a 25-year recovery period.

Under the bill, the special rules applicable to IDB-financed property (denial of ACRS and extended recovery periods) would not apply to property which is placed in service in connection with projects for residential rental property financed with tax-exempt IDBs under section 103(b)(4)(A) of the Code.[55] This property would therefore qualify both for tax-exempt financing and ACRS. The special rules would apply to all other property financed with tax-exempt IDBs (including public sewage or solid waste disposal facilities, air or water pollution control facilities, and facilities eligible for UDAG grants). The special rules would apply both to the first owner of the property and to any subsequent owners who acquire the property while the IDBs (including any refunding issues) are outstanding. The special rules would not apply if the taxpayer had elected a longer straight-line recovery period for the property than that determined under the rules.

Effective date

The provisions relating to cost recovery would apply with respect to property placed in service after the date of enactment of the bill to the extent the property is financed by the proceeds of an obligation issued after the date of enactment.

Revenue effect

These provisions are estimated to increase fiscal year receipts by less than $50 million in 1984, $0.1 billion in 1985, $0.3 billion in 1986, $0.6 billion in 1987, and $0.8 billion in 1988.

---

[55] In addition, certain multi-family rental projects would be exempt from the special rules if the projects were exempt from the restrictions on the use of IDBs for multi-family housing under the Mortgage Subsidy Bond Tax Act of 1980.

c. Denial of tax exemption where bond proceeds are invested in federally insured deposits

Explanation of provisions

The bill would eliminate the tax exemption for IDBs if a significant portion of the proceeds of the issue of which the obligation is a part is to be invested (directly or indirectly) 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 denial of tax exemption would not apply, under the bill, to (1) proceeds of the issues invested for an initial temporary period until such proceeds are needed for the purpose of the issue; (2) investments related to debt service; or (3) investments in a reasonably required reserve or replacement fund not exceeding 15 percent of the proceeds of the issue (unless the issuer establishes that a higher amount is necessary).

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

Effective date

The provisions relating to federally insured tax-exempt bonds would apply to obligations issued after April 14, 1983.

Revenue effect

The exact size of the revenue effect for these provisions 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.

d. Limitations on small issue IDBs

Explanation of provisions

Limitation to small businesses

The bill would eliminate the tax exemption for small issue IDBs used to finance any facilities the principal user of which is a large business. A large business would be defined as any person (including individuals, corporations or partnerships) which, during the 3-year period ending on the date of issuance, incurred an aggregate amount of capital expenditures in excess of $20,000,000 in connection with a trade or business. Capital expenditures to replace property destroyed or damaged by fire, storm or other casualty, certain unforeseen capital expenditures, and qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts) would not be taken into acount for purposes of the $20,000,000 limitation.

For purposes of the large business limitation, related persons would be treated as one person. Related persons would include family members, fiduciaries, and corporations (or partnerships) subject to common control.

Limitation on aggregate amount of small issue financing

The bill would eliminate the tax exemption for any small issue of IDBs the aggregate authorized face amount of which, together with the outstanding small issue obligations of any principal user of facilities being financed with the issue, exceeds $20,000,000. Outstanding small issue obligations would include the aggregate face amount of all small issue obligations which financed any facilities of which the person was a principal user and which are outstanding at the time of the later issue (not including any obligation which is to be redeemed from the proceeds of the later issue). The limitation would apply without regard to the location of the previously financed facilities. Outstanding small issue obligations would not include IDBs qualifying as tax-exempt under any provisions other than the small issue exemption.

For purposes of the limitation on the aggregate amount of small issue financing, related persons (including family members, fiduciaries, and corporations subject to common control) would be treated as one person. Thus any business, together with other related businesses, would be limited to an aggregate of $20,000,000 of outstanding small issue IDB financing.

Elimination of small issue exemption for financing land

The bill would eliminate the tax exemption for small issue IDBs used to finance the acquisition of land. The small issue exemption would be limited to bonds used to acquire, construct or improve property of a character subject to depreciation, and qualified refunding issues.

Effective date

The provisions regarding small issue IDBs would apply to obligations issued after the date of enactment of the bill. However, in determining the outstanding small issue obligations of any person for purposes of the aggregate $20,000,000 limitation on small issue financing, all previously issued obligations would be taken into account.

Revenue effect

These provisions are estimated to increase fiscal year receipts by less than $50 million in 1984, $0.2 billion in 1985, $0.4 billion in 1986, $0.5 billion in 1987, and $0.6 billion in 1988.

○