Possible Legislative Changes to Update, Reform and Rationalize the Tax-Exempt Bond Rules

This paper outlines a series of possible legislative changes to update, reform and rationalize the tax laws in the tax-exempt bond area. The rules applicable to tax-exempt bonds include a number of duplicative and/or outdated provisions, as well as provisions that impose significant compliance burdens on issuers with limited benefit to the public or the fisc. The summary of each possible change includes a brief statement of present law, an example under present law, reasons for change, and possible legislative language. The intent of this approach is to make the summaries of possible changes more understandable and useful as briefing papers for State and local governmental groups and Congressional officials and staff.

For a more in-depth technical analysis of most of the proposals herein, see NABL's Report on Tax Simplification Recommendations to Treasury on Tax-Exempt Bonds, dated June 14, 2002, which was published in *Tax Notes*. See 96 *Tax Notes* at 965 (August 12, 2002).
### TABLE OF CONTENTS


1. Permit Two Advance Refundings of Governmental Bonds and Qualified 501(c)(3) Bonds ......................................................1

2. Provide a Streamlined 3-Year Spending Exception to the Arbitrage Rebate Requirement in Lieu of the Present 2-Year Construction Spending Exception. .....3

3. Increase the Small Issuer Exception to the Arbitrage Rebate Requirement from $5 Million to $25 Million and Remove the General Taxing Power Condition .................................................................5

4. Increase the Small Issuer Bank Purchase Exception from $10 Million to $25 Million and Conform Provisions to the Small Issuer Exception to the Arbitrage Rebate Requirement ................................................7

5. Repeal the Alternative Minimum Tax Preference on Private Activity Bonds.......9

B. Repeal/Reform of Obsolete or Unnecessary Provisions

6. Repeal the 5% Unrelated or Disproportionate Private Business Use Limit on Governmental Bonds ..................................................10

7. Complete the Repeal of the $150 Million Nonhospital Bond Limitation on Qualified 501(c)(3) Bonds .......................................................................................11

8. Add An Exception to the Arbitrage Rebate Requirement for All Short-Term Bonafide Debt Service Funds .........................................................12


10. Repeal TEFRA Public Approval Requirement on Private Activity Bonds .......14

C. Repeal/Reform of Excessive Restrictions

11. Add An Exception to the Arbitrage Rebate Requirement for Equity-Funded Reserve Funds.............................................................................15

12. Repeal Special $15 Million Private Business Limit on Governmental Electric or Gas Facility Bonds ........................................................................17

13. Modify Private Loan Financing Limit on Governmental Bonds .....................18

14. Repeal 25% Land Acquisition Restriction on Private Activity Bonds ............19

15. Repeal Existing Property Acquisition Restriction on Private Activity Bonds ....20

16. Repeal 2% Issuance Cost Limit on Private Activity Bonds ............................20

17. Repeal Volume Cap Requirement on Governmental Bond Issues With a Private Business Amount in Excess of $15 Million...........................................21

18. Repeal Restriction on Governmental Acquisition of Certain Private Output Facilities .........................................................................................23
A. REFORMS OF OVERLY BURDENSOME/OUTDATED PROVISIONS

1. Permit Two Advance Refundings 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 or refinance 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. Current law allows the issuer only one advance refunding. Therefore, when interest rates dropped to historic lows in 2003 and 2004, this issuer would have been 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. 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 incorporate more flexible financial and legal covenants.

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). As a result, they essentially are put in the inflexible position of having to guess when the optimum time would be to utilize that one advance refunding to achieve the lowest net borrowing costs. The declining interest rate environment over the past few years demonstrates how the one advance refunding restriction might have caused State and local governments and Section 501(c)(3) nonprofit organizations 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. Allowing two advance refundings arguably strikes a reasonable balance between the needs of issuers described above and policy-based concerns regarding the overburdening of the market with multiple bond issues for the same project.

**Legislative language.**

Section 149(d)(3)(A)(i) (relating to advance refundings of other bonds) is amended—

(1) by striking 'or' at the end of subclause (I),

-1-
(2) by adding 'or' at the end of subclause (II), and
(3) by inserting after subclause (II) the following:

(III) the second advance refunding of the original bond if the original bond was issued after 1985 or the third advance refunding of the original bond if the original bond was issued before 1986.
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 prompt spending exception to arbitrage rebate is a complex 2-year rebate spending exception that applies only to governmental bonds and qualified 501(c)(3) bonds issued to finance certain construction projects, and includes a virtually never used election to pay a penalty in lieu of rebate if the spending requirements are not met.

**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 difficulties caused by the existing exception, suppose an issuer who infrequently accesses the market plans, for efficiency purposes, to do a single tax-exempt bond issue to finance several major capital projects with a total expected spending period of 2½ years. The 2½ year spending period would make this bond issue ineligible for the 2-year rebate spending exception. Suppose further that the issuer expects to use one-third of the bond proceeds to finance various land acquisitions and equipment purchases associated with those capital expenditures. The use of more than 25% of the bond proceeds on expenditures which are not technically "construction expenditures" would prevent application of the 2-year rebate spending exception to the issue as a whole, and would require the issuer to elect to bifurcate the issue into construction and non-construction portions in order to partially apply the 2-year rebate spending exception.

**Reason for Change.** The present 2-year rebate spending exception provides for difficult to attain spending periods, complex bifurcation procedures and a rarely used election to pay a penalty in lieu of rebate. The exception could be modified to be simpler 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 could 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). The proposed spending benchmarks could 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 could 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 could exclude bonds issued mainly for
working capital and refundings. The ability of issuers to issue bonds earlier than necessary (e.g., in the case of acquisitions) to take advantage of the this rule would be restricted by the temporary period requirements under the arbitrage rules. Finally, the election to pay a penalty in lieu of rebate if the spending requirements are not met could be eliminated as it is virtually never used.

**Legislative language.**

Section 148(f)(4)(C) (relating to exception from rebate for certain proceeds to be used to finance construction expenditures) is amended to read as follows:

'(C) EXCEPTION FROM REBATE FOR PROMPT EXPENDITURE.---

(i) An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraphs (2) and (3) if---

(I) At least 90 percent of the gross proceeds are used to provide capital projects (other than in a refunding),

(II) At least 25 percent of the gross proceeds are spent within the 12-month period beginning on the issue date, at least 50 percent of the gross proceeds are spent within the 24-month period beginning on the issue date, and at least 95 percent of the gross proceeds are spent within the 36-month period beginning on the issue date,

(III) The gross proceeds are spent with due diligence, and

(IV) The yield on the issue is a fixed yield.

(ii) For purposes of this subparagraph, the term "gross proceeds" does not include amounts in a bona fide debt service fund or earnings on those amounts, amounts in a reasonably required reserve fund, amounts that (as of the issue date) are not reasonably expected to be gross proceeds but that become gross proceeds after the end of the 12-month period beginning on the issue date, amounts derived from payments under an investment that is a purpose investment in that it is acquired in order to carry out the governmental purposes of the issue, or amounts representing repayments of grants.'
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 governmental unit in the calendar year is not reasonably expected to exceed $5 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 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 (e.g., is 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 ordinary inflation has caused all other costs associated with capital expenditures (construction, acquisition, administrative, etc.) to increase, the $5 million limitation has remained stagnant.

Increasing the small issuer exception could 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, 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. The basis for requiring the existence of general taxing powers is unclear, but it significantly 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.

**Legislative language.**

Section subparagraph (D) of section 148(f)(4)(D) (relating to exception for governmental units issuing $5,000,000 or less of bonds) is amended--

(A) In the title and in clauses (i), (iv), (v), and (vi) by striking '$5,000,000' each place it appears and inserting '$25,000,000','
(B) In clauses (i), (ii), (iv), and (vi), by striking 'with general taxing powers' each place it appears, and

(C) By striking clause (viii).
4. **Increase the Small Issuer Bank Purchase Exception from $10 Million to $25 Million and Conform Provisions 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 makes the bonds less attractive to a bank as a potential purchaser.

**Reason for Change.** The apparent 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 could be increased in order for the intended level of benefit to stay constant. Also, the eligibility requirements for the exception could be conformed to those for the small issuer exception from the rebate requirement (see item 7 above), as the differences between the statutory language of the two provisions are a trap for the less sophisticated issuers for whom the provisions were designed. While some suggest 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.

**Legislative language.**

Section 265(b)(3) (relating to exception for certain tax-exempt obligations) is amended--

(A) In subparagraph (C)(i) by striking subparagraph (C) and inserting 'For purposes of subparagraph (B), the term "qualified small issuer" means, with respect to obligations issued during any calendar year 'any issuer if the reasonably anticipated amount of tax-exempt obligations (other than obligations described in clause (ii)) which will be issued by such issuer during such calendar year does not exceed $25,000,000' and inserting 'any issuer eligible in that calendar year for the
exception set forth in section 148(f)(4)(D) (relating to the exception from the rebate requirement for certain governmental units)."

(B) In subparagraph (D)(i), by striking '10,000,000' and inserting '25,000,000',

(C) By amending subparagraph (D)(ii) to read as follows:

'(ii) TREATMENT OF REFUNDING OBLIGATIONS. A refunding obligation shall be treated as a qualified tax-exempt obligation if it is not taken into account for purposes of the exception set forth in section 148(f)(4)(D) pursuant to clause (iii) of section 148(f)(4)(D), and if it is treated as eligible for the exception set forth section 148(f)(4)(D) by reason of clause (v) of section 148(f)(4)(D).', and

(D) In subparagraph (D)(iii)(II), by striking '10,000,000' and inserting '25,000,000.'
5. **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 ("AMT"). Instead, this interest is required to be included in a bondholder's tax base as an item of tax preference for purposes of computing the bondholder's AMT.

**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 AMT.

**Reason for Change.** The repeal of the AMT preference on tax-exempt qualified private activity bonds may simplify the tax-exempt interest exclusion, enhance market demand for these bonds, and increase market efficiency. In the municipal market, private activity bonds that are subject to the AMT carry a punitive higher interest rate. The repeal of the AMT preference on tax-exempt bonds could have an 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 could have the effect of lowering the interest rates on private activity bonds by an estimated 10 to 25 basis points.

**Legislative language.**

Section 57(a) (relating to items of tax preference, general rule) is amended by striking paragraph (5).
B. REPEAL/REFORM OF OBSELETE OR UNNECESSARY PROVISIONS

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

**Present Law.** While the private business use test generally limits the private business use of bond proceeds to 10% of the proceeds of the issue, any private business use that is not related to, or that is disproportionate to, the governmental use of the tax-exempt bond proceeds is subject to an additional restriction under which all such unrelated or disproportionate private business use is limited to 5% of the proceeds of the issue.

**Example.** If a governmental bond is issued to finance a courthouse facility which includes a staff cafeteria operated by a private business, the private business use test will restrict the amount of proceeds used for the cafeteria to 10% of bond proceeds 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 both a privately operated staff cafeteria and office space for lawyers, the private business use test will restrict the aggregate amount of proceeds used for the cafeteria and the law office space to 10% of bond proceeds, and will further restrict the amount of proceeds used for the law office space to 5% of bond proceeds because the law office use is treated as unrelated to the governmental courthouse use.

**Reason for Change.** 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 to avoid the interpretative difficulty of this requirement. The penalty for an erroneous determination is loss of tax-exemption for the entire bond issue. The general 10% private use limit already significantly controls excess private business use of governmental tax-exempt bond issues.

**Legislative language.**

Section 141(b) (relating to private business tests) is amended by striking paragraph (3) and by redesignating paragraphs (4), (5), (6), (7), (8), and (9) as paragraphs (3), (4), (5), (6), (7), and (8), respectively.
7. **Complete the Repeal of the $150 Million Nonhospital Bond Limitation on Qualified 501(c)(3) Bonds**

**Present Law.** The Taxpayer Relief Act of 1997 partially repealed the $150 million limitation on qualified 501(c)(3) bonds used to finance non-hospital facilities for Section 501(c)(3) nonprofit organizations. Vestiges of the $150 million limitation 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 in which more than 5% of the net proceeds 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.** 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 if 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 while post-August 5, 1997 bonds are exempt from this limitation particularly creates undue tax complexity without significant discernible benefit to the Treasury.

**Legislative language.**

Section 145(b) (relating to $150 million limitation on nonhospital bonds) is amended by striking all of paragraph (5) after 'issued' and inserting 'before or after the date of enactment of this paragraph (August 5, 1997).’
8. **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. To qualify for favorable treatment under the arbitrage rules, these funds generally must be fully depleted each year, subject to certain reasonable carryover amounts. Due to these constraints, bona fide debt service funds are invested 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 the 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 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 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.** As stated above, a bona fide debt service fund generally must be depleted annually and typically is 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 would simplify the law.

**Legislative language.**

Subparagraph (A) of section 148(f)(4) (relating to special rules for applying required rebate) is amended--

(A) in clause (ii) by striking 'if the gross earnings on such fund for the bond year is less than $100,000', and

(B) by striking the flush language following clause (ii).
9. **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 the following year. To be eligible, a carryforward election must identify (i) the specific purposes of the use of the bonds to be carried forward, and (ii) 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 permanently lost.

**Reason for Change.** 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. Eliminating the specific identification requirement could provide flexibility to State and local governments experiencing changed circumstances and needs, and could reduce administrative burdens on issuers of monitoring private activity bond volume cap carryforwards.

**Legislative Language.**

Section 146(f) (relating to elective carryforward of unused volume limitation) is amended--

(A) In the title thereof by striking 'FOR SPECIFIED PURPOSE',

(B) In the flush language following paragraph (1)(B), by striking 'carryforward purposes' and inserting 'private activity bond purposes',

(C) By striking paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively,

(D) By amending subparagraph (A) of paragraph (2) (as redesignated) by striking 'with respect to any carryforward purpose', 'with respect to such purpose' and 'for such purpose',

(E) By amending subparagraph (B) of paragraph (2) (as redesignated) by striking 'with respect to any purpose',

(F) By amending paragraph (3) (as redesignated) by striking '(and any identification or specification contained therein)', and

(G) By deleting paragraph (5).
10. **Repeal 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 the 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 each city 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.** NABL supports good government "sunshine" policy in favor of public hearings and public approval; however, in practice, many 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. In addition, this requirement has long outlived part of its original purpose to control private activity bond volume since it predates the volume cap, which by making private activity bonds a limited resource encourages more careful review of their issuance.

**Legislative language.**

Section 147 (relating to other requirements applicable to certain private activity bonds) is amended by striking subsection (f) and by redesignating subsections (g), and (h) as subsections (f), and (g), respectively.
C REPEAL/REFORM OF EXCESSIVE RESTRICTIONS

11. 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. Moreover, the debt service reserve fund will be subject to the rebate requirement even if the issuer funds the reserve fund from its own equity rather than from proceeds of the bonds, since such amounts will be considered replacement proceeds. 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 entirely to fund the construction fund for the project, and that the issuer uses its own equity to fund a 10% debt service reserve fund. Even if the amounts deposited in the construction fund (i.e., all of the sale proceeds of the bonds) are spent promptly within 2 years in compliance with a rebate spending exception, the rebate requirement will nevertheless continue to apply to the equity-funded 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 on issuers costly and cumbersome administrative burdens associated with recordkeeping and tracking investment earnings on the reserve funds. To relieve these administrative burdens, issuers could be permitted to disregard debt service reserve funds in complying with the rebate requirement, provided that the issuers fund the reserve funds from their own funds or from the proceeds of taxable bonds. This change could provide an incentive to issuers to decrease the principal amount of bonds burdening the tax-exempt bond market, as more issuers likely would choose to fund reserve funds from equity and/or taxable borrowings. The benefit of this rule would be limited to debt service reserve funds that are eligible for unrestricted investment under the arbitrage rules, i.e., to debt service reserve funds that are "reasonably required" and that do not exceed the 3-part size limitation for reasonably required reserve or replacement funds under the arbitrage regulations.
Legislative language.

Section 148(f)(4) (relating to required rebate to the United States) is amended by adding at the end thereof the following new subparagraph:

'(E) EXCEPTION FOR CERTAIN RESERVE FUNDS. Paragraph (2) shall not apply to the earnings on any reasonably required reserve or replacement fund funded from a source other than the proceeds of a tax-exempt bond.'
12. **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. 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 use restrictions.

**Reason for Change.** State and local governmental production and transmission of electricity and gas appropriately serve governmental purposes of benefit to the general public, and thus is it unclear why those purposes should be subject 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.

**Legislative language.**

Section 141(b) (relating to private business tests) is amended by striking paragraph (4) and by redesignating paragraphs (5), (6), (7), (8), and (9) as paragraphs (4), (5), (6), (7), and (8).
13. **Modify Private Loan Financing Limit on Governmental Bonds**

**Present Law.** If an amount exceeding the lesser of 5% or $5 million of the proceeds of a tax-exempt bond issue is 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). This is in contrast to the general 10% limitation on private business use of proceeds under the private business use test.

**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 restrictions.

**Reason for Change.** For federal tax purposes, the distinction between a "use" and a "loan" of bond proceeds is often difficult to discern. The original pre-1986 version of the private loan test was called the "consumer loan" limit - to address 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 current provision also places an additional, lower private business restriction on loans made to private businesses. Given the general 10% private business use limitation, the private loan test could be modified to incorporate a corresponding 10% limitation on private loans.

**Legislative language.**

Paragraph (1) of section 141(c) (relating to private loan financing test) is amended to read as follows:

'(1) IN GENERAL.—An issue meets the test of this subsection if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans (other than loans described in paragraph (2)) to persons other than governmental units exceeds 10 percent of such proceeds.'
14. **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 of land or an interest in land.

**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 $2.5 million (25% of the net proceeds) 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 the cost of the land may be disproportionate to other project costs when compared to other geographic areas, placing these projects at a disadvantage. In light of other, more generic, restrictions on private activity bonds, including the State volume cap on private activity bonds, the land acquisition restriction may be unnecessary.

**Legislative language.**

Section 147 (relating to other requirements applicable to certain private activity bonds) is amended by striking subsection (c) and by redesignating subsections (d), (e), (f), (g), and (h) as subsections (c), (d), (e), (f), and (g), respectively.
15. **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 at least $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 likely enacted to address concerns regarding accelerated depreciation of tax-exempt bond financed property. The current-law extended depreciation periods for tax-exempt bond-financed property provide a disincentive for this financing. Moreover, bond proceeds cannot be used to acquire used equipment, which can be the most cost effective method for a business to acquire equipment. Finally, the definition of rehabilitation is technical and can require considerable legal analysis.

**Legislative language.**

Section 147 (relating to other requirements applicable to certain private activity bonds) is amended by striking subsection (d) and by redesignating subsections (e), (f), (g), and (h) as subsections (d), (e), (f), and (g), respectively.
16. **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 a health care authority issues private activity bonds in the amount of $1 million 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.** Other tax-exempt bond restrictions already provide 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 arguably 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. Finally, the 2% issuance cost limitation may disproportionately burden small issuers because the dollar amounts of issuance costs generally do not decline as the principal amount of bonds declines.

**Legislative language.**

Section 147 (relating to other requirements applicable to certain private activity bonds) is amended by striking subsection (g) and by redesignating subsection (h) as subsection (g).
17. **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. Due to 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.** The general 10% private business use restrictions on tax-exempt governmental bonds already address the level of private business involvement and arguably should serve as the exclusive restrictions.

**Legislative Language.**

Section 141(b) is amended by striking subsection (5), and by redesignating subsections (6), (7), (8) and (9) subsections (5), (6), (7) and (8), respectively.
18. **Repeal Restriction on Governmental Acquisition of Certain Private Output Facilities**

**Present Law.** If an amount exceeding the lesser of 5% or $5 million of the proceeds of a bond issue is used by a State or local governmental unit to acquire a privately-owned electric or gas facility, the bonds are impermissible private activity bonds (subject to certain exceptions for bonds issued to finance the acquisition of facilities in a “qualified service area” or a “qualified annexed area”).

**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, and the exceptions for qualified service areas and qualified annexed areas are not met. Under present law, any bonds issued by the city to finance the acquisition of such an existing electric generation or transmission facility from a seller that 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 not qualify for the exception for facilities in a qualified service area (e.g., the State or local government has not provided the same type of output to the area at all times during the previous 10 years) or for the exception for facilities in a qualified annexed area (e.g., the annexed area exceeds 10 percent of the State or local government’s historic service area). 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. It is arguable that State and local governments 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.

**Legislative language.**

Section 141 (relating to private activity bonds, qualified bond) is amended by striking subsection (d) and by redesignating subsection (e) as subsection (d).