[JOINT COMMITTEE PRINT]

# TAX REFORM PROPOSALS: TAX TREATMENT OF STATE AND LOCAL GOVERNMENT BONDS

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

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# CONTENTS

# INTRODUCTION

This pamphlet[1] was prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with their respective reviews of comprehensive tax reform proposals. The pamphlet is one of a series of pamphlets regarding the effect of tax reform proposals. It describes and analyzes tax provisions and proposals relating to tax-exemption of interest on State and local government bonds, the treatment of bond-financed property under other provisions of the Internal Revenue Code, and other related matters.

The pamphlet describes present-law tax provisions, the tax reform proposal made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), and Congressional proposals, identified by their primary sponsor(s).

The first part of the pamphlet is a summary of present law and the major tax reform proposals before Congress. Parts II through V provide a more detailed description of present law, legislative background, and the reform proposals. Part VI discusses issues related to the availability of tax-exempt financing, both generally and for private activities. Part VII provides statistical information related to the use of tax-exempt bonds, including information on volume of various types of financing, a profile of investors in tax-exempt bonds, and revenue analysis.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds* (JCS-23-85), July 16, 1985.

# I. SUMMARY

## *Present law*

Interest on obligations of States, territories and possessions of the United States, and the District of Columbia generally is exempt from Federal income tax (Code sec. 103). Similarly, interest on obligations of political subdivisions of these governmental entities is tax-exempt. Under this rule, State and local governments may issue tax-exempt bonds to finance public projects or services, including facilities such as schools, roads, and water and sewer facilities.

Additionally, State and local governments may provide tax-exempt financing for use by tax-exempt charitable, religious, scientific, or educational organizations (described in sec. 501(c)(3)) and for certain private activities (e.g., by means of industrial development bonds, student loan bonds, and mortgage subsidy bonds). Interest on bonds to finance private activities (other than the activities of nonprofit charitable organizations, described above) is taxable unless an exception is provided in the Internal Revenue Code for the specific type of financing. Three principal exceptions are provided under present law.

### *Industrial development bonds*

Interest on industrial development bonds (IDBs) is tax-exempt when the bonds are issued to finance (1) one of several enumerated exempt activities, (2) land for use as an industrial park, or (3) certain small issues for land or depreciable property. IDBs are obligations issued as part of an issue all or a major portion of the proceeds of which are to be used in a trade or business carried on by a nonexempt person and the payment of principal or interest on which is to be derived from, or secured by, money or property used in a trade or business. A nonexempt person is any person other than a State or local government or a tax-exempt charitable, religious, scientific, or educational organization (as described in sec. 501(c)(3)). Most IDBs, together with all student loan bonds, are subject to State volume limitations.

### *Mortgage subsidy bonds*

Interest on mortgage subsidy bonds (MSBs) is tax-exempt. MSBs may be issued as either qualified veterans' mortgage bonds or qualified mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds the proceeds of which are used to finance mortgage loans to veterans. These bonds may be issued only by States that had issued them before June 22, 1984; the bonds also are subject to special volume and other restrictions. Qualified mortgage bonds are bonds the proceeds of which generally are used to make mortgage loans to first-time homebuyers; these bonds are subject to separate State volume limitations and loans made with the bond proceeds are subject to several borrower-eligibility and targeting restrictions. Authority to issue qualified mortgage bonds expires after 1987.

### *Student loan bonds*

Interest on certain student loan bonds is tax-exempt. Only those student loan bonds issued in connection with the Guaranteed Student Loan and Parent Loans for Undergraduate Students programs of the U.S. Department of Education are eligible for tax-exemption.

All tax-exempt bonds are subject to arbitrage and certain other restrictions; additional restrictions apply to bonds to finance various private activities. Among these additional restrictions are information reporting requirements, a prohibition of advance refundings, and a requirement that arbitrage profits be rebated to the Federal Government in certain circumstances.

## *Proposals for Change*

### *Administration proposal*

The Administration proposal would limit tax-exemption to governmental bonds. Governmental bonds are defined as bonds no more than one percent of the proceeds of which are used, directly or indirectly, by a nongovernmental person.

The Administration proposal also would enact expanded arbitrage restrictions and information reporting requirements, and would prohibit advance refundings for all tax-exempt bonds.

### *Congressional proposals*

Both the Bradley-Gephardt (S. 409 and H.R. 800) and Kemp-Kasten (H.R. 2222 and S. 1006) tax reform bills would repeal the present-law tax-exemption for interest on IDBs, MSBs, student loan bonds, and bonds for charitable organizations (described in sec. 501(c)(3)).

## II. DESCRIPTION OF PRESENT LAW

Interest on obligations of States, territories and possessions of the United States, and the District of Columbia generally is exempt from Federal income tax (Code sec. 103). Similarly, interest on obligations of political subdivisions of these governmental entities is tax-exempt.[2] In determining whether interest on a particular obligation is tax-exempt, a three-part inquiry is necessary. First, the activity being financed, and thereby the type of bond being issued (e.g., general government financing, industrial development bond, etc.), must be determined. The type of bond is determined by the use of the bond proceeds. Second, the authority of the issuer to undertake the tax-exempt debt must be established. Finally, compliance with Internal Revenue Code rules governing tax-exempt bonds for the activity being financed must be established.

### A. Activities for Which Tax-Exempt Financing May Be Provided

#### *Obligations for exempt entities*

##### *General government operations*

State and local governments may issue tax-exempt bonds to finance general government operations and services, such as schools, courthouses, roads, and governmentally operated water, sewer, and electric facilities, without regard to most of the restrictions that apply to bonds used to finance private activities. Additionally, these governments may issue notes in anticipation of tax or other revenues (so-called tax anticipation or revenue anticipation notes (TANs or RANs)). The amount of such advance borrowings may not exceed projected cash flow shortfalls over a specified period.

##### *Installment sales agreements and other "non-bond" financing by State and local governments*

In addition to issuing bonds as evidence of indebtedness, State and local governments may undertake debt, the interest on which is tax-exempt, by means of installment sales contracts or finance leases. For example, a State or local government may purchase road construction equipment pursuant to a lease purchase agreement or an ordinary written agreement of purchase and sale. Interest paid on such acquisitions is tax-exempt if (1) the agreement calls for payment of the interest,[3] and (2) the amounts are true interest (as opposed to other payments labeled as interest). *See*, for

[2] In this pamphlet, governments of States, U.S. possessions and the District of Columbia, and their political subdivisions are referred to collectively as "qualified governmental units."

[3] Section 483 provides generally that interest is imputed for tax purposes at a prescribed rate on deferred payment agreements unless a minimum rate is specified in the agreements. The minimum rate required to be specified for tax-exempt debt is zero. The effect of this zero minimum rate is that no interest is imputed under section 483 in the case of State and local government debt. (Treas. Reg. sec. 1.483-1(d)(3).)

example, Rev. Rul. 60-179, 1960-1 C.B. 37 and Rev. Rul. 72-399, 1972-2 C.B. 73.

#### *Certain charitable organizations*

State and local governments may issue tax-exempt bonds to finance the activities of certain charitable organizations (described in sec. 501(c)(3)) on a basis similar to that for activities of the governments themselves. The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities.

### *Industrial development bonds*

Industrial development bonds (IDBs) are obligations issued as part of an issue all or a major portion of the proceeds[4] of which are to be used in a trade or business carried on by a nonexempt person[5] and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. Interest on IDBs is tax-exempt only if the bonds are issued for certain specified purposes. Issuance of most IDBs and all student loan bonds (i.e., private activity bonds) is subject to State volume limitations. These limitations, and other rules applicable to IDBs, are discussed more fully in II.D. and II.E., below.

#### *Exempt-activity IDBs*

One of the exceptions pursuant to which interest on IDBs is tax-exempt is where the proceeds of the bonds are used to finance an exempt activity. Exempt activities include the following activities: (1) projects for multifamily residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities,[6] parking facilities, or storage or training facilities directly related to these facilities; (5) sewage or 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;[7] and (9) local district heating or cooling facilities. In addition, interest on IDBs used to finance the acquisition or development of land as a site for an industrial park is exempt from tax.

The property that may be financed within each category of exempt-activity IDBs varies widely, both as to persons to be served by the facility and characteristics of the property itself. The scope of these exceptions may be illustrated by rules applicable to the following three exempt activities:

*Multifamily residential rental property*.—The rules governing projects for multifamily residential rental property illustrate both types of requirements that apply to exempt-activity IDBs. First, bond-financed multifamily residential rental property must be targeted to specified groups of tenants. This property must satisfy a

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[4] A major portion is defined as more than 25 percent of the bond proceeds.

[5] *See*, II.C., below.

[6] Tax-exempt financing for mass commuting vehicles formerly was authorized under the exempt activity exception; that authorization expired for bonds issued after December 31, 1984.

[7] Generally, only costs of hydroelectric generating facilities attributable to periods before 1986 may be financed with tax-exempt bonds.

20-percent (15 percent in targeted areas) set-aside requirement for low -and moderate-income tenants and must remain as rental housing for the longer of the term of the IDBs or a statutorily prescribed minimum period. (The determination of low -or moderate-income is made by reference to the rules established under section 8 of the United States Housing Act of 1937, except that the base percentage of median gross income that qualifies as low or moderate is 80 percent.)

Second, the rules governing this multifamily residential rental property illustrate the application of property targeting rules. Bond-financed multifamily residential rental property includes property that is functionally related and subordinate to the housing units (as well as the units themselves). For example, swimming pools, tennis and racquet sports facilities, other athletic facilities, and parking garages for tenant use may be constructed with IDB proceeds. (Treas. Reg. sec. 1.103-8(b)(4).)

*Certain transportation property.*—Property financed pursuant to this exception includes both the specified type of property (e.g., airports, docks, wharves, and mass commuting facilities) and other related storage or training facilities. These related facilities must directly relate to the exempt activity and must be located on or adjacent to the exempt property for which the bonds are issued. In the case of airports, for example, a hotel located adjacent to the airport is a related facility, provided it is of a size commensurate with the size of the airport. (Treas. Reg. sec. 1.103-8(e)(2)(D).) Similarly, a maintenance hangar for airplanes is a related structure, but office space or a computer serving a regional function of an airline company is not related property. (Treas. Reg. sec. 1.103-8(e)(2)(C).)

*Facilities for the local furnishing of electricity or gas.*—An investor-owned electric or gas utility may use tax-exempt IDB financing if the utility serves the general public in a service area that does not exceed two contiguous counties (or a city and one contiguous county). If this local furnishing requirement is satisfied, all property used in the production or transmission of electricity or gas may be financed with exempt-activity IDBs. Larger investor-owned utilities are not permitted to finance their property with tax-exempt bonds, other than pursuant to exceptions of more general application (e.g., air and water pollution control equipment).[8]

### *Small-issue IDBs*

Present law also permits tax-exemption for interest on small issues of IDBs, the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property used in privately owned and operated businesses (the small-issue exception).[9] The small-issue exception expires generally after December 31, 1986; small-issue IDBs to finance manufacturing facilities may be issued under the exception for an additional two years, through 1988.

[8] Governmentally owned and operated utilities may use tax-exempt financing under the general rules for borrowing for government operations, discussed above.

[9] The small-issue exception does not apply to obligations a significant portion of the proceeds of which are used to provide multifamily residential rental property. Thus, IDBs to finance residential rental property must be issued under the exempt-activity exception, discussed above.

Small-issue IDBs are 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 six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million.[10]

In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10 million limitation, previous capital expenditures) are taken into account if (1) they are 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 the small-issue IDBs, and (2) the principal users of both facilities are the same, or two or more related, persons.

Capital expenditures are not considered if the expenditures (1) 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 made after the date of issue; (3) are required by circumstances that reasonably could not be foreseen on the date of issue;[11] or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

***Mortgage subsidy bonds and mortgage credit certificates***

Mortgage subsidy bonds (MSBs) are bonds issued to finance the purchase or qualifying rehabilitation of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds. Before 1980, no restrictions were placed on the issuance of these bonds. The Mortgage Subsidy Bond Tax Act of 1980 limited tax-exemption to two types of MSBs, qualified veterans' mortgage bonds and qualified mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to make mortgage loans to veterans. Since 1984, these bonds may be issued only by States that had issued the bonds before June 22, 1984, and in amounts that reflect average annual issuance levels before that date.[12] Additionally, the Deficit Reduction Act of 1984 (the 1984 Act) provided for a gradual elimination of these bonds by restricting the veterans eligible for bond-financed loans to persons who served on active duty before 1977 and who apply for loans before the later of January 31, 1985,[13] or 30 years after leaving active service.

Qualified mortgage bonds are subject to the rules governing tax-exempt bonds generally and also to State volume limitations[14] and

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

[11] The excluded expenditures under this exception may not exceed $1 million.

[12] Sec. 611(c) of the Deficit Reduction Act of 1984 (P. L. 98-369). The States authorized to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

[13] Sec. 611(c) of the 1984 Act incorrectly provided that this date was January 1, 1985. H.R. 1800 and S. 814, the Technical Corrections Act of 1985, would correct this reference.

[14] These volume limitations are separate from the volume limitations for other private activity bonds (e.g., most IDBs, all student loan bonds, and qualified veterans' mortgage bonds).

other restrictions that apply only to these bonds. Authority to issue qualified mortgage bonds is scheduled to expire after December 31, 1987. At least 20 percent of the lendable proceeds of each issue must be made available for owner financing in targeted areas for a period of at least one year. Additionally, at least 90 percent of the lendable proceeds of each bond issue must be used to finance residences for first-time homebuyers (using a three-year test period) and the purchase price of the residences may not exceed certain prescribed amounts for each local area. Finally, qualified mortgage bonds are subject to additional arbitrage restrictions that require a rebate to the Federal Government of earnings in excess of specified amounts. Each of these requirements is discussed more fully in II.D. and II.F., below.

Issuers of qualified mortgage bonds may elect to exchange part or all of their authorized volume of these bonds and issue mortgage credit certificates (MCCs) in lieu of bonds. MCCs generally are subject to the same eligibility restrictions as qualified mortgage bonds. Authority to issue MCCs will expire with the underlying authority to issue qualified mortgage bonds. Taxpayers to whom MCCs are issued may claim a credit against their Federal income tax liability for a portion of the interest paid on their home mortgage.

***Student loan bonds***

State and local governments may issue tax-exempt bonds to finance student loans. Subject to certain transitional exceptions, issuance of these bonds is permitted only in connection with loans guaranteed under the Guaranteed Student Loan (GSL) and Parent Loans for Undergraduate Students (PLUS) programs of the United States Department of Education.

The GSL and PLUS programs provide three direct Federal Government subsidies for qualified student loans. First, the Department of Education guarantees repayment of qualified student loans. Second, that Department pays special allowance payments (SAPs) as an interest subsidy on qualified student loans so that the student-borrowers will be charged lower interest rates on the loans. Third, the Education Department pays an additional interest subsidy on qualified loans while the student-borrowers attend school.

***Tax-exempt bonds authorized by Federal statutes other than the Internal Revenue Code***

In addition to the Internal Revenue Code, several other Federal statutes have in the past authorized issuance of bonds on which the interest is tax-exempt. Examples of these "non-Code" bonds are housing bonds issued under section 11b of the United States Housing Act of 1937, and certain types of bonds issued by the District of Columbia and certain United States possessions (Puerto Rico, the Virgin Islands, American Samoa, and Guam).

Non-Code bonds were first made subject to the Code in 1983 with enactment of the Surface Transportation Assistance Act of 1982.[15] That Act provided that the tax-exemption for interest on non-Code

[15] P.L. 97-424.

bonds was derived from the Code, rather than from the other Federal statutes authorizing their issuance.

The Deficit Reduction Act of 1984 (the 1984 Act) first extended substantive Code restrictions to non-Code bonds.[16] The requirements extended to these bonds are (1) the Code rules relating to IDBs and MSBs, (2) the Code arbitrage restrictions, (3) the public approval and information reporting requirements applicable to private activity bonds; (4) the requirement that obligations be in registered form; (5) the disallowance of tax-exemption for obligations that are Federally guaranteed; (6) the overall State volume limitations applicable to most private activity bonds; and, (7) the private loan bond restriction.[17] The requirements applicable to a bond depend on the type of bond, i.e., the use of the proceeds. For example, the requirement that bonds be in registered form applies to all non-Code bonds, while the State volume limitations for most private activity bonds apply only if the non-Code bonds are IDBs subject to those limitations or are student loan bonds.

The 1984 Act also provided that future Federal tax-exemptions are available for bonds only when enacted as part of a revenue Act; this restriction applies to bonds issued after July 18, 1984.

[16] These restrictions apply generally to bonds issued after December 31, 1983; the restrictions apply to bonds issued under section 11b of the Housing Act of 1937 after June 18, 1984.

[17] H.R. 1800 and S. 814, the Technical Corrections Act of 1985, would clarify the application of the registered form requirement and the private loan bond restriction to these bonds.

## B. Qualified Issuers

Tax-exempt bonds must be issued by or on behalf of a qualified governmental unit. If the bonds are issued directly by a State, city, or county, compliance with this requirement is easily determined; however, bonds often are issued by other entities that are not clearly political subdivisions of a State. For example, private activity bonds such as IDBs frequently are issued by entities with limited sovereign powers (e.g., an industrial development commission). In such cases, the determination of whether the issuer is a political subdivision of the State may be less clear than in cases involving direct financings for local government operations. In general, an entity is a political subdivision (and thereby a qualified governmental unit) only if it has more than an insubstantial amount of one or more of the following governmental powers: the power to tax, the power of eminent domain, and the police power (in the law enforcement sense).

In addition to issuing bonds directly, a qualified governmental unit may establish other entities to issue bonds "on behalf of" the governmental unit. These on-behalf-of corporations developed historically because some State laws defined the purposes for which the State could issue bonds more narrowly than did Federal tax law. For example, qualified scholarship funding bonds are bonds issued by specially constituted nonprofit corporations acting on behalf of governmental units (sec. 103(e)). Similarly, a nonprofit corporation might own, operate, and issue debt to finance a local airport. The requirements that must be satisfied by these nonprofit corporations are specified in two administrative determinations of the Internal Revenue Service (Rev. Rul. 63-20, 1963-2 C.B. 397, and Rev. Proc. 82-26, 1982-1 C.B. 476). In general, these requirements are as follows:

(1) The corporation must engage in activities that are essentially public in nature;

(2) The corporation must not be organized for profit (except to the extent of retiring indebtedness);

(3) The corporate income must not inure to any private person;

(4) The State or a political subdivision thereof must have a beneficial interest in the nonprofit corporation while the indebtedness remains outstanding and must be able to obtain full legal title to the property of the corporation with respect to which the indebtedness was incurred by repaying the bonds; and

(5) The corporation must have been approved by the State or a political subdivision thereof, either of which also must have approved the specific obligations issued by the corporation. (Rev. Rul. 63–20, *supra.*)

## C. The Concept of Use

The *use* of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for a private activity, and thereby indirectly for determining the restrictions that must be satisfied if interest on the bonds is to be tax-exempt. Additionally, satisfaction of numerous requirements for tax-exempt IDBs is determined by reference to the concept of use.

The ultimate beneficiary of the tax-exempt financed property generally is treated as the user of the bond proceeds and of bond-financed property. A person may be a user of bond proceeds or a user of bond-financed property whether the use is direct or indirect. Under the Code rules, a person may be treated as a user of bond proceeds or bond-financed property as a result of (1) ownership or actual or beneficial use of the property pursuant to a lease, (2) a management contract, or (3) arrangements such as take-or-pay or output contracts.

***Determination of type of bond***

Interest on bonds the proceeds of which are to be used by *nonexempt persons* is taxable unless an exception is provided in the Code for the type of activity to be financed. A nonexempt person is defined as any person other than a qualified governmental unit or a private charitable, scientific, religious, or educational organization (described in sec. 501(c)(3)). Thus, the United States (including its agencies and instrumentalities) and all private persons (other than organizations described in sec. 501(c)(3)) are nonexempt persons, and interest on bonds the proceeds of which are to be used by these persons is tax-exempt only when a specific exception is provided in the Code. On the other hand, interest on State or local government bonds the proceeds of which are used for general government operations or for private, nonprofit hospitals or universities and other charitable organizations (described in sec. 501(c)(3)) is tax-exempt under the general Code rule allowing issuance of tax-exempt obligations.

Bonds issued for use by nonexempt persons are divided into three major categories based upon *the use of the bond proceeds*—IDBs, MSBs, and student loan bonds. For example, present law defines IDBs as bonds all or a major portion of *the proceeds of which are to be used* in the trade or business of a nonexempt person and with respect to which a security interest test is satisfied. Interest on bonds issued for use by nonexempt persons that do not fall into any of these categories generally is taxable as interest on a private loan bond, discussed in II.A., above.

***Specific requirements based on the concept of use***

In addition to determining indirectly the restrictions that must be satisfied by an issue, the concept of use is important in applying various specific restrictions that must be satisfied by bonds for private activities as a condition of tax-exemption. For example, the following IDB restrictions require a determination of who is the user of tax-exempt bond proceeds or of bond-financed property:

*Ownership of IDBs by substantial users of bond-financed property prohibited.*—Interest on IDBs is not tax-exempt during any period when the bonds are owned by a person who is a *substantial user* [18] of the bond-financed property (sec. 103(b)(13)). Bonds owned by related parties to a substantial user are treated as owned by the user. This prohibition prevents a person from lending funds to himself or herself at tax-exempt interest rates, and receiving an income tax deduction for tax-exempt interest paid to himself or herself (or a related party).

*Public use requirement for exempt-activity IDBs.*—Tax-exempt IDBs may be issued for certain prescribed exempt activities (sec. 103(b)(4)). To qualify under this exception, the bond-financed property must be used for the prescribed exempt activity and must be available on a regular basis for general public use as opposed to being used exclusively by the persons in whose trade or business the property is used. For example, a dock serving a single manufacturer does not satisfy this public use requirement, but an airport hangar leased to a common carrier serving the general public does satisfy the requirement.

*Small-issue volume limitations.*—Tax-exempt small-issue IDBs must satisfy one of two special volume limitations, a $1 million "clean limit" restriction or an elective $10 million limitation. In determining whether the $1 million limitation is satisfied, outstanding prior issues are considered if (1) the bond-financed properties are located in the same municipality (or county, if not in any incorporated municipality), and (2) the *principal user* [19] of the properties will be the same person (or related person) (sec. 103(b)(6)(B)).

Under the elective $10 million limitation, all capital expenditures by principal users of the bond-financed property for any property located in the same municipality (or county, if not in any incorporated municipality) during a six-year period are aggregated (sec. 103(b)(6)(D) and (E)). Additionally, multiple issues of small-issue IDBs are aggregated in applying these volume limitations if the multiple issues are with respect to the same or related property, and principal users of any one or part of the properties are treated as such with respect to the entire property (or all of the related properties).

*Aggregate limit for small-issue IDBs.*—Interest on small-issue IDBs is not tax-exempt if the owner or any *principal user* of the bond-financed property during a three-year test period benefits from $40 million of outstanding IDBs (including both small-issue and exempt-activity IDBs).[20]

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[18] A substantial user is a user of more than five percent of the bond-financed property.
[19] A principal user is a user of more than 10 percent of the bond-financed property.
[20] *See*, II.E., below.

## D. Restrictions Applicable to Tax-Exempt Bonds Generally

### *Private loan bond restriction*

Interest on private loan bonds [21] is not tax-exempt unless tax-exempt financing is authorized by the Code for the purpose for which bond proceeds are to be used (sec. 103(o)). Private loan bonds are obligations that are part of an issue of which five percent or more of the proceeds is to be used, directly or indirectly, to make or finance loans to persons other than exempt persons.[22] Although the proceeds of IDBs, MSBs, and qualified student loan bonds are used to make loans to nonexempt persons, these bonds are not subject to the restriction since tax-exemption is authorized specifically in the Code for all three of these types of bonds.[23]

An additional exception is provided for bonds issued to enable a borrower to finance any tax or governmental assessment of general application for an essential governmental function. For example, bonds to finance mandatory municipal water or sewer installation assessments that a local government generally permits residents to pay over a period of years are not treated as private loan bonds. On the other hand, bonds to finance loans that are available to the public generally, but that are not used to finance governmentally mandated activities, are taxable private loan bonds.

The private loan bond restriction applies whether bonds are used to finance loans for businesses or to finance personal loans. For example, an issue may be an issue of private loan bonds if five percent or more, but less than 25 percent, of the proceeds are used to make loans that would be considered IDB financing, but for the fact that bonds are not treated as IDBs if less than 25 percent of the proceeds is used to finance an activity satisfying the trade or business and security interest tests of the Code (sec. 103(b)(2)).

### *Arbitrage restrictions*

Interest on arbitrage bonds is taxable. All types of tax-exempt bonds are subject to one or more sets of restrictions on investment of bond proceeds, the violation of any one of which results in the bonds being arbitrage bonds. Under the first set of restrictions, if the proceeds of any otherwise tax-exempt bonds are reasonably expected to be invested at a yield that is materially higher than that of the bonds, the interest is taxable. Most IDBs are subject to additional arbitrage restrictions, that limit investment of the IDB proceeds in obligations that are unrelated to the purpose for which the

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[21] The more descriptive term "private loan bonds" would be substituted for the present-law term consumer loan bonds by the Technical Corrections Act of 1985.

[22] The term exempt person includes qualified governmental units and certain charitable organizations. *See,* II.C., above.

[23] Certain specified private loan bond programs in existence when this restriction was enacted also are not subject to the requirement. *See*, sec. 626(b) of the 1984 Act.

IDBs are issued and that require a rebate to the Federal Government of excess earnings on the bonds. Qualified mortgage bonds also are subject to additional arbitrage restrictions that require that excess earnings be applied for benefit of the mortgagors or rebated to the Federal Government. Finally, the 1984 Act directed the Treasury Department, by regulations, to prescribe new arbitrage restrictions for qualified student loan bonds. These regulations will be effective no earlier than six months after their issuance.

The permissible arbitrage earnings under all of these restrictions depends on a comparison of the yield on the bonds and the yield on the investments acquired with the bonds. Various deductions are permitted that either increase the computed bond yield or decrease the computed yield on investments. For example, the Court of Appeals for the D.C. Circuit held in *State of Washington* v. *Commissioner* [24] that bond yield is the discount rate at which the present value of all anticipated payments of principal and interest on the bonds equals the net proceeds of the issue after deducting the costs of issuing the bonds. Because costs are deducted in determining net proceeds, there is a corresponding increase in the bond yield. Therefore, under the case, the bond issuer is permitted a higher yield on the investment of bond proceeds and may pay issuance costs out of arbitrage profits.

The method of determining bond yield provided by this case is used for the general arbitrage restrictions that apply to all tax-exempt bonds, but does not apply under the additional restrictions for IDBs or for qualified mortgage bonds. Under the additional IDB and qualified mortgage bond restrictions, the bond yield is based on the initial offering price to the public. The yield on the bonds is calculated without considering the present value of certain costs associated with the bonds that are considered under the general arbitrage restrictions. Thus, these costs may not be taken into account two times, thereby increasing permitted arbitrage profits.

### *Arbitrage restrictions applicable to all tax-exempt bonds*

#### *In general*

All tax-exempt bonds are subject to arbitrage restrictions limiting the investment of bond proceeds in investments whose yield is materially higher than that of the bonds. Exceptions are provided for materially higher yielding obligations that do not exceed a minor portion (15 percent) of the bond proceeds and for obligations held for a temporary period, both discussed below.

Treasury Department regulations provide rules for determining when an obligation has a yield that is materially higher than the bond yield. These regulations apply different arbitrage restrictions to "acquired purpose obligations" and "acquired nonpurpose obligations." Acquired purpose obligations are investments made to carry out the purpose of the bond issue. All other investments of bond proceeds are acquired nonpurpose obligations. Permissible arbitrage earnings generally are limited so the issuer may earn a spread between the yield on the bonds and the yield on acquired

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[24] 692 F.2d 128 (D.C. Cir. 1982).

nonpurpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, or redeeming the bonds, and the underwriter's discount.

There are two principal exceptions to this restriction. First, unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use, whether by the issuer or the user of bond proceeds. This temporary period generally may not exceed three years from the date of issue. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percentage points plus allowable costs (instead of 0.125 percentage points) with respect to the bonds. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. All amounts held in a reserve fund are applied against the 15-percent minor portion that may be invested without regard to yield restrictions. Since an issue may not be deliberately increased to take advantage of the minor portion rule, reserve funds are the most important example of a minor portion.

*Increased yield permitted for certain governmental programs*

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, permissible arbitrage earnings on investments acquired in connection with the program ("acquired program obligations") are restricted to the difference between the interest on the bonds and the interest on the acquired program obligations, but not exceeding the greater of (1) 1.5 percentage points plus reasonable administrative costs or (2) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). SAP payments made by the Department of Education are not taken into account in determining yield on student loan bonds, and thereby the amount of arbitrage profits earned with respect to the bonds.

### *Additional arbitrage restrictions for most IDBs*

*Rebate requirement*

IDBs other than IDBs for multifamily residential rental property are subject to additional arbitrage restrictions.[25] Under these additional restrictions, certain arbitrage profits earned on nonpurpose obligations acquired with the gross proceeds of the IDBs must be rebated to the Federal Government. No rebate is required if all gross proceeds of an issue are expended within six months of the issue date and for the purpose for which the bonds are issued. Additionally, if less than $100,000 is earned on a bona fide debt service fund with respect to an issue in a bond year, arbitrage earned on the fund in that year is not subject to the rebate requirement, unless the issuer elects to consider those earnings when determining if a rebate otherwise is due with respect to the bonds.

For purposes of these additional IDB restrictions, nonpurpose obligations generally include all investments other than those specifi-

[25] Housing bonds issued under section 11b of the Housing Act of 1937 that are IDBs also are exempt from these additional restrictions.

cally made to carry out the purpose for which the IDBs are issued. Gross proceeds include both the original proceeds of the borrowing, the return on investments of the bond proceeds, and amounts used or available to pay debt service on the bonds. Arbitrage profits that must be rebated include both income earned on investment of the bond proceeds and earnings on that income. Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being paid within 30 days after retirement of the bonds.

*Limitation on investment in nonpurpose obligations*

In addition to the rebate requirement, the amount of IDB proceeds that may be invested in nonpurpose obligations at a yield above the bond yield generally is restricted to 150 percent of the debt service. This limitation does not apply to amounts invested for certain initial temporary periods or to amounts held in a bona fide debt service fund. Debt service includes interest and amortization of principal scheduled to be paid with respect to an issue for the bond year, but does not include payments with respect to bonds that are retired before the beginning of the bond year.

***Additional arbitrage restrictions applicable to qualified mortgage bonds***

Additional arbitrage restrictions also are imposed on qualified mortgage bonds.[26] These restrictions apply both to arbitrage earnings on mortgage investments and on nonmortgage investments.

*Mortgage investments*

The effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for all mortgage loans made from the proceeds of the issue. Consequently, the effective interest rate on some mortgage loans is permitted to 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 amount of qualified mortgage bond proceeds that may be invested at an unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for an initial temporary period until the proceeds are needed for mortgage loans or for temporary debt service funds. Arbitrage earned on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

[26] Qualified veterans' mortgage bonds are not subject to any additional arbitrage restrictions beyond the restrictions imposed on tax-exempt bonds generally.

***Prohibition on Federal guarantees of tax-exempt bonds***

In general, tax-exemption is not permitted for interest on any bond that is Federally guaranteed. A bond is treated as Federally guaranteed if (1) the payment of principal or interest is directly or indirectly guaranteed, in whole or in part, by the United States;[27] (2) a significant portion (5 percent or more) of the proceeds of the issue of which the bond is a part is to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States; (3) a significant portion of the proceeds of the issue is to be invested in Federally insured deposits or accounts in a financial institution; or (4) the payment of the principal of or interest on the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States. For purposes of this prohibition, an entity with Federal statutory authority to borrow from the United States is treated as an instrumentality of the United States, and a guarantee of bonds by the entity results in the denial of tax-exemption.

Tax-exemption is denied under this prohibition in any case where the substance of a transaction, as opposed to its form, results in the United States being the party ultimately responsible for repayment of the bonds. A number of exceptions are provided, however, under which Federal programs in existence at the time the prohibition was enacted are permitted to continue to provide Federal guarantees of tax-exempt bonds. For example, guarantees provided under the GSL program of the Department of Education or by the Student Loan Marketing Association (SLMA) are permitted as are guarantees by the Federal Housing Administration (FHA), the Veterans' Administration (VA), the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA). Additionally, guarantees by the Small Business Administration with respect to qualified contracts for pollution control facilities are permitted in certain cases.

***Registered form requirement***

Tax-exempt bonds must be issued in registered form. This requirement is satisfied if the bonds are issued so as to require surrender of the old bond and either (1) reissuance by the issuer to the transferee, or (2) issuance of a new bond. Additionally, book-entry registration systems are permitted if the right to payment of the bond principal and interest is transferable only through a book entry that satisfies the requirements of Treasury Department regulations.

***Information reporting requirements***

Issuers of IDBs, student loan bonds, bonds for charitable and educational institutions (described in sec. 501(c)(3)), and MSBs must report certain information to the Internal Revenue Service about bonds issued by them during each preceding calendar quarter. This report is due on the 15th day of the second month after the close of

[27] For purposes of this prohibition, the term United States includes all agencies and instrumentalities thereof.

the calendar quarter in which the bonds are issued. Interest is taxable on bonds with respect to which the required report is not made.

The reports for bonds other than MSBs must include the following information with respect to each bond issue:

(1) The date of the issue, the stated interest rate, the term, the face amount of each bond that is part of the issue, and the amount of lendable proceeds of the issue;

(2) In the case of IDBs, the name of the elected official or legislative body that approved the issue;[28]

(3) The name, address, and tax identification number of each initial principal user of any property financed with the bond proceeds, and of certain related parties to the principal users; and

(4) A description of the property financed with the bond proceeds.

Similar information must be reported for each issue of mortgage subsidy bonds.

[28] *See*, II.E., below, for a discussion of the public approval requirements that apply to IDBs.

## E. Additional Requirements for Private Activity Bonds (Other than Mortgage Subsidy Bonds)

### *State volume limitations*

#### *General rules*

The amount of private activity bonds that a State, and other qualified issuers within the State, may issue during any calendar year is limited to the greater of $150 for each resident of the State [29] or $200 million.[30] Private activity bonds subject to these State volume limitations include most IDBs and all student loan bonds. The $150 per capita limitation continues until 1987, at which time it is scheduled to be reduced to $100 to reflect the termination of the small-issue exception for other than manufacturing facilities.[31]

Each State's volume limitation for private activity bonds is allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations, unless the State adopts a statute providing for a different allocation. There also was an interim provision allowing the Governor of any State to adopt an allocation formula by gubernatorial proclamation. A public official responsible for allocating volume limitation must certify, under penalty of perjury, that each allocation is not made in consideration of any bribe, gift, gratuity, or direct or indirect contribution to any political campaign.

An issuer's volume authority generally must be used for bonds issued in the calendar year for which it is allocated. An issuer may elect, however, to carry forward unused bond authority for up to three years for specific, identified projects, or for the general purpose of issuing student loan bonds. This carryforward period is extended to six years in the case of pollution control projects (described in sec. 103(b)(4)(F)). Carryforward allocations may not be made for small-issue IDBs.

#### *Exceptions*

IDBs to finance projects for multifamily residential rental property (sec. 103(b)(4)(A)) are not subject to the State volume limitations. This exception includes public housing program obligations issued under section 11(b) of the United States Housing Act of 1937 that are IDBs. In addition to these bonds for rental housing, the volume limitations do not apply to certain IDBs the proceeds of which are used to finance convention or trade show facilities, air-

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[29] The population of each State is based on the most recent estimate of the Bureau of the Census.

[30] The District of Columbia is treated as a State. U.S. possessions (e.g., Puerto Rico, the Virgin Islands, Guam, and American Samoa) are subject to a limitation of $150 per resident of the possession.

[31] The $200 million minimum State volume limitation is not scheduled to be reduced.

ports, docks, wharves, or mass commuting facilities (described in sec. 103(b)(4)(C) and (D)). IDBs for these latter facilities are exempt from the volume limitations, however, only if the property financed with the IDBs is owned for Federal tax purposes by, or on behalf of, a qualified governmental unit. The exception from the volume limitations does not apply to parking facilities financed with IDBs (even though described in sec. 103(b)(4)(D)) unless the parking facilities also are governmentally owned and are functionally related and subordinate to other property that qualifies under the exception (e.g., an airport parking lot).

Bonds issued to refund other private activity bonds also are not subject to the State volume limitations, provided that the amount of the refunding bonds does not exceed the outstanding principal amount of the refunded obligations. In the case of student loan bonds, refunding bonds are not subject to the limitation only if, in addition to the rule above, the maturity date of the refunding bonds do not exceed the later of (1) the maturity date of the refunded obligation, or (2) the date that is 17 years after the date on which the original obligation was issued.

### *Public approval requirement*

For interest on IDBs to be tax-exempt, a public hearing must be held, and the issuance of the bonds must be approved by an elected public official or elected legislative body. As an alternative to these requirements, issuance of the IDBs may be approved by a voter referendum. These restrictions apply to all IDBs, including IDBs exempt from the State volume limitations; however, they do not apply to student loan bonds or to other non-IDB tax-exempt bonds.

If the bond-financed property is located outside of the issuing jurisdiction, the public approval requirement generally must be satisfied by the issuing jurisdiction and all other jurisdictions in which the bond-financed property (or parts thereof) will be located.[32] The public approval requirement is satisfied, however, if one governmental unit, having jurisdiction over all the property being financed, holds a hearing and approves issuance of the bonds (e.g., a hearing held at the State level followed by governor's approval of the issue).

### *Restrictions on acquisition of land and existing property*

#### *Nonagricultural land*

Interest on IDBs is taxable if more than 25 percent of the proceeds of the issue of which the IDBs are a part is used to finance the acquisition of any interest in nonagricultural land. This restriction applies both to exempt-activity and to small-issue IDBs. The 25-percent restriction is increased to 50 percent in the case of IDBs issued to finance an industrial park (described in sec. 103(b)(5)). An additional exception to the land acquisition rules is provided for certain land acquired by a public agency in connection with an airport, mass transit, or port development project (described in sec.

[32] In the case of governmentally owned airports located outside of the boundaries of an issuing authority that also owns the airport, only the issuer/owner is required to satisfy the public approval requirement.

103(b)(4)(D)) for a noise abatement, wetland preservation, future use, or other public use, but only if there is no other significant use of the land before the expansion occurs.

#### *Agricultural land*

Agricultural land may be financed with IDBs without regard to the general 25-percent limitation on the use of IDBs to finance land, discussed above, if two conditions are satisfied.[33] First, this exception is limited to loans to first-time farmers, and second, each first-time farmer is limited to a maximum of $250,000 of IDB-financing. A first-time farmer is an individual who has not at any time had any direct or indirect ownership in substantial farmland in the operation of which the individual or the individual's spouse or dependent children have materially participated. Substantial farmland for this purpose includes any parcel of land (1) that is greater than 15 percent of the median size of a farm in the county in which the land is located, or (2) the fair market value of which exceeds $125,000 at any time when the land is held by the individual in question.

A *de minimis* portion of IDB financing provided under this exception may be used for the acquisition of used farming equipment (without regard to the restriction on financing existing property, discussed below). Only equipment acquired within one year after acquisition of the farmland is eligible for tax-exempt financing under this exception.

#### *Existing property*

Tax-exempt IDBs generally may not be used to finance the acquisition of previously used property. As with the restriction on the acquisition of land, this restriction applies both to exempt-activity and small-issue IDBs. An exception is provided, however, permitting the acquisition of an existing building (and equipment for such a building) if expenditures for rehabilitation of the building and equipment exceed 15 percent of the lesser of (1) the purchase price of the building and related equipment, or (2) the amount of bonds issued for acquisition of the building and related equipment. For example, if IDBs are used to purchase a building for $500,000, and existing equipment in the building for $250,000, interest on the bonds would be tax-exempt if rehabilitation expenditures of at least $112,500 (i.e., 15 percent of $750,000) were made. A parallel exception also applies to nonbuilding structures (e.g., dry docks), but in such cases, the rehabilitation expenditures must exceed 100 percent of the lesser of the cost or the bond-financing.

Qualified rehabilitation expenditures generally include any amount chargeable to capital account that is incurred in connection with the rehabilitation project. Only expenditures incurred before the date that is two years after the date the building is acquired, or (if later) the date the bonds are issued, are qualified rehabilitation expenditures. In the case of an integrated operation contained in a building before its acquisition, rehabilitation expenditures also include the expenses of rehabilitating existing

[33] Agricultural land is eligible for financing only under the small-issue exception.

equipment previously used to perform the same function in the building, or replacing the existing equipment with equipment having substantially the same function.

***Restrictions on financing certain specified property***

In addition to the general restrictions imposed on IDB-financing for land and existing property, additional restrictions are imposed with respect to certain specified property. First, interest on IDBs (both exempt-activity and small-issue IDBs) is taxable if any portion of the bond proceeds is used to finance any airplane, any skybox or other private luxury box, any health club facility, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption.

Second, interest on small-issue IDBs is not tax-exempt if (1) more than 25 percent of the proceeds of the issue is 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 the proceeds is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub or sun tan facility, or racetrack.

***Restriction on maturity of IDBs***

The average maturity of all IDBs may not exceed 120 percent of the economic life of the property to be financed. For example, if the proceeds of an issue of IDBs are used to purchase assets with an average estimated economic life of 10 years, the average maturity for the bonds may not exceed 12 years. The economic life of a facility is measured from the later of the date the bonds are issued or the date the assets are placed in service.

For purposes of this restriction, the economic life of facilities is determined on a case-by-case basis. However, the legislative history of the restriction states that, in order to provide guidance and certainty, the administrative guidelines used to determine useful lives for depreciation purposes before enactment of the ACRS system (i.e., ADR midpoint lives and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) may be used to establish the economic lives of assets.[34]

***$40 million limitation with respect to small-issue IDBs***

Interest on small-issue IDBs is taxable if the aggregate face amount of all outstanding tax-exempt IDBs (both exempt-activity and small-issue) that would be allocated to any beneficiary of the IDBs exceeds $40 million. To avoid double counting, bonds that are to be redeemed with the proceeds of a new issue are not considered.

The face amount of any issue is allocated among persons who are owners or principal users of the bond-financed property during a three-year test period. This may result in all or part of a facility being allocated to more than one person, as when one person owns

[34] *See*, H. Rpt. No. 97-760, 97th Cong., 2d Sess. (August 17, 1982), p. 519.

bond-financed property and other persons are principal users, or when owners and/or principal users change during the three-year test period.[35] Once an allocation to a test-period beneficiary is made, that allocation remains in effect as long as the bonds are outstanding, even if the beneficiary no longer owns or uses the bond-financed property.

***Advance refundings prohibited***

In the case of IDBs and mortgage subsidy bonds,[36] interest on refunding bonds is tax-exempt only if the refunding bonds are issued no more than 180 days before the refunded issue is redeemed (i.e., the refunded and the refunding issues may not be outstanding simultaneously for more than 180 days). Interest on refunding bonds that are outstanding for more than 180 days before refunded IDBs or mortgage subsidy bonds are redeemed (advance refunding bonds) does not qualify for tax-exemption. Advance refundings are permitted in the case of bonds used by exempt entities (e.g., for general government operations or by charitable organizations described in sec. 501(c)(3)).

A refunding issue generally is considered to be used for the same purposes as the issue being refunded. For example, if the refunded issue was used for an exempt activity under the rules applicable to IDBs, the refunding obligation generally is also considered to be so used. A refunding issue is an issue used to pay principal, interest, or call premium on a prior issue, together with reasonable incidental costs of the refunding. An issue is not treated as a refunding issue for purposes of the restriction on advance refunding if the prior issue had a term of less than 3 years (including the term of any prior refunded notes) and was sold in anticipation of permanent financing. (Prop. Treas. Reg. sec. 1.103-7(e).)

[35] If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of IDBs that cause the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other, previously issued, IDBs is not affected.

[36] This provision applies to both qualified mortgage bonds and qualified veterans' mortgage bonds. (*See*, II.F., below.)

## F. Additional Requirements for Mortgage Subsidy Bonds

### *Qualified veterans' mortgage bonds*

As stated in II.A. above, tax-exemption is allowed for two types of mortgage subsidy bonds—qualified veterans' mortgage bonds and qualified mortgage bonds.

#### *General rules*

Qualified veterans' mortgage bonds are general obligation bonds the proceeds of which are used to make mortgage loans to veterans. These bonds are subject to various limitations that will lead to an eventual phase-out of the programs. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. The States qualifying under this restriction are Alaska, California, Oregon, Texas, and Wisconsin. Additionally, loans financed with qualified veterans' mortgage bonds may be made only with respect to principal residences.

#### *State volume limitations*

The annual volume of qualified veterans' mortgage bonds that qualifying States may issue is limited according to a formula based on the aggregate volume of such bonds issued by qualified issuers within the State during the period beginning on January 1, 1979, and ending on June 22, 1984. Under the formula, the aggregate amount of these bonds is divided by the number of years (not exceeding five) during which such bonds were issued.[37]

#### *Loans may be made only to qualified veterans*

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds may be made only to veterans who served on active duty before 1977, and who apply for the loan before the later of (1) 30 years after the veteran leaves active service, or (2) January 31, 1985.[38]

### *Qualified mortgage bonds*

In addition to the rules applicable to all tax-exempt bonds, qualified mortgage bonds are subject to various restrictions, including separate State volume limitations; borrower eligibility and targeting rules; special arbitrage restrictions; a prohibition on advance

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[37] For purposes of these volume limitations, certain short-term notes to finance property taxes on residences financed with qualified veterans' mortgage bond loans are counted at one-fifteenth of their principal amount. Additionally, bonds issued in the year of lowest issuance from 1979 through June 22, 1984, are not counted.

[38] Sec. 611(c) of the 1984 Act incorrectly provided that this date was January 1, 1985. H.R. 1800 and S. 814, the Technical Corrections Act of 1985, would correct this reference.

refunding; information reporting requirements; and an annual policy statement requirement.[39]

### *Volume limitations*

The aggregate annual volume of qualified mortgage bonds that a State, and local governments within the State, are permitted to issue is limited to the greater of (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. Each State's volume limitation is allocated 50 percent to State and 50 percent to local issuers (on the basis of mortgage activity), unless the State enacts a statute providing for a different allocation.

### *Eligibility requirements*

*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 or rehabilitation of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must reasonably be expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. The term single-family residence includes two-, three-, and four-family residences if (1) the units in the residence are first occupied at least five years before the mortgage is executed, and (2) one unit in the residence is occupied by the owner of the units.

Tenant-stockholders of cooperative housing corporations (sec. 216) may qualify for qualified mortgage bond financing under certain conditions.

*General limitation to new mortgages*

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new, rather than existing, mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Assumptions of loans financed with qualified mortgage bond proceeds are permitted 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.

*Three-year requirement ("first-time homebuyer" rule)*

In order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who have had no present ownership interest in a principal residence at any time during the three-year period ending on the date the mortgage loan is executed. The three-year requirement does not apply with respect to mortgagors

[39] *See*, II.D., above, for a discussion of the arbitrage restrictions and information reporting requirements that apply to qualified mortgage bonds, and II.E. for a discussion of the prohibition on advance refunding of these bonds.

in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans; and (3) mortgagors who receive qualified rehabilitation loans.

*Purchase price restrictions*

All mortgage loans provided from the bond proceeds (except qualified home improvement loans) must be for the purchase of residences the acquisition cost of which does not exceed 110 percent of the average area purchase price applicable to that residence. This limit is increased to 120 percent of the average area purchase price in targeted areas (described below). The determination of average area purchase price is made separately (1) with respect to new and previously occupied residences, and (2) with respect to one-, two-, three-, and four-family residences.

***Targeted area requirement***

At least 20 percent of the lendable proceeds of each qualified mortgage bond issue (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 is defined as (1) a census tract in which 70 percent or more of the resident families have income that is 80 percent or less of the Statewide median family income, or (2) an area designated as an area of chronic economic distress using statutorily defined criteria (described in sec. 103A(k)(3)).

***Annual policy statement***

Issuers of qualified mortgage bonds and MCCs must publish and submit to the Treasury Department an annual report detailing the policies that the jurisdiction intends to follow in the succeeding year with respect to these programs. This report must be published and submitted before the last day of the year preceding each year in which any such bonds are issued. A public hearing must be held before publication and submission of the report.

***Mortgage credit certificate (MCC) alternative to qualified mortgage bonds***

State and local governments may elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the credit-recipient's principal residence. Credit amounts that may not be used in any year (because the credit is nonrefundable) may be carried forward for up to three years. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for at least 10 percent (but not more than 50 percent) of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed \$2,000.[40] Thus, only individuals who purchase lower-priced residences may benefit from a credit rate in excess of 20 percent.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue \$200 million of qualified mortgage bonds, and that elects to exchange \$100 million of that bond authority, may distribute an aggregate amount of MCCs equal to \$20 million.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness (under sec. 163(a)) is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making \$4,000 of mortgage interest payments in a given year, would receive a \$2,000 credit and a deduction for the remaining \$2,000 of interest payments.

The authority to issue mortgage credit certificates terminates on December 31, 1987, together with the authority to issue qualified mortgage bonds.

[40] In States whose volume limitation for qualified mortgage bonds exceeds 20 percent of the average mortgage originations and that issued fewer than \$150 million of qualified mortgage bonds in 1983, the weighted average percentage of MCCs may not exceed 20 percent.

# III. OTHER PROVISIONS AFFECTING THE TAX TREATMENT OF STATE AND LOCAL GOVERNMENT BONDS

In addition to the general tax-exemption provided for interest on State and local government bonds, other provisions affect the Federal subsidy available to owners and other beneficiaries of these bonds.

## A. Cost Recovery Deductions for Property Used in a Trade or Business or for the Production of Income

The cost of property that is used in a trade or business, or otherwise for the production of income, and that has a useful life of more than one year may be recovered through tax deductions (sec. 168). The present-law Accelerated Cost Recovery System (ACRS) prescribes recovery periods of from 3 years (automobiles) to 18 years (real property).[41] These recovery periods generally are shorter than the economic life of the property. In addition, the ACRS system prescribes a cost recovery method that further accelerates cost recovery by permitting larger deductions in the early years of the recovery period. For personal property, this cost recovery method approximates the effect of using a 150 percent declining balance method in the initial years followed by the straight-line method in years when the declining balance method would produce smaller deductions. For real property, the ACRS method for the initial years is the equivalent of a 175 percent declining balance method.[42]

The cost of property financed with tax-exempt bonds is eligible for recovery over the prescribed ACRS periods, but generally is not eligible for the accelerated cost recovery methods provided by ACRS (sec. 168(f)(12)). Projects for multifamily residential rental property (sec. 103(b)(4)(A)) are not subject to this restriction, and therefore may qualify for both tax-exempt financing and accelerated ACRS deductions.[43]

## B. Investment Tax Credit

A tax credit is permitted with respect to investment in certain types of property (sec. 38). The amount of this credit ranges from six percent of qualified investment expenditures for automobiles to

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[41] Taxpayers may elect extended recovery periods of up to 45 years (sec. 168(b)(3)). Additionally, in the case of certain property leased to governments and other tax-exempt entities, extended recovery periods are required under the present-law ACRS system (sec. 168(j)).

[42] Certain low-income housing is permitted a 200 percent declining balance method (as well as a shorter recovery period than real property generally) (secs. 168(c)(4) and 1250(a)(1)(B)).

[43] This cost recovery restriction originally was enacted by the Tax Equity and Fiscal Responsibility Act of 1982, and included exceptions for multifamily residential rental property, certain public sewage or solid waste facilities, certain air or water pollution control facilities, and property with respect to which an Urban Development Action Grant (UDAG) was made. The exceptions for bond-financed property other than multifamily residential rental property were repealed in 1984.

25 percent of such expenditures for rehabilitation of certified historic structures. An adjustment to the basis of property equal to one-half of the credit claimed generally is required.[44] Property that is financed with tax-exempt bonds generally is eligible for the investment credit on the same basis as property financed with taxable debt. However, a special rule requires taxpayers to elect between the rehabilitation tax credit and tax-exempt financing in the case of certain property leased to governments or other tax-exempt entities (i.e., tax-exempt use property).

### C. Deductibility of Expenses Related to Tax-Exempt Income

Taxpayers are not permitted to deduct interest expense incurred or continued to purchase or carry tax-exempt obligations (sec. 265(2)). This rule applies both to individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues interest expense and a related person acquires or holds tax-exempt obligations.[45]

The courts and the Internal Revenue Service have interpreted the section 265(2) rule to disallow an interest deduction only when a taxpayer incurs or continues indebtedness for the purpose of acquiring or holding tax-exempt obligations. Because banks are not considered to accept deposits for the purpose of acquiring tax-exempt obligations, the disallowance rule generally has not been applied to them. In other cases, the rule has been applied on a case-by-case basis. *See,* e.g., Rev. Proc. 72-18, 1972-1 C.B. 740; *Wisconsin Cheeseman, Inc.* v. *United States*, 388 F.2d 420 (7th Cir. 1968). Under a related provision, however, the amount of the otherwise allowable deduction for interest allocable to tax-exempt obligations is reduced by 20 percent under rules on preference items for banks.[46]

### D. Income Tax Treatment of Social Security Benefits

The amount of tax-exempt interest received by an individual can affect the extent to which he or she is taxable with respect to social security benefits received (sec. 86). In general, up to one-half of such benefits are taxable to the extent that the taxpayer's modified adjusted gross income, when added to the amount of the benefits, exceeds a base amount. The base amount is $32,000 in the case of a joint return, zero in the case of married taxpayers who do not live separately for the entire year but who file separate returns, and $25,000 for all other taxpayers.

Modified adjusted gross income is calculated by adding to adjusted gross income certain items that otherwise are excludable. Tax-exempt interest is among these items. If the sum of modified adjusted gross income and one-half of social security benefits received exceeds the base amount, then the taxpayer's adjusted gross

[44] In the case of the 15 -and 20-percent rehabilitation credits, this basis adjustment is equal to the full amount of the credit.

[45] In addition to interest deductions, present law (sec. 265(1)) denies a deduction for nonbusiness expenses for the production of tax-exempt interest income, which expenses would otherwise be deductible under section 212 of the Code. This may include, for example, brokerage and other fees associated with a tax-exempt portfolio. Present law also disallows deductions for certain expenses of tax-exempt mutual funds and for interest to purchase or carry shares in such a fund.

[46] *See*, II.E., below.

49-969 O—85——3

income is increased by the lesser of (1) one-half of this excess, or (2) one-half of the social security benefits received. Under this provision, tax-exempt interest may cause a taxpayer's adjusted gross income to be greater, by as much as one-half of the amount of the social security benefits received, than it would have been had he or she not received any tax-exempt interest.

### E. Minimum Tax and Preference Reduction Provisions

Minimum taxes are imposed, respectively, on individuals and on corporations (secs. 55-58). In general, minimum taxes are designed to ensure that taxpayers with substantial economic income pay tax equaling at least a specified percentage of that income. To accomplish this goal, the minimum tax provisions require that certain tax preferences[47] be regarded as income for minimum tax purposes.

Individuals are subject to an alternative minimum tax, imposed at a 20-percent rate (above an exemption amount) on an income base derived by adding certain preferences to taxable income and by denying certain itemized deductions. The tax is payable to the extent that it exceeds the taxpayer's regular tax liability. Corporations are subject to an add-on minimum tax, imposed at a 15-percent rate on a base derived by adding together certain preferences (but without adding them to taxable income) and then subtracting the amount of regular tax paid.

Tax-exempt interest presently is not treated as a preference for minimum tax purposes. However, tax-exempt interest is relevant under a related provision that restricts the use of certain preference items for regular tax purposes (sec. 291). In general, this related provision requires reductions (typically, 15 or 20 percent) in the amount by which the regular tax treatment of a particular item is more favorable than it would be under a rule that is deemed more economically accurate, or that applies to a more general category of items.

Among the items with respect to which a reduction must be made is interest on debt incurred by banks.[48] to purchase or carry tax-exempt obligations acquired after 1982.[49] The determination of what interest was incurred to purchase or carry tax-exempt obligations is made through allocation on a percentage-of-assets basis. Specifically, a bank that is subject to this restriction first must calculate the percentage of average adjusted basis for its assets that it derives from tax-exempt obligations acquired in 1983 or thereafter. It then must treat the same percentage of its total interest deductions that otherwise are allowable as having been incurred to purchase or carry the obligations. A deduction is disallowed for 20 percent of the interest so allocated to the purchase and carrying cost of the tax-exempt obligations.

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[47] In general, a tax preference may be defined as an incentive provision that causes the taxable income of benefited taxpayers to be less than their economic income.

[48] A bank in this context is defined as (1) any institution that is incorporated as a bank in the United States, any State, or the District of Columbia, and (2) any nonprofit mutual savings bank, domestic building and loan association, or cooperative bank without capital stock.

[49] *See*, III.C., above, for a discussion of the general rule governing deductibility of expenses related to tax-exempt income.

### F. Gift, Estate, and Generation-Skipping Transfer Tax Treatment of State and Local Government Bonds

The value of State and local government obligations is subject to Federal gift, estate, or generation-skipping transfer tax if the obligations are transferred by gift or as a result of death.[50] Additionally, present law provides that an exemption from these taxes arises only if the Federal statute under which the tax-exemption is granted specifically refers to the appropriate provisions of the Internal Revenue Code that impose those taxes. Therefore, any general grant of tax-exemption applies only to the income tax. Any tax-exemption provided by laws enacted before 1984 applies to Federal gift, estate, or generation-skipping transfer taxes only if those tax-exemptions specifically refer to these taxes (even if not to the actual Code provisions under which the taxes are imposed).

[50] In *Haffner* v. *U.S.*, the Court of Appeals for the Seventh Circuit held that the transfer of public housing notes for which tax-exemption formerly was provided under section 11b of the Housing Act of 1987 was not subject to Federal estate tax. *Haffner* v. *U.S.*, 757 F. 2d 920 (7th Cir., 1985), affg. 585 F. Supp. 354 (N.D., Ill., 1984). This decision applies only to such transfers that occurred before June 19, 1984.

# IV. LEGISLATIVE BACKGROUND OF THE TAX-EXEMPTION FOR PRIVATE ACTIVITY BONDS

Federal income tax law has provided an exemption for interest on obligations issued by or on behalf of States or local governments since the income tax was enacted in 1913. General obligation bonds were first issued by some 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.)

## A. 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 1960's. At that time, the volume of these obligations began to grow rapidly. In response to this increased volume, on March 22, 1968,[51] the IRS issued proposed regulations regarding private activity bonds. The regulations provided that, in general, interest on IDBs would thereafter be taxable if (1) an identifiable party other than the issuing governmental unit had the right to use all or a major portion of the bond proceeds or the property acquired with bond proceeds, (2) that party was responsible for all or a major portion of the principal and interest payments, and (3) the payments were secured by an interest in the financed property.

In response to the increased volume of IDBs, and the proposed regulations, Congress enacted the first statutory provisions limiting the circumstances under which interest on IDBs would be tax-exempt as part of the Revenue Adjustment Act of 1968.[52] This 1968 Act provided that interest on IDBs generally is taxable. Exceptions were provided, however, in the form of a list of activities for which tax-exempt IDB financing could be provided (exempt-activity IDBs) and a more general exception for certain small issues (the small-issue exception).

The original exempt activities were—

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

(2) Sports facilities;

(3) Convention or trade show facilities;

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

[51] 33 Fed. Reg. 4950 (March 22, 1968).
[52] P.L. 90-364.

(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 exception 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, and controlled by the government itself.

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

The $1 million small-issue limit was modified later in 1968[53] to permit governmental units to elect to increase the $1 million limit to $5 million if both outstanding issues and certain capital expenditures by principal users of the bond-financed property 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, were taken into account. This Act also provided that certain specified capital expenditures are excluded from this computation. These excluded capital expenditures were limited in 1968 to $250,000. If 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, exceeded the small-issue limitation of $5 million, loss of tax-exemption was to be effective only from the date of the disqualifying capital expenditures.

***Tax Reform Act of 1969 arbitrage rules***

The Tax Reform Act of 1969[54] provided rules restricting the ability of State and local governments to invest the proceeds of tax-exempt bonds in other obligations that provide a yield materially higher than the yield on the tax-exempt bonds (i.e., arbitrage bonds).

***1971 increase in excluded capital expenditures for small-issue IDBs***

The next amendments to the IDB provisions were made by the Revenue Act of 1971.[55] In the 1971 Act, the limitation on certain subsequent capital expenditures that are permitted without disqualifying the tax-exempt status of small-issue bonds was increased from $250,000 to $1 million.

***Certain dam construction as an exempt activity***

In 1975,[56] Congress added a new exempt activity, permitting tax-exempt IDB financing for dams that furnish water for irrigation

[53] The Renegotiation Amendments Act of 1968 (P.L. 90-634).
[54] P.L. 91-172.
[55] P.L. 92-178.
[56] The Revenue Adjustment Act of 1975 (P.L. 94-164).

purposes and that 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 tax-exemption for IDBs*

The Revenue Act of 1978[57] increased the elective $5 million limit on small-issue IDBs to $10 million, and permitted exclusion of up to $10 million of capital expenditures for facilities with respect to which an urban development action grant (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 considered to be provided to the public and prohibiting advance refunding of IDBs, except in limited cases.

### *1980 restriction of rental housing as an exempt activity*

In 1980, IDBs for residential rental property were limited to bonds used to finance multifamily residential rental property having a minimum percentage of its housing units occupied by individuals of low- or moderate-income. These restrictions were added as part of the Mortgage Subsidy Bond Tax Act of 1980, 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 (defined as persons with incomes of less than 80 percent of the area median income).

### *Financing of mass commuting vehicles as an exempt activity and exemption of certain volunteer fire department bonds*

In 1981, the Economic Recovery Tax Act[58] (ERTA) further expanded the exempt activities for which IDBs may be issued to include financing of certain mass commuting vehicles. (Mass commuting terminal facilities were among the original exempt activities.)

ERTA also provided that obligations of certain volunteer fire departments are tax-exempt as obligations of a political subdivision of a State, 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[59] (TEFRA) made the following changes to the IDB rules:

[57] P.L. 95-600.
[58] P.L. 97-34.
[59] P.L. 97-248.

(1) Issuers of private activity bonds[60] are required to make quarterly information reports to the IRS concerning bonds issued by them;

(2) Issuance of IDBs was required to be approved by an elected official in the issuing jurisdiction, and all jurisdictions where the facilities were to 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 were reduced, with certain exceptions, for IDB-financed property;

(4) The average length of time to maturity of IDBs is limited to 120 percent of the economic life of the property financed;

(5) The definition of facilities for the local furnishing of 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 regional pollution control facilities.

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

***Deficit Reduction Act of 1984 amendments***

The Deficit Reduction Act of 1984 (the 1984 Act)[61] imposed volume limitations on the aggregate annual amount of private activity bonds (all student loan bonds and most IDBs) that may be issued by each State and its political subdivisions. In addition to the volume limitations, the 1984 Act also made the following major changes to the rules governing IDBs:

(1) Three of the four TEFRA exceptions to the ACRS restrictions on tax-exempt bond financed property were repealed, with only projects for multifamily residential rental property remaining eligible for full ACRS deductions;

(2) Additional arbitrage restrictions, requiring a rebate of certain profits and limiting the amount of bond proceeds that may be invested in obligations unrelated to the purpose of the issue, were enacted for IDBs (other than IDBs for multifamily residential rental property);

(3) Limitations were placed on the amount of IDB proceeds that may be used to finance the acquisition of land and certain specified

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[60] Under the information reporting requirements, the term private activity bond includes IDBs, scholarship funding bonds, and bonds issued by charitable, educational, religious, and scientific organizations (described in sec. 501(c)(3)). This is broader than the definition of the term private activity bond for purposes of the state volume limitations adopted in 1984.

[61] P.L. 98-369.

facilities and the circumstances in which existing property may be financed with IDBs;

(4) The special rule under which IDBs for certain airports, docks, wharves, and convention and trade show facilities could be advance refunded was repealed;

(5) The Act clarified that tax-exempt bond financed multifamily residential rental property may be part of a building that also is used for nonresidential purposes; and

(6) The rule under which tax-exempt bonds may not be owned by a substantial user of the bond-financed property was extended to treat certain related parties to substantial users as users of the property.

In addition, three changes were made to the small-issue exception. First, the exception was extended through 1988 for manufacturing property. Second, the small-issue exception was limited to persons benefiting from $40 million or less in all types of IDBs. Third, the 1984 Act provided that multiple issues are aggregated for purposes of the small-issue capital expenditure limitations when the bonds are issued for a single building or a group of related facilities.

The 1984 Act also made certain changes applicable to all tax-exempt bonds. These changes are discussed in IV. D., below.

## B. Single-Family Housing Bonds

### *Mortgage Subisdy Bond Tax Act of 1980*

The Mortgage Subsidy Bond Tax Act of 1980[62] 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. Before 1978, however, most State housing finance agency bonds were issued to provide multifamily rental housing.[63] 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 tax-exempt only if the bonds are qualified veterans' mortgage bonds or qualified mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. The 1980 Act exempted qualified veterans' mortgage bonds from the volume, arbitrage, and targeting limitations applicable to qualified mortgage bonds. The 1980 Act required qualified mortgage bonds to satisfy several requirements:

(1) Qualified mortgage bonds were required to be issued before January 1, 1984.

(2) The aggregate annual volume of such bonds that a State, and local governments within the State, may issue was 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 were required to be used to finance the purchase of single-family residences that are located within the jurisdiction of the issuing authority and that are reasonably expected to become the principal residences of the mortgagors.

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

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

(6) All of the mortgage loans made from each issue generally were required to 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 were made.

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[62] Title XI of the Omnibus Reconciliation Act of 1980 (P.L. 96-499).

[63] The tax-exemption for bonds for multifamily residential rental property remains as an exempt activity under the IDB rules.

(7) All of the mortgage loans were required to be made to finance the purchase of residences for which the acquisition cost did not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence.

(8) Each issue of qualified mortgage bonds was required to satisfy certain special arbitrage restrictions, both as to mortgage loans and nonmortgage investments.

*TEFRA amendments to eligibility and arbitrage requirements*

TEFRA amended the first-time homebuyer and purchase price restrictions for qualified mortgage bonds (items 6 and 7, above). After TEFRA, only 90 percent of the mortgage loans financed by an issue are required to be made to first-time homebuyers, and the purchase price limit for homes is 110 percent (120 percent in targeted areas) of the average area purchase price.

Finally, TEFRA increased the permissible arbitrage earnings on qualified mortgage bonds and provided that, for purposes of the requirement that nonmortgage investments bearing a yield higher than that of the issue be liquidated in certain cases, no liquidation is required when a loss in excess of the amount of undistributed arbitrage profits in nonmortgage investments would result.

*1984 Act amendments*

The 1984 Act restricted the issuance of qualified veterans' mortgage bonds to States that had issued those bonds before June 22, 1984, imposed State volume limitations on the amount of the bonds that may be issued, and restricted mortgage loans made with the bond proceeds to loans to veterans who served on active duty before 1977 and who apply for a loan before a specified date.

The 1984 Act also reenacted and extended through December 31, 1987, the authority to issue tax-exempt qualified mortgage bonds. The requirements applicable to these bonds are the same as applied before expiration of the provision at the end of 1983.

Additionally, the 1984 Act authorized States to exchange all or a portion of their qualified mortgage bond volume authority for authority to issue MCCs. MCCs generally are subject to the same eligibility requirements as qualified mortgage bonds.

## C. Qualified Scholarship Funding Bonds

### *1976 restrictions*

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 nonexempt interest could have violated the arbitrage rules adopted in 1969.

In response to this situation, the Tax Reform Act of 1976 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.

### *1984 Act restrictions*

Student loan bonds are private activity bonds subject to the State volume limitations imposed under the 1984 Act. The 1984 Act further limited tax-exemption for student loan bonds to those bonds repayment of which is guaranteed under the GSL or PLUS programs of the Department of Education, effective for bonds issued after July 18, 1984. Finally, the 1984 Act provided that, subject to Treasury Department regulations, additional arbitrage restrictions like those applicable to IDBs will apply to tax-exempt student loan bonds. The legislative history accompanying this provision indicates that these rules may require rebate of certain arbitrage profits and may restrict investment of student loan bond proceeds in investments unrelated to the purpose of the bonds.

## D. Tax-Exemptions Provided by Federal Statutes Other Than the Internal Revenue Code

In addition to the activities for which tax-exempt financing is provided under the Internal Revenue Code, certain nontax statutes provided an exemption for interest on specified obligations before 1983. Bonds issued pursuant to these non-Code exemptions generally were not subject to the restrictions on tax-exempt bonds contained in the Internal Revenue Code.

### *District of Columbia bonds*

Under the District of Columbia Self-Government and Governmental Reorganization Act,[64] 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 commercial development. Under that Act, the obligations were exempted from all Federal and District taxation (except gift, estate, and generation-skipping transfer taxes).[65]

The Internal Revenue Service held that interest on bonds and notes issued by the District of Columbia, before 1984, was exempt from Federal income taxes notwithstanding the IDB provisions of the Internal Revenue Code.[66] Thus, the District could issue bonds for industrial and commercial development without regard to the limitations on small-issue IDBs; however, IRS concluded that the District of Columbia did not have the authority to issue arbitrage bonds.

### *Bonds issued by U.S. possessions*

#### *Puerto Rican bonds*

Under the Puerto Rico Federal Relations Act,[67] interest on bonds issued by the Government of Puerto Rico, or by its authority, was exempted from Federal, State, or Puerto Rican taxation.

#### *Virgin Islands and American Samoa 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. Since 1984, the Virgin Islands also may issue IDBs.[68] Interest on bonds issued by the Virgin Islands (or any municipality thereof) may be exempt from Federal, State, or Virgin Islands taxation.[69]

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[64] 87 Stat. 774 (1973); Pub. L. 93-198.
[65] D.C. Code sec. 47-332.
[66] Rev. Rul. 76-202, 1976-1 C.B. 26.
[67] Laws 1917, c. 145, 39 Stat. 953 (48 U.S.C. sec. 745).
[68] P.L. 98-369.
[69] Pub. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1403).

The Government of American Samoa is authorized to issue tax-exempt IDBs.[70]

### *State and local housing agency bonds*

Section 11(b) of the Housing Act of 1937[71] provided that interest on certain obligations issued by State and local public housing agencies in connection with low-income housing projects is tax-exempt. This tax-exemption is limited to bonds for projects developed, acquired, or assisted by the State or local agency. The project units generally must 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).

#### *1982 amendment*

The Surface Transportation Assistance Act of 1982[72] expanded the scope of the tax-exemption provisions of the Internal Revenue Code (sec. 103(a)) to include obligations the interest on which previously was tax-exempt under Federal statutes other than the Code. This Act did not, however, extend substantive Code restrictions to non-Code bonds.

#### *1984 Act amendments*

The 1984 Act expanded the application of Internal Revenue Code provisions to bonds authorized by other Federal statutes. Under the 1984 Act, these non-Code bonds must satisfy all Code provisions that apply to bonds issued under the Code for like purposes. The specific Code provisions extended to non-Code bonds are (1) the State private activity bond volume limitations, (2) the Code arbitrage restrictions, (3) the public approval and information reporting requirements for private activity bonds, (4) the requirement that obligations be issued in registered form, (5) the disallowance of tax-exemption for Federally guaranteed obligations, and (6) the private loan bond restriction.

[70] P.L. 98-369.
[71] 42 U.S.C. sec. 1437i(b).
[72] P.L. 97-424.

## E. 1984 Restrictions on Tax-Exempt Bonds Generally

The 1984 Act included four provisions of general application to tax-exempt bonds, including bonds issued for private activities.

### *Private loan bond restriction*

The 1984 Act provided that interest on bonds issued to provide loans to nonexempt persons is taxable. Private activity bonds for which Congress previously has authorized tax-exemption (i.e., IDBs, MSBs, and qualified student loan bonds) are not subject to this restriction. In addition, an exception is provided for bonds issued to enable the borrower to finance any tax or governmental assessment of general application.

### *Prohibition on Federal guarantees*

The 1984 Act generally prohibited tax-exemption for interest on bonds that are guaranteed, in whole or in part, by a direct or indirect guarantee of the Federal Government. Exceptions were provided for certain guarantee programs in existence when the 1984 Act was enacted.

### *Transfer tax treatment of tax-exempt bonds*

The 1984 Act provided that the Federal gift, estate, and generation-skipping transfer taxes apply to transfers of tax-exempt bonds unless an exemption that specifically refers to the gift, estate, or generation-skipping provisions of the Internal Revenue Code is enacted. (At the present time, no bonds are exempt from these Federal transfer taxes.)

### *Future grants of tax-exemption*

The 1984 Act provided that all future grants of exemption from Federal tax must be enacted as part of a revenue Act.

# V. DESCRIPTION OF TAX REFORM PROPOSALS

## A. Administration Proposal

### *Tax-exemption generally*

#### *Repeal of tax-exemption for nongovernmental bonds*

*General rule*

Under the Administration proposal, interest on State and local government bonds would be tax-exempt only if the bonds were "governmental" bonds. Bonds would be governmental bonds if no more than one percent of the bond proceeds were used directly or indirectly by any person other than a State or local government. The use of bond proceeds would include the use of property financed with those proceeds.[73] Thus, interest on IDBs, MSBs, and student loan bonds (using present-law definitions), as well as bonds to benefit charitable organizations (described in sec. 501(c)(3)), would no longer qualify for tax-exemption.[74] Tax-exemption would continue to be permitted for interest on bonds issued to finance State or local government operations (including TANs and RANs) and to finance the acquisition or construction of government buildings. These rules would apply both to general obligation bonds (i.e., bonds backed by the general revenues of the issuing government) and revenue bonds (i.e., bonds to be repaid from the revenues from a specific project).

If bond-financed property were used partially for governmental purposes and partially for nongovernmental purposes, an allocable portion of the property could be financed with tax-exempt bonds. As illustrated in the Administration proposal,[75] if a government-owned and -operated electric generating facility contracted to sell 10 percent of its output over the life of the facility to an investor-owned utility, and supplied the remaining 90 percent of the power generated by it directly to the general public, 90 percent of the costs of the facility could be financed with tax-exempt bonds. (A government-owned and -operated utility that provided electricity to the general public would qualify for tax-exempt financing under the proposal.)

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[73] The Administration proposal would discontinue the present-law concepts of exempt activity and public *versus* private use. The concept of use, discussed in II.C., above, would continue to be relevant for determining whether the use of bond proceeds was by a governmental entity, and thus whether the bonds were governmental bonds.

[74] A few bonds that are IDBs under present law would be governmental bonds under the Administration proposal. For example, bonds to finance the extension of a governmental sewer system to serve a single corporation are IDBs under present law, but would be governmental bonds, and thereby eligible for tax-exemption under the Administration proposal.

[75] The governmental use requirement is described on on p. 282 *et seq.* of the Administration proposal.

*Exceptions*

The Administration proposal includes three exceptions to the governmental use restriction—a special rule for certain facilities, owned and operated by a governmental unit, that are available to the general public on the same basis; a *de minimis* exception for certain short-term leases and management contracts; and an exception for certain investments relating to temporary periods or to reasonably required reserve or bona fide debt service funds.

*Requirement of availability on the same basis to all members of the general public.*—Under the Administration proposal, the use of bond-financed property, owned and operated by a governmental unit, by a nongovernmental person would not result in a denial of tax-exempt financing, if the property were available for use by all members of the general public on the same basis. The use of bond-financed property by one or more nongovernmental persons on a basis other than that available to the general public would, however, result in loss of tax-exemption. Such a different use by one or more nongovernmental persons could be demonstrated by a formal or informal agreement between the governmental unit and the nongovernmental person, or by the fact that the property was located at a site that was not readily accessible to the general public. As an example, the Administration proposal states that extension of a road, sewer, or similar system to a newly constructed house or business could continue to be financed with tax-exempt obligations. However, construction of an airstrip adjacent to a business that would be the primary user of the airstrip could not be so financed.

The Administration proposal states that a facility used by a nongovernmental person would not qualify for this exception merely because it also is used by the general public. For example, a leased airline terminal could not be financed with tax-exempt bonds, since the airline's use of the terminal would be on a basis different from that available to the general public.

*Exception for short-term contracts and initial-period leases.*—The leasing of property to a nongovernmental person, or its operation by such a person pursuant to a management contract, ordinarily would disqualify the property from tax-exempt financing under the Administration proposal. Similarly, tax-exempt financing generally would not be available for property operated by nongovernmental persons, pursuant to management contracts. An exception would be provided for management contracts of one year or less in duration. For example, a solid waste disposal facility owned by a city government and serving the general public in the city could be financed with tax-exempt obligations if it were operated either (1) by the city, or (2) by a private manager under a short-term (one year or less) management contract.

An exception also is provided for certain leases of one year or less duration; however, this exception is limited to the period immediately after substantial completion of construction of the bond-financed property. Other leases to nongovernmental persons would preclude the use of tax-exempt financing for the property (or the leased portion thereof).

*Exception for certain temporary period investments.*—Bond proceeds could be invested for an initial temporary period without loss of tax-exempt status.[76] Exceptions also would be provided for (1) reasonably required reserve funds, and (2) bona fide debt service funds, both defined as under present law.

### *Additional arbitrage restrictions*

The Administration proposal would extend additional arbitrage restrictions, similar to the present-law rules applicable to IDBs and mortgage subsidy bonds, to all tax-exempt bonds. Under these additional restrictions, investments not directly related to the purpose for which bonds are issued (i.e., investments in acquired nonpurpose obligations) would be limited to 150 percent of annual debt service, with exceptions for an initial temporary period and for bona fide debt service funds.

Additionally, all tax-exempt bond issuers would be required to rebate arbitrage profits on nonpurpose obligations to the United States.[77] For this purpose, profits would be adjusted for gains and losses on the nonpurpose obligations and for earnings on the arbitrage profits themselves (as under the present-law IDB rules). For purposes of determining the amount of arbitrage profits, the yield of a bond issue would be determined without regard to costs (including underwriter's discount, issuance costs, credit enhancement fees, and other costs). The yield on acquired obligations similarly would be determined without regard to costs.

The present-law rules, under which unlimited arbitrage may be earned during certain initial temporary periods of up to three years, also would be restricted under the Administration proposal. No temporary period would be allowed for bond issues that financed the acquisition of property. In the case of construction projects, the temporary period would end when the project was substantially complete, or when an amount equal to the bond proceeds has been expended on the project.

In no event could the temporary period exceed three years. In conjunction with these changes, the option to waive the temporary period and earn an 0.5 percent (rather than 0.125 percent) arbitrage spread would be repealed.

### *Restriction on early issuance of bonds*

Early issuance of tax-exempt bonds would be restricted more tightly than under present law. An issuer would be required to spend a significant portion of the bond proceeds within one month of the issue. All bond proceeds would be required to be expended within three years of the date of issue, with an exception for reasonably required reserve and replacement funds.

### *Prohibition of all advance refundings*

The Administration proposal would prohibit advance refundings of all tax-exempt bonds. Advance refundings would be defined to include any refunding when the refunded bonds were not redeemed

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[76] *But see,* the discussion below of proposed new restrictions on the length of permitted temporary periods during which unlimited arbitrage profits could be earned.

[77] But the proposal does not specify any exceptions to this rebate requirement. The present-law IDB rules allow exceptions (1) where the gross proceeds of the issue are expended for a governmental purpose within 6 months of the issue date, and (2) for certain debt service funds. (*See,* II.D., above.)

immediately (i.e., the 180-day rule of present law for IDBs and mortgage subsidy bonds would be repealed).

***Information reporting and other requirements***

The present-law information reporting requirements for IDBs would be extended to all tax-exempt obligations.

***Deductibility of expenses related to tax-exempt income***

In addition to the proposed restrictions on tax-exempt financing generally, the Administration proposal also would deny banks a deduction for any interest payments that are allocable to the purchase or carrying of tax-exempt obligations. The amount of interest allocable to tax-exempt obligations would be determined as it is for purposes of the 20 percent reduction in preference items under present law.[78] Thus, a deduction would be denied for that portion of a bank's otherwise allowable interest deduction that is equivalent to the ratio of (1) the average adjusted basis during the year of tax-exempt obligations held by the bank,[79] to (2) the average adjusted basis of all assets held by the bank. For example, if an average of one-third of a bank's assets over the year consisted of tax-exempt obligations, the bank would be denied one-third of its otherwise allowable interest deduction. This prorata presumption could not be rebutted by evidence of the bank's purpose in incurring interest payments.[80]

***Minimum taxes***

The Administration proposal would impose alternative minimum taxes on individuals and corporations. As under present law, tax-exempt interest would not be treated as a preference item.

[78] *See*, III.C., and II.E., above.
[79] For this purpose, only obligations acquired after December 31, 1985, would be taken into account.
[80] This provision will be analyzed more completely in a subsequent pamphlet on tax reform proposals regarding financial institutions.

## B. Congressional Proposals

### *Tax-exemption generally*

The Bradley-Gephardt (S. 409 and H.R. 800) and Kemp-Kasten (H.R. 2222 and S. 1006) bills would repeal the tax-exemption for interest on IDBs and mortgage subsidy bonds. Repeal of authority to issue qualified mortgage bonds also would have the effect of terminating authority to issue MCCs. Tax-exemption also would be denied for interest on obligations the proceeds of which are used by charitable organizations (described in sec. 501(c)(3)), or to finance loans to individuals for educational expenses (student loan bonds).

The present-law arbitrage rules would be retained without change under these bills.

### *Minimum tax and preference reduction proposals*

The Russo-Schumer minimum tax bill (H.R. 2424) would impose an expanded alternative minimum tax for both individuals and corporations. The tax would be imposed at a 25 percent rate on alternative minimum taxable income of $100,000 or more for individuals and $150,000 or more for corporations. The tax would be phased in for income levels in excess of $70,000. Interest on tax-exempt obligations issued after the date of the bill's enactment would be treated as a preference item, and thus would be included in the alternative minimum tax base.

# VI. ISSUES RAISED BY THE TAX-EXEMPTION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS

## A. Issues Related to the Effect of Tax-Exempt Bonds on the Tax System and the Economy

Permitting tax-exemption for interest on bonds issued by State and local governments raises numerous policy issues. These issues include (1) the effect of permitting tax-exemption for certain types of income on the overall fairness of the tax system; (2) the effect of tax-exempt private activity (nongovernmental) bonds on the cost of financing traditional government activities; (3) the efficiency of tax-exemption as a means of providing a Federal subsidy to selected activities; (4) the change in market allocation of capital that may result from tax-exempt bonds; and (5) governmental *versus* nongovernmental use of bond proceeds and bond-financed property.

### *Effect on fairness of the tax system*

Outstanding tax-exempt bond holdings totaled $539 billion at the end of 1984. This amount represents an increase of $54 billion over the $485 billion year-end total for 1983.[81] The bulk (about 94 percent in 1983 and 1984) of the bonds were held by four groups: households, mutual funds, commercial banks, and insurance companies (other than life insurance).

Households and mutual funds holding tax-exempt bonds represent individuals who have found tax-exempt yields more attractive than the after-tax yields on taxable investments. Since the ratio of tax-exempt to taxable yields has been above 65 percent during the past five years,[82] joint return filers with a 33-percent or higher marginal tax rate (i.e., having taxable income above $35,200), and individual filers in a 34-percent or higher marginal tax bracket (taxable income above $28,800) would increase their after-tax yield by investing in tax-exempt bonds. Since 1980, households have increased their holdings of tax-exempt bonds both absolutely and as a percentage of the outstanding amount of such bonds (from 25.5 percent at the end of 1980 to 38.1 percent at the end of 1984). Mutual funds specializing in tax-exempt bonds have increased seven-fold since 1980, and their share of the total amount invested in these obligations has increased from 1.8 to 8.3 percent.

The widespread use of tax-exempt debt raises questions about the fairness of the tax system. This issue arises both with respect to tax-exempt borrowers and with respect to investors in tax-exempt bonds. Some persons suggest that by reducing the costs of capital to

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[81] These statistics are shown in more detail Tables 1, 9, and 10 in VII.A., below. Those tables show the year-end amounts and distribution of ownership of tax-exempt bonds held by various groups from 1972 through 1984.

[82] *See*, the table accompanying the discussion of the efficiency of tax-exempt bonds as a means of providing a Federal subsidy, below, and also Table 7 in Part VII.A.

some businesses, tax-exempt financing for private activities puts at a disadvantage businesses that must pay market interest rates. The loss of fairness (or its perception) becomes more important to business as firms in closely related lines of business in the same marketing areas pay different interest rates as a result of the nonmarket decisions that determine who receives tax-exempt financing.

Similarly, investors in tax-exempt bonds gain after-tax income advantages that are unrelated to the concepts of ability-to-pay and fairness-of-tax-burden within (and between) income classes. Although many aspects of the tax structure have changed, the ability-to-pay and progressive rate concepts have remained a basic part of the tax structure. The fairness issue is most pronounced when the use of tax-exempt bonds and other sheltering devices so change the distribution of after-tax income that higher income taxpayers pay proportionately less income tax than lower income taxpayers—with some high income taxpayers reportedly being able to avoid paying any Federal income tax. On the other hand, a basic principle of tax law also is that no person need pay more taxes than the law requires. Reduction of tax liability through investment in tax-exempt bonds is in this respect no different from any other considerations (deductions, etc.) that may reduce taxable income.

Proponents of restricting or eliminating tax-exempt financing for private activities suggest that tax-exempt income is inconsistent with basic rate reduction embodied in all three of the major tax reform proposals currently before Congress. These persons suggest that the trade-off for low rates is full taxation of economic income, including tax-exempt interest. Some of these persons suggest that, even if tax-exempt income were not taxed under the basic income tax, this income should be treated as a preference item under any restructured minimum tax. The proponents of subjecting all economic income to tax state that steps such as these are necessary if unfairness, either actual or perceived, is to be avoided in any reformed tax structure.

Opponents of making interest on State and local government bonds taxable (or of treating the interest as a minimum tax preference item) suggest that such proposals are inconsistent with the principle of comity between the States and the Federal Government, and possibly might be unconstitutional.[83] These opponents suggest that this principle is particularly important given reduced direct Federal spending for various activities (including for exam-

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[83] The Code has provided since 1968 that interest on IDBs is taxable unless a specific exception is provided in the Code. Since 1980, the tax law has provided that interest on mortgage subsidy bonds is taxable unless Code restrictions are satisfied. Additionally, the Deficit Reduction Act of 1984 provided that interest on all bonds the proceeds of which are used to finance loans to nonexempt persons is taxable unless a specific Code exception allows tax-exemption.

In the only case in which it has considered this issue directly, the Supreme Court ruled that the tax-exemption of interest on State and local government bonds is constitutionally protected. (*Pollock* v. *Farmers' Loan and Trust Company* (157 U.S. 429 (1895).) That case involved debt issued for basic governmental activities as opposed to bonds for private activities. In later cases, the Court upheld the application of the Federal income tax to wages of State employees (*Helvering* v. *Gerhardt* (304 U.S. 405 (1938)) and *Graves* v. *N.Y. ex. rel. O'Keefe* (306 U.S. 466 (1939)). Some commentators have suggested that taxation of wages of State employees is a similar issue to taxation of interest on State and local government bonds.

Finally, the Federal Government statutorily has precluded the taxation of interest on its debt by States. (31 U.S.C. 3124.) This prohibition applies whether the State law results in direct or indirect consideration of the interest in computation of tax. (*American Bank and Trust Co.* v. *Dallas County* (463 U.S. 855 (1983).)

ple, housing and education), and the concomitant increase in State responsibilities in these areas. The opponents further suggest that even a reformed tax structure in which rates were significantly lower properly should not preclude special treatment in certain cases. As an example, these persons point to the deduction for mortgage loan interest incurred with respect to a principal residence, a deduction that is retained under all three of the major tax reform proposals currently before Congress. The opponents of taxing interest on State and local government bonds suggest that assistance for local economic development and other purposes represents a similar overriding social objective.

***Effect on the cost of financing traditional government activities***

The use of tax-exempt bonds for private activities increases the competition for the limited pool of assets available for investment in tax-exempt obligations generally. The overall result is higher interest rates on tax-exempt bonds generally, including bonds issued for traditional governmental activities, as issuers of this debt must bid funds away from other uses.

Proponents of restricting tax-exempt financing for private activities suggest that the increase in the municipal-corporate bond ratio in recent years reflects the increased cost of government finance, including increased costs of providing local capital improvements. (*See*, Table 7 in VII.A., below.) These persons suggest that, as a result of the widespread availability of tax-exempt financing for private activities, tax-exempt bond yields are higher than the yields necessary to induce investment in State and local government obligations.

Opponents of restricting tax-exempt financing for private activities suggest that the term private-activity is a misnomer. These persons suggest that the so-called private activities for which tax-exempt financing currently is permitted serve a public purpose, even if only indirectly. These persons suggest that financed activities may be in the nature of public works, even though a private user may enjoy the benefit of the tax-exempt financing. In addition, the opponents suggest that increases in employment and expansion of the local tax base are public activities of sufficient importance to justify any increase in other interest expenses incurred for traditional governmental activities, even if such increases result in higher yields to bond investors than are needed to induce investment.

***Efficiency of tax-exempt bonds as a means of providing a Federal subsidy***

Tax-exempt financing for private activities provides a direct Federal subsidy to at least two parties to each transaction—the borrower and the bond investor (the lender).[84] The private borrower receives a Federal subsidy equal to the difference between the tax-exempt interest rate paid and the taxable bond rate that otherwise would be paid.[85] Column 3 of Table 7 in VII.A., below, may be used

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[84] These subsidies are in addition to any benefits received by the State or local government issuing the bonds or by facilitators of the transaction, such as bond counsel and underwriters.

[85] The borrower may deduct interest costs, whether the interest income is taxable or tax-exempt to the lender.

to illustrate the measure of the borrower's subsidy measured as a percentage of the otherwise applicable taxable rate. For example, for 1984, if the ratio of tax-exempt to taxable rates was .749, or 74.9 percent, the subsidy was equal to 25 percent of the taxable rate, or approximately 2.5 percentage points on a 10-percent taxable rate.

The bond investor also receives a Federal subsidy from tax-exempt financing equal to the difference between the tax-exempt interest rate and the after-tax yield on a taxable corporate investment. In many cases, the bond investor's subsidy is greater than the subsidy received by the borrower. The marginal tax rate of the bond investor determines the extent of the subsidy.

The table below illustrates that an investor in the 50-percent marginal tax bracket would receive a five percent after-tax yield on a 10-percent taxable bond. This taxpayer would receive a higher effective yield from any tax-exempt bond with an interest rate of more than 5 percent than from a taxable bond yielding 10 percent. If the bond yield ratio were .65, assuming a 10-percent taxable yield, a State or local government bond would pay 6.5 percent interest. In this case, the 50-percent marginal tax rate taxpayer would receive a subsidy of 1.5 percentage points on the yield (6.5 minus 5 percent after-tax income on the taxable bond), resulting in 30 percent more after-tax interest income than if a taxable bond had been purchased.

**After-Tax Yield on Taxable Bonds, by Marginal Rates**

[in percentages]

| Investors' marginal tax rate | Taxable bond yields | | | | | |
|---|---|---|---|---|---|---|
| | 10 | 9 | 8 | 7 | 6 | 5 |
| 50 | 5.0 | 4.5 | 4.0 | 3.5 | 3.0 | 2.5 |
| 40 | 6.0 | 5.4 | 4.8 | 4.2 | 3.8 | 3.0 |
| 35 | 6.5 | 5.9 | 5.2 | 4.6 | 3.9 | 3.2 |
| 30 | 7.0 | 6.3 | 5.6 | 4.9 | 4.2 | 3.5 |
| 25 | 7.5 | 6.8 | 6.0 | 5.3 | 4.5 | 3.8 |

Source: Joint Committee on Taxation.

Proponents of additional restrictions on private activity bonds suggest that the subsidy to borrowers provided by these bonds is very inefficient. These persons state that, for every $2 of benefit to a user of bond financed property, the Federal Government loses $3 or more in tax revenues. The foregone tax revenues may result in (1) increases in the Federal deficit; (2) higher marginal tax rates than otherwise would be necessary; or (3) reductions in other Federal Government programs. The proponents suggest that properly designed direct subsidy programs are a more efficient method of maximizing the portion of any subsidy that actually is received by intended beneficiaries of Federal subsidies.

Opponents of additional restrictions on private activity bonds suggest that the alternative to the indirect subsidy provided by tax-exempt financing is creation of new Federal bureaucracies to administer direct Federal programs. These persons suggest that the inefficiency in targeting the benefits from tax-exempt bonds is no greater than the inefficiency of such bureaucracies.

***Change in market allocation***

Tax-exempt bonds change the allocation of capital by encouraging investment in projects eligible for tax-exempt financing, at the expense of other investments. To some extent, this change is an intended result. However, in certain cases, tax-exempt bonds may encourage investment in projects that serve little or no public purpose. In particular, the availability of small-issue IDB financing may encourage small projects at the expense of larger ones, regardless of relative economic efficiency. Similarly, the tax-exemption provided for interest on mortgage subsidy bonds may encourage construction of single-family housing at the expense of industrial or commercial facilities that would develop the economic base of an area.

In addition to changing market allocation between competing investment purposes, tax-exempt bonds may change the allocation of funds between persons eligible to receive tax-exempt financing (including certain tax-exempt charitable organizations, and businesses eligible for IDB financing) and other, ineligible persons. Also, by increasing the demand for bond-financed property, tax-exempt financing may encourage increases in the prices of this property. For example, mortgage subsidy bonds, by reducing the effective mortgage interest rate, may increase the demand for eligible single-family residences. This may result in higher home prices for purchasers receiving taxable financing, as well as for those benefiting from tax-exempt financing.

Proponents of restricting tax-exempt financing for private activities suggest that, if no tax subsidy were provided, all persons engaged in private activities would have to pay market determined prices for productive resources. Thus, all borrowers with essentially the same credit rating would be charged the same rate of interest. These persons further suggest that borrowers at tax-exempt rates either (1) do not have to meet a test of whether they could operate profitably while paying the same interest cost as other borrowers, or (2) even if they could operate profitably without the subsidy, invest more extensively in the subsidized activities than they would if they had to pay market, i.e., taxable and unsubsidized, interest rates. Finally, the proponents of restricting this form of financing suggest that its principal effect is to provide an opportunity for State and local governments to use the Federal income tax base, a free good to them, as a marketing device that may cause increased taxes for other parties.

Opponents of additional restrictions on tax-exempt financing for private activities suggest that the market changes caused by tax-exempt bonds are appropriate as a means of effecting certain social objectives that Congress has determined to be sufficiently important to subsidize. These persons suggest that, without the subsidy (and accompanying change in market allocation), socially desirable activities might not occur. The opponents of further restrictions also suggest that the diversity of local needs makes additional Federal restrictions on the types of activities to be subsidized, or otherwise on the allocation of the overall subsidy allowed each State, counterproductive.

***Governmental* v. *nongovernmental use of bond proceeds and bond-financed property***

In recent years, State and local governments increasingly have contracted with private businesses to provide, as private activities, services that by some are considered governmental services (e.g., sewage and solid waste disposal). This phenomenon is referred to as "privatization." Additionally, qualified governmental units have issued tax-exempt bonds to finance other, private, activities that many consider unrelated to governmental services (e.g., small-issue IDBs, IDBs for multifamily residential rental property and air and water pollution control facilities, and mortgage subsidy bonds).

Some proponents of restricting tax-exempt financing suggest that the indirect Federal subsidy provided by tax-exempt bonds should be permitted exclusively for those functions that actually are conducted by State and local governments. These persons suggest that it is inappropriate for the Federal Government to provide indirect subsidies for private businesses through use of the Federal tax law, particularly in times of budget constraint. Proponents of further restricting tax-exemption also suggest that the indirect Federal subsidy from bonds encourages the expansion of tax-exempt financing beyond the scope of traditional government services to new private activities.

The proponents suggest further that restricting tax-exemption to financing for services directly provided by State and local governments will not disrupt privatization of government services to the extent it is economically based, as opposed to being simply a method of shifting to the Federal Government costs that are more appropriately borne by State and local governments and private enterprise. These persons state that only those privatization projects that are profitable because of the subsidy provided by tax-exempt financing would be prevented from going forward by restrictions on such financing and that privatization resulting from private sector efficiency would continue.

Opponents of additional restrictions on tax-exempt financing suggest that many activities, nominally private, are in reality public services. The opponents of additional restrictions cite as an example bonds for airports that are IDBs because the users of the airports are private businesses (airlines) even though airports form an important necessary link in the nationwide transportation system. The opponents suggest that a governmental-nongovernmental distinction is impossible to make at the Federal level because of the diversity of different sections of the country; therefore, they suggest that discretion should be given to State and local governments.

Opponents of additional restrictions further suggest that in some instances services that are public in nature may be provided more efficiently by private businesses contracting with governmental units because of factors unrelated to the type of financing. These persons frequently cite economies of scale and greater flexibility in business management as examples of greater private sector efficiency in providing privatized services. Opponents of eliminating tax-exempt financing for these activities suggest that the fact that a private party provides a public service should not affect the nature of the available financing.

## B. Issues Related to Activities for Which Tax-Exempt Bonds May Be Issued

All of the major tax reform proposals before Congress would repeal the present tax-exemption for interest on State and local government bonds for private activities. The Administration proposal generally would permit tax-exemption only if the bond-financed property or services were governmentally used or provided. The Bradley-Gephardt and Kemp-Kasten bills would repeal the present tax-exemption for private activity bonds (IDBs, MSBs, student loan bonds, and bonds for nonprofit charitable organizations).

In most respects, the effect of these proposals is the same; however, in certain cases, bonds that are IDBs because the bond proceeds are used by a single or a limited group of users and the IDB security interest test is satisfied may be governmental bonds under the Administration proposal. For example, bonds to finance an extension of a governmentally owned and operated water system for a single manufacturing plant are IDBs, and interest on them would be taxable under both the Bradley-Gephardt and Kemp-Kasten bills. On the other hand, if the water system as a whole served all members of the public on the same basis, the interest on the bonds would be tax-exempt under the Administration proposal.

Conversely, if a city issued a single issue of bonds for several city activities, and between one and five percent of the bond proceeds were to be used indirectly to finance loans to individuals, the bond interest would be tax-exempt under both the Bradley-Gephardt and Kemp-Kasten bills while the interest would be taxable under the Administration proposal. This result would obtain because bonds are not taxable private loan bonds unless five percent or more of the proceeds are to be used for loans to nonexempt persons (a restriction that is retained by the Bradley-Gephardt and Kemp-Kasten bills). On the other hand, the Administration proposal provides that bond interest is taxable if more than one percent of the proceeds is to be used by a nongovernmental person.

In addition to considering the general concepts discussed above in VI.A., the tax reform proposals raise specific issues concerning what types of tax-exempt financing, if any, should be continued. If Congress determines that certain private activities should continue to receive tax-exempt financing, a number of issues remain to be addressed as to the volume of these bonds permitted, the types of activities eligible for such financing, and the depth of the overall Federal subsidy to be provided. The following questions illustrate specific issues that arise if such a determination is made.

***Targeting the subsidy provided by tax-exempt bonds***

*Volume*

What volume of tax-exempt bond financing for private activities, if any, is appropriate?

To the extent that issuance of tax-exempt bonds for private activities is permitted, should a single annual volume limitation be imposed for all such bonds issued by or on behalf of a State and its political subdivisions rather than continuing the separate limitations presently applicable to most IDBs and all student loan bonds, to qualified mortgage bonds, and to qualified veterans' mortgage bonds?

If tax-exempt financing continues to be permitted for charitable organizations (described in sec. 501(c)(3)) and for IDBs presently excepted from the State volume limitations, should bonds for these purposes be subject to volume limitations?

Should authority for all tax-exempt financing for private activities be authorized only for a specified period to ensure periodic review of the degree to which the subsidy continues to be appropriate and effective?

Because the ability under present law to advance refund bonds other than IDBs and mortgage subsidy bonds may result in two or more issues of bonds for the same project being outstanding for an extended period of time, is it appropriate to permit such advance refundings?

*Types of permitted financings*

Should tax-exempt financing be available only for activities directly serving the general public, or are there activities exclusively or principally benefitting a single private party that should qualify for this subsidy?

Should tax-exempt financing be available on a proportional basis only if substantially all of the bond-financed property is used to provide a governmental service?

Should IDB financing be available only for activities presently qualifying under the exempt-activity exception when those activities entail relatively large expenditures and reflect "privatization" of governmental services? (Under such a rule, for example, facilities for the furnishing of water, sewer and solid waste disposal facilities might qualify for tax-exempt financing while air and water pollution control facilities and projects for multifamily residential rental property might not since these latter facilities normally serve a single or a limited group of private users.)

Should tax-exempt financing for privatization of certain activities be permitted only where the private business provides services to the State or local government with the government then providing such services to its citizens?

If tax-exempt financing continues to be allowed for facilities that serve limited groups (e.g., IDBs for multifamily residential rental property and mortgage subsidy bonds for single family, owner-occupied housing), should new targeting rules be enacted to ensure that a greater portion of the subsidy benefits the group with the greatest need for the subsidy?

Should the maturity of tax-exempt bonds (in addition to IDBs) be limited in relation to the economic life of the bond-financed property?

Should continued compliance with Congressional requirements for tax-exempt bonds be required throughout the period that the bonds are outstanding, and if so, should additional steps be taken to ensure that continued compliance? (For example, under present law, projects for multifamily residential rental property must satisfy the low- and moderate-income set-aside requirement for a qualified project period, but no regular reporting or evaluation of compliance is required. The sanction for noncompliance is loss of tax-exemption to the bond investor rather than a penalty (e.g., nondeductibility of interest payments) imposed on the issuer of the bonds or the user of the bond-financed property.)

***Combination of Federal subsidies***

To what extent should the combination of Federal subsidies be permitted for private activities that continue to receive the benefits of tax-exempt financing? More specifically—

*Investment credit and cost recovery deductions*

Should private ownership for tax purposes of tax-exempt bond-financed property be permitted? (If the investment credit is repealed and ACRS modified to lessen the extent of those subsidies, limitations on tax ownership would be less severe because a greater percentage of the combined Federal subsidy would be provided by the tax-exempt bonds.)

If private ownership of tax-exempt bond-financed property is permitted, should cost recovery deductions be determined using a longer period than is allowed for property financed with taxable debt?

*Federal guarantees of tax-exempt bonds*

Because the combination of tax-exemption and a Federal guarantee makes State and local bonds a more attractive investment than Federal Government debt obligations, should all Federal guarantees of tax-exempt bonds be prohibited? (The 1984 Act restricted the combination of these two benefits, but provided exceptions for numerous guarantee programs in existence at that time.)

***Arbitrage and related issues involving use of bond proceeds by issuers and parties other than ultimate beneficiaries***

Should tax-exempt bond proceeds be required to be spent for the purpose of the issue within a relatively short time after the bonds are issued? (Such a rule would preclude earlier than needed issuance of bonds primarily to earn arbitrage profits.)

Should the temporary period exceptions during which time unlimited amounts of arbitrage profits may be earned be shortened or eliminated?

Should rules such as the additional arbitrage restrictions that apply to most IDBs (e.g., a rebate requirement) be extended to all tax-exempt bonds?

Should the costs of issuance (e.g., bond counsel and underwriters' fees) be paid by the person for whom the bonds are issued rather than being recovered out of arbitrage profits?

Should all of the proceeds of an issue of tax-exempt bonds be required to be spent for the purpose for which the bonds are issued? (Under present law, 10 percent of IDB proceeds may be used for purposes other than the purpose qualifying the interest on the bonds for tax-exemption.)

# VII. REVENUE ANALYSIS

## A. Statistical Data Relating to Tax-Exempt Bonds (Other Than Mortgage Subsidy Bonds)

### *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 through 1984. The total volume of tax-exempt obligations increased from $30.5 billion in 1975 to $114.3 billion in 1984. During this period, the volume of bonds for private activities (including tax-exempt IDBs, student loan bonds, mortgage subsidy bonds, and bonds for use by certain nonprofit charitable organizations) increased from $8.9 billion (approximately 29 percent of total State and local government borrowing) to $71.8 billion (approximately 63 percent of State and local government borrowing). Conversely, the volume of bonds for traditional public activities, while increasing in dollar volume from $21.6 billion to $42.6 billion, decreased as a percentage of total tax-exempt bonds issued, from approximately 71 percent of total borrowings to approximately 37 percent.

**Table 1.—Volume of Long-Term Tax-Exempt Bonds by Type of Activity, Calendar Years 1975–1984**

[In billions of dollars]

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|
| Total issues, long-term tax exempt bonds [1] [2] | 30.5 | 35.0 | 46.9 | 49.1 | 48.4 | 54.4 | 55.1 | 84.9 | 93.3 | 114.3 |
| Nongovernmental tax-exempt bonds | 8.9 | 11.4 | 17.4 | 19.7 | 28.1 | 32.5 | 30.9 | 49.6 | 57.1 | 71.7 |
| Housing bonds: | 1.4 | 2.7 | 4.4 | 6.9 | 12.1 | 14.0 | 4.8 | 14.6 | 17.0 | 20.0 |
| Single family mortgage subsidy bonds | * | 0.7 | 1.0 | 3.4 | 7.8 | 10.5 | 2.8 | 9.0 | 11.0 | 12.8 |
| Multi-family rental housing IDBs | 0.9 | 1.4 | 2.9 | 2.5 | 2.7 | 2.2 | 1.1 | 5.1 | 5.3 | 5.1 |
| Veterans' general obligation bonds | 0.6 | 0.6 | 0.6 | 1.2 | 1.6 | 1.3 | 0.9 | 0.5 | 0.7 | 2.1 |
| Private exempt entity bonds [3] | 1.8 | 2.5 | 4.3 | 2.9 | 3.2 | 3.3 | 4.7 | 8.5 | 11.7 | 11.6 |
| Student loan bonds | * | 0.1 | 0.1 | 0.3 | 0.6 | 0.5 | 1.1 | 1.8 | 3.3 | 1.1 |
| Pollution control IDBs | 2.1 | 2.1 | 3.0 | 2.8 | 2.5 | 2.5 | 4.3 | 5.9 | 4.5 | 7.5 |
| Small-issue IDBs | 1.3 | 1.5 | 2.4 | 3.6 | 7.5 | 9.7 | 13.3 | 14.7 | 14.6 | 17.4 |
| Other IDBs [4] | 2.3 | 2.5 | 3.2 | 3.2 | 2.2 | 2.5 | 2.7 | 4.1 | 6.0 | 14.0 |
| Other tax-exempt bonds [5] | 21.6 | 23.6 | 29.5 | 29.3 | 20.3 | 22.0 | 24.2 | 35.3 | 36.2 | 42.6 |

* $50 million or less.

[1] Total reported volume from *Bond Buyer Municipal State Book (1985)* adjusted for privately placed small-issue IDBs.

[2] This volume does not reflect amounts borrowed pursuant to installment sales agreements, financing leases, or other, non-bond, borrowing by State and local governments. *See,* II.A., above, for a discussion of the tax treatment of these types of debt.

[3] Private-exempt entity bonds are obligations issued for the benefit of section 501(c)(3) organizations such as private nonprofit hospitals and universities.

[4] Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

[5] Some of these may be nongovernmental bonds.

Note.—Totals may not add due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

***Use of tax-exempt bonds for certain charitable organizations, by State***

Table 2 sets forth the volume of tax-exempt bonds issued for charitable organizations (described in sec. 501(c)(3)) in 1984, by State. (Nonprofit tax-exempt organizations include private nonprofit hospitals and universities.) As shown in the table, the use of tax-exempt financing for these organizations varies significantly, by State. For example, Texas issued $1.447 billion of tax-exempt bonds for nonprofit charitable organizations in 1984, while Wyoming, Utah, Maine, and Alaska issued no such bonds.

**Table 2.—Volume of New Issue Tax-Exempt Bonds for Certain Charitable Organizations, by State, 1983-1984** [1]

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| United States, total | 8,096 | 10,055 |
| Alabama | 103 | 338 |
| Alaska | 4 | 0 |
| Arizona | 102 | 319 |
| Arkansas | 31 | 44 |
| California | 1,210 | 783 |
| Colorado | 146 | 246 |
| Connecticut | 77 | 79 |
| Delaware | 10 | 8 |
| Florida | 610 | 748 |
| Georgia | 91 | 31 |
| Hawaii | 20 | 82 |
| Idaho | 28 | 5 |
| Illinois | 404 | 477 |
| Indiana | 384 | 315 |
| Iowa | 28 | 4 |
| Kansas | 11 | 38 |
| Kentucky | 144 | 113 |
| Lousiana | 124 | 195 |
| Maine | 4 | 0 |
| Maryland | 47 | 164 |
| Massachusetts | 698 | 506 |
| Michigan | 219 | 248 |
| Minnesota | 206 | 78 |
| Mississippi | 9 | 42 |
| Missouri | 201 | 357 |
| Montana | 5 | 26 |
| Nebraska | 13 | 116 |
| Nevada | 4 | 9 |
| New Hampshire | 35 | 45 |
| New Jersey | 334 | 252 |
| New Mexico | 77 | 13 |
| New York | 450 | 1,004 |
| North Carolina | 67 | 38 |

**Table 2.—Volume of New Issue Tax-Exempt Bonds for Certain Charitable Organizations, by State, 1983-1984 [1]—Continued**

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| North Dakota | 41 | 27 |
| Ohio | 332 | 271 |
| Oklahoma | 33 | 3 |
| Oregon | 60 | 105 |
| Pennsylvania | 650 | 782 |
| Rhode Island | 26 | 86 |
| South Carolina | 17 | 18 |
| South Dakota | 26 | 23 |
| Tennessee | 104 | 146 |
| Texas | 0611 | 1,447 |
| Utah | 37 | 0 |
| Vermont | 8 | 32 |
| Virginia | 175 | 129 |
| Washington | 47 | 50 |
| West Virginia | 23 | 61 |
| Wisconsin | 11 | 152 |
| Wyoming | [2] | 0 |

[1] New issue volume equals the purchase price of the bond minus proceeds used to retire earlier issues.
[2] Less than $500,000.

Source: Office of the Secretary of the Treasury.

### *Use of exempt-activity IDBs and student loan bonds, by State*

Tables 3 and 4 set forth the volume of exempt-activity IDBs, and student loan bonds, by State, during 1983 and 1984, respectively. The table shows that the volume of the different types of these bonds varies significantly by State. For example, in 1983, Texas issued $1.117 billion of IDBs for multifamily residential rental property while New York issued $367 million. Similarly, in 1984, Georgia issued $1.016 billion of IDBs for air and water pollution control property while North Carolina issued $280 million of such bonds.

**Table 3.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1983**

[In millions of dollars]

| State | Type of Activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| United States, total | 3,086 | 5,337 | 2,089 | 1,442 | 3,411 |
| Alabama | 75 | 82 | 1 | 113 | 34 |
| Alaska | 0 | 38 | 28 | 0 | 10 |
| Arizona | 204 | 172 | 9 | 204 | 184 |
| Arkansas | 0 | 18 | 0 | 1 | 26 |
| California | 576 | 784 | 166 | 122 | 75 |
| Colorado | 133 | 81 | 21 | 7 | 42 |
| Connecticut | 16 | 82 | 13 | 0 | 0 |
| Delaware | 0 | 20 | 0 | 1 | 2 |
| Florida | 0 | 353 | 395 | 220 | 226 |
| Georgia | 0 | 328 | 40 | 1 | 24 |
| Hawaii | 0 | 0 | 57 | 0 | 0 |
| Idaho | 17 | 4 | 0 | 0 | 13 |
| Illinois | 159 | 99 | 311 | 126 | 24 |
| Indiana | 82 | 43 | 6 | 24 | 123 |
| Iowa | 60 | 13 | 0 | 0 | 4 |
| Kansas | 0 | 45 | 22 | 0 | 225 |
| Kentucky | 119 | 15 | 27 | 6 | 112 |
| Louisiana | 0 | 188 | 151 | 1 | 167 |
| Maine | 6 | 0 | 0 | 0 | 0 |
| Maryland | 0 | 296 | 48 | 236 | 10 |
| Massachusetts | 132 | 55 | 0 | 167 | 136 |
| Michigan | 0 | 96 | 0 | 11 | 151 |

**Table 3.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1983—Continued**

[In millions of dollars]

| State | Type of Activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| Minnesota | 168 | 140 | 1 | 0 | 109 |
| Mississippi | 20 | 8 | 0 | 8 | 82 |
| Missouri | 0 | 177 | 58 | 0 | 34 |
| Montana | 34 | 16 | 0 | 1 | 75 |
| Nebraska | 0 | 9 | 0 | 0 | 6 |
| Nevada | 0 | 17 | 16 | 0 | 53 |
| New Hampshire | 42 | 0 | 0 | 0 | 75 |
| New Jersey | 0 | 48 | 67 | 4 | 102 |
| New Mexico | 42 | 11 | 0 | 0 | 22 |
| New York | 0 | 367 | 107 | 31 | 48 |
| North Carolina | 0 | 44 | 6 | 0 | 23 |
| North Dakota | 0 | 1 | 0 | 5 | 21 |
| Ohio | 198 | 7 | 20 | 3 | 140 |
| Oklahoma | 0 | 177 | 29 | 0 | 49 |
| Oregon | 0 | 0 | 6 | 0 | 0 |
| Pennsylvania | 201 | 30 | 41 | 18 | 125 |
| Rhode Island | 0 | 13 | 0 | 0 | 0 |
| South Carolina | 50 | 4 | 0 | 40 | 192 |
| South Dakota | 25 | 10 | 0 | 9 | 9 |
| Tennessee | 0 | 70 | 0 | 13 | 17 |
| Texas | 259 | 1,117 | 329 | 30 | 230 |
| Utah | 50 | 40 | 25 | 2 | 118 |
| Vermont | 75 | 8 | 0 | 2 | 0 |
| Virginia | 299 | 173 | 1 | 33 | 51 |
| Washington | 0 | 0 | 88 | 0 | 6 |
| West Virginia | 0 | 28 | 0 | 2 | 23 |
| Wisconsin | 46 | 7 | 0 | 2 | 2 |
| Wyoming | 0 | 3 | 0 | 0 | 211 |

[1] Volume for new issues is the purchase price of the bonds minus the amount used to refund previously issued obligations.

Source: Office of the Secretary of the Treasury.

**Table 4.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1984**

[In millions of dollars]

| State | Type of activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| United States, total | 1,680 | 5,028 | 3,770 | 6,601 | 7,616 |
| Alabama | 0 | 0 | 29 | 55 | 260 |
| Alaska | 0 | 2 | 27 | 0 | 0 |
| Arizona | 0 | 66 | 20 | 402 | 198 |
| Arkansas | 0 | 17 | 4 | 29 | 13 |
| California | 426 | 927 | 339 | 552 | 309 |
| Colorado | 0 | 113 | 1 | 20 | 117 |
| Connecticut | 309 | 71 | 8 | 35 | 72 |
| Delaware | 0 | 7 | 0 | 0 | 168 |
| Florida | 12 | 470 | 417 | 1,002 | 214 |
| Georgia | 0 | 223 | 0 | 524 | 1,016 |
| Hawaii | 0 | 0 | 66 | 0 | 0 |
| Idaho | 37 | 0 | 4 | 0 | 9 |
| Illinois | 132 | 96 | 887 | 38 | 85 |
| Indiana | 0 | 25 | 53 | 87 | 400 |
| Iowa | 11 | 40 | 0 | 0 | 0 |
| Kansas | 0 | 39 | 0 | 100 | 114 |
| Kentucky | 41 | 4 | 163 | 61 | 69 |
| Louisiana | 196 | 104 | 41 | 198 | 389 |
| Maine | 0 | 14 | 0 | 0 | 0 |
| Maryland | 14 | 407 | 62 | 0 | 62 |
| Massachusets | 122 | 22 | 49 | 112 | 11 |
| Michigan | 0 | 66 | 0 | 426 | 97 |
| Minnesota | 60 | 123 | 15 | 172 | 39 |
| Mississippi | 0 | 20 | 0 | 149 | 84 |
| Missouri | 0 | 204 | 41 | 61 | 235 |
| Montana | 68 | 0 | 0 | 13 | 29 |
| Nebraska | 0 | 4 | 61 | 0 | 0 |
| Nevada | 0 | 63 | 0 | 0 | 13 |
| New Hampshire | 5 | 22 | 0 | 15 | 108 |
| New Jersey | 0 | 30 | 85 | 293 | 339 |
| New Mexico | 0 | 20 | 65 | 0 | 17 |
| New York | 0 | 314 | 342 | 174 | 343 |
| North Carolina | 0 | 73 | 22 | 9 | 280 |
| North Dakota | 128 | 3 | 2 | 19 | 33 |

**Table 4.—Volume of New Issue Bonds for Selected Activities,[1] by State, 1984—Continued**

[In millions of dollars]

| State | Type of activity | | | | |
|---|---|---|---|---|---|
| | Student loan bonds | Multi-family housing | Airport and dock, etc. | Sewage and waste disposal | Pollution control |
| Ohio | 0 | 64 | 29 | 42 | 220 |
| Oklahoma | 0 | 112 | 3 | 128 | 0 |
| Oregon | 0 | 0 | 26 | 57 | 3 |
| Pennsylvania | 200 | 53 | 25 | 606 | 571 |
| Rhode Island | 0 | 33 | 17 | 210 | 0 |
| South Carolina | 0 | 36 | 5 | 261 | 227 |
| South Dakota | 49 | 0 | 0 | 0 | 0 |
| Tennessee | 0 | 215 | 234 | 0 | 3 |
| Texas | 25 | 402 | 476 | 334 | 881 |
| Utah | 0 | 52 | 0 | 90 | 155 |
| Vermont | 0 | 0 | 0 | 1 | 0 |
| Virginia | 88 | 287 | 68 | 234 | 39 |
| Washington | 46 | 122 | 85 | 50 | 27 |
| West Virginia | 0 | 26 | 0 | 0 | 25 |
| Wisconsin | 20 | 10 | 0 | 2 | 23 |
| Wyoming | 0 | 0 | 0 | 0 | 319 |
| Others | 0 | 26 | 0 | 41 | 0 |

[1]Volume for new issues is the purchase price of the bond minus the amount used to refund earlier obligations.

Source: Office of the Secretary of the Treasury.

### *Use of small-issue IDBs by State*

Table 5 sets forth the volume of small-issue IDBs for 1983 and 1984, by State. The table indicates that the volume of small-issue IDBs varies significantly from State to State. For example, for 1984, Pennsylvania issued $1.480 billion of small-issue IDBs while Hawaii issued no such bonds.

**Table 5.—Volume of Small-Issue IDBs Issued, by State, 1983–1984**

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| United States, total | 13,879 | 16,949 |
| Alabama | 260 | 365 |
| Alaska | 159 | 89 |
| Arizona | 285 | 318 |
| Arkansas | 155 | 102 |
| California | 382 | 492 |
| Colorado | 212 | 218 |
| Connecticut | 119 | 203 |
| Delaware | 77 | 134 |
| Florida | 512 | 541 |
| Georgia | 505 | 745 |
| Hawaii | 0 | 0 |
| Idaho | 8 | 18 |
| Illinois | 579 | 728 |
| Indiana | 380 | 359 |
| Iowa | 211 | 186 |
| Kansas | 183 | 178 |
| Kentucky | 173 | 218 |
| Louisiana | 380 | 406 |
| Maine | 40 | 60 |
| Maryland | 322 | 561 |
| Massachusetts | 362 | 503 |
| Michigan | 273 | 631 |
| Minnesota | 565 | 585 |
| Mississippi | 108 | 111 |
| Missouri | 577 | 383 |
| Montana | 81 | 59 |
| Nebraska | 98 | 110 |
| Nevada | 26 | 21 |
| New Hampshire | 61 | 90 |
| New Jersey | 810 | 1,009 |
| New Mexico | 94 | 59 |
| New York | 574 | 1,149 |

**Table 5.—Volume of Small-Issue IDBs Issued, by State, 1983–1984—Continued**

[In millions of dollars]

| State | 1983 | 1984 |
|---|---|---|
| North Carolina | 177 | 349 |
| North Dakota | 56 | 20 |
| Ohio | 645 | 661 |
| Oklahoma | 106 | 116 |
| Oregon | 37 | 78 |
| Pennsylvania | 1,231 | 1,480 |
| Rhode Island | 67 | 60 |
| South Carolina | 178 | 301 |
| South Dakota | 23 | 42 |
| Tennessee | 677 | 679 |
| Texas | 786 | 969 |
| Utah | 155 | 165 |
| Vermont | 13 | 72 |
| Virginia | 691 | 996 |
| Washington | 80 | 100 |
| West Virginia | 133 | 80 |
| Wisconsin | 231 | 309 |
| Wyoming | 22 | 45 |

Source: Office of the Secretary of the Treasury.

### *State volume limitations for private activity bonds*

Since 1983, the issuance of private activity bonds[1] (i.e., most IDBs[2] and student loan bonds) has been subject to State volume limitations. The applicable limitations are equal to the greater of $150 per resident of the State or $200 million. Table 6 shows the applicable private State activity bond volume limitations for 1984.

**Table 6.—1984 State Volume Limits on Tax-Exempt Student Loan Bonds and Certain IDBs**

[In thousands of dollars]

| State | 1984 volume limit[1] |
|---|---|
| United States, total | 36,561,775 |
| Alabama | 591,450 |
| Alaska | 200,000 |
| Arizona | 499,170 |
| Arkansas | 343,650 |
| California | 3,708,600 |
| Colorado | 456,750 |
| Connecticut | 472,950 |
| D.C. | 200,000 |
| Delaware | 200,000 |
| Florida | 1,562,400 |
| Georgia | 845,850 |
| Hawaii | 200,000 |
| Idaho | 200,000 |
| Illinois | 1,717,200 |
| Indiana | 820,650 |
| Iowa | 435,750 |
| Kansas | 361,200 |
| Kentucky | 550,050 |
| Louisiana | 654,300 |
| Maine | 200,000 |
| Maryland | 639,750 |
| Massachusetts | 867,150 |
| Michigan | 1,366,350 |

[1] IDBs for multifamily residential rental property and certain governmentally owned convention, trade show, and transportation property (including airports) are not subject to these volume limitations.

[2] The term private activity bond is defined more narrowly for purposes of the State volume limitations than for the information reporting requirement, discussed in II.D., above. Under the information reporting requirement, the term includes all IDBs, student loan bonds, and bonds for section 501(c)(3) organizations.

**Table 6.—1984 State Volume Limits on Tax-Exempt Student Loan Bonds and Certain IDBs—Continued**

[In thousands of dollars]

| State | 1984 volume limit[1] |
|---|---|
| Minnesota | 619,950 |
| Mississippi | 382,650 |
| Missouri | 742,650 |
| Montana | 200,000 |
| Nebraska | 237,900 |
| Nevada | 200,000 |
| New Hampshire | 200,000 |
| New Jersey | 1,115,700 |
| New Mexico | 203,850 |
| New York | 2,648,850 |
| North Carolina | 902,850 |
| North Dakota | 200,000 |
| Ohio | 1,618,650 |
| Oklahoma | 476,550 |
| Oregon | 397,350 |
| Pennsylvania | 1,779,750 |
| Rhode Island | 200,000 |
| South Carolina | 480,450 |
| South Dakota | 200,000 |
| Tennessee | 697,650 |
| Texas | 2,292,000 |
| Utah | 253,220 |
| Vermont | 200,000 |
| Virginia | 830,500 |
| Washington | 636,750 |
| West Virginia | 292,200 |
| Wisconsin | 714,750 |
| Wyoming | 200,000 |
| Puerto Rico | 487,650 |
| Virgin Island | 14,910 |
| American Samoa | 4,950 |
| Guam | 16,485 |
| Trust Territory of the Pacific | 17,745 |
| Northern Mariana Islands | 2,595 |

[1] The State volume limit equals the greater of $200 million or $150 per capita. Three States (Arizona, Utah, and Virginia) had additional transitional volume equal to one-half the difference between the annualized volume and the $150 per capita amount in 1984.

Source: Internal Revenue Service.

***Nature of the subsidy provided by tax-exempt financing***

Table 7 sets forth the ratio of the average interest rates on long-term tax-exempt bonds to the average interest rate on taxable obligations for selected years. The ratio provides a measure of the depth of the subsidy provided by tax-exempt financing. Together with the marginal tax bracket of the average investor in tax-exempt bonds, the ratio also provides a measure of the efficiency of tax-exempt financing as a means of subsidizing eligible activities. In general, as the yield on tax-exempt obligations more closely approaches that on taxable obligations, a higher portion of the subsidy flows to the investor in tax-exempt obligations (in the form of increased after-tax yields) rather than to the eligible activity (in the form of reduced borrowing costs). The table 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.

**Table 7.—Comparison of Yields on Taxable and Tax-Exempt Bonds, 1950–1984**

| Year | Average taxable yield [1] | Average tax-exempt bond yield [2] | Ratio of tax-exempt to taxable yield |
|---|---|---|---|
| 1950 | 2.86 | 1.90 | 0.664 |
| 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 |
| 1983 | 12.78 | 9.51 | .744 |
| 1984 | 13.49 | 10.10 | .749 |

[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, 1970–1984***

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 bonds as a percentage of the principal amount of the bonds. If 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 equivalent to the amount of the cost of the facilities financed by the subsidy. (This may also be thought of as an effective tax credit equal to the present value of that amount.) That present 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 for Federal income tax purposes whether the interest is taxable or tax-exempt to the lender.

Table 9 sets forth the percentage values of tax-exemption for various differences in interest rates and average duration of bonds. The amounts in the table are the present value of the interest savings from tax-exempt financing expressed as a percentage of the amount of the loan. For example, if bonds have an average maturity of 15 years, a tax-exempt interest rate 3 points lower than the comparable taxable rate, the subsidy provided by tax-exempt financing is equivalent to a payment of 11.4 percent of the costs of the facility being financed.

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 with mortgage subsidy bonds or student loan bonds), the value of the subsidy would be increased proportionately (e.g., the values for a borrower in a 30-percent marginal tax bracket would be 40 percent higher). (Tax-exemption typically has resulted in reduced interest rates of from 2 to 4 percentage points, with the average being approximately 3 percentage points in recent years.)

**Table 8.—Present Value of Tax-Exempt Financing Expressed as a Percentage of the Amount of the Bonds**

| | Difference in interest rate | | |
|---|---|---|---|
| | 2 percentage points | 3 percentage points | 4 percentage points |
| Average life of bonds: | | | |
| 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 9 and 10 present statistics on the major owners of tax-exempt bonds, by dollar amount and as a percentage of total bonds outstanding. During the period 1972 through 1984, the percentage of State and local government bonds held by banks and thrift institutions decreased from 51.1 percent to 32.1 percent. During this same period, holdings by mutual funds increased from 27.4 percent to 38.1 percent. Private households held between 25.0 percent (in 1978) and 38.1 percent (in 1984) of the total bonds outstanding during this period.

## Table 9.—Ownership of Tax-Exempt State-Local Bonds by Class of Holder, 1972–1984 [1] Volume

[In millions of dollars]

| Class of holder | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Households | 48,373 | 53,658 | 61,860 | 68,061 | 70,070 | 70,148 | 72,738 | 82,719 | 89,879 | 100,810 | 132,803 | 173,831 | 205,308 |
| Nonfinancial corporate business | 4,175 | 4,038 | 4,654 | 4,481 | 3,419 | 3,468 | 3,658 | 3,687 | 3,490 | 3,470 | 3,536 | 4,201 | 4,066 |
| State and local governments | 1,833 | 2,062 | 2,586 | 4,969 | 7,341 | 7,920 | 7,238 | 6,788 | 7,008 | 7,139 | 8,718 | 9,521 | 9,954 |
| Commercial banks | 89,960 | 95,656 | 101,148 | 102,927 | 105,976 | 115,155 | 126,205 | 135,583 | 149,199 | 154,174 | 158,690 | 162,540 | 171,961 |
| Savings and loan associations | 165 | 185 | 500 | 1,508 | 1,225 | 1,200 | 1,275 | 1,150 | 1,190 | 1,305 | 838 | 907 | 920 |
| Mutual savings banks | 873 | 921 | 930 | 1,545 | 2,417 | 2,828 | 3,335 | 2,930 | 2,390 | 2,288 | 2,470 | 2,177 | 2,075 |
| Mutual funds | 0 | 0 | 0 | 0 | 525 | 2,156 | 2,684 | 4,040 | 6,357 | 9,278 | 21,130 | 31,451 | 44,847 |
| Life insurance companies | 3,367 | 3,412 | 3,667 | 4,508 | 5,594 | 6,051 | 6,402 | 6,428 | 6,701 | 7,151 | 9,047 | 9,986 | 9,425 |
| State and local government retirement funds | 2,029 | 1,691 | 983 | 1,940 | 3,360 | 3,544 | 3,951 | 3,910 | 4,059 | 3,856 | 3,131 | 1,957 | 1,500 |
| Other insurance companies | 24,820 | 28,462 | 30,662 | 33,273 | 38,679 | 49,390 | 62,931 | 72,811 | 80,533 | 83,923 | 86,968 | 86,667 | 87,193 |
| Brokers and dealers | 912 | 1,130 | 705 | 631 | 901 | 1,065 | 864 | 1,046 | 1,064 | 1,220 | 1,047 | 1,400 | 2,000 |
| Total | 176,507 | 191,215 | 207,695 | 223,843 | 239,507 | 262,925 | 291,281 | 321,092 | 351,870 | 374,614 | 428,378 | 484,638 | 539,249 |

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

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

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

**Table 10.—Ownership of Tax-Exempt State-Local Bonds by Class of Holder, 1972–1984 [1] Percent**

| Class of holder | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Households | 27.4 | 28.1 | 29.8 | 30.4 | 29.3 | 26.7 | 25.0 | 25.8 | 25.5 | 26.9 | 31.0 | 35.9 | 38.1 |
| Nonfinancial corporate business | 2.4 | 2.1 | 2.2 | 2.0 | 1.4 | 1.3 | 1.3 | 1.1 | 1.0 | .9 | .8 | 0.9 | 0.8 |
| State and local governments | 1.0 | 1.1 | 1.2 | 2.2 | 3.1 | 3.0 | 2.5 | 2.1 | 2.0 | 1.9 | 2.0 | 2.0 | 1.8 |
| Commercial banks | 51.0 | 50.0 | 48.7 | 46.0 | 44.2 | 43.8 | 43.3 | 42.2 | 42.4 | 41.2 | 37.0 | 33.5 | 31.9 |
| Savings and loan associations | .1 | .1 | .2 | .7 | .5 | .5 | .4 | .4 | .3 | .3 | .2 | .2 | .2 |
| Mutual savings banks | .5 | .5 | .4 | .7 | 1.0 | 1.1 | 1.1 | .9 | .7 | .6 | .6 | .4 | .4 |
| Mutual funds | 0 | 0 | 0 | 0 | .2 | .8 | .9 | 1.3 | 1.8 | 2.5 | 4.9 | 6.5 | 8.3 |
| Life insurance companies | 1.9 | 1.8 | 1.8 | 2.0 | 2.3 | 2.3 | 2.2 | 2.0 | 1.9 | 1.9 | 2.1 | 2.1 | 1.7 |
| State and local government retirement funds | 1.1 | .9 | .5 | .9 | 1.4 | 1.3 | 1.4 | 1.2 | 1.2 | .0 | .7 | .4 | .3 |
| Other insurance companies | 14.1 | 14.9 | 14.8 | 14.9 | 16.1 | 18.8 | 21.6 | 22.7 | 22.9 | 22.4 | 20.3 | 17.9 | 16.2 |
| Brokers and dealers | .5 | .6 | .3 | .3 | .4 | .4 | .3 | .3 | .3 | .3 | .2 | .3 | .4 |
| 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.

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

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

## B. Statistical Data Relating to Mortgage Subsidy Bonds

### *Volume of mortgage subsidy bonds*

The volume of mortgage subsidy bonds for the period 1980 through 1984 is shown in Table 11. State and local governments issued a total of $12.8 billion of qualified mortgage bonds (i.e., single-family mortgage bonds other than veterans' mortgage bonds) in 1984, or approximately 11 percent of total State and local government borrowing. By contrast, in 1980, the volume of qualified mortgage bonds was $10.5 billion (19.3 percent of State and local government borrowing), while for 1981 (a comparatively depressed year for the housing industry) the volume was $2.8 billion (5.1 percent).

Since 1984 only five States are authorized to issue qualified veterans' mortgage bonds. These five States are the only States that have issued such bonds historically. Table 12 shows the volume of veterans' mortgage bonds issued during the period 1980 through 1984. In 1983 and 1984, States issued approximately $600 million per year of qualified veterans' mortgage bonds, or approximately 0.65 percent of total State and local government borrowing.

**Table 11.—Volume of Qualified Mortgage Bonds Issued, by State, 1980–1984**

[In millions of dollars]

| State | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| United States, total | 10,821 | 3,673 | 8,627 | 10,982 | 12,758 |
| Alabama | 150 | 100 | 200 | 200 | 198 |
| Alaska | 460 | 200 | 235 | 200 | 200 |
| Arizona | 133 | 0 | 192 | 114 | 105 |
| Arkansas | 196 | 47 | 100 | 200 | 107 |
| California | 1,601 | 446 | 1,865 | 1,429 | 2,193 |
| Colorado | 473 | 135 | 163 | 228 | 241 |
| Connecticut | 178 | 200 | 200 | 200 | 200 |
| Delaware | 191 | 0 | 40 | 39 | 75 |
| D.C. | 0 | 0 | 57 | 0 | 100 |
| Florida | 612 | 475 | 406 | 544 | 597 |
| Georgia | 115 | 0 | 157 | 56 | 186 |
| Hawaii | 150 | 20 | 60 | 141 | 100 |
| Idaho | 56 | 30 | 4 | 90 | 56 |
| Illinois | 52 | 20 | 191 | 261 | 432 |
| Indiana | 150 | 0 | 75 | 200 | 200 |
| Iowa | 0 | 0 | 14 | 36 | 200 |
| Kansas | 433 | 356 | 146 | 141 | 201 |

**Table 11.—Volume of Qualified Mortgage Bonds Issued, by State, 1980–1984—Continued**

[In millions of dollars]

| State | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Kentucky | 55 | 36 | 31 | 181 | 200 |
| Louisiana | 496 | 350 | 149 | 190 | 200 |
| Maine | 70 | 0 | 54 | 122 | 91 |
| Maryland | 210 | 141 | 281 | 198 | 256 |
| Massachusetts | 75 | 0 | 200 | 214 | 237 |
| Michigan | 114 | 25 | 30 | 200 | 145 |
| Minnesota | 326 | 201 | 218 | 172 | 280 |
| Mississippi | 150 | 0 | 151 | 127 | 200 |
| Missouri | 133 | 0 | 200 | 200 | 211 |
| Montana | 50 | 0 | 55 | 200 | 75 |
| Nebraska | 200 | 0 | 137 | 200 | 180 |
| Nevada | 30 | 0 | 60 | 98 | 200 |
| New Hampshire | 60 | 0 | 167 | 60 | 50 |
| New Jersey | 130 | 15 | 275 | 171 | 332 |
| New Mexico | 75 | 20 | 118 | 80 | 106 |
| New York | 125 | 105 | 402 | 376 | 445 |
| North Carolina | 58 | 55 | 0 | 186 | 110 |
| North Dakota | 0 | 0 | 29 | 120 | 73 |
| Ohio | 0 | 0 | 0 | 410 | 335 |
| Oklahoma | 739 | 100 | 25 | 200 | 200 |
| Oregon | 165 | 0 | 125 | 15 | 0 |
| Pennsylvania | 23 | 85 | 266 | 280 | 293 |
| Rhode Island | 149 | 65 | 72 | 190 | 200 |
| South Carolina | 0 | 0 | 83 | 100 | 80 |
| South Dakota | 162 | 0 | 24 | 200 | 200 |
| Tennessee | 350 | 50 | 150 | 197 | 200 |
| Texas | 1,076 | 156 | 622 | 801 | 1,015 |
| Utah | 150 | 0 | 122 | 198 | 198 |
| Vermont | 75 | 0 | 35 | 58 | 48 |
| Virginia | 121 | 100 | 266 | 238 | 366 |
| Washington | 0 | 0 | 0 | 199 | 175 |
| West Virginia | 229 | 0 | 25 | 87 | 201 |
| Wisconsin | 125 | 20 | 150 | 185 | 191 |
| Wyoming | 150 | 75 | 0 | 200 | 74 |
| Puerto Rico | 0 | 0 | 0 | 250 | 200 |

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

**Table 12.—Volume of Veterans' Mortgage Bonds Issued, by State, 1980–1984**

[In millions of dollars]

| State | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Alaska | 0 | 0 | 0 | 475 | 632 |
| California | 652 | 250 | 150 | 250 | 710 |
| Oregon | 900 | 620 | 300 | 0 | 131 |
| Texas | 0 | 0 | 0 | 0 | 500 |
| Wisconsin | 0 | 0 | 30 | 20 | 50 |
| Total | 1,552 | 870 | 480 | 745 | 1,992 |

Note.—The amounts listed are for tax-exempt general obligation bonds issued only for mortgage loans to veterans. Therefore, the data does not include revenue bonds issued for the purchase of land only or issued primarily for other purposes. These issues are included in other classifications, such as IDBs.

Source: Joint Committee on Taxation.

### *State volume limitations*

Issuance of qualified mortgage bonds and qualified veterans' mortgage bonds is subject to separate annual State volume limitations. The qualified mortgage bond volume limitation is equal to the greater of (1) 9 percent of average mortgage originations for single-family owner-occupied residences in the State during the preceding 3 years, or (2) $200 million. Table 13 shows the 1984 qualified mortgage bond volume limitation applicable to each State.

Qualified veterans' mortgage bonds may be issued only by States that issued such bonds before June 22, 1984, and the annual volume of these bonds is limited by reference to issuances during the period 1979 through June 22, 1984. Table 14 shows the applicable State volume limitations for qualified veterans' mortgage bonds.

**Table 13.—1984 State Volume Limitations for Qualified Mortgage Bonds**

[In millions of dollars]

| State | Safe harbor ceiling |
|---|---|
| United States, total | 14,454 |
| Alabama | 200 |
| Alaska | 200 |
| Arizona | 211 |
| Arkansas | 200 |
| California | 1,756 |
| Colorado | 294 |
| Connecticut | 200 |

**Table 13.—1984 State Volume Limitations for Qualified Mortgage Bonds—Continued**

[In millions of dollars]

| State | Safe harbor ceiling |
|---|---|
| Delaware | 200 |
| D.C. | 200 |
| Florida | 597 |
| Georgia | 200 |
| Hawaii | 200 |
| Idaho | 200 |
| Illinois | 432 |
| Indiana | 200 |
| Iowa | 200 |
| Kansas | 200 |
| Kentucky | 200 |
| Louisiana | 200 |
| Maine | 200 |
| Maryland | 265 |
| Massachusetts | 200 |
| Michigan | 234 |
| Minnesota | 200 |
| Mississippi | 200 |
| Missouri | 200 |
| Montana | 200 |
| Nebraska | 200 |
| Nevada | 200 |
| New Hampshire | 200 |
| New Jersey | 331 |
| New Mexico | 200 |
| New York | 445 |
| North Carolina | 202 |
| North Dakota | 200 |
| Ohio | 346 |
| Oklahoma | 200 |
| Oregon | 200 |
| Pennsylvania | 347 |
| Rhode Island | 200 |
| South Carolina | 200 |
| South Dakota | 200 |
| Tennessee | 200 |
| Texas | 1,014 |
| Utah | 200 |
| Vermont | 200 |
| Virginia | 365 |
| Washington | 215 |
| West Virginia | 200 |
| Wisconsin | 200 |
| Wyoming | 200 |
| Puerto Rico | 200 |

Source: Internal Revenue Service.

**Table 14.—1984 State Volume Limitations for Qualified Veterans' Mortgage Bonds**

[In millions of dollars]

| State | Volume limitation |
| --- | --- |
| Alaska | 302 |
| California | 340 |
| Oregon | 584 |
| Texas | 250 |
| Wisconsin | 72 |

Source: Joint Committee on Taxation.

**Table 14.—1984 State Volume Limitations for Qualified Veterans' Mortgage Bonds**

[In millions of dollars]

| State | Volume limitation |
|---|---|
| Alaska | 302 |
| California | 340 |
| Oregon | 584 |
| Texas | 250 |
| Wisconsin | 72 |

Source: Joint Committee on Taxation.

### *Effect of volume limitations*

The effect of the State volume limitations on qualified mortgage bonds is illustrated by the data provided in Table 15. Note that, in 1984, the $200 million limit was greater than 9 percent of average mortgage activity in 36 states (and Puerto Rico). Also, in 1984, the State volume limitations varied between 75.2 percent of total mortgage originations for Vermont to 4.7 percent for New York.

**Table 15.—Comparison of Statutory State Volume Limitations for Qualified Mortgage Bonds and Total Mortgage Originations, by State, 1984**

[In millions of dollars]

| | State volume limitations | Total mortgage originations | State volume limitations as a percent of total mortgage originations |
|---|---|---|---|
| United States, total | 14,454 | 169,311 | 8.5 |
| Alabama | 200 | 1,498 | 13.4 |
| Alaska | 200 | 702 | 28.5 |
| Arizona | 211 | 3,564 | 5.9 |
| Arkansas | 200 | 1,095 | 18.3 |
| California | 1,756 | 36,276 | 4.8 |
| Colorado | 294 | 4,899 | 6.0 |
| Connecticut | 200 | 2,909 | 6.9 |
| Delaware | 200 | 350 | 57.1 |
| D.C. | 200 | 560 | 35.7 |
| Florida | 597 | 9,791 | 6.1 |
| Georgia | 200 | 3,572 | 5.6 |
| Hawaii | 200 | 1,265 | 15.8 |
| Idaho | 200 | 376 | 53.2 |
| Illinois | 432 | 6,105 | 7.1 |
| Indiana | 200 | 2,338 | 8.6 |
| Iowa | 200 | 926 | 21.6 |
| Kansas | 200 | 1,294 | 15.5 |
| Kentucky | 200 | 1,124 | 17.8 |
| Louisiana | 200 | 2,205 | 9.1 |
| Maine | 200 | 588 | 34.0 |
| Maryland | 265 | 4,564 | 5.8 |
| Massachusetts | 200 | 3,886 | 5.1 |
| Michigan | 234 | 3,358 | 7.0 |
| Minnesota | 200 | 2,277 | 8.8 |
| Mississippi | 200 | 1,168 | 17.1 |

**Table 15.—Comparison of Statutory State Volume Limitations for Qualified Mortgage Bonds and Total Mortgage Originations, by State, 1984—Continued**

[In millions of dollars]

| | State volume limitations | Total mortgage originations | State volume limitations as a percent of total mortgage originations |
|---|---|---|---|
| Missouri | 200 | 2,553 | 7.8 |
| Montana | 200 | 460 | 43.5 |
| Nebraska | 200 | 648 | 30.9 |
| Nevada | 200 | 1,130 | 17.7 |
| New Hampshire | 200 | 820 | 24.4 |
| New Jersey | 331 | 6,560 | 5.0 |
| New Mexico | 200 | 953 | 21.0 |
| New York | 445 | 9,431 | 4.7 |
| North Carolina | 202 | 3,233 | 6.2 |
| North Dakota | 200 | 338 | 59.2 |
| Ohio | 346 | 4,987 | 6.9 |
| Oklahoma | 200 | 1,938 | 10.3 |
| Oregon | 200 | 810 | 24.7 |
| Pennsylvania | 347 | 5,753 | 6.0 |
| Rhode Island | 200 | 443 | 45.1 |
| South Carolina | 200 | 1,566 | 12.8 |
| South Dakota | 200 | 283 | 70.7 |
| Tennessee | 200 | 2,331 | 8.6 |
| Texas | 1,014 | 13,373 | 7.6 |
| Utah | 200 | 1,324 | 15.1 |
| Vermont | 200 | 266 | 75.2 |
| Virginia | 365 | 6,378 | 5.7 |
| Washington | 215 | 3,287 | 6.5 |
| West Virginia | 200 | 561 | 35.7 |
| Wisconsin | 200 | 2,307 | 8.7 |
| Wyoming | 200 | 410 | 48.8 |
| Puerto Rico | 200 | 478 | 41.8 |

Source: Office of Financial Management, U.S. Department of Housing and Urban Development, and Internal Revenue Service.

### *Purchase price levels*

Table 16 sets forth data that 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 1983, approximately 83.8 percent (67.9 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 83.8 percent or more of first time purchasers would have qualified under the average area purchase price limitations applicable to qualified mortgage bonds.

Table 17 shows the applicable price limitations for selected areas.

**Table 16.—Percent of Homes Sold to First-Time Purchasers at Less Than Selected Percentages of Average Purchase Prices in 1983**

| Percentage of average purchase price | 80 | 90 | 100 | 110 | 120 |
|---|---|---|---|---|---|
| Percent of homes measured by: | | | | | |
| Number | 55.8 | 67.5 | 75.8 | 83.8 | 88.3 |
| Value | 36.2 | 48.7 | 58.0 | 67.9 | 74.2 |

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

**Table 17.—Average Purchase Price Safe Harbor Limitations for Single Family Residences for Selected Areas**

| State and area designation | Average area purchase price safe harbor limitations for single family residences | |
|---|---|---|
| | New residences | Existing residences |
| Alabama: | | |
| All areas | $72,400 | $59,100 |
| Arkansas: | | |
| All areas | 86,100 | 84,900 |
| California: | | |
| Bakersfield MSA | 110,400 | 107,000 |
| Oakland PMSA | 153,100 | 149,200 |
| Sacramento MSA | 92,800 | 109,200 |

**Table 17.—Average Purchase Price Safe Harbor Limitations for Single Family Residences for Selected Areas—Continued**

| State and area designation | Average area purchase price safe harbor limitations for single family residences | |
|---|---|---|
| | New residences | Existing residences |
| Colorado: | | |
| Boulder-Longmont PMSA | 114,900 | 124,700 |
| Connecticut: | | |
| Hartford PMSA | 82,800 | 94,500 |
| Delaware: | | |
| Wilmington (DE-NI-MD) | 75,900 | 58,400 |
| Florida: | | |
| Tampa-St. Petersburg-Clearwater MSA | 76,700 | 76,400 |
| Georgia: | | |
| Atlanta MSA | 100,000 | 95,100 |
| All other areas | 62,700 | 61,600 |
| Hawaii: | | |
| All areas | 137,300 | 124,600 |
| Idaho: | | |
| All areas | 88,300 | 78,300 |
| Illinois: | | |
| Chicago PMSA | 113,600 | 94,400 |
| Indiana: | | |
| All areas | 46,700 | 55,400 |
| Iowa: | | |
| All areas | 70,100 | 51,200 |
| Kansas: | | |
| Wichita MSA | 80,000 | 74,400 |
| Louisiana: | | |
| All areas | 83,700 | 93,400 |
| Maine: | | |
| All areas | 66,800 | 64,300 |
| Massachusetts: | | |
| Boston PMSA | 88,500 | 99,300 |
| Michigan: | | |
| Grand Rapids MSA | 66,900 | 67,900 |
| Minnesota: | | |
| Minneapolis-St. Paul (MN-WI) MSA | 91,800 | 99,700 |
| All other areas | 57,200 | 56,600 |
| Missouri: | | |
| St. Louis (MO-IL) PMSA | 84,600 | 71,400 |
| Montana: | | |
| All areas | 70,400 | 86,800 |
| Nebraska: | | |
| All areas | 106,000 | 68,100 |
| New Hampshire: | | |
| All areas | 77,300 | 78,400 |

**Table 17.—Average Purchase Price Safe Harbor Limitations for Single Family Residences for Selected Areas—Continued**

| State and area designation | Average area purchase price safe harbor limitations for single family residences | |
|---|---|---|
| | New residences | Existing residences |
| New Jersey: | | |
| Newark PSMA | 136,300 | 122,000 |
| All other areas | 87,300 | 89,300 |
| New York: | | |
| Nassau-Suffolk PMSA | 122,000 | 110,000 |
| New York PMSA | 121,200 | 123,400 |
| Rochester MSA | 81,100 | 73,400 |
| Syracuse MSA | 71,300 | 58,900 |
| All other areas | 59,000 | 48,200 |
| North Dakota: | | |
| All areas | 70,400 | 86,800 |
| Ohio: | | |
| Akron PMSA | 81,000 | 70,800 |
| Cincinnati (OH-KY-IN) PMSA | 101,500 | 83,500 |
| Oklahoma: | | |
| All areas | 70,000 | 73,600 |
| Oregon: | | |
| Portland PMSA | 85,600 | 81,300 |
| Pennsylvania: | | |
| Philadelphia (PA-NJ) MSA | 88,600 | 71,400 |
| Pittsburgh PMSA | 96,500 | 67,000 |
| Rhode Island: | | |
| Providence PMSA | 67,800 | 61,500 |
| South Carolina: | | |
| Greenville-Spartenburg MSA | 83,100 | 54,800 |
| Tennessee: | | |
| Nashville MSA | 79,300 | 78,600 |
| All other areas | 88,100 | 56,000 |
| Texas: | | |
| Austin MSA | 104,200 | 108,500 |
| Houston PMSA | 99,700 | 107,600 |
| Wyoming: | | |
| All areas | 70,400 | 86,800 |

Source: Internal Revenue Service.

### *First-time home-purchasers*

Table 18 shows the percentage of homebuyers 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 persons being considered first-time purchasers.) From 1976 to 1983, the percentage of homes purchased by first-time purchasers varied from 44.8 percent in 1976 to 40.5 percent in 1983, with a mean of 39.95 percent.

**Table 18.—Percentage of Homes Purchased by First-Time Purchasers, 1976–1983**

| Year | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|---|---|
| Percentage........ | 44.8 | 48.1 | 36.7 | 36.6 | 32.9 | 39.4 | 40.6 | 40.5 |

Source: U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1985.*

## C. Revenue Effect

Table 19 indicates the estimated revenue cost ("tax expenditure") for private activity tax-exempt bonds during the next five fiscal years. For this purpose, private activity bonds include all IDBs, student loan bonds, mortgage subsidy bonds, and bonds for the benefit of charitable organizations (described in sec. 501 (c)(3)). The total fiscal year revenue cost for 1986 through 1990 from bonds to finance private activities is estimated at $68.5 billion. These estimates assume that the present law "sunsets" for qualified mortgage bonds (1987) and small-issue IDBs (1986 generally) remain in effect.

**Table 19.—Estimated Revenue Cost for Private Activity Bonds, Fiscal Years 1986–1990**

[In billions of dollars]

| Type of bond | 1986 | 1987 | 1988 | 1989 | 1990 | 1986–90 |
|---|---|---|---|---|---|---|
| Total private activity bonds | 11.0 | 12.4 | 13.9 | 15.1 | 16.1 | 68.5 |
| Exempt organization bonds | 2.1 | 2.5 | 2.9 | 3.3 | 3.8 | 14.6 |
| Exempt activity IDBs: | | | | | | |
| Pollution control bonds | 1.1 | 1.2 | 1.3 | 1.4 | 1.6 | 6.6 |
| Airport, dock, etc. bonds | 0.5 | 0.5 | 0.6 | 0.7 | 0.8 | 3.1 |
| Solid waste facility bonds | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 1.7 |
| Energy production facility bonds | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | 1.1 |
| Mass transit bonds | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.5 |
| Multifamily residential rental housing | 1.0 | 1.2 | 1.4 | 1.7 | 1.9 | 7.2 |
| Student loan bonds | 0.4 | 0.5 | 0.5 | 0.6 | 0.6 | 2.6 |
| Mortgage subsidy bonds: | | | | | | |
| Qualified mortgage bonds | 2.2 | 2.5 | 2.8 | 2.8 | 2.6 | 12.9 |

**Table 19.—Estimated Revenue Cost for Private Activity Bonds, Fiscal Years 1986-1990—Continued**

[In billions of dollars]

| Type of bond | 1986 | 1987 | 1988 | 1989 | 1990 | 1986-90 |
|---|---|---|---|---|---|---|
| Veterans' mortgage bonds | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 | 1.8 |
| Small-issue IDBs | 2.8 | 3.0 | 3.3 | 3.5 | 3.5 | 16.1 |

Source: Joint Committee on Taxation.

Revenue effects of tax-exempt bonds traditionally have been expressed as the revenue foregone on a year-by-year basis as a result of the issuance of the bonds. 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 is helpful to express the revenue effect of these obligations in terms of the total value of future revenue losses. Table 20 indicates projected future revenue losses from bonds forecast to be issued in calendar year 1985. For example, the $6.9 billion of bonds for multifamily residential rental property forecast to be issued in calendar year 1985 is estimated to result in total future revenue losses of $2.9 billion, with a present value of $1.6 billion. Similarly, the $11.2 billion of small-issue IDBs forecast to be issued in 1985 is estimated to result in total future revenue losses of $5.5 billion, with a present value of $2.9 billion.

**Table 20.—Various Measures of Total Revenue Cost of Private Activity Tax-Exempt Bonds Issued in 1985**

[In billions of dollars]

| Type of bond | Dollar amount of estimated 1985 bond issues | Total revenue loss attributable to bonds issued in 1985 | Present value of total in year of issue |
|---|---|---|---|
| Exempt organization bonds | 10.8 | 7.8 | 3.6 |
| Exempt activity bonds: | | | |
| Pollution control bonds | 3.7 | 2.4 | 1.1 |
| Airport, dock, etc. bonds | 1.9 | 1.2 | .6 |
| Solid waste facility bonds | 1.1 | .7 | .3 |
| Energy production facility bonds | .8 | .5 | .2 |
| Multifamily residential rental property bonds | 6.9 | 2.9 | 1.6 |
| Student loan bonds | 2.8 | .7 | .5 |

**Table 20.—Various Measures of Total Revenue Cost of Private Activity Tax-Exempt Bonds Issued in 1985—Continued**

[In billions of dollars]

| Type of bond | Dollar amount of estimated 1985 bond issues | Total revenue loss attributable to bonds issued in 1985 | Present value of total in year of issue |
|---|---|---|---|
| Mortgage subsidy bonds: | | | |
| Qualified mortgage bonds | 12.5 | 5.1 | 3.0 |
| Veterans' mortgage bonds | 1.5 | .6 | .4 |
| Small-issue IDBs | 11.2 | 5.5 | 2.9 |

Source: Joint Committee on Taxation.

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