PRESENT LAW AND BACKGROUND RELATING TO STATE AND LOCAL GOVERNMENT BONDS

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on March 16, 2006

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

March 14, 2006
JCX-14-06

CONTENTS

INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for March 16, 2006, on State and local government bonds. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the present law and background relating to State and local government bonds.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to State and Local Government Bonds* (JCX-14-06), March 14, 2006.

I. GENERAL OVERVIEW OF THE TAX SUBSIDY PROVIDED FOR STATE AND LOCAL BONDS

A. Tax-Exempt Bonds

In general

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code[2] requirements are met.

In addition to formally 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 computers or other office 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, and (2) the amounts are true interest (as opposed to other payments labeled as interest).[3] However, interest paid by State and local governments other than pursuant to the exercise of their borrowing power is not tax-exempt (e.g., interest on State income tax refunds).

Permitted Issuers

Qualified governmental units

Tax-exempt bonds must be issued by or on behalf of a State[4] or local government, or any political subdivision thereof ("qualified governmental units"). If 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 frequently are issued by entities with limited sovereign powers (e.g., an economic development authority). In such cases, the determination of whether the

---

[2] All section references are to the Internal Revenue Code of 1986 ("the Code") unless otherwise indicated.

[3] See Rev. Rul. 60-179, 1960-1 C.B. 37; Rev. Rul. 72-399, 1972-2 C.B. 73.

[4] For this purpose, the term "State" includes the District of Columbia and any possession of the United States (e.g., Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands).

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).[5]

On behalf of entities

In addition to issuing bonds directly, State or local governments may establish other entities to issue bonds "on behalf of" such governmental units. These "on behalf of" corporations developed historically because some State laws and constitutions defined the purposes for which the State could issue bonds more narrowly than Federal tax law did. For example, qualified scholarship funding bonds are bonds issued by specially constituted nonprofit corporations acting on behalf of governmental units to facilitate the making of student loans.[6] Similarly, a nonprofit corporation might own, operate, and issue debt to finance a local airport. The general requirements that must be satisfied by these nonprofit corporations are specified in two administrative determinations of the Internal Revenue Service.[7]

Indian tribal governments

Although not States or subdivisions of States, Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.[8] Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.[9]

Qualified Purposes

Governmental bonds

Qualified governmental units generally may issue governmental 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. For example, governmental bonds are not subject to

---

[5] See *Commissioner v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945).*

[6] Sec. 150(d).

[7] Rev. Rul. 63-20, 1963-1 C.B. 24; Rev. Proc. 82-26, 1982-1 C.B. 476.

[8] Sec. 7871.

[9] Sec. 7871(c).

issuance cost, maturity, and annual volume limitations that generally apply to qualified private activity bonds (see Part IV, below, for a general discussion of tax-exempt bond requirements).

Qualified private activity bonds

In addition to issuing bonds for government operations and services, present law permits qualified governmental units to issue qualified private activity bonds to provide tax-exempt financing for certain private activities. In these cases, the qualified governmental unit generally acts as a conduit, that is, the qualified governmental unit issues the bonds, but the nongovernmental person[10] receiving the benefit of tax-exempt financing (the "conduit borrower") is the obligor on the bonds.

The definition of a qualified private activity bond includes an exempt facility bond,[11] or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[12]

Present law also provides special rules for qualified private activity bonds issued within certain geographic areas (e.g., enterprise or empowerment zones, the New York Liberty Zone, and the Gulf Opportunity Zone) to provide incentives for businesses to locate in those areas.

The general requirements for qualified private activity bonds are discussed in Part IV, below.

Benefits and cost of the subsidy

Issuer benefit

Tax-exempt financing provides a direct Federal subsidy to at least two parties to each transaction, the borrower (i.e., either the qualified governmental unit or the conduit borrower) and the bond investor (the lender). Because interest income on the bonds is excluded from gross income, the bond investor is willing to accept a lower rate on the bonds than he might otherwise accept on a taxable investment. Thus, the qualified issuer receives an implicit Federal subsidy equal to the difference between the tax-exempt interest rate paid and the taxable rate that

---

[10] For these purposes, the term "nongovernmental person" generally includes the Federal Government and all other individuals and entities other than States or local governments.

[11] Exempt facility bonds are bonds issued to finance: (1) airports; (2) docks and wharves; (3) mass commuting facilities; (4) high-speed intercity rail facilities; (5) facilities for the furnishing of water; (6) sewage facilities; (7) solid waste disposal facilities; (8) hazardous waste disposal facilities; (9) qualified residential rental projects; (10) facilities for the local furnishing of electric energy or gas; (11) local district heating or cooling facilities; (12) environmental enhancements of hydroelectric generating facilities; (13) qualified public educational facilities; (14) qualified green building and sustainable design projects; or (15) qualified highway or surface freight transfer facilities (sec. 142(a)).

[12] Sec. 141(e).

otherwise would be paid. In this way, the income exclusion lowers the cost of capital for the State and local governments (or private parties in the case of private activity bonds).

The following example illustrates the Federal subsidy measured as a percentage of the otherwise applicable taxable rate. Assume a school district may borrow either at a taxable rate of 6.25 percent or a tax-exempt rate of 4.5 percent. The yield spread in this example is 1.75 percentage points and the ratio of tax-exempt to taxable rates is .72, or 72 percent, and the subsidy is equal to 28 percent of the otherwise applicable taxable rate.[13] To illustrate the benefit of the subsidy in dollar terms, if the school district borrows $1 million at the taxable rate of 6.25 percent and $1 million at the tax-exempt rate of 4.5 percent, the school district's annual interest payments would be $62,500 on the taxable debt, but $45,000 on the tax-exempt debt, a $17,500 savings. In practice, however, this calculation overstates the issuer's interest savings because of certain inefficiencies associated with the issuance of tax-exempt bonds (explained below).

Finally, as the ratio of tax-exempt rates to taxable debt rates moves closer to one (i.e., the spread between tax-exempt and taxable debt narrows), the value of the subsidy to the issuer also diminishes. Among other reasons, this may occur as the volume of tax-exempt bond issuances increases and tax-exempt issuers respond by offering higher interest rates to attract investors. (See Table 1, below, comparing the average tax-exempt rate on high-grade municipal bonds and the average taxable rate on corporate bonds for the period 1986-2005).

[13] Column 5 of Table 1, below, may be used to illustrate the measure of the subsidy measured as a percentage of the otherwise applicable taxable rate for the period 1986-2005.

Table 1.−Comparison of Taxable Interest Rates and Tax-Exempt Interest Rates, 1986-2005

Year	Corporate Bonds[1] [Percent]	High-Grade Municipal Bonds[1] [Percent]	Yield Spread	Implied Tax Rate of Marginal Holder [Percent]
1986	9.02	7.38	1.64	18
1987	9.38	7.73	1.65	18
1988	9.71	7.76	1.95	20
1989	9.26	7.24	2.02	22
1990	9.32	7.25	2.07	22
1991	8.77	6.89	1.88	21
1992	8.14	6.41	1.73	21
1993	7.22	5.63	1.59	22
1994	7.96	6.19	1.77	22
1995	7.59	5.95	1.64	22
1996	7.37	5.75	1.62	22
1997	7.26	5.55	1.71	24
1998	6.53	5.12	1.41	22
1999	7.04	5.43	1.61	23
2000	7.62	5.77	1.85	24
2001	7.08	5.19	1.89	27
2002	6.49	5.05	1.44	22
2003	5.67	4.73	0.94	17
2004	5.63	4.63	1.00	18
2005	5.24	4.29	1.05	18

[1] Annual average bond yield.
Source: Economic Report of the President, 2006, Table B-73.

Investor benefit

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 investment. The investor's willingness to purchase tax-exempt bonds also depends on the investor's marginal tax rate. Generally, all other things being equal (such as credit worthiness), a taxpayer is indifferent between a tax-exempt bond and a taxable bond with an equivalent after-tax yield.[14] To illustrate using the example from above, if a taxpayer with a 28-percent marginal tax rate purchased a $1 million taxable bond at a 6.25-percent rate, as an alternative to the tax-exempt bond, he would receive $62,500 in interest income and pay $17,500 in income tax for a net return of $45,000 and an after-tax yield of 4.5 percent. This is the same net return the taxpayer receives if he were to purchase the $1 million tax-exempt bond. Thus, this investor generally would be indifferent to a taxable investment with a 6.25-percent rate and a tax-exempt investment with a 4.5-percent rate.

With many investors in different tax brackets, taxpayers in higher marginal tax-brackets receive a larger tax benefit than those in lower brackets. For example, if a taxpayer with a 33-percent marginal tax rate purchased the alternative $1 million taxable bond at a 6.25-percent rate, he would receive $62,500 in interest income and pay $20,625 in income tax for a net return of $41,875 and an after-tax yield of 4.19 percent. However, this taxpayer would receive a 4.5 percent net return on the school district's tax-exempt bond. Thus, unlike the taxpayer in the 28-percent marginal tax rate who is indifferent to investment in taxable or tax-exempt bonds, the taxpayer in the 33-percent marginal tax rate receives a greater benefit by purchasing the tax-exempt bond. In contrast, a taxpayer with a 15-percent marginal tax rate receives no benefit from purchasing the tax-exempt bond.

Revenue loss associated with tax-exempt bonds

The direct cost to the Federal government of the interest exclusion for State and local bonds is the income tax revenue forgone. Under our example, if the taxpayer with a 28-percent marginal tax rate purchases the school district's $1 million tax-exempt bond with a 4.5-percent interest rate, the taxpayer receives $45,000 of tax-exempt interest income for each year the bond is outstanding. However, assuming the taxpayer's preferred alternative investment is a taxable bond, the actual revenue loss to the Federal government is based upon the taxable yield the taxpayer forgoes. For example, if the taxpayer purchased the taxable bond at a 6.25-percent rate, rather than the tax-exempt bond, he would have received $62,500 in interest income and paid $17,500 in income tax. In this case, the revenue forgone to the Federal Government equals the interest savings of the school district.

However, using the example from above, if the taxpayer in the 33-percent bracket purchases the school district's tax-exempt bond it costs the Federal Government $20,625 ($62,500 of interest income taxed at a 33-percent rate). Due to the existence of multiple tax

[14] This may be represented as $r_e = (1-t)r$, where r_e is the tax-exempt yield, t is the investor's marginal tax rate, and r is the taxable bond yield.

brackets, the loss of Federal receipts is greater than the reduction in the tax-exempt issuer's interest savings. In this case, the $17,500 interest subsidy realized by the school district costs the Federal Government $20,625. The difference accrues to investors in tax brackets higher than those that would be implied by the yield spread between taxable and tax-exempt bonds. Thus, if a taxpayer in the 28-percent bracket finds it profitable to hold a tax-exempt security, a taxpayer in the 33-percent bracket will find it even more profitable. This implies that the Federal Government will lose more in revenue than the tax-exempt issuer gains in reduced interest payments. This is one source of inefficiency to the subsidy provided by the tax exemption.

Issuance costs

Generally, issuing tax-exempt bonds to finance capital costs is a complex and expensive process. In addition to the issuer and investor, there are a number of parties employed to facilitate a bond issuance (e.g., investment bankers and attorneys). The requirements for tax exemption may result in higher incremental costs of issuance for tax-exempt bonds than those associated with issuing taxable bonds. Because a portion of the benefits of tax exemption flows to these intermediaries in the way of fees, such fees are a second potential source of inefficiency resulting from tax-exempt financing.

Arbitrage potential

The lower borrowing cost obtained through tax-exempt bonds provides the opportunity to earn arbitrage profits by investing tax-exempt bond proceeds in higher yielding investments, unless such transactions are restricted. Arbitrage transactions have no economic substance, but are made profitable solely through the ability to borrow at tax-exempt rates. If permitted to earn and retain arbitrage profits, issuers would have a substantial incentive to issue more bonds, to issue them earlier, and to leave them outstanding longer than necessary. From a Federal standpoint, arbitrage is an inefficient alternative to additional borrowing, because it is more costly to the Federal Government in terms of forgone tax revenue than the additional borrowing that would be necessary to produce the same amount of proceeds.

As discussed in Part IV, C, below, present law generally restricts the ability of qualified governmental units and other parties to earn and retain arbitrage profits.

B. Tax-Credit Bonds

In general

As an alternative to traditional tax-exempt bonds, the Code permits three types of tax-credit bonds. States and local governments have the authority to issue qualified zone academy bonds ("QZABS"), clean renewable energy bonds ("CREBS"), and "Gulf tax credit bonds."[15] The specific requirements for QZABS, CREBS, and Gulf tax credit bonds are discussed in Part IV, C, below.

Tax-credit bonds are not interest-bearing obligations. Rather, the taxpayer holding a tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount[16] on the holder's bond. For the present law categories of tax-credit bonds, the credit rate on the bonds is determined by the Secretary of the Treasury and is an estimate of the rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

Description of the subsidy

Under present law, the subsidy provided by tax-credit bonds is deeper than the subsidy for tax-exempt bonds. This is because (if the bonds are not issued at discount) the issuer of tax-credit bonds pays no interest, only principal.[17] The "interest" is paid by the Federal Government in the form of tax credits. Thus, the issuer theoretically has an interest-free loan. In comparison, issuers of tax-exempt bonds pay both interest and principal on such obligations albeit less interest than if the debt were taxable. As noted above, the Federal subsidy provided to issuers of tax-exempt bonds is limited to the difference between the tax-exempt interest rate paid and the taxable bond rate that otherwise would be paid.

---

[15] Secs. 1397E, 54, and 1400N(l), respectively.

[16] The "face amount" (or par value) represents the value of a bond at maturity as stated on the bond certificate.

[17] On the other hand, if tax-credit bonds are issued at discount, i.e., less than par value, the issuer incurs interest cost to the extent its debt service payments will exceed the amount of proceeds received from the sale of the bonds. This may occur because the rate on a prospective issue of tax-credit bonds is set lower than what investors are willing to accept to purchase the bonds at par value. To illustrate, assume the credit rate on tax-credit bonds with a face amount of $100 is set at five percent. If investors do not view the five percent credit rate as an acceptable return given the riskiness of the investment, they will purchase the bonds for something less than $100, e.g., $90. Because the credit is determined by reference to the face amount of bonds ($100), the investor purchasing tax-credit bonds at a discount ($90) receives a higher yield than the stated credit rate. However, the issuer must repay the full face value of the bonds, $100 in this example, even though it received less than $100 in proceeds.

Though called a tax credit, the Federal subsidy for tax-credit bonds is equivalent to the Federal Government directly paying the interest on a taxable bond issue on behalf of the State or local government benefiting from the bond proceeds.[18] To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of $100 annually. The owner of the bond that receives this payment would receive a net payment of $100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive $72 after Federal taxes. Regardless of whether the State government or the Federal Government pays the interest, the taxpayer receives the same net of tax return of $72. In the case of tax-credit bonds, no formal interest is paid by the Federal Government. Rather, a tax credit of $100 is allowed to be taken by the holder of the bond. In general, a $100 tax credit would be worth $100 to a taxpayer, provided that the taxpayer had at least $100 in tax liability. However, for tax-credit bonds, the $100 credit also has to be claimed as income. Claiming an additional $100 in income costs a taxpayer in the 28-percent tax bracket an additional $28 in income taxes, payable to the Federal Government. With the $100 tax credit that is ultimately claimed, the taxpayer nets $72 of interest income by holding the bond. The Federal Government loses $100 on the credit, but recoups $28 of that by the requirement that it be included in income, for a net cost of $72, which is exactly the net return to the taxpayer. If the Federal Government had simply agreed to pay the interest on behalf of the State or local government, both the Federal Government and the bondholder/taxpayer would be in the same situation. The Federal Government would make outlays of $100 in interest payments, but would recoup $28 of that in tax receipts, for a net budgetary cost of $72, as before. Similarly, the bondholder/taxpayer would receive a taxable $100 in interest, and would owe $28 in taxes, for a net gain of $72, as before. The State or local government also would be in the same situation in both cases.

QZABs, unlike interest-bearing State and local bonds, CREBs, and Gulf tax credit bonds, are not subject to the arbitrage or rebate requirements of the Code. The ability of issuers of QZABs to invest proceeds at unrestricted yields and retain the earnings from such investments, increases the subsidy available for qualified expenditures, as well as the repayment of principal on such bonds, beyond the savings achieved through having the issuer's interest costs paid by the Federal tax credit. Moreover, the ability to earn and retain arbitrage profits provides an incentive for issuers to issue more bonds and to issue them earlier than necessary. As a result, there may be increased delays in the expenditure of bond proceeds for approved purposes in order to earn greater arbitrage profits.[19]

---

[18] This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.

[19] The Treasury Department issued proposed regulations on March 26, 2004 that would require issuers of QZABs to spend proceeds with due diligence. Prop. Reg. sec. 1.1397E-1(h), 69 Fed. Reg. 15747 (March 26, 2004).

Table 2, below, provides an estimate of tax expenditures for governmental bonds, qualified private activity bonds and tax-credit bonds for fiscal years 2006-2010.

Table 2.−Tax Expenditure, Total for 2006-2010
[dollars in billions]

Tax Exempt Bonds:	
Governmental Bonds	149.2
Private Activity Bonds (Total)	47.5
Select Categories of Private Activity Bonds by Purpose:	
Sewage Water, Waste	4.7
Airports, Docks and Mass Commuting	6.0
Nonprofit Health	11.9
Nonprofit Education	7.7
Rental Housing	1.7
Owner Occupied Housing	8.3
Tax Credit Bonds:	
Qualified Zone Academy Bonds ("QZABS")	2.1
Clean Renewable Energy Bonds ("CREBs")	0.2
Gulf Tax Credit Bonds	[less than 50 million]

Source: Joint Committee on Taxation.

II. LEGISLATIVE HISTORY RELATING TO PRIVATE USE OF STATE AND LOCAL BOND PROCEEDS

In general

Federal income tax law has provided an exclusion for interest on bonds issued by or on behalf of State and local governments since the income tax was enacted in 1913. Throughout most of the twentieth century, State and local bonds primarily were issued to finance public infrastructure projects, e.g., schools, roads, public utilities, and mass transit systems. Federal tax law at that time, however, did not distinguish between bonds issued for public as opposed to private purposes.[20]

The 1954 Tax Code (1954-1985)

In 1954, the Internal Revenue Service ruled favorably on the use of tax-exempt revenue bonds[21] to provide financing for private businesses.[22] However, 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 bonds for private activities began to grow rapidly.

In response to the increased volume of bonds issued for private activities, Congress, as part of the Revenue Adjustment Act of 1968 (the "1968 Act"),[23] enacted the first statutory provisions limiting the circumstances under which interest on such bonds would be tax exempt. Specifically, the 1968 Act provided that interest on industrial development bonds ("IDBs," the original private-activity bonds) generally is taxable. IDBs were defined as obligations: (1) more than 25 percent of the proceeds of which were to be used in a trade or business carried on by a nonexempt person (any person other than a governmental unit or a 501(c)(3) organization), and

[20] In fact, until the Supreme Court clarified the issue in a 1988 decision, some questioned whether the Constitution precluded Congress from imposing restrictions on tax-exempt bonds. The exemption for interest on tax-exempt bonds initially was viewed as constitutionally protected under the doctrine of intergovernmental immunities. See *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429, *modified*, 158 U.S. 601 (1895) (holding earlier income tax unconstitutional for various reasons, including the taxation of municipal bond interest). In *South Carolina v. Baker*, 108 S.Ct. 1355 (1988), the Supreme Court rejected the argument that the tax exemption for State and local bonds is constitutionally protected. The Supreme Court's decision in *Baker* removed most constitutional constraints on congressional action to tax and restrict municipal finance.

[21] "Revenue bonds" are bonds payable solely from revenue derived from the property financed with bond proceeds. For example, bonds payable solely from tolls generated from the use of a road financed with such bonds would be revenue bonds. In contrast, "general obligation bonds" are bonds secured by the "full faith and credit" of the issuer, i.e., the issuing government makes an unconditional pledge to use its taxing powers to raise revenues to support debt service payments on the bonds.

[22] Rev. Rul. 54-106, 1954-1 C.B. 28.

[23] Pub. L. No. 90-364.

(2) the payment of more than 25 percent of the principal or interest on which was to be derived from or secured by money or property used in a trade or business.

Congress stated that the interest income on IDBs should be taxable because such bonds "were not 'obligations of a State or any political subdivision' within the meaning of section 103 since the primary obligor was not a State or political subdivision."[24] Exceptions were provided, however, in the form of a list of activities for which tax-exempt IDB financing could be provided[25] and a more general exception for certain small issues (the "small issue exception").

Although the 1968 Act imposed the first statutory restrictions on tax-exempt financing for private activities, it also left large exceptions to the prohibition and issuances continued to increase. In 1975, $8.9 billion of tax-exempt bonds for private activities were issued. By 1980, issuance had increased to $32.5 billion, or more than half the total tax-exempt market.[26] In addition, this period of time saw an increase in the volume of bonds issued to finance mortgage loans for single-family housing ("mortgage subsidy bonds"), which were not affected by the 1968 Act restrictions. State housing finance agencies began issuing mortgage subsidy bonds in the early 1970s and by 1980 the volume had grown to $10.5 billion. This increase in issuance volume led to the Mortgage Subsidy Act of 1980 (the "1980 Act").[27] The 1980 Act limited the tax exemption for mortgage subsidy bonds to two types, qualified veterans' mortgage bonds and qualified mortgage bonds (see Part IV, below, for present-law requirements). The 1980 Act also imposed a volume limitation on mortgage bonds, the first time such a limitation was imposed on a category of tax-exempt bonds.

With the continued expansion of the private activity bond market, in 1982, Congress imposed additional restrictions on such bonds. The changes to the private activity bond rules made by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") included the following: (1) issuers of private activity bonds were required to make quarterly information reports to the IRS;[28] (2) issuance of IDBs was required to be approved by an elected official following a public hearing; and (3) the average length of time to maturity of IDBs was limited to

---

[24] H.R. Rep. No. 90-533, at 32 (1968).

[25] 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; (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.

[26] Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds* (JCS-23-85), July 16, 1985.

[27] Title XI of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499.

[28] Under the information reporting requirements, the term "private activity bond" included IDBs, student loan bonds, and bonds issued by charitable, educational, religious, and scientific organizations (described in section 501(c)(3)).

120 percent of the economic life of the property financed. Additionally, the small issue exception was to sunset at the end of 1986.[29]

By 1984, Congress was "extremely concerned with the volume of tax-exempt bonds used to finance private activities."[30] The volume of these bonds had increased to $62.4 billion in 1983, representing 68 percent of total State and local borrowings.[31] Moreover, Congress determined that the TEFRA rules enacted in 1982 appeared unlikely to impose adequate limits on the overall growth in the volume of private activity bonds. In response, the Deficit Reduction Act of 1984 (the "1984 Act")[32] imposed volume limitations on the aggregate annual amount of private activity bonds (most IDBs and all bonds issued to finance student loans) that could be issued by each State and its political subdivisions. The 1984 Act also provided that interest on bonds issued to provide loans to nonexempt persons is taxable. Private activity bonds for which Congress previously had authorized tax exemption (i.e., IDBs, mortgage subsidy bonds, and student loan bonds) were not subject to the private-loan restriction.

The 1984 Act also included provisions of general application to tax-exempt bonds, including bonds issued for private activities. For example, 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.[33] Exceptions were provided for certain guarantee programs in existence when the 1984 Act was enacted. In addition, the 1984 Act provided that all future grants of exemption from Federal tax for bond interest must be enacted as part of a revenue act.

The Tax Reform Act of 1986

Between 1975 and 1985, the volume of long-term tax-exempt bonds issued for private activities (including tax-exempt IDBs, student loan bonds, mortgage bonds, and bonds issued for 501(c)(3) organizations) increased from $8.9 billion to $116.4 billion.[34] As a share of total State

[29] The general small issue exception does not apply to bonds issued after December 31, 1986. However, as discussed below, certain private business manufacturing facilities (including certain directly related and ancillary facilities) and certain farm land and equipment may be financed with small issue bonds under present law.

[30] Joint Committee on Taxation, *General Explanation of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984.

[31] *Id.* at 930.

[32] Pub. L. No. 98-369.

[33] Congress was concerned with the issuance of tax-exempt bonds combined with Federal guarantees. This combination resulted in a double subsidy for certain activities and created bonds that were more attractive than United States Treasury securities (the interest on which is taxable). The present-law prohibition on Federal guarantees, and exceptions thereto, is contained in section 149(b).

[34] Joint Committee on Taxation, *General Explanation of the Tax Reform of 1986* (JCS-10-87), May 4, 1987.

and local government borrowings, financing for private activities increased from 29 percent to 53 percent. This increase in volume affected the efficiency and equity of the tax system in several ways.

First, the large volume of tax-exempt bonds issued for private activities increased the interest rates that State and local governments were required to pay to finance their activities. As the total volume of tax-exempt bonds increases, the interest rate on such bonds must increase to attract investment from competing sources, thus, increasing the cost of financing essential governmental services.

Second, tax-exempt financing for certain private activities may have resulted in a misallocation of capital. Efficient allocation of capital requires that the return from a marginal unit of investment be equal across activities. Tax-exempt bonds change the allocation of capital by encouraging investment in projects eligible for tax-exempt financing, at the expense of other investments. In certain cases, tax-exempt bonds may encourage investment in projects that serve little or no public purpose. For example, the availability of small issue financing may have encouraged small projects at the expense of larger ones, regardless of relative economic efficiency.[35]

Third, the growth of issuances for private activities raised concerns of fairness. Because of the large volume of tax-exempt obligations issued for private activities, tax-exempt yields were often close to taxable yields. Taxpayers with high marginal tax rates accordingly received an after-tax yield on tax-exempt bonds significantly higher than the yield they would have received from taxable investments. A perception of inequity arises when such investors are able to reduce their tax liability and still receive a rate of return nearly as high as that on taxable investments.

In response to these and other concerns, the Tax Reform Act of 1986 (the "1986 Act")[36] made significant changes to the rules regarding all tax-exempt bonds. The 1986 Act retained the tax-exemption for interest on State and local government bonds used to finance traditional government operations, but adopted new tests to restrict the diversion of governmental bond proceeds for private purposes not specifically authorized to receive tax-exempt financing. Specifically, the 1986 Act provided that a bond is not a tax-exempt bond if it is a private activity bond. The 1986 Act defined a private activity bonds as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[37] The private business test is a modified version of the two-part test used to define IDBs under prior law, but the thresholds for impermissible private use and private payments were tightened from 25 percent to 10 percent.

---

[35] These effects may be present under present law, as well. For example, as discussed below, tax-exempt small-issue bonds may be issued for certain manufacturing facilities subject to limitations on the total capital expenditures incurred with respect to such facilities within a three-year test period.

[36] Pub. L. No. 99-514.

[37] See Part IV, A, below, for a description of present-law requirements for governmental bonds.

The 1986 Act continued many of the prior-law exceptions allowing tax-exempt financing for certain private activities. Under the 1986 Act, the definition of a tax-exempt, qualified private activity bond included: exempt facility bonds,[38] mortgage revenue bonds (including veterans' bonds), qualified 501(c)(3) bonds, qualified student loan bonds, qualified small-issue bonds, and qualified redevelopment bonds.[39] The 1986 Act eliminated sports facilities, convention and trade show facilities, parking facilities, private pollution control facilities, and industrial parks from the list of facilities eligible for tax-exempt financing. Eligibility was extended, however, to hazardous waste disposal facility bonds and qualified redevelopment bonds.

Prior law contained separate volume limitations for (1) IDBs and student loan bonds, (2) mortgage bonds, and (3) veterans' mortgage bonds. The 1986 Act provided a unified State annual volume limitation ("volume cap") for most qualified private activity bonds. The 1986 Act set the volume cap for each State at the greater of $50 per resident or $150 million per annum.[40] Qualified 501(c)(3) bonds and exempt facility bonds for governmentally owned airports, docks and wharves and governmentally owned solid waste disposal facilities were not subject to volume limitations under the 1986 Act.

Generally, the 1986 Act requires 95 percent of the net proceeds of qualified private activity bonds to be spent for the exempt purpose of the borrowing. The 1986 Act also limits the amount of costs of issuance that may be paid from most private activity bond proceeds to two percent and further provides that amounts paid for costs of issuance are not treated as spent for the exempt purpose of the borrowing (i.e., are not counted in determining whether the 95 percent requirement, etc. is satisfied).

The 1986 Act extended the public approval requirements that previously applied to IDBs to all private activity bonds. The maturity restrictions on IDBs were extended to qualified 501(c)(3) bonds under the 1986 Act, and qualified 501(c)(3) bonds (other than hospital bonds) were subject to a $150 million per institution limit on outstanding bonds.[41]

---

[38] Before subsequent amendment, the list of exempt facilities consisted of bonds issued to finance: airports; docks and wharves; mass commuting facilities; facilities for the furnishing of water; sewage and solid waste disposal facilities; hazardous waste disposal facilities; and multifamily residential rental projects.

[39] The general requirements for each category of qualified private activity bond are discussed below.

[40] In 1987, these amounts were $75 and $250 million, respectively. The lower amounts were to coincide with the termination of the mortgage bond program, but were kept in place although the 1986 Act extended the mortgage bond program through 1988. The mortgage bond program subsequently was extended several times before being made permanent by the Omnibus Budget Reconciliation Act of 1992.

[41] The Taxpayer Relief Act of 1997 repealed the $150 million limit for bonds issued after August 5, 1997, to finance capital expenditures incurred after such date.

Post-1986 Act (1988-Present)

Expansion of eligible activities

The Technical and Miscellaneous Revenue Act of 1988[42] added high-speed intercity rail facilities to the list of activities eligible for tax-exempt financing.[43] Seventy-five percent of the principal amount of the bonds issued for high-speed rail facilities is exempt from the volume limit.[44] If all the property to be financed by the net proceeds of the issue is to be owned by a governmental unit, then such bonds are completely exempt from the volume limit.

The Energy Policy Act of 1992[45] added environmental enhancements of hydro-electric generating facilities to the list of exempt facility bonds. Eligible facilities include those that protect or promote fisheries or other wildlife resources and those for recreational purposes or other improvements required by the terms of a Federal license for the operation of a hydro-electric generating facilities. Bonds issued for these purposes are not subject to volume limitations.

The Omnibus Budget Reconciliation Act of 1993 (the "1993 Act") authorized the designation of a total of nine empowerment zones and 95 enterprise communities to provide tax incentives for businesses to locate within certain geographic areas designated by the Secretaries of Housing and Urban Development ("HUD") and Agriculture. The 1993 Act provided expanded tax-exempt financing for certain businesses in empowerment zones and enterprise communities.

The Tax Relief Act of 1997[46] authorized the issuance of qualified zone academy bonds ("QZABS"), the first type of tax-credit bond. A total of $400 million of QZABs was authorized to be issued annually in calendar years 1998 and 1999.[47]

The Economic Growth and Tax Reconciliation Act of 2001 ("EGTRA") added qualified public education facilities to the list of exempt facilities. Qualified public education facilities include elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational

[42] Pub. L. No. 100-647.

[43] Sec. 142(a)(11) and sec. 142(i). A high-speed intercity rail facility is a facility providing rail transportation of passengers and their baggage that uses vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.

[44] Sec. 146(g)(4).

[45] Pub. L. No. 102-486.

[46] Pub. L. No. 105-34.

[47] A series of extensions authorized issuance through 2005.

agency. Issuance of these bonds is subject to a separate annual per-State volume limit equal to $10 per resident (or $5 million, if greater) in lieu of the general State volume cap limits.

The Job Creation and Worker Assistance Act of 2002 ("JCWAA") authorized an aggregate of $8 billion in exempt facility bonds for the purpose of financing the construction and rehabilitation of nonresidential real property and residential rental real property in the New York Liberty Zone ("New York Liberty Zone Bonds").[48]

The American Jobs Creation Act of 2004[49] created a new category of exempt facility bond, the qualified green building and sustainable design project bond ("qualified green bond"). Generally, a qualified green bond is defined as any bond issued as part of an issue that finances a project designated by the Secretary, after consultation with the Administrator of the Environmental Protection Agency, as a green building and sustainable design project. Green bonds are not subject to the State bond volume cap. Rather, there is a national limitation of $2 billion of qualified green bond issuance authority that may be allocated to qualified green building and sustainable design projects. The authority to issue green bonds terminates after September 30, 2009.

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users,[50] authorized new categories of exempt facility bonds to finance qualified highway or surface freight transfer facilities. Qualified highway or surface freight transfer facilities are not subject to the State volume cap. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities.

The Energy Policy Act of 2005[51] authorized the second type of tax-credit bond, clean renewable energy bonds ("CREBs"), to finance the type of facilities that qualify for the tax credit under section 45. There is a national CREB limitation of $800 million that must be issued before December 31, 2007.

The Gulf Opportunity Zone Act of 2005[52] authorized both the third category of tax-credit bonds, Gulf tax credit bonds, and a new type of qualified private activity bond, Gulf Opportunity Zone Bonds. The maximum amount of Gulf tax credit bonds that may be issued is $200 million in the case of Louisiana, $100 million in the case of Mississippi, and $50 million in the case of

[48] Pub. L. No. 107-147. The New York Liberty Zone consists of all business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan.

[49] Pub. L. No. 108-357.

[50] Pub. L. No. 109-59.

[51] Pub. L. No. 109-58.

[52] Pub. L. No. 109-135.

Alabama. Gulf Opportunity Zone Bonds are not subject to the State volume cap. Rather, the volume on bonds that may be issued is based on the population of the three States that may issue such bonds, Alabama, Louisiana, or Mississippi, that resides within the Gulf Opportunity Zone.[53]

Increases in volume cap

In addition to expanding the types of private activities eligible for tax-exempt financing, Congress also has increased the State volume cap applicable to most categories of qualified private activity bonds.

The Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999[54] increased the annual volume cap that applies to private activity bonds to $75 per resident of each State or $225 million, if greater, beginning in calendar year 2007. The increase was to be, ratably phased in, beginning with $55 per capita or $165 million, if greater, in calendar year 2003.

The Community Renewal Tax Relief Act of 2000[55] accelerated the increase to the volume cap that was enacted in 1998. The State volume cap was increased to the greater of $62.50 per resident or $187.5 million in calendar year 2001, the greater of $75 per resident or $225 million in calendar year 2002, and, beginning in calendar year 2003, volume cap is adjusted annually for inflation.[56]

Since the volume cap limits have been increased, significant amounts of the State volume cap have been unused.[57] Table 3, below, shows both the allocated and unused volume cap amounts for the years 1998-2004.

---

[53] The "Gulf Opportunity Zone" is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

[54] Pub. L. No. 105-277.

[55] Pub. L. No. 106-554.

[56] Although the volume cap is now indexed for inflation, as discussed above, a number of activities (e.g., qualified public education facilities, green bonds, highway and surface freight transfer facility bonds, New York Liberty Zone Bonds, Gulf Opportunity Zone Bonds) are not subject to the volume cap.

[57] As discussed in Part IV, B, below, unused volume cap generally may be carried forward for three years.

Table 3.−Private Activity Bond Volume Cap and Carryforward
[dollars in millions]

Year	Allocated[1]	Unused Cap[2] (Carryforwards)
1998	15,151	3,097
1999	15,271	3,346
2000	15,380	3,615
2001	19,704	6,684
2002	23,876	12,150
2003	24,198	17,346
2004	25,766	22,950

[1] Source: The Bond Buyer Yearbook.

[2] Source: The Bond Buyer.

III. SELECT ISSUES RELATED TO USE OF TAX-EXEMPT BOND AND TAX-CREDIT BOND PROCEEDS

A. The Concept of Private Use of Governmental Bonds

Present law does not define the governmental or public purposes for which governmental bonds maybe issued. Rather, the Code defines a taxable private activity bond based on use of bond proceeds and the manner in which bonds are paid or secured. Congress adopted the private activity bond rules in response to concerns that a significant amount of proceeds from governmental bonds was being used to finance private activities.[58] The use of tax-exempt bond proceeds to finance private activities was viewed as an inefficient use of the Federal subsidy that increased the cost of financing traditional government activities.[59] The private activity bond rules enacted in the 1986 Act reflected the intent of Congress to restrict the diversion of governmental bond proceeds for private purposes not specifically authorized to receive tax-exempt financing.

Classification as a private activity bond can be avoided, however, by "failing" to meet either prong of the private business test: the private business use test or the private payment test.[60] By requiring that both the use and payment tests be met before a bond is a taxable private activity bond, the law permits the issuance of tax-exempt bonds to finance private activities in situations in which taxpayers, rather than the private party receiving the benefit of tax-exempt financing, are the obligors on the debt. As a result, present law permits the use of bond proceeds for private activities that Congress has not specifically approved to benefit from the indirect Federal subsidy provided through tax exemption if bonds are secured and paid by public funds (i.e., tax revenues).

For example, prior to the 1986 Act, the Code expressly allowed tax-exempt financing for sports facilities. The 1986 Act discontinued this express authority by eliminating sports facilities from the list of activities eligible for tax-exempt financing.[61] Municipalities, however, continue to subsidize sports facilities using tax-exempt bonds. This is because stadiums qualify for tax-exempt financing under present law even if the bonds providing such financing exceed either the 10-percent private business use test or the 10-percent private payment test, but not both. Use by a professional sports team almost always will cause the private business use test to be met, so a stadium bond must be structured so that debt service is primarily paid from sources other than

[58] S. Rep. No. 99-313, at 826 (1986).

[59] H.R. Rep. No. 99-426, at 514 (1985); S. Rep. No. 99-313, at 825-826 (1986)

[60] The original House bill that led to the 1986 Act would have repealed the ten-percent security or payment test, leaving only the ten-percent private business use test. H.R. Rep. No. 99-426, at 520 (1985).

[61] Pub. L. No. 99-514 (1986).

stadium revenues or other private payments.[62] Because only one prong of the private business test is satisfied in such cases, the bonds are not treated as private activity bonds.[63] In effect, present law virtually requires that if a stadium is to be financed with tax-exempt bonds, a municipality must enter into an arrangement granting a professional sports team use of the stadium at substantially less than market value. This example is not unique to stadiums, however. Qualified governmental units may issue governmental bonds for any number of privately used facilities (e.g., corporate industrial parks and parking garages) if the debt service on the bonds is secured by public funds.

Present law also may provide issuers with an incentive to issue bonds as governmental rather than qualified private activity bonds, even when an activity may be financed with either type of bond. As described above, governmental bonds are not subject to volume cap and other limitations that apply to qualified private activity bonds.[64] In addition, investor demand may be greater for governmental bonds than qualified private activity bonds because the interest income on most qualified private activity bonds is subject to the alternative minimum tax ("AMT"),[65] whereas the interest income on governmental bonds is not. The preferential treatment afforded governmental bonds may have the effect of encouraging the commitment of public funds to certain activities to avoid the private business tests. In such a case, more of the benefit of tax-exempt financing is transferred to private parties, rather than to State or local governments, a result that is inconsistent with the purpose of the subsidy.

---

[62] This may be accomplished by securing the repayment of the bonds with generally applicable taxes, which, under Treas. Reg. Sec. 1.141-4(e), are not taken into account for purposes of the private security or payment test.

[63] There also is no loan to a private person in these transactions that would meet the private loan financing test.

[64] See Figure 1, page 25, for a comparison of the annual issuance volume of long-term governmental bonds and long-term qualified private activity bonds for 1993-2003.

[65] Sec. 57(a)(5).

B. Growth of Activities Eligible for Tax-Exempt Bonds and Attendant Increase in Volume Limits

While continuing tax-exempt financing for a number of private activities eligible under prior law, the 1986 Act reflected Congress' intent to control the volume of bonds issued for such activities. To accomplish this, the 1986 Act established the volume cap, rules provided to limit the aggregate annual volume of most qualified private activity bonds that each State (including local governments therein) may issue.[66] Moreover, the imposition of a single volume cap in 1986, in place of the separate limitations imposed on different categories of private activity bonds under prior law, was intended to allow State and local governments flexibility in allocating the limited Federal subsidy among qualifying activities.

In recent years, Congress has expanded the list of private activities eligible for tax-exempt financing. Including the preferential rules for certain geographic areas (e.g., enterprise zones, the New York Liberty Zone, and the Gulf Opportunity Zone), there are now 25 categories of private activities eligible for tax-exempt financing. Moreover, every type of private activity bond added to the Code since 1988 has been either wholly or partially excepted from the unified volume cap. Continued expansion of the types of private activities eligible for tax-exempt financing but excepted from volume cap limitations may result in the situation Congress attempted to address through the 1986 Act, i.e., increased amounts of bonds issued for private activities which had the effect of increasing the borrowing costs for all issuers of tax-exempt bonds because of competition for the limited pool of assets for investment in such obligations.

To constrain issuance volume, many of the recent categories of private activities are subject to separate volume limitations (e.g., green bonds, highway or surface freight transfer facility bonds, public education facilities).[67] However, separate volume limitations may result in inefficient allocations of capital because State and local governments are restricted in their ability to allocate the subsidy to projects that may provide the greatest benefit; precisely the situation Congress intended to eliminate when creating the unified volume cap.

Separate volume limitations for certain activities ensure that such activities receive a dedicated allocation of issuance authority. A unified volume cap may force projects to compete for limited allocations. Congress, however, has raised the volume cap limits and, under present law, the volume cap is now indexed for inflation. As a result of the increases in the State volume cap, most States have had unused issuance authority in recent years. With excess volume cap available to issuers, there is less need to provide separate volume limitations for certain activities.

---

[66] Sec. 146.

[67] Table 4, below, provides a list of privately-used facilities or property eligible for tax-exempt financing and applicable volume limitations.

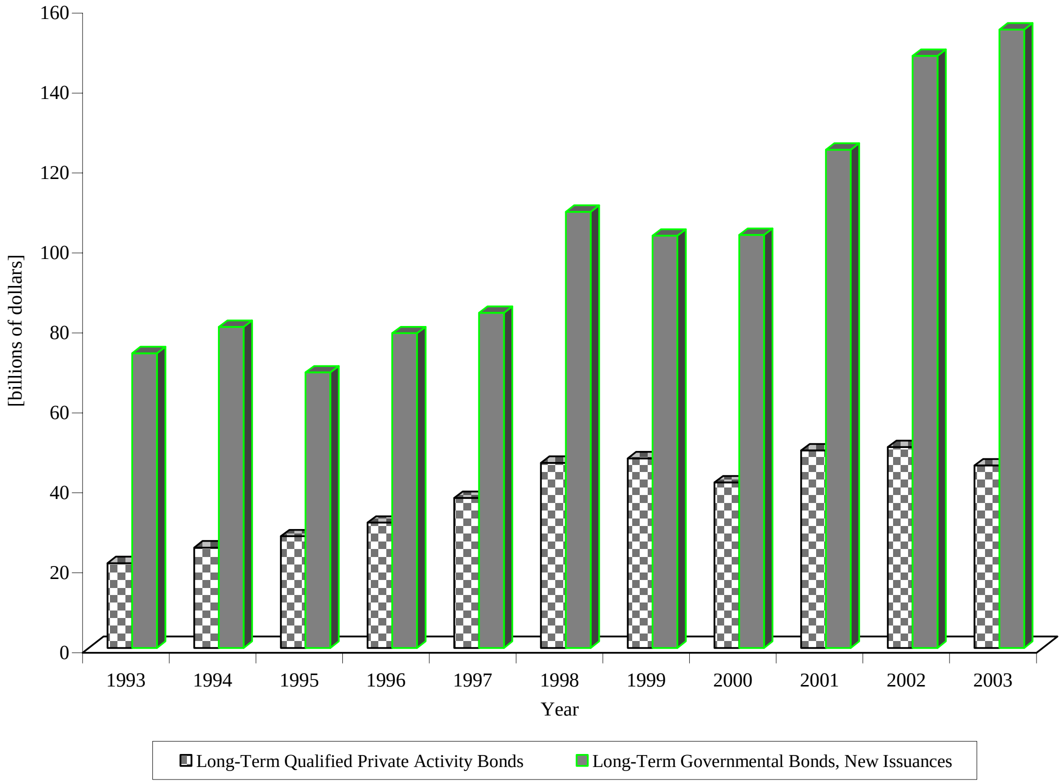
Table 3, above, shows the national amount of volume cap that was allocated to private activity bonds and the amount of unused volume cap from 1998-2004.

In addition, the volume allocations with respect to certain categories of bonds (e.g., highway or surface freight transfer facility bonds) are made at the Federal level, rather than the local level. Historically, State and local governments have controlled the decision as to whether to provide financing for private activities within their jurisdiction. Allocating private activity bond issuance authority at the Federal level removes the element of local control and may force State and local governments to directly compete with private businesses to raise capital.

Although present law does not impose a "public purpose" requirement on qualified private activity bonds, many of the original activities eligible for tax-exempt financing under the 1986 Act perform essentially public functions (e.g., airports, docks and wharves, solid waste facilities). As the benefit of tax-exempt financing is extended to additional, but narrower, categories of private activities it becomes more difficult to identify the public purpose served by such activities. To the extent tax-exempt financing is provided for narrowly defined business activities, there may be little or no public benefit provided by such activities. While some suggest that increases in employment and expansion of the local tax base are public activities of sufficient importance to justify subsidized financing for private activities, others respond that expanding the use of tax-exempt bonds for private activities has anti-competitive and distortive effects on the economy. Parties eligible for subsidized financing receive a significant advantage over their competitors, which must raise capital with higher-cost taxable obligations. Moreover, tax-exempt financing changes the allocation of capital by encouraging investment in projects eligible for such financing, at the expense of other investments, regardless of the relative economic efficiencies of the competing investments.

See Figure 1, page 25, for a comparison of the annual issuance volume of long-term governmental bonds and long-term qualified private activity bonds for the period 1993-2003.

Figure 1.−Annual Issuance of Tax-Exempt Governmental and Private Activity Bonds,* 1993-2003



Note: *Issues of long-term bonds.

C. Use of Tax-Credit Bond Proceeds as an Alternative to Tax-Exempt Bonds

Like tax-exempt bonds, tax-credit bonds operate to lower the borrowing costs of eligible borrowers. Tax-credit bonds also raise many of the same issues as tax-exempt bonds. For example, parties eligible for tax-credit bond financing receive a significant advantage over their competitors. Similarly, tax-credit bonds encourage investment in projects eligible for such financing, at the expense of other investments.

<u>Expansion of permitted issuers beyond State and local governments</u>

Historically, the subsidy provided by tax-exempt financing has been limited to obligations issued by qualified governmental units, i.e., States or local governments, or any political subdivisions thereof. However, under present law, CREBs may be issued by certain cooperative lenders and electric companies, in addition to qualified governmental units. Moreover, some have advocated expansion of this approach, i.e., permitting nongovernmental, private entities to issue tax-credit bonds for an expanded list of activities. Permitting nongovernmental entities to issue tax-exempt or tax-credit bonds represents a significant change in tax policy. As discussed above, present law subsidizes the activities of State and local governments in order to reduce the borrowing costs of such entities. In addition, present law limits financing for private activities because of the potential effect such financings have on the cost of capital for traditional public infrastructure projects, i.e., higher interest rates on tax-exempt bonds generally as competition increases for the limited pool of assets available for investment in tax-exempt obligations generally. Permitting nongovernmental parties to issue tax-subsidized obligations (whether as tax-exempt or tax-credit bonds) exacerbates that problem because, in addition to the increased volume of financing for private activities that may not serve a public purpose, governmental units lose the ability to determine the projects within their jurisdiction that should receive the benefit of subsidized financing.[68] As discussed, State and local governments traditionally have controlled the decisions of whether to provide financing for private activities. In contrast, permitting nongovernmental persons to directly issue bonds for private activities will force governmental units financing public projects to compete with these private entities to raise capital.[69]

<u>Arbitrage</u>

QZABs, unlike interest-bearing State and local bonds, CREBs, and Gulf tax credit bonds, are not subject to the arbitrage or rebate requirements of the Code. The ability of issuers of QZABs to invest proceeds at unrestricted yields and retain the arbitrage earnings from such investments increases the subsidy available for qualified expenditures, as well as the repayment of principal on such bonds, beyond the savings achieved through having the issuer's interest costs paid by the Federal tax credit. Moreover, the ability to earn and retain arbitrage profits

---

[68] Local governments also lose control when tax-credit bond issuance authority is allocated at the Federal level (e.g., CREBs).

[69] Table 5, page 47, provides a list of facilities or property eligible for tax-credit bond financing and applicable volume limitations.

provides an incentive for issuers to issue more bonds and to issue them earlier than necessary. As a result, there may be increased delays in the expenditure of bond proceeds for approved purposes in order to earn greater arbitrage profits.[70]

[70] The Treasury Department issued proposed regulations on March 26, 2004, that would require issuers of QZABs to spend proceeds with due diligence. Prop. Reg. sec. 1.1397E-1(h), 69 Fed. Reg. 15747 (March 26, 2004).

IV. PRESENT-LAW REQUIREMENTS RELATED TO USE OF TAX-EXEMPT AND TAX-CREDIT BOND PROCEEDS

A. Governmental Bonds

In general

Whether bonds are governmental bonds is not determined by the type of facility financed, but rather the use of the bond proceeds and the manner in which the bonds are paid or secured. The Code also does not define a governmental bond, but rather defines an impermissible private activity bond, i.e., a bond that is not a governmental bond. The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[71] Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

Private activity bond tests

Two-part private business test

Under the private business test, a bond is a private activity bond if it is part of an issue in which:

1. More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit ("private business use"); and

2. More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[72]

A bond is not a private activity bond unless both parts of the private business test (i.e., the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, a stadium that will be used by a professional sports team may be financed with governmental bonds if the team, or other private party, does not pay the debt service on such bonds.

A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use

[71] Sec. 141.

[72] The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.

depending on the terms of the contract.[73] In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits. Contracts for service incidental to the facility's primary functions, such as janitorial, office equipment repair and similar services, are not considered management contracts. Certain contracts involving hospital-admitting privileges, operation of public utility property, and expense reimbursements are not treated as management contracts.

For purposes of the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.[74]

Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

[73] Treas. Reg. sec. 1.141-3(b)(4).

[74] Treas. Reg. sec. 1.141-4(c)(3).

B. Qualified Private Activity Bonds

In general

Qualified private activity bonds are tax-exempt bonds issued to provide financing for specified privately used facilities.[75] Generally, qualified private activity bonds are subject to a number of restrictions that do not apply to governmental bonds, such as issuance cost, maturity, and annual volume limitations. In addition, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[76]

Exempt facility bonds

The definition of a qualified private activity bond includes "exempt facility bonds." To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.[77] Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities); privately owned and/or operated public works facilities (sewage, solid waste disposal, water, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated residential rental housing; and certain private facilities for the local furnishing of electricity or gas. Bonds issued to finance "environmental enhancements of hydro-electric generating facilities," qualified public educational facilities, and qualified green building and sustainable design projects also may qualify as exempt facility bonds.

Residential rental projects are one of the more common types of projects financed with exempt-facility bonds. Residential rental property may be financed with exempt-facility bonds if the financed project is a "qualified residential rental project." A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test").

Qualified mortgage bonds

Owner-occupied housing may be financed with qualified mortgage bonds. Qualified mortgage bonds are bonds issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes

---

[75] Table 4, page 41, provides a list of privately-used facilities or property eligible for tax-exempt financing and applicable volume limitations.

[76] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.

[77] Sec. 142(a).

several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).[78]

Special income and purchase price limitations apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the State-wide median income or (2) an area of chronic economic distress. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the mortgages are made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Generally, qualified home-improvement loans may not exceed $15,000.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences of qualified veterans located within the jurisdiction of the issuer of the bonds. A qualified veterans' mortgage bond may be issued only by those States that issued such bonds before June 22, 1984. These States are Alaska, California, Oregon, Texas, and Wisconsin. Annual issuance of qualified veterans' mortgage bonds is subject to a separate State limit, but not to the unified State volume cap applicable to most other private activity bonds.

Persons receiving qualified veterans' mortgage bond loans must be veterans who served on active duty at some time before January 1, 1977, and who applied for the financing before the later of the date 30 years after the last date on which the borrower left active service, or January 31, 1985. There are no restrictions on purchase price or borrower income, and no first-time homebuyer requirement for qualified veterans' mortgage bond loans.

[78] The qualified mortgage bond rules are modified for certain residences located in areas affected by Hurricanes Katrina, Rita, and Wilma.

Student loan bonds

Qualified student loan bonds are bonds issued to finance eligible student loans. Interest on qualified student loan bonds is tax-exempt. Eligible student loans include Federally guaranteed loans under the Higher Education Act of 1965 and other loans financed as part of a program of general application approved by the State.[79]

Small issue bonds

Qualified small issue bonds are tax-exempt bonds issued by State and local governments to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if, in addition to outstanding bonds, all other capital expenditures of the business (including related parties) in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located.

For bonds issued after September 30, 2009, the Code permits up to $10 million of capital expenditures to be disregarded, in effect increasing from $10 million to $20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county.[80] However, no more than $10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other limits (e.g., the $40 million per borrower limit) also continue to apply.

Redevelopment bonds

Qualified redevelopment bonds are bonds issued as part of an issue 95-percent or more of the net proceeds of which is to be used for one or more redevelopment purposes in a designated "blighted area." A blighted area is an area designated as such by the local governing body of such area based on the substantial presence of factors such as excessive vacant, abandoned or vacant buildings, substandard structures, vacancies, and delinquencies in payment of real property taxes.

Qualified redevelopment bonds must be issued pursuant to state law authorization and under an existing redevelopment plan. The payment of interest and principal on the issue must

---

[79] Sec. 144(b)(1).

[80] Sec. 144(a)(4)(G) as added by sec. 340(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

be financed, in effect, by taxes of general application or earmarked real estate tax increases. In addition, each real property interest in the designated blighted area that is acquired by a governmental unit and transferred to a nongovernmental person must be transferred for fair market value. No owner or user of property located in the financed area can be subject to a charge or fee which similarly situated owners or users of comparable property outside such area are not subject.

Qualified 501(c)(3) bonds

State and local governments may issue tax-exempt bonds to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds"). The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with qualified 501(c)(3) bonds.

Qualified 501(c)(3) bonds are not subject to the State volume cap.

New York Liberty Zone Bonds

Present law permits an aggregate of $8 billion in exempt facility bonds for the purpose of financing the construction and rehabilitation of nonresidential real property and residential rental real property in a designated "Liberty Zone" (the "Zone") of New York City ("Liberty Zone bonds"). The Zone consists of all business addresses located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan.

Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements, and public utility property (e.g., gas, water, electric, and telecommunication lines). Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds. Issuance of these bonds is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to $4 billion of the aggregate bond authority.

Liberty Zone Bonds must be issued before January 1, 2010, and are not subject to the State volume cap.

Gulf Opportunity Zone Bonds

Present law permits the issuance of qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone ("Gulf Opportunity Zone Bonds").[81] Gulf Opportunity Zone Bonds must be issued before January 1, 2011.

[81] The "Gulf Opportunity Zone" is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal

Gulf Opportunity Zone Bonds may be issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof. Gulf Opportunity Zone Bonds are not subject to the State volume cap. Rather, the maximum aggregate face amount of Gulf Opportunity Zone Bonds that may be issued in any State is limited to $2,500 multiplied by the population of the respective State within the Gulf Opportunity Zone. Depending on the purpose for which such bonds are issued, Gulf Opportunity Zone Bonds are treated as either exempt facility bonds or qualified mortgage bonds.

Gulf Opportunity Zone Bonds are treated as exempt facility bonds if 95 percent or more of the net proceeds of such bonds are to be used for qualified project costs located in the Gulf Opportunity Zone. Qualified project costs include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property, qualified residential rental projects (as defined in section 142(d) with certain modifications), and public utility property.

Gulf Opportunity Zone Bonds are treated as qualified mortgage bonds if the bonds of such issue meet the general requirements of a qualified mortgage issue and the residences financed with such bonds are located in the Gulf Opportunity Zone. For these residences the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply. In addition, 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less of the applicable median family income.

Tax-exempt enterprise zone facility bonds

Enterprise zone facility bonds are issued to finance "enterprise zone facilities" located in "enterprise communities" or "empowerment zones"[82] if the principal users of such facilities are "qualified enterprise zone businesses." Ninety-five percent or more of the net proceeds of the bonds must be used to provide an enterprise zone facility. An enterprise zone facility is defined as any qualified zone property the principal user of which is an "enterprise zone business," and any land that is functionally related and subordinate to such property.[83] Enterprise zone businesses are defined as certain partnerships or corporations conducting a qualified business in, and employing residents of, an empowerment zone.[84]

Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

[82] The Omnibus Budget Reconciliation Act of 1993 authorized the designation of a total of nine empowerment zones and 95 enterprise communities to provide tax incentives for businesses to locate within certain geographic areas designated by the Secretaries of Housing and Urban Development ("HUD") and Agriculture.

[83] Sec. 1394(b).

[84] Sec. 1397C.

Additional qualified private activity bonds requirements

Volume Cap

Unlike governmental bonds, the aggregate volume of most qualified private activity bonds is restricted by the annual volume cap imposed on issuers within each State.[85] As discussed above, the volume cap rules reflect Congress' intent to control the total volume of tax-exempt bonds issued for private activities.

For calendar year 2006, these annual volume limits, which are indexed for inflation, equal $80 per resident of the State, or $246,610,000 million, if greater.

Exceptions from the volume cap are provided for bonds for certain governmentally owned facilities (e.g., airports, ports, high-speed intercity rail, and solid waste disposal) and bonds issued to finance the activities of certain charitable organizations. In addition, bonds which are subject to separate local, State, or national volume limits are not subject to the unified volume cap (e.g., public/private educational facility bonds, enterprise zone facility bonds, qualified green building bonds, and qualified highway or surface freight transfer facility bonds).

If an issuer's volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.[86] Carryforwards of unused volume cap are valid for three years.

Maturity limitations

Most qualified private activity bonds are subject to a term to maturity rule which limits the period of time such bonds may remain outstanding. Generally, this rule provides that the average maturity of a qualified private activity bond cannot exceed 120 percent of the economic life of the property being financed.[87] The term to maturity rule does not apply to qualified mortgage or student loan bonds.[88]

---

[85] Sec. 146.

[86] Sec. 146(f)(5).

[87] Sec. 147(b).

[88] Sec. 147(h).

Issuance costs

Generally, the amount of costs of issuance (e.g., bond counsel and underwriter fees) that may be paid from qualified private activity bond proceeds is limited to two percent. In addition, amounts paid for costs of issuance are not treated as spent for the exempt purpose of the borrowing (i.e., are not "good costs").

Public approval

To be a qualified private activity bond, a bond must satisfy a public approval requirement including providing reasonable public notice for a hearing. Regardless of State and local law, reasonable public notice must include notice "published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or television broadcast to those residents."[89]

Prohibited facilities

Qualified private activity bonds generally are subject to restrictions on the use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores), and use of proceeds to pay costs of issuance. Small-issue and redevelopment bonds also are subject to additional restrictions on the use of proceeds for certain facilities (e.g., golf courses and massage parlors).

[89] Treas. Reg. sec. 5f.103-2(g)(3).

C. Rules Applicable to All Tax-Exempt Bonds

Arbitrage restrictions

To prevent the issuance of more Federally subsidized tax-exempt bonds than necessary, the tax exemption for State and local bonds does not apply to any arbitrage bond.[90] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government ("arbitrage rebate").

Advance refundings

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for "current" as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond (thus, two or more issues of tax-exempt bonds are outstanding simultaneously).[91] Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.[92] Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.[93]

Federal guarantees

Generally, interest on State and local bonds that are Federally guaranteed does not qualify for tax exemption. A bond is Federally guaranteed if: (1) the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency

[90] Secs. 103(a) and (b)(2).

[91] Sec. 149(d)(5).

[92] Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

[93] Sec. 149(d)(2). Special rules apply for certain advance refundings in the New York Liberty Zone and the Gulf Opportunity Zone.

or instrumentality thereof); (2) such bond is issued as part of an issue and five percent of more of the proceeds of such issue is to be (a) used in making loans the payment of principal or interest with respect to which is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or (b) invested directly or indirectly in federally insured deposits or accounts; or (3) the payment of principal or interest on such bond is otherwise indirectly guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof).

The Federal guarantee restriction was enacted in 1984 with certain exceptions for certain guarantee programs in existence at that time.[94]

Information returns

An issuer of bonds must file with the IRS certain information in order for the interest on such bond to be tax-exempt.[95] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

[94] The exceptions include guarantees by: the Federal Housing Administration, the Department of Veterans' Affairs, the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, the Government National Mortgage Association; the Student Loan Marketing Association; and the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d). The exception also includes guarantees for certain housing programs. These are: (a) private activity bonds for a qualified residential rental project or a housing program obligation under section 11(b) of the United States Housing Act of 1937; (b) a qualified mortgage bond; or (c) a qualified veterans' mortgage bond.

[95] Sec. 149(e).

D. Tax-Credit Bonds

In general

The three types of tax-credit bonds authorized under present law are QZABs, CREBs, and Gulf tax credit bonds.[96] A common feature of the three types of bonds is that the taxpayer holding a tax-credit bond on certain dates receives a tax credit, rather than interest. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the taxpayer's bond. The credit rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. The specific requirements for each category of tax-credit bond is described below.

QZABs (Qualified zone academy bonds)

QZABs are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy," and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

A total of $400 million of QZABs was authorized to be issued annually in calendar years 1998 through 2005. The $400 million aggregate bond cap is allocated to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State. Eligible holders of QZABs are limited to financial institutions.

Unlike issuers of tax-exempt bonds, issuers of QZABs are not required to file information returns with the Treasury. Moreover, such bonds are not subject to the general private use or arbitrage restrictions.

[96] Secs. 1397E, 54, and 1400N(l), respectively.

Clean renewable energy bonds

CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for facilities that qualify for the tax credit under section 45 ("qualified projects" other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section. There is a national CREB limitation of $800 millions. CREBs must be issued before December 31, 2007.

Unlike QZABs, CREBs are subject to the arbitrage requirements of section 148 that apply to tax-exempt bonds. In addition, to qualify as CREBs, generally, the qualified issuer must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified projects within the five-year period that begins on the date of issuance.

Unlike QZABs, issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

Gulf tax credit bonds

Gulf tax credit bonds may be issued by the States of Louisiana, Mississippi, and Alabama. To qualify as Gulf tax credit bonds, 95 percent or more of the proceeds of such bonds must be used to (i) pay principal, interest, or premium on a bond (other than a private activity bond) that was outstanding on August 28, 2005, and was issued by the State issuing the Gulf tax credit bonds, or any political subdivision thereof, or (ii) make a loan to any political subdivision of such State to pay principal, interest, or premium on a bond issued by such political subdivision. In addition, the issuer of Gulf tax credit bonds must provide additional funds to pay principal, interest, or premium on outstanding bonds equal to the amount of Gulf tax credit bonds issued to repay such outstanding bonds. Gulf tax credit bonds must be a general obligation of the issuing State and must be designated by the Governor of such State. The maximum maturity on Gulf tax credit bonds is two years. The arbitrage rules restricting the ability of State and local governments to invest bond proceeds apply to Gulf tax credit bonds.

Gulf tax credit bonds must be issued in calendar year 2006. The maximum amount of Gulf tax credit bonds that may be issued is $200 million in the case of Louisiana, $100 million in the case of Mississippi, and $50 million in the case of Alabama. Gulf tax credit bonds may not be used to pay principal, interest, or premium on any bond with respect to which there is any outstanding refunded or refunding bond. Gulf tax credit bonds may not be used to pay principal, interest, or premium on any prior bond if the proceeds of such prior bond were used to provide any of the following types of property: a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale of alcoholic beverages for consumption off premises.

As with CREBs, issuers of Gulf tax credit bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

TABLE 4.−CATEGORIES OF QUALIFIED PRIVATE ACTIVITY BONDS

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
1. Airports (sec. 142(a)(1))	Airport terminals, runways, etc. (but not hotels, retail facilities, and offices if used in a private business).	1968	No
2. Docks and wharves (sec. 142(a)(2))	Private docks and wharves, including structures and equipment needed to discharge cargo and passengers.	1968	No
3. Mass commuting facilities (sec. 142(a)(3))	Property serving bus, subway, rail, ferry, or other commuters on a day-to-day basis.	1968	Yes
4. Sewage facilities (sec. 142(a)(4))	Property used for certain levels of treatment of wastewater and property used for collection, storage, use, processing, or final disposal of wastewater, sewage, septage.	1968	Yes
5. Water facilities (sec. 142(a)(5))	Facilities furnishing water that is made available to the general public, including electric utility, industrial, agricultural, or other commercial users. Such facilities must be operated by a governmental unit or the rates for sale of water must be approved by a governmental unit.	1968	Yes

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
6. Solid waste disposal facilities (sec. 142(a)(6))	Property used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste.	1968	Yes, unless all property to be financed by the net proceeds of the issue is to be owned by a governmental unit.
7. Residential rental projects (sec. 142(a)(7))	A residential rental project in which 20 percent or more of the residential units are occupied by individuals whose income is 50 percent or less of area median gross income or 40 percent or more of the residential units are occupied by individuals whose income is 60 percent or less of area median gross income.	1968	Yes
8. Facilities for the local furnishing of electric energy or gas (sec. 142(a)(8))	Generally, a facility furnishing electric energy or gas serving an area not exceeding two contiguous counties or a city and one contiguous county.	1968	Yes
9. Qualified small issues (sec. 144(a))	Certain manufacturing facilities or the acquisition of land and equipment by certain farmers.	1968	Yes
10. Qualified 501(c)(3) property (sec. 145)	Capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3),	1968	No

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
11. Qualified student loans (sec. 144(b))	Financing of student loans guaranteed under the Higher Education Act of 1965 and other loans financed as part of a program of general application approved by the State.	1976	Yes
12. Qualified mortgages (sec. 143(a))	Financing of mortgages for individuals meeting certain income, purchase price, and home-ownership requirements.	1980	Yes
13. Qualified veterans' mortgages (sec. 143(a))	Financing of mortgages for veterans serving prior to January 1, 1977, and applying for such a mortgage within 30 years of leaving active service. The only States that may issue bonds for this purpose are those States that had programs in effect before June 22, 1984.	1980	No. Annual issuance is subject to a separate State limit based on the average amount of bonds issued for such purposes from January 1, 1979, through June 22, 1984.
14. Local district heating or cooling facilities (sec. 142(a)(9))	A facility providing hot water, chilled water, or steam to two or more users for residential, commercial, or industrial heating or cooling, or process steam.	1982	Yes

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
15. Qualified hazardous waste facilities (sec. 142(a)(10))	Facilities for the incineration or permanent entombment of hazardous waste generated by the public.	1986	Yes
16. Qualified redevelopment purposes (sec. 144(c))	Financing of redevelopment in a locally designated “blighted area.”	1986	Yes
17. High-speed intercity rail facilities (sec. 142(a)(11))	Facilities providing rail transportation of passengers and their baggage that uses vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.	1988	No, if all property to be financed by the net proceeds of the issue is to be owned by a governmental unit. Otherwise, 75 percent of the principal amount is exempt from the volume cap.
18. Environmental enhancements of hydro-electric generating facilities (sec. 142(a)(12))	Eligible facilities include those that protect or promote fisheries or other wildlife resources and those for recreational purposes or other improvements required by the terms of a Federal license for the operation of a hydro-electric generating facilities.	1992	No

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
19. Enterprise zones (sec. 1394)	Financing for certain “enterprise zone businesses” which are defined as certain partnerships or corporations conducting a qualified business in, and employing residents of, an empowerment zone.	1993	Yes, unless issued with respect to certain empowerment zones.
20. Qualified public education facilities (sec. 142(a)(13))	Elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency.	2001	No. Subject to a separate annual per-State volume limit equal to $10 per resident (or $5 million, if greater) in lieu of the general State volume cap limits.
21. New York Liberty Zone (sec. 1400L)	Financing for the construction and rehabilitation of nonresidential real property and residential rental real property in a designated area of New York City.	2002	No. Subject to a separate $8 billion issuance limitation.
22. Qualified green building and sustainable design projects (sec. 142(a)(14))	Projects designated by the Secretary, after consultation with the Environmental Protection Agency, as a green building and sustainable design project.	2004	No. Subject to a separate, national limitation of $2 billion of issuance authority that may be allocated to eligible projects.

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
23. Qualified highway facilities (sec. 142(a)(15))	Any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code (relating to Highways).	2005	No. Subject to a national limitation of $15 billion that the Secretary of Transportation may allocate to qualified highway or surface freight transfer facilities.
24. Qualified surface freight transfer facilities (sec. 142(a)(16))	A facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code (relating to Transportation).	2005	No. Subject to a national limitation of $15 billion that the Secretary of Transportation may allocate to qualified highway or surface freight transfer facilities.
25. Gulf Opportunity Zone (sec. 1400N)	Financing for the construction and rehabilitation of residential and nonresidential property located in certain geographic areas of Mississippi, Louisiana, and Alabama affected by Hurricane Katrina.	2005	No. Subject to a separate limitation that is based on the population of the issuing State that resides within the Gulf Opportunity Zone.

TABLE 5.−CATEGORIES OF TAX-CREDIT BONDS

Eligible Facility	Purpose	Code Authorized	Subject to General Private Activity Bond Volume Cap
1. Qualified zone academy bonds ("QZABs") (sec. 1397E)	Renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in certain public schools.	1997	Subject to an aggregate annual limitation of $400 million through 2005.
2. Clean renewable energy bonds ("CREBs") (sec. 54)	Financing of capital expenditures for facilities that qualify for the tax credit under section 45 for electricity production from renewable sources.	2005	Subject to an aggregate national limitation of $800 million.
3. Gulf tax credit bonds (sec. 1400N)	The payment of principal, interest, or premium on certain bonds issued by Mississippi, Louisiana, or Alabama.	2005	Subject to separate State limitations of $200 million in the case of Louisiana, $100 million in the case of Mississippi, and $50 million in the case of Alabama.