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In the past few years, local governments and nontaxable entities have begun to use with increasing frequency a financing mechanism known as a sale-leaseback, which enables them to benefit from tax deductions normally available only to the private sector. Under sale-leaseback agreements, a local government or a tax-exempt institution sells real property, such as a museum or a library, to private investors and simultaneously leases it back. The local government or tax-exempt institution--which can be a university, foundation, or church--gets a cash payment from the investors and an opportunity to lease back the facility at a reduced rate reflecting the owner's tax benefits.

Sale-leasebacks can be used for all manner of facilities from college campuses to city halls. In the past year, Bennington College has arranged to lease its campus from private investors and will use the cash payment to retire a bank loan. Towson State University in Towson, Maryland, has arranged a sale-leaseback to finance the construction of new dormitories. The City of Oakland has sold and leased back a museum and an auditorium, which will be converted into a convention center. And the City of Atlanta is reportedly considering a sale-leaseback to finance the rehabilitation of its city hall.

The potential revenue losses to the federal government from sale-leasebacks involving nontaxable entities are extremely large. Governments and tax-exempt organizations currently own more than $2 trillion in property that could be transferred to private investors and then leased back. The only real limit on the potential extent of this activity is the capacity of private investors to absorb the tax deductions and credits that sale-leasebacks make available.

Nontaxable entities could simply be denied the benefits of capital investment subsidies that are provided through the tax code. This raises some difficult questions, however. If these subsidies--accelerated depreciation in excess of real economic depreciation plus investment tax credits for building rehabilitation--are intended primarily to encourage investment in plant, equipment, and rehabilitation rather than to measure taxable income, why should it matter whether or not the entity making the investment is taxable? The Congress could decide, of course, that the tax code is not the appropriate vehicle for delivering subsidies to nontaxable entities, since existing federal programs offer alternative vehicles that avoid the administrative problems and inefficiencies of using the tax system.

My testimony this morning will cover three areas:

- o The growing use of sale-leasebacks as a financing mechanism;
- o Tax and budget policy implications of sale-leasebacks; and
- o Policy alternatives that the Congress may wish to consider.

CBO has prepared for the record a more detailed paper on recent trends in municipal leasing. This statement will briefly summarize some of the main points of that report.

THE GROWING USE OF SALE-LEASEBACKS

In the past few years, as budget pressures have grown more severe at the state and local level, leasing has become an increasingly important municipal financing tool. In general, the trend in municipal financing has been away from traditional general obligation bonds and toward mechanisms that make it possible to avoid seeking voter approval and to raise funds without being subject to established debt limits. The growth in the use of revenue bonds and, more recently, innovations in municipal leasing are manifestations of the search for new funding sources.

Sale-leasebacks provide municipalities with a means of raising funds that may be less costly than issuing general obligation bonds. The lower costs result from the returns that the municipality receives from investing the payment made by the private investors plus the portion of tax benefits that private investors will pass on to the muncipality in the form of lower rental fees. Sale-leasebacks have another advantage: current law places limits on a municipality's ability to issue tax-exempt bonds and invest the proceeds in higher-yielding taxable securities. But no limits are placed on investment of the proceeds from the sale of property. In choosing a sale-leaseback over general obligation financing, a state or locality can in effect get around the arbitrage provisions in current law.

So far, most sale-leaseback arrangements have involved the rehabilitation of existing property or the construction of new facilities, but their usefulness as a means of raising funds is similar whether capital improvements are undertaken or whether the

transactions are simple transfers of ownership. In either case, the private investors can claim depreciation deductions, and the nontaxable institution receives an cash payment that can be invested in high-yielding securities or used to retire existing debt. The depreciation deductions are generally lower in the case of simple transfers, however.

Typically, sale-leasebacks involve at least four primary participants:

- o A municipality, county, state, or tax-exempt organization, which owns and will subsequently lease back the property;
- o A private investor;
- o An underwriter, or lender; and
- o A public authority, which will issue tax-exempt industrial revenue bonds to finance acquisition and construction costs.

Sale-leaseback transactions are generally quite complex, and not many have actually been completed. The numbers are growing, however. Many municipalities are looking into sale-leasebacks, particularly for historic structures. So are tax-exempt nonprofit institutions, particularly universities.

TAX AND BUDGET POLICY IMPLICATIONS

As a result of the Economic Recovery Tax Act of 1981 (ERTA), state and local governments and other tax-exempt entities now have a much stronger incentive to sell property to private investors than in the past. The new Accelerated Cost Recovery

System (ACRS) enacted in ERTA permits much shorter recovery periods for equipment and buildings than were allowed under prior law. In addition, ERTA provides generous investment tax credits ranging from 15 to 25 percent for the rehabilitation of buildings over 30 years old or of historic significance.

It has always been more beneficial for governments and other nontaxable entities to lease, rather than own, tax-favored assets, since ownership confers no benefits from the special tax advantages. Before 1981, however, the tax advantages available for property used by nontaxable entities were quite limited. With a few exceptions, the investment tax credit was not permitted for property used by governments or tax-exempt organizations, and accelerated depreciation allowances were generally not large enough to induce nontaxable entities to enter into special arrangements to take advantage of them.

The 1981 act changed this, however. Although the regular 10 percent investment tax credit is still not allowed for property used by nontaxable entities, the new tax credits for rehabilitation of older and historic buildings were specifically extended to property leased to governments or tax-exempt organizations. In addition, the depreciation allowances permitted by ACRS are now so large that nontaxable entities are almost required to use them. This is because the combination of ACRS and deductions for interest can reduce the effective tax rate below zero for many assets owned by taxable entities, giving them a major advantage in the competition for resources over nontaxable entities unless nontaxables can somehow benefit from these provisions themselves.

The sale-leaseback arrangements that have grown up in the last two years are thus a direct consequence of the 1981 act. They raise three major tax and budget policy questions:

- o To what extent is the tax code an appropriate mechanism for the delivery of subsidies for investment in equipment and buildings?
- o How large should federal subsidies be for state and local governments and tax-exempt organizations?
- o What effects does the extension of subsidies through the tax system have on the allocation of resources generally?

Subsidy Delivery Mechanisms. As noted earlier, the regular investment tax credit has never been permitted for property used by governments or tax-exempt organizations. The original rationales for that denial are not especially compelling. The purpose of the investment tax credit is to encourage business investment by, in effect, reducing the purchase price of machinery and equipment. The credit was denied to governments on the theory that their demand for equipment is not sensitive to price, and to tax-exempt organizations on the theory that they might improperly use the credit to reduce the taxes due on unrelated trade or business income.

Another possible justification for denying the credit to governments and tax-exempt organizations is that these entities do not generally use machinery and equipment for additional production as many private-sector industries do. But many private taxable entities do not use their equipment for additional production either;

they use trucks and typewriters and computers in the same way that nontaxable entities do, but they get the investment tax credit while nontaxable entities do not.

If the investment tax credit is viewed simply as a subsidy designed to encourage a particular type of activity, it is difficult to see why in principle it should not be available to any entity that can perform the activity, regardless of whether that entity has any tax liability. That, at least implicitly, is the approach the Congress took in 1981 when the rehabilitation tax credits were extended to property leased to nontaxable entities.

The Congress has never been willing to pursue this approach to its logical conclusion, and for good reasons. To do so would require converting the investment tax credit to a direct grant or making it fully refundable, with all entities, taxable or not, fully eligible. The resulting revenue loss would be very large. In addition, substantial administrative problems would arise in determining eligibility and auditing improper claims, especially for those entities not already in the tax system. For taxable entities, providing a capital investment subsidy through the tax system has administrative advantages, since they are already required to file tax returns containing most or all of the information required to determine eligibility, and their returns are subject to normal Internal Revenue Service (IRS) audit.

This is not the case for governments and other nontaxable entities. Governments are not in the tax system at all, and the IRS does not give the returns filed by most tax-exempt organizations the same kind of attention as those filed by taxable entities. In

addition, a great variety of federal direct grant or loan programs already extend assistance to nontaxable entities: revenue sharing, community development block grants, urban development action grants, college housing loans, sewage treatment grants, and the like. Moreover, using the tax code to assist nontaxable entities in the way it is now done requires complicated and elaborate leasing arrangements that divert part of the subsidy to investment bankers, lawyers, accountants, and other intermediaries needed to arrange the deal. This leakage makes the subsidy delivery mechanism less efficient. As a result, the Congress may very well decide that subsidy delivery mechanisms other than the tax code are more appropriate for nontaxable entities, and thus deny them any direct or indirect use of investment tax credits.

The question becomes more difficult in the case of accelerated depreciation deductions. Only a portion of ACRS can be considered a subsidy, but it is hard to know how large that portion is. In theory, any depreciation allowance that exceeds the real economic depreciation of the asset can be viewed as a subsidy. The measurement of real economic depreciation is subject to great uncertainty, however. As alternative approaches, the subsidy portion could be viewed as any amount in excess of what was allowed for depreciation before 1981, or any amount that pushes the effective tax rate on the asset below zero. Given the uncertainty involved, however, rough approximations may be appropriate for legislative purposes. The bill now before this Committee, H.R. 3110, follows this approach by requiring property used by nontaxable entities to be depreciated over extended recovery periods of from 5 to 35 years, which is probably a good approximation of economic depreciation.

Size of the Subsidy. Once the appropriate subsidy delivery mechanism is decided, the next question is the size of the subsidy, given scarce federal resources. If this Committee decides to exclude governments and tax-exempt organizations from tax subsidies completely, the question then becomes one for the committees with jurisdiction over direct grant and loan programs. If subsidies are provided through the tax code, however, this Committee has to consider the size of the potential revenue loss.

The revenue losses from sale-leasebacks depend on the nature of the transaction. Assuming that a municipal sale-leaseback takes the place of tax-exempt financing that would otherwise occur and that the private investors borrow funds at conventional rates, any net losses to the federal government would be limited. The savings from not issuing tax-exempt municipal bonds would largely offset the revenues forgone from the equity investors' depreciation deductions. Much more typically, however, sale-leasebacks involve the issuance of tax-exempt industrial revenue bonds (IRBs) to finance property acquisition and rehabilitation. In these instances, the tax losses are substantially greater than those resulting from general obligation financing because they include the revenues forgone from issuing IRBs, coupled with the value of depreciation deductions and, in some cases, investment tax credits. With general obligation bonds, the costs to the federal government are the revenues forgone from not collecting taxes on the interest income of the securities. These same losses are incurred whenever a project is financed with tax-exempt IRBs. Accordingly, a sale-leaseback involving IRB financing will always be more costly to the federal government than general obligation financing. The additional expense results from the revenues forgone from depreciation deductions and investment tax credits, where available.

Although revenue losses from sale-leasebacks have been minimal so far because of the limited number of transactions that have been completed, the potential future losses are significant. Since sale-leasebacks typically result in lower borrowing costs for municipalities, the incentive to use them instead of general obligation bonds is strong, and the potential for transferring ownership of facilities is vast. As of 1981, the net stock of state and local schools, hospitals, police and fire stations, courthouses, auditoriums, office buildings, and water supply and sewer systems was valued at nearly $2.2 trillion. Sale of even a small fraction of these assets to private parties, with a leaseback to the former nontaxable owner, would result in tax reductions far exceeding anything contemplated in current baseline revenue estimates.

Even if the subsidy is limited to new construction or rehabilitation of older buildings, the potential revenue loss is substantial. Excluding highways and streets, state and local governments accounted for about $22 billion in new construction in 1981, about 13 percent of total new construction in the economy that year.

To give an example of how the volume of sale-leaseback activity relates to the revenue loss, if sale-leasebacks amounted to $2 billion in 1984 and increased to $10 billion by 1988, the resulting revenue losses would be roughly $100 million in fiscal year 1984, rising to approximately $1.5 billion by fiscal year 1988.

Effects on the Allocation of Resources. The main limits on sale-leaseback financing are the complex nature of the transactions, which should ease as the practice becomes more widespread and familiar, and the demand for such tax shelters by high-

income investors, which should be fairly strong. Sale-leasebacks would appeal to the same high-income taxpayers who invest in real estate and other tax shelters, and they might even be preferable because they are less risky. The facilities are used by state and local governments, and the degree of risk of any investment can be gauged by the credit rating of the lessee. In time, private investment in the property of nontaxable entities--which need not involve any improvements to existing facilities--could displace investment in real property, plant, and equipment for both residential and business purposes. If the nontaxable entities then turned around and invested the proceeds from the sale of their assets in taxable bonds or other high-yielding assets, some of this capital would be restored to the private sector, but in a circuitous manner. Whether the Congress wants to encourage this kind of reallocation of investment resources is an issue that should be directly addressed.

POLICY ALTERNATIVES

H.R. 3110 would deny nontaxable entities a substantial portion of the ACRS depreciation deductions by requiring that property used by them be depreciated over longer recovery periods than are now permitted under ACRS.[1] As noted earlier, this provision would, in effect, deny most or all of the subsidy portion of ACRS to nontaxable entities. These longer recovery periods would substantially weaken the incentives for private investors to buy existing property from nontaxable entities. In

1. The proposed recovery periods are 5 years for property in the 3-year class; 12 years for property in the 5-year class; 25 years for property in the 10-year class; and 35 years for property in the 15-year class.

the case of newly constructed buildings, however, the shorter ACRS lives in existing law would continue to be allowed as long as the tax-exempt entity did not finance the property with tax-exempt bonds and as long as the lease arrangement met some standards specified in the bill.

H.R. 3110 would also tighten the restrictions on the use of the regular investment tax credit by tax-exempt entities. The special tax credits for rehabilitation of old or historic buildings would continue to be allowed for buildings used by governmental units or tax-exempt organizations, but these tax credits could not be combined with tax-exempt IRB financing. This suggests a view that, while it may be appropriate to provide a subsidy through the tax code to encourage nontaxable entities to rehabilitate older buildings, the total federal subsidy should be limited.

These measures would sharply reduce the use of sale-leaseback financing techniques. As a consequence, however, property used by nontaxable entities would receive a lower total federal subsidy than is received by comparable property used by taxable entities. As indicated earlier, if the Congress wants to provide equivalent subsidies for nontaxable entities, it could do so by providing grants or low-interest loans under existing or new programs, thereby avoiding the administrative problems and inefficiencies of using the tax system.

The approach taken by H.R. 3110 is simply to cut back on the use by tax-exempt entities of the generous tax subsidies provided by ACRS and the rehabilitation tax credits. The potential heavy use of these subsidies by nontaxable entities suggests,

however, that the subsidies themselves may be unduly large in a period when federal resources are scarce. If so, reduction in these subsidies for all users might be an appropriate way of simultaneously reducing the incentives for sale-leasebacks and raising some of the revenue needed to deal with projected long-term budget deficits. If, for example, ACRS depreciation for buildings was extended from 15 to 20 years and limited to straight-line for all users, revenues would be increased by $3.8 billion in fiscal year 1986 and $7.8 billion in fiscal year 1988. If the rehabilitation tax credits were scaled back to 10 percent for buildings more than 30 years old and 15 percent for certified historic structures, revenues would be increased by $600 million in 1986 and by nearly $800 million in 1988.