NATIONAL ASSOCIATION OF BOND LAWYERS

TAX SIMPLIFICATION PROPOSALS RELATING TO TAX-EXEMPT BONDS

I. Simplification Proposals Relating to Governmental Purpose Bonds

1. Permit One Additional Advance Refunding of Governmental Bonds and Qualified 501(c)(3) Bonds

**Present Law.** In general, issuers of tax-exempt governmental bonds (i.e., excluding most private activity bonds) and qualified 501(c)(3) bonds are provided one advance refunding opportunity for tax-exempt bond issues issued after December 31, 1985. Here, an “advance refunding” means an issuance of refunding bonds to refund other bonds (“refunded bonds”) where the refunding bonds are issued more than 90 days before the redemption of the refunded bonds.

**Example.** Assume a local government issued tax-exempt bonds in 1994 to finance the construction of a new school building. The bonds contain a 10-year no-call period which is standard in the municipal market. In 1999, with the decline of interest rates, the issuer decided to advance refund its bonds to achieve net interest cost savings. Under current law, the issuer is permitted only one advance refunding. Therefore, when interest rates dropped to historic lows in 2003 and 2004, this issuer would be prevented from doing an additional advance refunding to achieve further net interest cost savings.

**Reason for Change.** For State and local governmental issuers and Section 501(c)(3) exempt organizations, debt service represents one of the most significant elements of their operating expenses. These governmental and nonprofit entities must manage the burden of paying debt service on bonds that have been issued to finance significant capital investments, such as roads, schools, hospitals, universities, transit systems, and other types of infrastructure.

When possible, issuers may elect to refinance their debt to take advantage of lower interest rates, thereby lowering their cost of borrowing. In addition, issuers may desire to refinance their outstanding debt to restructure the timing of debt service payments to better coincide with available revenue flows, take advantage of more modern financing techniques or to incorporate more flexible financial and legal covenants.

Because State and local governments and Section 501(c)(3) exempt organizations generally have only one opportunity to advance refund their debt (for new money bonds issued after December 31, 1985), they are put in the inflexible position of having essentially to guess when would be the optimum time to do that advance refunding to achieve the lowest net borrowing costs. The declining interest rate environment over the past few years had provided clear circumstances in which the one advance refunding restriction might have caused State and local governments and Section 501(c)(3) nonprofit organization potentially to miss out on opportunities to lower their borrowing costs. As described in the example above, an issuer that chose to advance refund its debt in 1999 would be prevented from advance refunding the same debt in 2003 or 2004 for further interest cost savings simply because it “guessed” wrong in 1999.

Congress should amend Federal tax law requirements to permit State and local governments and Section 501(c)(3) nonprofit organizations one additional advance refunding opportunity for their tax-exempt bonds.
2. Provide a Streamlined 3-Year Spending Exception to the Arbitrage Rebate Requirement in Lieu of the Present 2-Year Construction Spending Exception

*Present law.* Generally, interest earnings on investments of tax-exempt bond proceeds in excess of the bond yield must be rebated to the Federal Government. The main existing spending exception to arbitrage rebate is a complex 2-year spending exception applicable only to governmental and qualified 501(c)(3) bonds issued to finance certain construction projects.

*Example.* Assume bonds are issued by a local government to construct a courthouse. The issuer plans to use the 2-year rebate spending exception and has sized the issue to meet the spending benchmarks, including expenditure of all investment earnings. The issuer meets the first two semiannual spending benchmarks, but unusual inclement weather causes the issuer to fall short of the third benchmark. Under current law, the issuer loses the total benefit of the rebate exception and must rebate any excess investment earnings over the yield on the tax-exempt bonds to the Federal Government, even though the issuer had sized the issue to spend all earnings on the project.

Alternatively, to further illustrate some of the conditions to the existing exception, suppose an issuer who infrequently came to market planned for efficiency purposes to do a single tax-exempt bond issue to finance several major capital projects with a total expected spending period of $2\frac{1}{2}$ years. Suppose further that the issuer expected to use about one-third of the bond proceeds to finance various land acquisitions and equipment purchases associated with these capital projects. Here, both the $2\frac{1}{2}$ year spending period and the use of more than 25% of the bond proceeds on expenditures which were not technically “construction” expenditures would make this bond issue ineligible for the 2-year rebate spending exception.

*Reason for Change.* The present 2-year rebate spending exception provides for unrealistic spending periods, complex bifurcation procedures, difficult and repetitive computations, and unclear multipart definitions. The exception should be modified to be simple in its application and to permit issuers and conduit borrowers three years (rather than two years) years to meet the applicable spending requirements. In addition, this exception should be expanded to include both private activity bonds and governmental bonds, as well as to include bonds for any capital project (encompassing both acquisition and construction purposes). Also, the election to pay a penalty in lieu of rebate is rarely used and should be eliminated. This streamlined 3-year rebate spending exception should apply as broadly as possible, particularly given that limited arbitrage potential exists for short-term investments in most in long-term tax-exempt bond issues. This 3-year rebate spending period would provide meaningful administrative relief from complex arbitrage calculations to a broad number of tax-exempt bond issuers. The proposed spending benchmarks should contain a de minimis exception to broaden the availability of the exception to cover many circumstances in which minor amounts of bond proceeds remain unspent for bona fide reasons. This spending exception should be limited to fixed rate tax-exempt bonds to recognize one area in which some arbitrage potential may exist under a 3-year spending period in normal yield curves, which involves tax-exempt floating rate bonds with short-term tender options. The new 3-year spending exception also should exclude bonds issued mainly for working capital and refundings.
3. Increase the Small Issuer Exception to the Arbitrage Rebate Requirement from $5 Million to $25 Million and Remove the General Taxing Power Condition

Present law. Generally, interest earnings on investments of tax-exempt bond proceeds above the yield on the tax-exempt bonds must be rebated to the Federal Government. Under the small issuer exception, the rebate requirement does not apply to governmental units with general taxing powers where the amount of bonds issued by the unit in the calendar year is not reasonably expected to exceed $5 million (excluding private activity bonds and most current refunding bonds with a principal amount not exceeding the principal amount of the refunded bonds).

Example. If an issuer with general taxing powers issues bonds to construct a library, and if the principal amount of bonds is $5 million or less (taking into account other bonds issued by the issuer in the calendar year), then the rebate requirement does not apply to the bonds. If, however, the principal amount of bonds is $5.1 million, or if the issuer does not have general taxing powers, such as a public building authority which is an instrumentality of a governmental unit with general taxing powers, then the rebate requirement applies to the bonds.

Reason for Change. With one exception, the small issuer exception to the rebate requirement has remained at $5 million since its inception in 1986. Thus, while all other costs associated with capital expenditures (construction, acquisition, administrative, etc.) have increased, the $5 million limitation has remained stagnant.

Increasing the small issuer exception will substantially reduce the administrative burden imposed on a large number of small issuers by the rebate requirement while affecting a disproportionately smaller amount of tax-exempt bond dollar volume. As an illustration of this disproportionate effect involving larger numbers of small affected bond issuers and smaller amounts of affected bond dollar volume, in 2003, tax-exempt issuers of $10 million or less of bank purchase qualified bonds issued 4,700 bond issues out of 14,833 total tax-exempt bond issues, representing 32% of the total number of such bond issues. The dollar volume of those bond issues, however, was only about $15.25 billion out of about $382.7 billion of total tax-exempt bond dollar volume, representing only about 4% of tax-exempt bond dollar volume. At the example $10 million level, the difference between the large number of small bond issuers who could be relieved of administrative burdens (32%) and the smaller affected tax-exempt bond dollar volume (4%) is compelling.

Moreover, if an issuer is a governmental unit authorized to issue bonds, it should be eligible for the small issuer exception to the rebate requirement even if it does not have general taxing powers. The requirement for the existence of general taxing powers unfairly narrows the benefit of the exception. State or local governments commonly use public instrumentalities without general taxing powers to carry out tax-exempt bond programs.

4. Add An Exception to the Arbitrage Rebate Requirement for Equity-Funded Reserve Funds

Present law. Although present law limits the amount of tax-exempt bond proceeds that may be used to fund a debt service reserve fund to 10% of the bond proceeds, the arbitrage rebate requirement nonetheless continues to apply to debt service reserve funds for most bond issues.
The rebate requirement will continue to apply to these reserve funds throughout the term of the bonds even if all other bond proceeds are spent promptly under a rebate spending exception.

**Example.** Assume bonds with a term of 20 years are issued to construct a library. Further assume that proceeds of the bonds are used to fund a construction fund and a 10% debt service reserve fund. Even if the amounts deposited in the construction fund are spent promptly within 2 years in compliance with a rebate spending exception, the rebate requirement will nevertheless continue to apply to the reserve fund for the entire 20-year term of the bonds. This result will apply even if the issuer does not comply with a spending exception but nevertheless spends the bond proceeds in due course.

**Reason for Change.** Except for amounts deposited in a reserve fund, the bond proceeds to which the rebate requirement relates are generally spent within 2 or 3 years of the date of issuance, whether or not a spending exception to the rebate requirement is satisfied. Because a reserve fund is not spent (except to pay debt service on the bonds in the event of unforeseen financial difficulties), present law mandates that the rebate requirement continues to apply for the entire term of the bonds, and imposes costly and cumbersome administrative burdens on issuers associated with recordkeeping and tracking investment earnings on the reserve funds. To relieve these administrative burdens, issuers should be permitted to disregard debt service reserve funds in complying with the rebate requirement if the issuers fund the reserve funds from their own funds or from the proceeds of taxable bonds. This change should provide an incentive to issuers to decrease the principal amount of bonds burdening the tax-exempt bond market, as more issuers would choose to fund reserve funds from equity and/or taxable borrowings.

5. **Increase the Small Issuer Bank Purchase Exception from $10 to $25 Million and Conform to the Small Issuer Exception to the Arbitrage Rebate Requirement**

**Present law.** Banks generally are prohibited from deducting interest on loans used to carry tax-exempt bonds. A small issuer bank purchase exception allows banks to deduct these carrying costs when banks purchase tax-exempt bonds issued by issuers whose total amount of tax-exempt bonds issued in a calendar year does not exceed $10 million (excluding private activity bonds and most current refunding bonds having a principal amount not in excess of the principal amount of the refunded bonds).

**Example.** If a bank purchases bonds issued to construct a city office building, and if the principal amount of bonds is $10 million or less (taking into account other bonds issued by the same issuer in the calendar year), then the prohibition against deduction of interest on loans to carry tax-exempt bonds does not apply. If, however, the principal amount of the bonds is $10.1 million (or if the issuer previously issued bonds that, together with the office building bonds, exceed $10 million), the issuer is less likely to be able to market the bonds to a financial institution because the nondeductibility limitation applies to the bank and makes the bonds less attractive to a bank as a potential purchaser.

**Reason for Change.** The purpose of the small issuer bank purchase exception to bank nondeductibility is to preserve the ability of small issuers, with limited access to the capital markets, to place bonds with local banks. Because the cost of capital projects and, as a consequence, the principal amount of bonds necessary to fund capital projects, has increased dramatically since 1986, while the $10 million limitation has remained the same, the principal
amount of the exception should be increased. Also, the eligibility requirements for the exception should be conformed to those for the small issuer exception from the rebate requirement, as the slight differences between the statutory language of the two provisions are a trap for the less sophisticated issuers for whom the provisions were designed. Here, in short, it would be much simpler if a single definition of a “small” issuer were used for both the rebate exception and the bank nondeductibility exception. In addition, for the same reasons noted with respect to the recommended change in the small issuer rebate exception, an increase in this exception would provide access to bank purchasers for a disproportionately large number of issuers while affecting a comparatively small amount of bond dollar volume. While it has been suggested that the small issuer bank purchase exception is no longer necessary because of the access to capital markets provided by state-level bond banks and pooled loan programs, many states have no such bond banks or pooled loan programs and many small issuers continue to rely heavily on local banks as their main source of financing. Finally, in the case of an issue of obligations the proceeds of which are to be used to make one or more loans (i.e., pooled financing bonds), an issuer should be permitted to elect to treat each conduit borrower as the issuer of a separate issue. If such an election is made, the bank deductibility provision would apply to each conduit borrower.

6. **Repeal 5% Unrelated or Disproportionate Private Business Use Limit on Governmental Bonds**

**Present law.** If private business use is not related or is disproportionate to the governmental use of tax-exempt bond proceeds, then a 5% private business use restriction applies to tax-exempt governmental bonds instead of the general 10% private business restriction on such bonds.

**Example.** If a governmental bond is issued to finance a courthouse facility which includes a staff cafeteria operated by a private business, a 10% private business use restriction applies to such bond issue because the cafeteria use is treated as related to the courthouse use. If, however, a governmental bond is issued to finance a courthouse which includes office space for lawyers, a 5% private business use restriction applies to such bond issue because the law office use is treated as unrelated to the governmental courthouse use.

**Reason for Change.** The unrelated or disproportionate use test is cumbersome, inappropriately intricate, and difficult to understand and to apply. The determination of whether a particular use is related or unrelated to a governmental use or whether a use is proportionate or disproportionate to a governmental use can be vague and arbitrary. The application of the test is especially complex in the case of bond issues financing multiple facilities. Out of an abundance of caution, some issuers automatically reduce their otherwise-permitted level of private business involvement from 10% to 5% in governmental tax-exempt bond issues just to avoid the interpretative difficulty of this requirement which seems contrary to the intent of the private business restrictions. The penalty for an erroneous determination is loss of tax-exemption for the entire bond issue. The general 10% private use limit effectively controls excess private business use of governmental tax-exempt bond issues.
7. Modify Private Loan Financing Limit on Governmental Bonds

Present law. If more than the lesser of 5% or $5 million of the proceeds of a tax-exempt bond issue are used to finance a loan to a private person, the bonds generally are treated as private activity bonds (even if there is no private business use).

Example. If tax-exempt governmental bonds are issued in the principal amount of $20 million to finance governmentally-used public housing facilities, up to $1 million (5%) of bond proceeds may be used to make low-interest consumer loans to low-income persons to provide rental assistance. If, instead, no loans were made from this bond issue, then up to $2 million of the proceeds (equal to 10% of the proceeds), could be used to finance housing units to be rented to private businesses without impairing the governmental, non-private activity status of the bonds under the general private business limitations.

Reason for Change. For Federal tax purposes, the distinction between a “use” and a “loan” of bond proceeds is often artificial and is difficult to discern. The main intent of the private loan test was to limit the use of proceeds to make loans to persons not in a trade or business (e.g., consumer loans) in circumstances outside of the existing tax-exempt private activity bond programs, such as single-family housing and student loans. The existing provision also can be interpreted to place an additional, lower private business restriction on loans made to private businesses. Given the complexity of the private loan test limit and the similar policy of controlling private activity bond volume, the private loan test should be modified to be a straight 10% limitation which corresponds to the general private business limitation.

8. Repeal Volume Cap Requirement For Governmental Bond Issues With a Nonqualified Private Business Amount in Excess of $15 Million

Present law. Volume cap is required for tax-exempt governmental bond issues that have private business use or private payment or security that is within the general permitted 10% threshold, but that has a “nonqualified amount” of private business involvement which exceeds $15 million.

Example. Assume that an issuer issues bonds in the amount of $200 million. Because of the $15 million limitation, without obtaining volume cap, the issuer would be limited to $15 million of private business involvement. If, however, this issuer issued two separate issues of tax-exempt governmental bonds in principal amounts of $100 million each, the issuer would be permitted the full 10% amount of private business involvement for each bond issue under the general private business restrictions, which would aggregate $20 million of permitted private business involvement.

Reasons for Change. Mandating that an issuer receive volume cap where the amount of private business use or private payments and security (i.e., the nonqualified amount) exceeds $15 million has no sound tax policy justification. The general 10% private business limits on tax-exempt governmental bonds adequately address the level of private business involvement and should serve as the exclusive restrictions.
9. **Repeal Restriction on Governmental Acquisition of Certain Private Output Facilities**

*Present law.* If more than the lesser of 5% or $5 million of the proceeds of a bond issue are used by a State or local governmental unit to acquire a privately-owned electric or gas facility, the bonds generally are impermissible private activity bonds.

*Example.* Suppose a city determined that it wanted to purchase an existing electric generation or transmission facility to be used by the city to assure reliable electric service for its citizens. Under present law, any bonds issued by the city to finance such the acquisition of such an existing electric generation or transmission facility from a seller which was a private utility would be treated as taxable private activity bonds, absent meeting another exception for certain local furnishing of electricity.

*Reason for Change.* In many circumstances, State and local governments determine to provide electricity or natural gas services to their citizens for reasons which include reducing utility rates, assuring reliability, and assuring adequacy of supply. One appropriate way to accomplish these public purposes may be for the State or local government to acquire output facilities from a private utility. The acquisition may be the result of negotiations on price or the acquisition may be through eminent domain proceedings based on payment of fair market value and a finding that a more important public purpose will be achieved by the acquisition than can be achieved through continued private ownership. The prohibition on the acquisition of privately-owned electric or gas facilities with tax-exempt governmental bonds represents an impairment of the ability of local government to serve their citizens. From a tax policy perspective, State and local governments properly ought to be able to use tax-exempt governmental bonds to carry out these public purposes by financing either new output facilities or acquiring existing privately-owned output facilities.

II. **Simplification Proposals Relating to Qualified Private Activity Bonds and Other Matters**

1. **Repeal the Alternative Minimum Tax Preference on Private Activity Bonds**

*Present law.* Although interest on qualified tax-exempt private activity bonds is excluded from Federal gross income, this interest is not tax-exempt for purposes of the Federal alternative minimum tax. Instead, this interest must be included in a bondholder’s tax base as an item of tax preference for purposes of computing the bondholder’s Federal alternative minimum tax.

*Example.* If a holder of qualified tax-exempt private activity bonds receives $100,000 of interest on the bonds in a year, that amount is not included in the holder’s Federal adjusted gross income for computing the holder’s Federal regular income tax. That interest, however, is required to be added to the holder’s Federal adjusted gross income base in determining whether the holder is subject to the Federal alternative minimum tax.

*Reason for Change.* The repeal of the alternative minimum tax preference on tax-exempt qualified private activity bonds will simplify the tax-exempt interest exclusion, enhance market demand for these bonds, and increase market efficiency. In the municipal market, private activity bonds which are subject to the alternative minimum tax carry a punitive higher interest rate. This higher interest cost adds to Federal tax expenditures without a corresponding increase in Federal tax revenues because investors subject to the alternative minimum tax do not purchase...
these bonds. The proposed repeal of the alternative minimum tax preference on tax-exempt bonds will have increasing market significance as an increasing number of taxpayers are expected to be subject to this tax in future years. The increased demand for tax-exempt private activity bonds from this proposed change should have the effect of lowering the interest rates on private activity bonds by an estimated 10 to 25 basis points. This proposed change should decrease the burden on the tax-exempt bond market and increase Federal revenues.

2. **Complete the Repeal of the $150 Million Nonhospital Bond Limitation on Qualified 501(c)(3) Bonds**

*Present law.* The Taxpayer Relief Act of 1997 provided for the partial repeal of the $150 million limitation on qualified 501(c)(3) bonds used to finance facilities besides hospitals for Section 501(c)(3) nonprofit organizations. Vestiges of the $150 million continue to apply to qualified 501(c)(3) bonds in a number of circumstances, including: (i) outstanding bonds issued before August 5, 1997 for capital expenditures; (ii) certain refundings of those bonds; and (iii) nonhospital bonds 5% of the net proceeds of which were used for working capital expenditures.

*Example.* If bonds were issued in 1996 to construct a Section 501(c)(3) university building, those bonds were, and continue to be, subject to the $150 million limitation. Also, certain bonds now issued to refund those bonds are subject to the limitation. If $50 million of bonds are now issued to finance a Section 501(c)(3) university classroom building and more than $2.5 million (5% of $50 million) of proceeds are used for working capital, then those bonds are also subject to the $150 million limitation.

*Reason for Change.* The complex analysis and monitoring requirements associated with tracking the continuing vestiges of the $150 million nonhospital bond limitation undermine the tax policy inherent in the predominant repeal of this provision. Many universities and other 501(c)(3) organizations have bonds outstanding which have been issued in furtherance of their charitable purposes in order to fulfill those purposes at the lowest possible cost. The continuance of a small portion of the $150 million limitation into the future may limit the ability to refund those bonds to provide cost savings (i.e., a borrower may not have any room under the cap to advance refund bonds subject to such limitation) or limit the ability to merge or combine with other institutions having outstanding bonds subject to the limitation (i.e., two unrelated organization may not be permitted to merge in the event the new combined entity has in excess of $150 million of bonds allocable to it). The bifurcation regime of having pre-August 5, 1997 non-hospital bonds subject to this limitation) and post-August 5, 1997 bonds exempt from this limitation creates undue tax complexity without any discernible benefit to the Treasury.

3. **Eliminate the Specific Identification Requirement for Volume Cap Carryforward for Private Activity Bonds**

*Present Law.* Private activity bonds are subject to a statewide volume cap. If the full amount of the cap is not used in any year, the unused portion may be carried forward. To be eligible, a carryforward election must identify the specific purposes of the use of the bonds to be carried forward and must identify the carryforward amount to be used for each identified purpose.

*Example.* If a local government has been allocated state volume cap in the amount of $30 million in a particular year, and only $25 million is applied to qualified private activity bonds
issued in that year, the remaining $5 million may be “carried forward” to subsequent years if an appropriate election is made which specifically identifies the purpose for which the bonds carried forward are to be used. If, however, the specific identification of the carryforward purpose is not made, or if the purpose for which the specific identification is made is not financed, the volume cap is forever lost.

**Reason for Change.** The complexity associated with monitoring of private activity bond volume cap carryforwards for particular facilities and tracking expirations of elections under a stacking order is unwarranted. Identifying the total amount of the unused private activity bond volume cap in a particular year should be sufficient. Financing circumstances will often change in terms of the facilities and amounts needed to be financed despite an issuer’s bona fide expectations at the time of a carryforward election. These circumstances may involve anything from the discovery of environmental hazards on a proposed construction site to an unexpected shift in government priorities.

4. **Repeal 25% Land Acquisition Restriction on Private Activity Bonds**

*Present law.* For private activity bonds, only an amount equal to less than 25% of the net proceeds may be used for the acquisition or land or an interest therein.

*Example.* If private activity bonds in the amount of $10 million are issued by a city to finance a low-income rental housing project, only an amount equal to less than 25% of the net proceeds or $2.5 million may be used to acquire the land on which the facility is to be located, regardless of whether the project is in a high-cost urban redevelopment area or a low-cost rural area.

*Reason for Change.* The cost of land continues to increase. In some urban areas, for example, the cost of the land may be disproportionate to other project costs when compared to other geographic areas, placing these projects at a disadvantage. There is no sound tax policy reason to penalize tax-exempt private activity bonds in high land-cost areas, such as inner cities with acute redevelopment needs. In light of other, more logical, restrictions on private activity bonds, including the state volume cap on private activity bonds, the land acquisition restriction seems unnecessary. In addition, the substantive requirements relating to the eligible uses of private activity bonds, including the general requirement that costs be functionally related and subordinate to the project purpose, limit the overall uses of proceeds appropriately.

5. **Repeal Existing Property Acquisition Restriction on Private Activity Bonds**

*Present law.* For private activity bonds, proceeds generally may not be used to finance existing property unless rehabilitation expenditures in an amount equal to least 15% of the portion of the acquisition costs of building (or 100% for certain other structures) financed with the net proceeds of the bonds are made within a prescribed 2-year period.

*Example.* If private activity bonds in the amount of $10 million are to be issued by a city to finance the acquisition of an existing low-income rental housing facility consisting of land costing $1 million and a building costing $9 million, then interest on the bonds is not tax-exempt unless $1.35 million (15% of $9 million) is spent for rehabilitation expenditures related to the building within a prescribed 2-year period.
Reason for Change. The existing property acquisition restriction was originally enacted to address concerns regarding accelerated depreciation of tax-exempt bond financed property. Such provisions no longer exist. Moreover, the long depreciation periods for tax-exempt bond-financed property under current law provide a disincentive for this financing. In general, the state volume cap limitation adequately controls the amount of private activity bonds that may be issued to finance existing property. Bond proceeds cannot be used to acquire used equipment, which can be the most cost effective method for a business. The definition of rehabilitation is technical and can require considerable legal analysis. Finally, the 15% rehabilitation requirement for buildings is arbitrary and the 100% rehabilitation expenditure requirements for other types of costs lack a sound policy footing and are unduly burdensome.

6. Overhaul the TEFRA Public Approval Requirement on Private Activity Bonds

Present law. All qualified tax-exempt private activity bonds must meet a public approval requirement prior to the issuance of the bonds. The public approval must be done by the applicable elected representative of governmental unit issuing the bonds and, with certain exceptions, by each governmental unit in which the bond-financed facility is to be located. The public approval can take place only after a public hearing with specified public notice.

Example. If qualified tax-exempt private activity bonds are to be issued by a city to finance a nonprofit hospital located within the city and within another city, the governing body of both cities must approve the bonds after a public hearing. If bonds are to be issued by a state for a multifamily housing facility to be located in a city, the bonds must be approved by the governor of the state (or other designated elected official) following a public hearing.

Reason for Change. While one cannot object in theory to a good government “sunshine” policy in favor of public hearings and public approval, in practice, most State and local governments believe that this TEFRA public approval requirement is costly, cumbersome, and ineffective. Members of the public rarely attend the public hearing required by this provision. This provision often conflicts with or is duplicative of state law requirements relating to the issuance of bonds. These state laws generally require a public hearing when the legislature enacting the state law has determined a hearing to be appropriate and useful Federal tax law should not interfere with what is essentially a local matter regarding the issuance of debt for the facility in question. In addition, this requirement has long outlived part of its original purpose to control private activity bond volume and it predates the volume cap. The private activity bond volume cap is sufficient to control private activity bond volume.

7. Repeal 2% Issuance Cost Limit on Private Activity Bonds

Present law. For private activity bonds, issuance costs financed by the issue generally may not exceed 2% of the proceeds of the issue.

Example. If private activity bonds in the amount of $1 million are issued by a health care authority on behalf of a Section 501(c)(3) organization to finance hospital improvements, then interest on the bonds is not tax-exempt if more than $20,000 of the bond proceeds is spent for issuance costs.

Reason for Change. The 2% bond issuance cost limit reflects undue micromanagement of State and local governmental finance. Other tax-exempt bonds restrictions already provide appropriate
economic incentives for issuers to control issuance costs and generally limit tax-exempt bond
financed issuance costs to 5% in any event for most private activity bonds. For a period of time
in the early 1980s, issuers could “recover” the costs of issuance under the arbitrage rules. Thus,
if issuance costs were included in the yield on tax-exempt bonds in the arbitrage yield
calculation, the arbitrage yield would increase which will permit an issuer to retain more
investment earnings not subject to rebate. Changes to the arbitrage rules in the 1986 Tax Act,
however, now prevent issuers from “recovering” issuance costs of bonds in the arbitrage yield on
their bonds. This change has the effect of restricting the excessive use of proceeds for issuance
costs because the issuer must now pay the amounts back for its own funds rather than arbitrage
profits, which makes the 2% limit unnecessary. Also, under the private activity bond rules, at
least 95% of net bond proceeds must be spent for the private activity project being financed.
Finally, the 2% issuance cost limitation imposes a disproportionate burden on small issuers
because the dollar amounts of issuance costs do not generally decline as the principal amount of
bonds declines.

8. **Repeal Special $15 Million Private Business Limit on Governmental Electric and
Gas Facility Bonds**

*Present law.* If 5% or more of the proceeds of tax-exempt governmental bonds will be used for
an electric or gas output facility, the maximum amount of the bonds that may be applied to
private business use is $15,000,000, taking into account proceeds of prior bond issues used for
the same project.

*Example.* Assume that tax-exempt bonds in the principal amount of $100 million are issued to
finance a governmental gas generation facility. Under the private business tests, up to $10
million may be used for facilities providing for the take-or-pay sale of output to a private utility
under the 10% private business use restriction. If, however, a second issue of tax-exempt
governmental bonds of $100 million is issued for the same project, then only $5 million of that
issue may be used for such output contract facilities even though 10% of the proceeds otherwise
would be permitted to be used for private business use under the general private business
restrictions. If, further, if a third issue of tax-exempt governmental bonds of any amount is
issued for the same project, no proceeds may be used for such output facilities even though 10%
otherwise would be permitted under the general private business limitations.

*Reason for Change.* State and local governmental production and transmission electricity and
gas appropriately serve governmental purposes of benefit to the general public. It is punitive and
inappropriate to subject those purposes to a special limit other than the general 10% private
business use test. Moreover, as a matter of federal energy policy, the existing special $15
million private business restriction may frustrate the Federal Energy Regulatory Commission’s
efforts to open up the nation’s transmission grid to public access.

9. **Add An Exception to the Arbitrage Rebate Requirement for All Short-Term Bona
Fide Debt Service Funds**

*Present law.* A “bona fide debt service fund” is a fund used to match revenues and debt service
expenses each year. These funds generally must be fully depleted each year, subject to certain
reasonable carryover amounts. For this reason, bona fide debt service funds are constrained to
invest in short-term investments. Bona fide debt service funds are eligible for exceptions to the
arbitrage rebate requirement if either: (i) the bonds are governmental, fixed-rate, non-private activity bonds with an average maturity of at least five years; or (ii) the gross earnings on such a fund in a year are less than $100,000.

**Example.** If governmental tax-exempt bonds are used to construct a public airport runway, and revenues are deposited in a bona fide debt service fund to pay debt service on the bonds, the bond fund is not subject to the rebate requirement if the average maturity of the bonds is at least 5 years and the interest on the bonds is fixed (rather than variable). If, however, private activity bonds are issued to finance terminal facilities leased to airlines, the debt service fund will be subject to the rebate requirement if the gross earnings on the fund in the year are more than $100,000.

**Reason for Change.** The present law exceptions to arbitrage rebate for bona fide debt service funds are very complex. Yet, at the same time, bona fide debt service fund generally must be depleted annually and typically are invested at yields well below the bond yield because of the inherently short-term nature of the investments. Moreover, bona fide debt service funds may actually “blend down” other higher-yielding investments and thus decrease the amount of rebate owed to the Federal Government. The provision of a blanket exception to arbitrage rebate for bona fide debt service funds will simplify the law and may well have a positive revenue impact in terms of increased rebate amounts to be paid to Federal Government.