

## CHAPTER 11

### REFORM TREATMENT OF STATE AND LOCAL GOVERNMENT DEBT AND INVESTMENTS

This Chapter discusses proposals to limit the tax exemption of interest on State and local obligations to its proper scope -- the financing of governmental activities, such as schools and roads for State and local governments. Future issues of nongovernmental bonds would not be exempt from Federal income tax. Restrictions on arbitrage with respect to tax-exempt obligations would be tightened, and advance refundings would be prohibited. Finally, the general stock ownership corporation provisions would be repealed as deadwood.

# REPEAL TAX EXEMPTION FOR NONGOVERNMENTAL BONDS

## General Explanation

### Chapter 11.01

#### Current Law

Interest on State and local obligations generally is exempt from Federal income tax. In many cases, proceeds from the issuance of tax-exempt bonds are made available for use by private businesses, certain tax-exempt organizations, homeowners and students, as well as for use by State and local governments.

**Industrial development bonds.** State and local government obligations are classified as industrial development bonds ("IDBs") if the bond proceeds are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on the bonds is derived from or secured by money or property used in a trade or business. Interest on IDBs as a general rule is taxable, but interest on two categories of IDBs is tax exempt: (1) IDBs that qualify as exempt small issues, and (2) IDBs issued to finance certain exempt activities.

Exempt small issue IDBs can be issued in amounts of \$1 million or less to assist any principal user in the acquisition, construction or improvement of land or depreciable property located in any one city or county. The \$1 million limitation may be increased to \$10 million if the aggregate amount of capital expenditures of the principal users in the particular jurisdiction do not exceed \$10 million over a six-year period. Current law also provides an exemption for interest on IDBs used to finance certain specific exempt activities. Any land, buildings or other property that is functionally related and subordinate to the exempt facility also may be financed through tax-exempt bonds.

**Mortgage subsidy bonds.** State and local governments may issue mortgage subsidy bonds to finance mortgages on owner-occupied residences. There are two categories of mortgage subsidy bonds that are tax-exempt: (1) qualified mortgage bonds, and (2) qualified veterans' mortgage bonds. Qualified mortgage bonds provide mortgage financing for qualified homebuyers. Qualified veterans' mortgage bonds provide mortgage financing for certain veterans, but may be issued only by States with programs in place before June 22, 1984.

**Other nongovernmental bonds.** Tax-exempt obligations may be issued for certain tax-exempt organizations such as nonprofit hospitals and educational institutions. Tax-exempt student loan bonds

may be issued to finance educational and related expenses by nonprofit corporations or public agencies or instrumentalities of a State. Finally, other tax-exempt bonds that are not IDBs may be used to provide financing to nongovernmental entities, businesses and individuals.

### Reasons for Change

The exemption from Federal income tax of interest on State and local government obligations exists as a matter of comity between the Federal government and State and local governments. This tax exemption lowers the cost to State and local governments of financing public facilities, such as schools, roads and sewers. Increasingly, however, State and local governments have used their tax-exempt financing privilege to obtain funds for use by nongovernmental persons. Thus, State and local tax-exempt obligations are now commonly used to provide financing for private businesses, residential mortgages, nonprofit corporations and student loans. Table 1 shows the volume of long-term tax-exempt bond issues from 1975 to 1983 by type of activity. A total of \$58 billion of such nongovernmental bonds was issued in 1983, accounting for 61 percent of all long-term tax-exempt bonds issued that year.

Tax-exempt nongovernmental bonds have caused serious erosion in the Federal income tax base, lowering tax receipts and forcing increases in the tax rates on nonexempt income. The revenues lost as a result of tax-exempt nongovernmental bonds represent an indirect Federal subsidy program, based in the tax code, and thus significantly free of the scrutiny that attaches to direct Federal expenditures. In many cases, the issuer of nongovernmental bonds would not spend its own revenues to support the activities that are Federally subsidized through tax-exempt nongovernmental bonds.

The Federal subsidy provided through tax-exempt bonds is inefficient because the subsidy is filtered through high-income investors. Because part of the subsidy is captured by these investors, the revenue loss to the Federal government is approximately 33-50 percent higher than the benefits received by the borrower.

Tax-exempt nongovernmental bonds also have anti-competitive and distortive effects on the economy. Activities receiving tax-exempt financing have a significant advantage over their competitors, which must raise capital with higher-cost taxable obligations. Yet, the availability of tax-exempt financing for nongovernmental persons depends upon which jurisdictions have the necessary programs in place and upon the ability of persons to negotiate through obstacles of State and local law and procedure. These factors have little relation to the value or efficiency of particular activities, and ought not to influence the allocation of capital among sectors of the economy.

Table 11.01-1

## Volume of Long-Term Tax-Exempt Bonds by Type of Activity, 1975-1983

(In billions of dollars)

	Calendar Years								
	1975	1976	1977	1978	1979	1980	1981	1982	1983
Total issues, long-term tax exempts <u>1/</u> .....	30.5	35.0	46.9	49.1	48.4	54.5	55.1	84.9	93.3
Nongovernmental tax exempts .....	8.9	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1
Housing bonds .....	1.4	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0
Single-family mortgage subsidy bonds .....	*	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0
Multi-family rental housing bonds .....	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3
Veterans general obligation bonds .....	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7
Private exempt entity bonds <u>2/</u> .....	1.8	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7
Student loan bonds .....	*	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3
Pollution control industrial development bonds .....	2.1	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5
Small-issue industrial development bonds .....	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6
Other industrial development bonds <u>3/</u> .....	2.3	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0
Other tax-exempt bonds <u>4/</u> .....	21.6	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2

Office of the Secretary of the Treasury

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Note: Totals may not add due to rounding.

\* \$50 million or less.

1/ Total reported volume from Credit Markets (formerly the Bond Buyer) adjusted for privately placed small-issue IDBs.

2/ Private-exempt entity bonds are obligations of Internal Revenue Code Section 501(c)(3) organizations such as private nonprofit hospitals and educational facilities.

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

4/ Some of these may be nongovernmental bonds.

Finally, the volume of tax-exempt nongovernmental bonds has worked to the detriment of bonds issued to provide financing for State and local governments. As a result of the issuance of these additional securities, tax-exempt interest rates must rise in order to attract additional capital. This increases costs for State and local governments, with no corresponding increase in the level of government services provided. Moreover, these increased costs are borne by all State and local governments, not simply those issuing nongovernmental bonds.

### Proposal

Interest on obligations issued by a State or local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government. Generally, use of a facility financed with proceeds of tax-exempt obligations would be considered to be use of those proceeds. The proposal would preserve the tax exemption for obligations issued to finance ordinary government operations, such as tax anticipation notes, as well as those issued to finance the acquisition or construction of government buildings.

Under an exception to the general rule, use of tax-exempt financed facilities by a nongovernmental person would be permissible if the facilities were available for use by the general public on the same basis. Use of or access to a facility by a nongovernmental person on a basis other than that available to the general public could be shown by a formal or informal agreement with the nongovernmental person or by locating a facility at a site to which the general public does not have ready access. For example, extension of a road, sewer or other system serving the general public to a newly constructed house or business could be financed on a tax-exempt basis. On the other hand, construction of an airstrip adjacent to a business that would be its primary user could not be financed through the issuance of tax-exempt bonds. Use of a facility by a nongovernmental person would not qualify for the exception simply because there was also some use of the facility by the general public. Thus, an airport terminal leased to an airline that ultimately provides service to the public could not be financed on a tax-exempt basis, since the airline's use of the terminal is on a basis different than that available to the general public.

In addition, a de minimis exception would allow use of tax-exempt financed facilities by a nongovernmental person pursuant to a short-term (one year or less) management contract. Thus, for example, a solid waste disposal facility serving the general public could be financed with tax-exempt obligations if it were owned by a city and operated by the city or by a private manager under a short-term management contract. If the proceeds of the financing were made

available to a nongovernmental person to construct a privately-owned solid waste disposal facility, however, the bonds would not be tax-exempt.

In general, the lease of all or part of a government-owned facility to a nongovernmental person would disqualify the portion so leased for tax-exempt financing. This rule would not apply to leases for a brief interim period, i.e., leases of one year or less for the period immediately after the facility was substantially completed.

Allocation rules would permit tax-exempt financing for a proportionate share of the cost of a facility used in part for governmental and in part for nongovernmental purposes. For example, a government-owned and operated electric generating facility which by contract sold 10 percent of its output over its entire life to an investor-owned utility, and supplied its remaining power directly to the general public, could have 90 percent of its costs financed on a tax-exempt basis.

Finally, an exception to the nongovernmental use rule would permit bond proceeds to be (a) used to fund a reasonably required reserve fund, (b) invested for the initial temporary period before use for the governmental purpose of the borrowing, or (c) deposited in a bona fide debt service fund.

The proposal would extend to all tax-exempt bonds the IDB reporting requirements, and would retain certain other existing restrictions, including the prohibition against Federal guarantees, arbitrage restrictions, registration requirements and limitations on bonds granted tax-exemption by Federal law other than the Internal Revenue Code. Most other provisions of Internal Revenue Code section 103 would be repealed. Since State and local governments would no longer be entitled to issue mortgage subsidy bonds under the proposal, the mortgage credit certificate program would be terminated.

#### Effective Date

The proposal would be effective for obligations issued on or after January 1, 1986. A transition rule would be provided for current refundings of outstanding obligations if the refunding does not extend the weighted average maturity date of the obligations outstanding at the time of the refunding or exceed the outstanding amount of the refunded obligation.

#### Analysis

The proposal would replace the standard for tax-exemption in current law, which grants tax-exempt status to obligations on the basis of their qualifying as student loan bonds, mortgage subsidy

bonds, veterans' mortgage bonds, small issue IDBs, exempt activity IDBs or other tax-exempt non-IDBs, with a new standard for determining the tax-exempt status of obligations. The proposal would virtually eliminate (rather than limit through a volume ceiling) the Federal subsidy currently made available to nongovernmental persons through tax-exempt financing. State and local governments would, however, retain the ability to finance projects with tax-exempt obligations if the proceeds are not used by nongovernmental persons.

Under any given set of tax rates, elimination of nongovernmental tax-exempt bonds would cause the spread between tax-exempt and taxable interest rates to increase, due to a lower volume of tax-exempt obligations. Thus, the value of the Federal subsidy provided to governmental activities financed with tax-exempt bonds would increase. The proposal would, of course, increase financing costs for nongovernmental persons currently receiving tax-exempt financing. Such increase, however, would simply restore parity among all nongovernmental persons in the competition for capital.

LIMIT TAX ARBITRAGE AND ADVANCE  
REFUNDING FOR TAX-EXEMPT BONDS

General Explanation

Chapter 11.02

Current Law

Interest on State and local obligations generally is exempt from Federal income tax. An issuer of tax-exempt bonds may borrow at tax-exempt rates and earn "arbitrage" by investing the borrowed amounts in obligations that pay higher returns. Current law denies tax-exempt status to interest on bonds issued with the expectation that the proceeds will be used to earn arbitrage in excess of specified amounts.

Restrictions on Arbitrage. Treasury regulations apply different arbitrage restrictions to different types of obligations acquired with bond proceeds. "Acquired purpose obligations" are obligations acquired to carry out the purpose of the bond issue. Permissible arbitrage on acquired purpose obligations generally is limited to a spread between the yield on the bonds and the yield on the acquired purpose obligations of 0.125 percent plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying and repaying the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming or selling the obligation of the bond user. All obligations other than acquired purpose obligations acquired with bond proceeds are "acquired nonpurpose obligations." The arbitrage spread for investments of bond proceeds in acquired nonpurpose obligations is restricted to 0.125 percent plus certain costs. There are two principal exceptions to these rules. First, unlimited arbitrage is permitted on bond proceeds invested for a temporary period prior to use, without regard to whether such proceeds are held by the user or the issuer. The temporary period is generally three years for new money financings and up to two years for a refunding transaction. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percent plus allowable costs with respect to obligations subject to yield restrictions. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund ("4R fund"). Additional arbitrage restrictions apply to other types of tax-exempt obligations, as discussed below.

Calculation of Yield. The limitations on permissible arbitrage earnings under current law require a comparison of the yield on the bonds and the yield on the acquired obligations. In computing yield, current law permits various costs to be taken into account that either increase bond yield or decrease acquired obligation yield. The result is to increase the amount of permissible arbitrage that issuers may earn. One court has held that bond yield is the discount rate at which the present value of all payments of principal and interest on

the bonds equals the net proceeds of the issue after deducting the costs of issuing the bonds. Permitting issuance costs to reduce net proceeds results in a corresponding increase in the bond yield. The effect of calculating bond yield in this fashion is that the bond issuer is permitted to earn an amount equal to issuance costs out of arbitrage. This method of calculating bond yield does not apply for mortgage subsidy bond rebate purposes, where bond yield is based on the initial offering price to the public (excluding bond houses and brokers). In addition, premiums paid to insure a bond issue are treated as additional interest on the issue (to the extent that the present value of the premiums does not exceed the present value of the interest savings) with a resulting increase in the yield on the bond issue. Similarly, the yield on acquired purpose obligations is calculated by excluding from the payments to be received with respect to such obligations a portion of the payments having a present value equal to the costs of issuing, carrying or repaying the bonds, the underwriter's spread and the costs of purchasing, carrying, redeeming or selling acquired purpose obligations. The bond issuer cannot use the same cost to both increase bond yield and decrease yield on acquired obligations.

**Advance Refundings.** Current law permits the advance refunding of certain tax-exempt bonds. For this purpose, an advance refunding generally is defined as the issuance of bonds to retire another bond issue on a date after the issuance date of the refunding bonds. Advance refundings of industrial development bonds and mortgage subsidy bonds are generally prohibited. For industrial development bonds and mortgage subsidy bonds, however, an advance refunding is defined as the issuance of bonds to retire another bond issue more than 180 days after the issuance date of the refunding bonds. Permissible arbitrage on advance refunding issues, in addition to that earned during any applicable temporary period, basically is limited to interest on \$25,000 at the bond rate, plus an amount sufficient to recover reasonable administrative costs.

**Special Arbitrage Rules for Certain Bonds.** Current law applies special arbitrage rules to certain types of tax-exempt bonds. Mortgage subsidy bonds are permitted to earn an arbitrage spread of 1.125 percent on acquired purpose obligations (the mortgages). Arbitrage earned on nonpurpose obligations must be paid to the mortgagors or to the United States. The amount of bond proceeds that can be invested in nonpurpose obligations at a yield above the bond yield is limited to 150 percent of annual debt service for the bond year. Certain industrial development bonds issued after December 31, 1984, are subject to an arbitrage rebate requirement and a limitation on investment in nonpurpose obligations similar to those imposed on mortgage subsidy bonds. Student loan bonds and other obligations issued in connection with certain governmental programs are generally permitted an arbitrage spread of 1.5 percent plus reasonable administrative costs on the acquired purpose obligations. Interest subsidies paid by the Department of Education can be excluded in determining yield on the acquired purpose obligations (student loans) for student loan bond issues.

## Reasons for Change

Under current law, the exclusion from Federal income tax of interest on State and local government obligations provides two separate benefits to State and local issuers. The basic benefit is the reduction in interest cost for the financing. The additional benefit, however, is the ability of the issuer to invest bond proceeds to earn arbitrage. Arbitrage consists of the amounts directly permitted as arbitrage spread and amounts earned when yield restrictions do not apply. By virtue of the definition of yield, the spread includes issuance costs and bond insurance premiums.

Current law is overly generous in that it allows issuers or bond users to retain the economic benefit of all permissible arbitrage, even though many of the rules permitting arbitrage (those for temporary periods and 4R funds, for example) are intended only to reduce the complexity of the arbitrage restrictions. Moreover, because the current rules generally prevent only the issuance of bonds that are expected to earn arbitrage and do not prohibit the retention of arbitrage ultimately earned, issuers and bond users often are rewarded with substantial amounts of "unexpected" arbitrage.

Arbitrage has two undesirable results. First, it may be used for activities ineligible for tax-exempt bond financing, since arbitrage is not subject to the use limitations applicable to proceeds of tax-exempt bonds. Second, arbitrage also increases the volume of tax-exempt bonds. This increase in volume occurs for several reasons. First, the availability of arbitrage makes feasible bond issues that otherwise would be uneconomical. For example, since issuance costs for advance refundings can be recovered out of arbitrage, such bonds may be issued even though issuance costs dwarf the economic benefit to the issuer or the bond user. Bond counsel and underwriters benefit from the resulting lack of motivation on the part of the issuer to restrain costs. Second, the arbitrage encourages issuers to sell more bonds than are necessary in order to invest the excess proceeds in higher yielding investments. Finally, the arbitrage encourages issuers to sell bonds earlier or keep them outstanding longer than is necessary in order to invest the proceeds to earn the arbitrage. For example, it was recently reported that New York City will earn \$3 million in legal arbitrage simply by extending the maturity of its tax anticipation notes five months beyond the date on which the taxes will be collected.

Advance refundings of tax-exempt bonds also have the undesirable effect of increasing the volume of tax-exempt bonds. Advance refundings result in twice as many bonds being outstanding as are required for a given project.

Increased bond volume brought about by arbitrage and advance refundings increases the Federal revenue loss associated with tax-exempt bonds, thereby causing taxpayers all over the country to pay additional taxes to support this subsidy of selected governmental issuers. Furthermore, additional volume in the tax-exempt bond market

raises the interest rates that must be paid to finance State and local government projects. This expansion also results in pressure for additional Federal aid for those projects from more jurisdictions because of the increased cost of providing the governmental services.

### Proposal

Issuers of tax-exempt bonds would be required to rebate to the United States all arbitrage on acquired nonpurpose obligations (adjusted for gains and losses on the obligations and earnings on the gains and on the arbitrage). Investments in acquired nonpurpose obligations would be limited to 150 percent of annual debt service with exceptions for the initial temporary period and for bona fide debt service funds.

Yield on the bond issue would be determined without regard to the underwriter's discount, costs of issuance, credit enhancement fees or other costs. Calculation of yield on acquired obligations also would be changed to prevent any reduction for costs.

The reasonable expectations test would be clarified to provide explicitly that it only protects inadvertent errors and not intentional acts to create arbitrage. For example, any fund that will be used to pay debt service on an issue will be subject to the rebate requirement regardless of whether its creation or its arbitrage was anticipated at the time of the tax-exempt bond issuance.

Temporary period rules permitting unlimited arbitrage until bond proceeds are used would be made more strict than the current rules. There would be no temporary period for bond issues to finance acquisitions. The temporary period for construction projects would terminate when the project is substantially completed or when an amount equal to bond proceeds has been expended on the project and would in all cases be limited to three years. The right to waive the temporary period and earn a yield exceeding the bond yield by 0.5 percent would be repealed.

[Early issuance of bonds for a project would be prohibited. The issuer would be required to spend a significant part of the bond proceeds within one month and spend all bond proceeds (excluding proceeds in a 4R fund) within three years of issuance.]

Advance refundings would be prohibited for all tax-exempt bonds. Refundings would be permitted only if the proceeds of the refunding bonds are used immediately to retire the prior bond issue.

### Effective Date

The proposal would be effective for obligations issued on or after January 1, 1986.

## Analysis

The proposal's rebate requirement would eliminate most of the economic motivation to issue tax-exempt bonds to earn arbitrage. In addition, arbitrage earned on obligations that are issued for governmental functions would not result in a windfall profit for the issuer. Proposed changes in the method of calculating yield and in the reasonable expectations test are necessary to implement the rebate requirement properly.

The prohibition of advance refundings would result in a reduction in the aggregate volume of tax-exempt obligations being issued. Individual bond issues would be limited in size by the proposal's restriction on the amount of investments in acquired nonpurpose obligations. In addition, [the period during which bonds may be outstanding would be limited by the proposal's restrictions on temporary periods and early issuance. The reductions in both the overall volume and individual size of bond issues would reduce the Federal revenue cost of tax-exempt bonds and would also reduce the interest costs to issuers of obtaining financing for governmental functions.]

State and local governments would continue to fulfill necessary governmental functions. Governmental facilities and services could still be financed on a tax-exempt basis. Issuers, however, would not obtain the unnecessary "double dipping" provided by arbitrage in addition to the basic benefit of reduced interest cost.

The proposal would eliminate many complex provisions in the Code and in the Treasury regulations interpreting the Code. The rules on advance refundings would be unnecessary and those dealing with yield computation would be simplified. The special arbitrage rules for certain bonds under current law also would be unnecessary because these bonds would not be exempt under the proposal for repeal of tax exemption for nongovernmental bonds.

# REPEAL GENERAL STOCK OWNERSHIP CORPORATION PROVISIONS

## General Explanation

### Chapter 11.03

#### Current Law

Current law authorizes a State to establish a General Stock Ownership Corporation ("GSOC") for the benefit of its citizens. A GSOC meeting certain statutory requirements and making an appropriate election is exempt from Federal income tax. Instead, the shareholders of the GSOC are taxable on their daily pro rata share of the GSOC's taxable income. The GSOC computes its taxable income in the same manner as a regular corporation, but is not eligible for the dividends-received deduction. Losses of a GSOC do not flow through to its shareholders, but the GSOC is allowed a 10-year net operating loss carryforward.

Current law permits such corporations to be chartered after December 31, 1978, and before January 1, 1984.

#### Reasons for Change

No GSOC has been organized under this law and the period during which they may be formed has expired.

#### Proposal

The proposal would repeal the law permitting creation of GSOCs.

#### Effective Date

The proposal would be effective as of January 1, 1984, the sunset date for creation of GSOCs.

#### Analysis

The complex provisions governing organization and operation of GSOCs have never been utilized. Repeal of these provisions would simplify the Code and have no economic effect. There would be no impact on revenues or expenditures as a result of implementing this proposal.