# NATIONAL ASSOCIATION OF BOND LAWYERS

# TAX SIMPLIFICATION RECOMMENDATIONS TO TREASURY ON TAX-EXEMPT BONDS

This report was prepared by members of the General Tax Matters Committee of the National Association of Bond Lawyers ("NABL"). Primary responsibility for drafting this report was undertaken by John J. Cross III. Members of the Committee who contributed to this report include Charles C. Cardall, Jeffrey M. McHugh, and Mitchell H. Rapaport. In addition, members of the Board of Directors of NABL and other NABL members made many helpful comments.

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<u>Outline of NABL Tax Simplification Recommendations on Tax-exempt Bonds</u>

I. Introduction.

A. In General.

B. Highlights of Simplification Effects of Various Proposals.

II. Tax-exempt Governmental Non-Private Activity Bonds.

A. Present Law and Sources of Complexity.

B. General Recommendation: Retain and Simplify the Private Activity Bond Definition to Rely Mainly on the Basic Two-Part 10% Private Business Tests Under Section 141(b) to Decide Tax-Exempt Governmental Bond Status.

1. In General.

2. Important Role of Private Payments Test In Preserving State and Local Governmental Discretion.

C. Specific Recommendations to Repeal Various Subsidiary Parts of the Private Activity Bond Definition.

1. Repeal the Section 141(b)(3) Unrelated or Disproportionate Use Test.

2. Change the Section 141(c) Private Loan Test From a Separate $5 Million Test to a Straight 10% Test.

3. Repeal the Section 141(b)(4) Special $15 Million Private Business Limitation on Output Facilities and Section 141(d) Restriction on Acquisition of Nongovernmental Output Facilities.

D. Caution Against Replacing the Private Business Test Standard with a New Primary Standard for Defining Tax-Exempt Governmental Bonds

E. Consider Adding a New Intermediate Category of Specified Public Infrastructure Facilities Eligible for Tax-Exempt Governmental Bonds Based on Their Inherent Governmental Nature, Public Purpose, or Public Benefit (Despite Private Business Involvement).

III. Tax-Exempt Private Activity Bonds.

A. Present Law and Sources of Complexity.

B. General Recommendation: Simplify Rules for Tax-Exempt Private Activity Bonds In Recognition of Effectiveness of Volume Cap.

C. Specific Recommendations to Cut Back on Various Interim Restrictions Applicable to Most Tax-Exempt Private Activity Bonds.

1. Repeal the Section 147(c) Land Acquisition Restriction.

2. Repeal the Section 147(d) Rehabilitation Restriction.

3. Repeal or Significantly Simplify the Section 147(f) TEFRA Public Approval Requirement.

4. Repeal the Section 147(g) Bond Issuance Cost Limit.

D. Consider a Range of Ways to Give State and Local Governments More Flexibility and Discretion to Finance Different Kinds of Facilities With Tax-Exempt Private Activity Bonds Under the Volume Cap.

**National Association of Bond Lawyers**
**Tax Simplification Recommendations to Treasury on Tax-Exempt Bonds**

I. Introduction.

A. In General.

This report makes tax simplification recommendations regarding the rules applicable to tax-exempt bonds issued by State and local governments under Section 103 of the Internal Revenue Code.[1] These tax simplification recommendations were prepared by members of the General Tax Committee (the "Committee") of the National Association of Bond Lawyers ("NABL"), in accordance with NABL's purposes, including particularly its purpose of improving the state of the law in public finance. NABL is a nonprofit educational organization organized in 1979, which presently has over 3,000 members who specialize in the tax-exempt bond area. While not all members of the Committee necessarily concur in each of these recommendations, these recommendations generally represent the consensus of the participants. References herein to "the Committee" or "we" are to the participants identified on the cover page.

We want to state our strong support for tax simplification in general and in the tax-exempt bond area in particular. We commend Treasury for making tax simplification initiatives a high priority. We further commend the Joint Committee on Taxation (the "Joint Tax Committee") for raising awareness of this issue with its recent major tax simplification study.[2] Although the tax-exempt bond market involves over $1.6 trillion in outstanding tax-exempt bonds, it nonetheless represents a narrow part of the overall tax system. We believe, however, that the tax-exempt bond area has particular importance in our Federal-State governmental system. Simplifying and improving the efficiency of the tax-exempt bond market is critical to enable State and local governments to perform their role in providing cost-effective financing for ever-expanding public infrastructure needs and other public purposes. Moreover, from the perspective of achievability of tax simplification measures, the circumscribed nature of the tax-exempt bond area affords some real opportunities for achieving constructive tax simplification at a relatively small cost to the Federal government.

[1]Except as noted, section references herein are to the Code and the Treasury Regulations.

[2]Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01) (April 2001) (the "2001 Joint Tax Study").

We have focused mainly on three aspects of the tax-exempt bond rules. First, we looked at ways to simplify the basic boundary for traditional tax-exempt governmental bonds under the private activity bond definition under Section 141. Second, we looked at ways to reduce the administrative impact of the arbitrage investment restrictions applicable to most tax-exempt bonds. Third, we looked at ways to simplify the common restrictions on most tax-exempt private activity bonds in recognition of the effectiveness of the private activity bond volume cap. We have not undertaken here, however, to review the often-complex program eligibility requirements for all of the various types of tax-exempt private activity bonds (*e.g.*, the various specified exempt facilities under Section 142). Certain of the ideas discussed herein are not new and represent refinements of often-suggested, but unfulfilled tax simplifications proposals made by Treasury, Congress, State and local governmental groups, and practitioners alike over the years.[3] We believe that these ideas fairly represent the kinds of ideas that our members most often suggest to simplify the tax-exempt bond area.

We call your attention to one resource for further perspective in this area. Over a decade ago, the Anthony Commission on Public Finance prepared a report on simplification and reform of the tax-exempt bond area that raised many useful ideas and parallels many of the ideas discussed herein.[4] Notably, the Anthony Commission Report was led by then-Congressman Beryl Anthony and was a product of broad input from representatives of State and local governments. Many of its thoughtful ideas remain just as relevant today. We recommend the Anthony Commission Report for your consideration. We have provided copies to certain Treasury and IRS officials for convenient reference.

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[3] See House Ways and Means Committee Staff, Written Recommendations on Tax Simplification (W&M Committee Print No. 101-27, May 25, 1990) 90 Tax Notes Today 129-22 (June 19, 1990) (the "1990 House Ways and Means Committee Study"); Joint Tax Committee, Written Recommendations on Tax Simplification (W&M Committee Print No. 101-27, May 25, 1990) 90 Tax Notes Today 129-21 (June 19, 1990) (the "1990 Joint Tax Committee Study"); Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of Treasury, Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means (July 29, 1991), 91 Tax Notes Today 159-21 ("1991 Treasury Simplification Testimony"). Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of Treasury, Before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means (July 29, 1991), 91 Tax Notes Today 159-21 ("1991 Treasury Simplification Testimony"); Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of Treasury, Before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means (June 22,1993), 93 Tax Notes Today 133-44 ("1993 Treasury Simplification Testimony").

[4] See Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing (Anthony Commission on Public Finance) (October 1989) (the "Anthony Commission Report").

B. Highlights of Simplification Effects of Various Proposals.

Our recommendations are intended to represent a fairly comprehensive series of ideas on how to simplify the tax-exempt bond provisions, which would be best considered together as part of a thorough review of the tax-exempt bond area. We have not ranked or prioritized our recommendations because we do not want to place undue emphasis on particular priorities at the expense of full consideration of our entire report. One deficiency of some previous simplification initiatives was a tendency to focus on a handful of proposals without pursuing more meaningful and thorough simplification.

At the same time, we do want to take the opportunity to highlight certain proposals briefly in terms of their impact on simplification. Some proposals have a broader impact on simplification while others may promote other tax policy simplification principles.

One tax policy principle for assessing tax simplification proposals is to promote the broadest possible simplification in terms of both affecting the most taxpayers and having the greatest effects on reducing tax compliance burdens and administrative costs of compliance. Under this breadth of impact principle, certain of our proposals would have broader impacts than others. In particular, the arbitrage provisions under Section 148 both have a broad effect on all tax-exempt bonds and involve considerable complexity in terms of compliance burdens and administrative costs of compliance. Highlighted below are certain of our recommendations in the arbitrage area which would provide broad simplification of a complex area:

(1) Provide a Greatly Simplified, 3-year Prompt Spending Exception to Arbitrage Rebate for All Long-Term Fixed Rate Tax-Exempt Bond Issues (Excluding Refundings and Restricted Working Capital).

(2) Increase the Section 148(f)(4)(D) Small Issuer Rebate Exception from $5 Million to $10 Million or Preferably $25 Million (If Economic Impact Data Supports) and Unify it with the Section 265(b)(3) Bank Purchase Exception.

This proposal alone could impact nearly 40% of the number of tax-exempt bond issues each year, but with a very limited impact on affected tax-exempt bond volume.[5]

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[5] See Footnote 14 *infra* and accompanying text.

(3) Further Integrate Arbitrage Rebate and Yield Restriction in Most Circumstances (Except for Advance Refunding Escrows) Through Primary Reliance on Rebate or Quasi-Rebate Payments to Satisfy Yield Restriction.

In a similar regard, our recommendations to streamline the definition of tax-exempt governmental bonds (as contrasted with tax-exempt private activity bonds) may have a broad impact on simplification. The private activity bond status definition under Section 141 applies broadly to define the coverage of the governmental tax-exempt bond sector, which comprises about 90% of the total dollar volume of the overall tax-exempt bond market. In addition, these status provisions involve complexity in terms of ongoing monitoring of compliance with private business restrictions and associated administrative costs. Highlighted below are certain of our recommendations regarding the tax-exempt governmental bond status provisions which may provide broad simplification:

(1) General Recommendation: Retain and Simplify the Private Activity Bond Definition to Rely Mainly on the Basic Two-Part 10% Private Business Tests Under Section 141(b) to Determine Tax-Exempt Governmental Bond Status.

(2) Specific Recommendations to Repeal Subsidiary Parts of Private Activity Bond Definition.
   (a). Repeal the Section 141(b)(3) Unrelated or Disproportionate Use Test.
   (b). Change the Section 141(c) Private Loan Test From a Separate $5 Million Test to a Straight 10% Test.
   (c). Repeal the Section 141(b)(4) Special $15 Million Private Business Limitation on Output Facilities and the Section 141(d) Restriction on Acquiring Nongovernmental Output Facilities.

(3) Consider Adding a New Intermediate Category of Specified Public Infrastructure Facilities Eligible for Tax-Exempt Governmental Bonds Based on Their Inherent Governmental Nature, Public Purpose, or Public Benefit (Despite Private Business Involvement).

Our recommendations to streamline the tax-exempt private activity bond area have a narrower overall impact in that they affect only about 10% of the total tax-exempt bond market., but they advance another tax simplification principle of reducing unnecessary rules that have only a modest tax policy impact. Here, we recommend repealing a number of interim restrictions in recognition of the effectiveness of the private activity bond volume cap in controlling tax-exempt private activity bond volume. In addition, we offer a range of ideas to give State and local governments more flexibility and discretion to finance different kinds of facilities with tax-exempt private activity bonds under the volume cap, including: (i) expanding the list of eligible exempt facilities; (ii) giving States the discretion to allocate some percentage (*e.g.*, 25%) of the volume cap to unspecified facilities; or (iii) giving States full discretion to allocate their private activity bond volume cap to unspecified types of facilities.

Other recommendations only affect certain types of tax-exempt bond financing, but may provide significant simplification to the affected type. For example, in the qualified 501(c)(3) bond area under Section 145, we recommend repealing the vestige of the $150 nonhospital bond volume cap because it would eliminate a complex tracking requirement on existing tax-exempt bonds in circumstances in which Congress has made the policy decision to repeal the requirement going forward. In another example, the Section 144(a) small issue bond area is ripe for simplification because it has an administratively difficult definition of eligible manufacturing facility and it has a host of outdated interim restrictions that are product of a different era before the private activity bond volume cap.

Finally, on the demand side of tax-exempt bonds, our primary recommendation to repeal the alternative minimum tax treatment of tax-exempt private activity bonds is aimed at an efficiency concern involving the mismatch between high interest rate penalty suffered by tax-exempt private activity bonds that are subject to the alternative minimum tax preference and the suspected low corresponding receipt of Federal revenues associated with this preference.

We urge Treasury to support tax simplification of the tax-exempt bond area that is real and meaningful to the fullest extent possible consistent with other tax policy goals. When confronting choices between meaningful and incremental, we urge Treasury to choose meaningful simplification. We would welcome the opportunity to discuss these recommendations with representatives of Treasury, the IRS, or the Joint Committee on Taxation.

## II. Tax-Exempt Governmental Bonds.

### A. Present Law and Sources of Complexity.

Under present law, the characterization of bonds as traditional tax-exempt most-favored, non-private activity tax-exempt bonds under Section 141(sometimes referred to as tax-exempt "governmental bonds") begins with the fundamental, historic two-part private activity bond test under Section 141(b). This standard classifies bonds as tax-exempt governmental bonds so long as the level of private business involvement does not exceed both prongs of the following two-part private business limitations: (i) not more than 10% of the proceeds are used for private business use under Section 141(b)(1) (the "private business use test"); and (ii) not more than 10% of the debt service on the bonds is payable from or secured by payments from private business use under Section 141(b)(2) (the "private payments test") (these two tests are referred to together as the "10% private business tests"). In 1968, Congress first introduced these basic tests with 25% permitted levels of private business involvement. In 1986,[6] Congress retained these tests, but significantly reduced the permitted levels of private business involvement from 25% to 10%.

One source of complexity is the ongoing monitoring necessary to comply with the reduced 10% private business tests. Moreover, the 1986 Tax Act added a series of further limitations beyond the basic 10% private business tests that reduce the permitted thresholds of nongovernmental involvement for tax-exempt governmental bonds in several different ways. These further limitations include the provisions described briefly below. Section 141(b)(3) added an unrelated or disproportionate private use test that effectively reduces the 10% private business tests to 5% for covered unrelated or disproportionate private business use and payments therefrom. Section 141(b)(4) caps total private business use and private payments on tax-exempt governmental bonds at $15 million whenever more than 5% of the proceeds are used for output facilities (besides water facilities). Section 141(b)(5) requires use of private activity bond volume cap on tax-exempt governmental bonds to the extent that private business use and private payments exceed $15 million (i.e., bond issues over $150 million), even though private business involvement is still within the otherwise-permitted 10% thresholds. The two special $15 million private business restrictions under Sections 141(b)(4) and 141(b)(5) affect any tax-exempt bond issue with a size over $150 million. Section 141(c) independently treats bonds as private activity bonds if more than the lesser of 5% or $5 million of the proceeds are used to make private loans (both business and nonbusiness loans) (the "private loan test"). In addition, Section 141(d), added in 1987, automatically treats bonds as private activity bonds if the proceeds are used to acquire certain nongovernmental output facilities. These various additional restrictions increase compliance burdens and increase complexity through layers of different and increasingly "hair trigger" ways in which they can cause bonds to be disqualified from being characterized as tax-exempt governmental bonds, but otherwise provide no meaningful advancement or protection of the Federal interest.

B. <u>General Recommendation: Retain and Simplify the Private Activity Bond Definition to Rely Mainly on the Basic Two-Part 10% Private Business Tests Under Section 141(b) to Decide Tax-Exempt Governmental Bond Status</u>.

1. <u>In General</u>.

Our main recommendation here is that, if culled of further add-on restrictions, the 10% private business tests under Section 141(b) should suffice as a fair dividing line and the

[6] <u>See</u> Tax Reform Act of 1986, P.L. 99-514 (1986) (the "1986 Tax Act").

main tollgate for determining tax-exempt governmental bond status. These private business tests have fairly well-established analytic standards and have been part of the tax-exempt bond regime for over 30 years.

Moreover, a fair case can be made for raising the allowable thresholds for the private business tests from 10% to their historic 25% thresholds for two reasons. First, and most importantly, modestly higher permitted levels of private business involvement would promote a sound policy of encouraging public-private partnerships to provide public infrastructure projects with enhanced private operating efficiency. In addition, we believe that the reduction in the private business test percentages in 1986 arguably represented an overreaction by Congress to very isolated instances of perceived abuses (*e.g.*, airport hotels). State and local governments have struggled to monitor ongoing compliance with the private business tests under the reduced percentage standards.

2. <u>Important Role of Private Payments Test in Preserving State and Local Governmental Discretion</u>.

From a pure tax simplification perspective, further simplification could be achieved by deleting the second prong of the private business tests under Section 141(b)(2). That test focuses on assuring that not more than 10% of the debt service on tax-exempt governmental bonds is payable from or secured by payments derived from private business use. Under such an approach, tax-exempt governmental bonds would derive their status from one main test that focused on assuring that not more than 10% of the bond proceeds were used for private business use. The House of Representatives proposed to eliminate the private payments test in its original version of the bill that led to the 1986 Tax Act, but that proposal ultimately was dropped from the final version of the 1986 Tax Act after opposition from State and local governments and recognition of the modifications to the private business use test that would need to be made to make such an approach work. Superficially, such a streamlined one-part test offers considerable tax simplification because it would allow for deletion of about half of the rules on the private activity bond definition under Section 141.

On closer examination, however, we believe that the private payments test under Section 141(b)(2) plays an important role in the definition of tax-exempt governmental bonds because it is this test that gives State and local governments critical discretion and flexibility to use tax-exempt bonds to finance unspecified facilities with more than 10% private business use if they make strong public policy determinations to subsidize these facilities with governmental payments or generally applicable taxes as the sole security and source of payment for the bonds. Absent a completely new regime for tax-exempt governmental bonds that gives State and local governments comparable or greater discretion and flexibility, therefore, we believe that the 10% private payments test must be retained because it plays this important role in preserving State and local governmental discretion.

C. Specific Recommendations to Repeal Various Subsidiary Parts of Private Activity Bond Definition.

1. Repeal the Section 141(b)(3) Unrelated or Disproportionate Private Business Use Test.

We concur with the Joint Tax Committee's sound recommendation in the 2001 Joint Tax Study to repeal the unrelated or disproportionate private business use test under Section 141(b)(3).[7] This test involves vague factual determinations of relatedness. Moreover, this test has an unduly punitive effect in application because it constrains many State and local governments to limit otherwise-permitted 10% private business involvement to 5% across the board out of uncertainty about the scope of this test, particularly in those instances in which a single issue of bonds is being used to finance a variety of purposes or projects. This change would produce significant simplification.

2. Change the Section 141(c) Private Loan Test From a $5 Million Amount Test to a Straight 10% Test.

We recommend changing the Section 141(c) private loan test from a $5 million amount test to a straight 10% test that causes private activity bond status. For the most part, the existing private loan test is duplicative. Most loans to businesses are covered by the general 10% private business tests under Section 141(b). Most State and local governmental nonbusiness loans to consumers for nonbusiness purposes are for housing or education purposes covered by Sections 143 and 144(b). We recommend retaining the present law treatment of qualified mortgage bonds, qualified veterans' mortgage bonds, and qualified student loan bonds. We believe that a straight 10% private loan test provides reasonable constraints on nonbusiness loan programs that are not otherwise covered by the existing framework.

We believe that providing some relief from the current tightness of the boundary for violation of the private loan test would be a way to address some of the burden associated with the complexity of determining private loan character in some circumstances. The private loan test creates much complexity in the determination of whether various financing or operating arrangements involve loans in economic substance. The determination of what is a loan is based on all the facts and circumstances under general Federal tax principles and may involve a complex analysis. In particular, the private loan test presents subtle, complex private loan issues in tax increment financings and in various land-based infrastructure

[7] See 2001 Joint Tax Study. See also 1990 House Ways and Means Committee Study; 1990 Joint Tax Study; 1991 Treasury Simplification Testimony.

financing programs in different states. Section 141(c)(2), which provides a seemingly-innocuous "tax assessment loan" exception to the private loan restriction, only adds to the complexity. The proposed treatment of private loan issues and their effects on land-based infrastructure financing programs, particularly in California, nearly overwhelmed the entire IRS public comment process on the 1994 Proposed Treasury Regulations on the private activity bond tests under Section 141.

3. Repeal the Section 141(b)(4) Special $15 Million Private Business Limitation on Output Facilities and the Section 141(d) Restriction on Acquisition of Nongovernmental Output Facilities.

We recommend repealing the special add-on $15 million private business limitation on output facilities under Section 141(b)(4). These special additional private business limitations are excessive. They inexplicably and punitively treat certain kinds of facilities in governmental hands more harshly than others under the private activity bond tests for no clear tax policy reason. At a time in which the energy needs of the country and the reliable delivery of the same are critical, State and local governments properly should have the discretion to involve themselves in the tax-exempt financing and operation of governmental electric, gas, and other output facilities under the same set of private activity bond restrictions as apply to all other governmentally-conducted activities.

D. Caution Against Replacing the Existing Private Business Test Standard With a New Primary Standard to Define Tax-Exempt Governmental Bonds.

We looked at whether it might make sense to consider an entirely new primary standard to define tax-exempt governmental bonds. The suggestion has been made that perhaps a new alternative standard might try to define a "good" tax-exempt governmental bond rather than defining it negatively through the existing two-part private business test standard. Initially, as a matter of presentation, you easily could restate the existing definition positively to provide that a good tax-exempt governmental bond is one which involves at least 90% governmental use or 90% governmental sources of payment.

An alternative standard might try to define public purpose or public benefit as a primary basis to define tax-exempt governmental bonds. Our fundamental concern with an effort to develop an alternative primary standard is that it may well lead to an equally complex or more complex alternative regime.[8] The use of a public purpose test as a primary standard is problematic. State and local governments need discretion to make public purpose determinations under State law. Congress and State and local governments often have differing perspectives on public purposes. Moreover, any standard that tried to focus on quantifying broader public benefits as an economic matter could be very complex and involve administrative data difficulties with quantifying public benefits.

In short, we are unaware of a good substitute for the existing two-part private business test standard as the primary standard for determining tax-exempt governmental bond status. Although we recognize that the existing private business test standard involves some complexity, overall we believe that the existing standard is workable. The existing private business tests rely on concepts of "use" and "source of payment" of debt service that are analytically simple in theory.

E. Consider Adding a New Intermediate Category of Specified Public Infrastructure Facilities Which Could Qualify for Tax-Exempt Governmental Bonds Based on Their Inherent Governmental Nature, Public Purpose, or Public Benefit (Despite Private Business Involvement).

One deficiency of the existing private business test standard is that it is inadequate to accommodate many State and local governmental privatization initiatives involving facilities that are fundamentally governmental or public in nature. For example, under present law, a public toll road subject to a 30-year operating contract with a private business operator generally would be ineligible for tax-exempt governmental bond financing because it would violate the private business restrictions and it would be ineligible for tax-exempt private activity bond financing because roads are not listed as exempt facilities under Section 142. While the existing rules helpfully provide liberalized exceptions to private business use for qualified safe harbor management contracts under Rev. Proc. 97-13, 1997-1 C.B. 632, for periods of up to 15 years (20 years for certain public utility property) depending on the compensation arrangement, still these management contract safe harbors are insufficient to cover various desired privatization initiatives. Stated differently, there are some public infrastructure facilities that clearly should qualify for tax-exempt governmental bond status, based on the public nature of the good or service provided rather than on who (State or local governments or the private sector) can provide that good or service the most efficiently.

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[8] For a summary of the legislative development of the tax-exempt bond rules, Congressional efforts and difficulties in defining requisite public purposes for tax-exempt bonds over the years, and some observations on potential complexities associated moving away from a use-based standard, see Zimmerman, Tax-Exempt Bond Legislation, 1968-1990: An Economic Perspective, 91 Tax Notes Today 53-25 (Congressional Research Report, February 7, 1991).

Accordingly, we recommend that consideration be given to adding a new specified list of public infrastructure facilities that would be eligible for tax-exempt governmental bonds based on their inherent governmental or public nature (regardless of whether they involve more than 10% private business use and private payments). The purpose of this tax simplification suggestion would be to relieve certain facilities of the private business restrictions under the primary standard for tax-exempt governmental bonds in circumstances in which that carry out clearly governmental or public purpose functions or provide such clear public benefits. This possible additional category of public infrastructure facilities would be exempt from the volume cap under Section 146 and other general restrictions on less-favored tax-exempt private activity bonds.

An obvious challenge here would be to reach consensus on which types of facilities should qualify as potential candidates for this category of listed public infrastructure facilities eligible for tax-exempt governmental bonds. Congress and State and local governments should be able to reach consensus on the clear public purpose benefits of some identified kinds of public infrastructure facilities. Other candidates might generate more debate. Possible candidates for public infrastructure facilities might include schools, roads, prisons, mass commuting facilities, high speed rail facilities, airports, docks and wharves, water facilities, convention center facilities, electric transmission facilities, telecommunications facilities, and a variety of environmentally-focused facilities that presently involve some hard distinctions and overlap in definitions (*e.g.*, sewage facilities, pollution control facilities, and solid waste disposal facilities).

We further recommend imposing minimum operating conditions on the identified public infrastructure facilities as necessary requirements to qualify for tax-exempt governmental bonds. Some minimum necessary operating conditions on any such public infrastructure facilities financed with tax-exempt governmental bonds might include: (i) either actual governmental ownership or a private owner's agreement to forego the tax benefits of ownership, such as tax depreciation or investment tax credit; (ii) general public use, or, alternatively, general public benefit for certain facilities that technically might not qualify for general public use (*e.g.*, certain environmentally-focused facilities, such as certain wastewater treatment facilities that provide public benefits in the form of cleaner air or water); and (iii) generally applicable rates or fair market value rates.

This recommendation to consider extending tax-exempt governmental bond status to certain public infrastructure facilities overlaps with our later recommendations herein to consider expanding the list of eligible exempt facilities under Section 142 in recognition of the effectiveness of the private activity bond volume cap. This overlap relates partly to the fact that some of these types of facilities presently are in a "gap" in which they generally fail to qualify for either tax-exempt governmental bond financings (because of excess private business use and private payments) or tax-exempt private activity bonds financing (because they are not on the list of eligible exempt facilities). Another consideration with this overlap involves a qualitative judgment of whether certain public infrastructure facilities properly should qualify for most-favored tax-exempt governmental status in light of their inherently governmental or public nature or only for tax-exempt private activity bond status.

## III. Tax-Exempt Private Activity Bonds.

### A. Present Law and Sources of Complexity.

Under present law, private activity bonds under the Section 141 definition generally are taxable unless they meet specific targeting rules for particular types of facilities (*e.g.*, Section 142 exempt facilities and Section 144(a) qualified small issue manufacturing bonds) or for particular types of programs (*e.g.*, Section 143 qualified mortgage bonds, Section 144(b) qualified student loan bonds, or Section 145 qualified 501(c)(3) bonds for nonprofit exempt purposes). In addition, most tax-exempt private activity bonds are subject to an annual state volume cap under Section 146.

Furthermore, most tax-exempt private activity bonds are subject to a variety of additional restrictions on private activity bonds that add complexity. Many of these restrictions were added during the period between 1981 and 1986 as interim efforts aimed largely at controlling private activity bond volume. These additional general restrictions on most tax-exempt private activity bonds include the Section 147(b) 120% economic life test, the Section 147(c) 25% land acquisition restriction, the Section 147(d) existing property restriction absent rehabilitation, the Section 147(e) prohibited facilities limitation, the Section 147(f) public approval requirement, and the Section 147(g) 2% issuance cost limit. In addition, the Section 144(a) qualified small issue bond program has a number of subsidiary restrictions many of which were aimed at circumscribing this program before 1986 when small issue bonds could be used for unspecified capital projects instead of only just manufacturing facilities as under present law.

Many of these restrictions are ineffective, overlapping, cumbersome administratively, or outdated in light of other tax law changes. In addition, further complexity exists as a result of the detailed specific project or program targeting requirements for each type of eligible tax-exempt private activity bond. Much can be done here by way of simplification.

### B. General Recommendation: Simplify Rules for Tax-Exempt Private Activity Bonds In Recognition of Effectiveness of Volume Cap.

We submit that the private activity bond volume cap under Section 146 has been an effective provision to control tax-exempt private activity bond volume. We believe that this premise should support considerable simplification of the tax-exempt private activity bond rules. We expect that economic data would show that State and local governments largely use up the private activity bond volume cap. For rough illustrative purposes, in 2001, total private activity bond volume cap was about $19.7 billion and total tax-exempt AMT private activity bond volume was about $27.5 billion (before reduction for those types of AMT bonds that are exempt from the volume cap).[9] Tax-exempt private activity bonds comprise a fairly small percentage (about 10%) of total tax-exempt bond volume.[10]

We cite the effectiveness of the volume cap as a basis to justify a number of our recommendations to simplify the tax-exempt private activity bond provisions. We recognize that the recent increase in the volume cap to the greater of $75 per State resident or $225 million effective for 2002, together with future indexing for inflation, may dilute the strength of this premise somewhat. If the effectiveness of the volume cap was under review in the tax legislative process involving simplification of the tax-exempt bond area or if offsetting, revenue-raising restrictions were needed to support tax-exempt bond simplification of this kind, one possible approach to tighten the effectiveness of the private activity bond volume cap would be to eliminate the Section 146(f) volume cap carryforward provision entirely and to convert the volume cap system into a "use or lose" system.

### C. Specific Recommendations to Cut Back on Various Interim Restrictions Applicable to Most Tax-Exempt Private Activity Bonds.

#### 1. Repeal or Significantly Simplify the Section 147(f) TEFRA Public Approval Requirement.

Our primary recommendation here is to repeal the TEFRA public approval requirement under Section 147(f) entirely. Although one is hard-pressed to object in theory to a good government "sunshine" policy in favor of public hearings and public approval (akin to mom, home, and apple pie), the reality is that most affected State and local governments and our members believe that this public approval requirement is costly, cumbersome, and ineffective. These required public hearings and public approvals have been virtually ignored by the general public at which they are aimed. It is fair to say that this requirement has long outlived its original purpose in 1982 of helping to control private

[9] See IRS Notice 2001-21, 2001-11 I.R.B. (March 12, 2001)) (resident population figures for use for 2001 volume cap); The Bond Buyer at Page 4A (February 19, 2002) (Source: Thomson Financial Securities Data) (2001 tax-exempt bond volume statistics).

[10] During the decade from 1992 through 2001, total AMT tax-exempt private activity bond volume was about $209.84 billion or about 9.3% out of total tax-exempt bond volume of about $2.26 trillion. See The Bond Buyer at Page 38 (January 7, 2002) (Source: Thomson Financial Securities Data available on December 31, 2001).

activity bond volume. State procedures for obtaining volume cap serve the necessary role of providing a political check against any rare controversial projects. State volume cap allocation procedures have or presumably could incorporate a process to allow for public comment on potential volume cap allocations to address the "not in my back yard" or "NIMBY" issue.

In the 2001 Joint Tax Study, the Joint Tax Committee had several good recommendations, albeit limited, to simplify the public approval requirement. The Joint Tax Committee sensibly recommended alternative, less costly, forms of public notices, such as Internet notices. This idea could streamline the procedure and reduce the costs of public notices, particularly for large Statewide bond issues with many projects. The Joint Tax Committee also sensibly recommended permitting alternatives to public hearings, such as public comments in writing or by Internet. We concur with these recommendations.

Short of the preferred complete repeal of the Section 147(f) public approval requirement, we recommend simplifying the Section 147(f) public approval requirement to the fullest extent possible. We submit that much simplification of the Section 147(b) public approval requirement could be accomplished through regulations, given that many of the excessive details reside in old regulations in this area. In particular, we offer the following recommendations to simplify the public approval requirement. First, consider excluding refundings completely from this requirement because the public approval for the original new money financing duly addresses the nature of the financed project and the 120% economic life test under Section 147(b) duly addresses the burden on the tax-exempt market of the refunding. Second, consider giving more deference to State sunshine laws on the adequacy of various aspects of the public approval process. In many instances, these laws will be more than enough. Third, consider providing more flexibility to allow delegations of approval authority to particular State or local public officials below the "highest elected representative" to reduce the challenges of tracking down busy governors and mayors to sign these public approvals. Fourth, consider expressly permitting "post-issuance" amendatory public approvals to cure changes in the described nature and location of the financed project and, for qualified 501(c)(3) bonds, to address projects unknown at the time of the original tax-exempt bond issuance. Finally, consider replacing the old "insubstantial deviations" standard for project changes without new public approvals under Treas. Reg. §5f.103-2(f)(2) with a much stronger standard that requires new public approvals only if the fundamental nature and location of the project change.

2. <u>Repeal the Section 147(c) Land Acquisition Restriction</u>.

We recommend repealing the 25% land acquisition restriction under Section 147(c). We are unaware of a sound tax policy reason to penalize tax-exempt financing in areas with high land costs.  High land cost areas often exist in inner cities with acute economic redevelopment needs.

3. Repeal the Section 147(d) Existing Property Restriction and Rehabilitation Requirement.

We recommend repealing the restriction under Section 147(d) against financing existing property without substantial rehabilitation in an amount generally equal to 15% of the acquisition cost.  In part, we recognize that this provision aims to target tax-exempt bond financing to the provision of new or renovated facilities rather than just acquisitions of existing facilities.  In addition, however, this provision may be viewed as a response to obsolete tax policy concerns about accelerated depreciation on tax-exempt bond-financed facilities.  That concern no longer exists because tax law changes lengthened the depreciation periods for tax-exempt bond financed property.[11]  Also, the 15% rehabilitation percentage is arbitrary.  In addition, the portion of this provision that requires 100% rehabilitation for property other than structures other than buildings is difficult to apply.  The private activity bond volume cap should serve as a sufficient check against undue use of tax-exempt bonds to finance existing facilities.

4. Repeal the Section 147(g) Bond Issuance Cost Limit.

We recommend repealing the 2% tax-exempt bond-financed issuance cost limitation under Section 147(g)  for several reasons.  In the broadest context, we believe that the 2% issuance cost limitation reflects an overreaction by Congress in the 1986 Tax Act to a concern about excessive issuance costs that it otherwise effectively addressed in two different ways in the same legislation, as discussed below.  First, this provision is unnecessary because the change to the definition of arbitrage yield in Section 148(h) made in the 1986 Tax Act fully addressed the historic concern about recovering excessive bond issuance costs through an upward adjustment in the bond arbitrage yield to account for such costs.  Technically, in the 1986 Act, Section 148(h) was amended to base the arbitrage yield on tax-exempt bonds on the grossed up "issue price" of the tax-exempt bonds and thereby to reverse the opposite result in the State of Washington case.[12]  Thus, issuers bear the full economic consequences of bond issuance costs without regard to the arbitrage yield.

Second, the 2% issuance cost limitation is unnecessary because the  general rules for most private activity bonds already limit bond-financed issuance costs to a maximum of 5% in any event.  Specifically, Sections 142, 144, and 145 generally require that at least 95% of

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[11] See Section 168(g)(1)(C).

[12] See State of Washington v. Commissioner, 692 F.2d 128 (D.C. Cir. 1982).

the "net proceeds" of the bonds (i.e., the total proceeds, reduced for funding certain prescribed reasonably required reserve funds, but without reduction for bond issuance costs), be spent on qualified capital costs of providing the eligible project (or, for Section 501(c)(3) exempt organizations, carrying out their nonprofit exempt purposes). This 95% test requires issuers to be particularly careful with funding bond issuance costs because any such funding cuts into the balance of the already-tight permitted total 5% nonqualified cost limitation.

Third, the 2% issuance cost limitation imposes a disproportionate burden on the smallest issuers. From a policy perspective, this provision has a questionable effect in application because it is most likely to affect the smallest issuers who, at the same time, often may be the least able financially to bear the economic burden of paying the issuance costs of their tax-exempt bonds from non-bond funds. Thus, for example, an issuer who issues tax-exempt private activity bonds in a principal amount of $1 million will be required to use its own non-bond funds to pay any bond issuance costs in excess of $20,000.

Finally, the 2% issuance cost limitation has proven to be a technical "foot-fault" provision. It raises minor interpretative questions that have resulted in some counterproductive uses of IRS audit resources in audits and of issuer resources to address them.

D. Consider a Range of Ways to Give State and Local Governments More Flexibility and Discretion to Finance Different Kinds of Facilities With Tax-Exempt Private Activity Bonds Under the Volume Cap.

In recognition of the effectiveness of the private activity bond volume cap under Section 146 in controlling private activity bond volume, we have a series of simplification recommendations on ways to give States more discretion and flexibility to decide how best to allocate their private activity bond volume cap. This is a zero sum game as far as the Federal interest is concerned.

1. At Minimum, Consider Expanding the List of Eligible Exempt Facilities Under the Volume Cap.

First, at minimum, we recommend expanding the list of qualified exempt facilities under Section 142 within the constraint of the volume cap to foster more privatization and public-private partnerships. In this regard, we recommend adding the following types of facilities to the list of eligible exempt facilities under Section 142: (i) schools; (ii) roads; (iii) prisons; (iv) pollution control facilities; (v) sports facilities; (vi) convention center facilities; and (vii) electric transmission facilities operated on an open access, nondiscriminatory basis at generally applicable rates.

In the case of schools, roads, and prisons, we suggest their inclusion because these types of facilities clearly serve a public purpose by any measure. Increasingly, State and local governments are looking to privatize these facilities and their services in innovative ways that technically may have sufficient private business involvement to make them ineligible for tax-exempt financing at all. This surely is an imprudent result from tax policy and social policy standpoints.

In the case of pollution control facilities, we suggest their inclusion because it would simplify a difficult, highly-factual distinction between qualified "sewage facilities" under Section 142(a)(5) and other environmental facilities that perform similar functions for comparable societal benefit. Prior to the 1986 Tax Act, both sewage facilities and pollution control facilities were eligible exempt facilities and there was no need to try to draw fine lines between the two. Treas. Reg. §1.142(a)(5)-1 attempts to define the difference between qualified sewage facilities and now-nonqualified pollution control facilities. These regulations employ a series of further complex definitions that involve hard distinctions between primary and secondary treatment, preliminary and advanced or tertiary treatment, and various measures of biological oxygen demands that remain elusive at best. It would advance tax simplification and social policy to allow environmentally-focused facilities that serve similar functions more broadly.

In the case of sports facilities, we suggest their inclusion because it would relieve some of the undue pressure on State and local governments under current law to subsidize these facilities more significantly to enable them to be eligible for tax-exempt governmental bond financing. Current law provides some odd incentives. State and local governments to forego receiving any payments from any private business beneficiaries of financed sports facilities (other than generally applicable taxes) in order to preserve eligibility for tax-exempt governmental bond financing. This addition also should reduce policy criticism against use of tax-exempt governmental bonds for this purpose. Sports facilities were eligible exempt facilities before the 1986 Tax Act.

In the case of electric transmission facilities, presently, private business use restrictions constrain State and local governmental electric utilities with tax-exempt bond financed transmission facilities from participating in the provision of open access transmission services. We recognize that this is an energy policy issue as well as a tax policy issue. We point out that the Department of Energy recently recognized that the tax-exempt bond private business restriction rules were a barrier to the creation of regional transmission networks and recommended that Treasury evaluate whether tax law changes may be necessary to provide appropriate treatment for the transfer of electric transmission assets to independent transmission companies that operate on an open access basis.[13]

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[13]See U.S. Department of Energy, National Transmission Grid Study, at Pages 28 and 36 (May 2002).

2. <u>Intermediate Approach: Consider Giving States Discretion to Allocate Some Percentage (*e.g.*, 25%) of the Volume Cap to Unspecified Types of Facilities</u>.

Second, to provide an additional measure of discretion to States, we recommend that you consider giving States the discretion to allocate some specified percentage (*e.g.*, 10% or 25%) of the private activity bond volume cap to unspecified types of facilities. This additional measure of discretion would enable States to address their particular needs for privatization initiatives better in light of their circumstances at the State and local governmental levels, particularly when unique or presently uncontemplated types of facilities are involved.

3. <u>Full Flexibility Approach: Consider Giving States Full Discretion to Allocate the Total Volume Cap to Unspecified Types of Facilities</u>.

Third, to provide full discretion or flexibility to States, we recommend that you consider extending this concept most broadly to grant States full discretion to allocate their total private activity bond volume caps to finance any unspecified types of facilities. This full flexibility approach could provide significant tax simplification by eliminating the need for the detailed targeting rules for all of the various qualified facilities and programs which are now eligible for tax-exempt private activity bonds under the volume cap. This full flexibility approach would be a way to address a chronic tax guidance deficiency in the area of maintaining reasonably current regulatory guidance regarding the program targeting requirements for the numerous different specific categories of exempt facilities and programs that are eligible for financing with tax-exempt private activity bonds under the volume cap. To take one example, the regulations for the mortgage revenue bond program for single-family housing under Section 143 basically have never been updated since 1981 to address the effects of significant tax law changes in the 1986 Tax Act or otherwise.

This full flexibility approach would be a bold initiative. From a tax policy perspective, this approach would place the decision-making responsibility for project determinations at the State level closest to the affected constituents. This approach would be a way to allow State and local governments to tailor their tax-exempt bond programs to their specific local needs (*e.g.*, security needs in the wake of the September 11, 2002 terrorist disaster). This approach would give due recognition to the policy roles of State and local governments as partners with the Federal government in implementing the tax-exempt bond program. State and local governmental political pressures would serve as an effective check on the nature of financed projects. In pursuing such an approach legislatively, one issue that would need to be addressed would be the recognition that Congress typically prefers to impose some measure of program targeting on most Federal tax expenditures, including those associated with the tax-exempt bond program. At the outer boundaries, one way to address potential Congressional concern about particular kinds of facilities (*e.g.*, liquor stores and the like), would be to retain statutory prohibitions against tax-exempt private activity bond financing for certain prohibited facilities similar to Section 147(e). Congress also may have a concern that this full flexibility approach could place undue pressure on the volume cap system. Overall, we believe that this full flexibility approach merits serious consideration.

## IV. Simplification of the Section 148 Arbitrage Restrictions on Tax-Exempt Bonds.

### A. Present Law and Sources of Complexity.

Under present law, Section 148 and the Treasury Regulations thereunder impose a number of arbitrage investment restrictions on tax-exempt bonds. The overriding purpose of the arbitrage investment restrictions is to control arbitrage investment incentives to overburden the tax-exempt market through issuing more tax-exempt bonds, issuing them earlier, or letting them remain outstanding longer than is reasonably necessary to accomplish the governmental purposes of the bonds.

There are two basic kinds of arbitrage restrictions: yield restrictions and rebate. Arbitrage yield restrictions refer to limitations under Section 148(a) against investing tax-exempt bond proceeds at an effective interest rate or yield over the term of the bonds that is materially higher than the yield on the bonds themselves. Arbitrage rebate refers to the requirement under Section 148(f) to rebate certain excess earnings above the yield on the bonds to the Federal Government, even if the rules permitted earning a greater yield in the first instance. Arbitrage yield restrictions have been part of the tax-exempt bond provisions since 1969. Arbitrage rebate was extended to all tax-exempt bonds in 1986.

Various different prompt spending exceptions, small issuer exceptions, reasonable debt service reserve fund exceptions, and other exceptions to arbitrage yield restrictions and arbitrage rebate apply in different ways and in different circumstances.

By the nature of their subject matter, the arbitrage restrictions involve some inherent complexity. Some would suggest that they present the full panoply of different kinds of tax complexity. One source of complexity arises from the duplicative and overlapping nature of the two different sets of arbitrage restrictions (rebate and yield restrictions) that basically aim to address the same basic tax policy of controlling arbitrage incentives. These two different sets of arbitrage restrictions have developed in different ways over a long period of time. Notably, the 1993 final Treasury Regulations on the arbitrage restrictions went a long way towards integrating the rebate and yield restriction rules into a single regime to the extent possible through the concept that permits quasi-rebate "yield reduction payments" to be made under Treas. Reg. §1.148-5(c) to satisfy yield restriction requirements in prescribed circumstances. The 1993 final Treasury Regulations also took some further significant steps towards simplifying the arbitrage restrictions over previous rules. Still, much complexity remains in the arbitrage area and more simplification could be achieved both legislatively and by regulation. Other sources of complexity in the arbitrage area include, without limitation, complexities associated with investment tracking, mathematical computations, accounting principles, indirect replacement proceeds, various restrictive accounting rules for working capital expenditures, and special rules for disfavored advance refunding transactions.

One necessary assumption in the arbitrage area should be that the economic investment characteristics and incentives with tax-exempt bonds compel the need for some form of continuing arbitrage investment restrictions to backstop the area. Simplification measures, however, can reduce the administrative burdens of the arbitrage investment restrictions in a variety of ways and should be pursued.

B. <u>Specific Recommendations to Simplify the Arbitrage Restrictions</u>.

One way to simplify this area would be to reduce administrative burdens through more broadly applicable and achievable prompt spending exceptions in circumstances in which arbitrage investment incentives remain reasonably limited. Another way to simplify this area would be to reduce administrative burdens on less sophisticated smaller issuers through broader small issuer exceptions that cover disproportionately large numbers of issuers and bond issues without impacting much bond volume. Another way to simplify the arbitrage area would be to reduce the duplicative nature of the arbitrage rebate and yield restriction rules further. Another way to simplify this area would be to provide further exceptions to arbitrage rebate for limited debt service reserve funds and bona fide debt service matching funds. We will address each of these avenues below.

1. <u>Provide a Greatly Simplified, 3-year Prompt Spending Exception to Arbitrage Rebate for All Long-Term Fixed Rate Tax-Exempt Bond Issues (Excluding Refundings and Restricted Working Capital)</u>.

We believe that the Joint Tax Committee's recommendation in the 2001 Joint Tax Study to extend the spending period for the governmental construction spending exception to arbitrage rebate from two years to three years was a positive step. We further believe that more simplification is achievable here. We recommend a greatly simplified, 3-year prompt spending exception to arbitrage rebate that should apply broadly to all long-term fixed rate tax-exempt bond issues. Very limited exceptions should apply to refundings and bonds used to finance restricted working capital expenditures for which the six-month rebate spending exception should suffice.

We believe that a significant amount of simplification can be achieved with a broader, simpler prompt spending exception with reasonably attainable spending periods without undue arbitrage incentives. Further, particular simplification can be achieved by streamlining the rest of the apparatus of the two-year governmental construction spending exception under Section 148(f)(4)(C). The existing apparatus for this construction spending exception, including its eligibility restrictions, definitions, bifurcations, and penalty calculations, remains mind-numbingly complex, and furthers no obvious Federal interest.

Specifically, we suggest a clean, simple, reasonably prompt, 3-year spending exception to arbitrage rebate for all long-term fixed rate tax-exempt bonds (excluding refundings and restricted working capital expenditures) with the following parameters:

(1) <u>3-year spending period</u>. A 3-year spending period, with interim spending percentages of something like 15-25% by the end of the first year, either no specific percentage (simpler) or perhaps 50% (reasonably attainable with a lower revenue impact) by the end of the second year, and 95% by the end of the third year (with some *de minimis* relief from 100% expenditure being important to simplification because often small amounts of proceeds remain unspent).

(2) <u>Due diligence</u>. A requirement that the issuer proceed with due diligence to carry out the governmental purpose and spend the bond proceeds.

(3) <u>Underspending</u>. Address underspending either by reversion to arbitrage rebate entirely as an incentive to satisfy the spending exception or possibly by a prescribed penalty (but provide no choice), with yield restriction starting at the end of the third year on any remaining unspent proceeds.

The tax policy behind a prompt spending exception to arbitrage rebate generally is that arbitrage potential is limited if the issuer spends the tax-exempt bond proceeds fairly promptly. We believe that broadening this exception to include all types of tax-exempt bonds (*i.e.*, both governmental and private activity bonds) would be consistent with the policy behind a prompt spending exception and would provide much-needed, broader simplification. We believe that most tax-exempt bond issues finance modest amounts of equipment along with land and buildings that should be covered by this prompt spending exception.

To address failures to meet the prescribed spending periods, consideration could be given either to reverting to arbitrage rebate entirely or to imposing a one-time prescribed penalty on underspent proceeds. In all events, we recommend a single approach (versus optional choices) to address this issue. Any permitted issuer options in approach, such as either reverting to arbitrage rebate or paying a one-time penalty, would lead to more complexity as issuers invariably would want to calculate the economic results under any available options to minimize the impact.

One reason in favor of full reversion to arbitrage rebate is that it would provide an incentive to size tax-exempt bond issues to meet the spending periods. The simplification associated with a simplified spending exception lies largely in the use of a reasonably attainable spending period. On balance, we believe that reverting to arbitrage rebate makes the most sense here.

Alternatively, in theory, a one-time penalty on underspent proceeds may be simpler. In addition, a penalty approach is more consistent with the theme of intermediate sanctions for lesser violations. One concern about a penalty approach is that the focus on the design of such a penalty led to undue complexity in the existing two-year construction spending exception to arbitrage rebate.

We recommend limiting this spending exception to long-term fixed rate bonds. This limitation would provide an appropriate safeguard against the economic possibility of greater arbitrage potential in the one area in which we believe any real potential for arbitrage exists under a three-year spending period in most normal yield curves: tax-exempt floating rate or tender option bonds.

2. Increase the Section 148(f)(4)(D) Small Issuer Rebate Exception from $5 Million to $10 Million or preferably $25 million (If Economic Impact Data Supports) and Unify it with the Section 265(b)(3) Small Issuer Bank Purchase Exception.

We recommend increasing the small issuer exception to arbitrage rebate from $5 million to $10 million or preferably $25 million (if economic impact data supports such a greater increase, as discussed below).[14] This recommendation involves a different kind of tax simplification of the arbitrage area. In general, small issuers tend to be less sophisticated, less likely to be able to bear the costs of compliance, and arguably more deserving of administrative relief in most circumstances.

The compelling tax policy goal that could be achieved with an increase in the small issuer rebate exception would be to reduce the administrative burdens on the largest number of less sophisticated small issuers while affecting a vastly disproportionate smaller amount of affected tax-exempt bond dollar volume. To illustrate this disproportionate effect roughly, in 2001, tax-exempt small issuers of $10 million or less of bank qualified bonds under Section 265(b)(3) issued 5,238 bond issues out of 13,703 total bond issues, representing about 38%

[14] See 2001 Joint Tax Study; 1990 House Ways and Means Committee Study; 1990 Joint Tax Study; and 1991 Treasury Simplification Testimony. In the 1993 Treasury Simplification Testimony, Treasury did not oppose raising the Section 265(b)(3) small issuer bank purchase exception to $25 million.

of the total number of bond issues, but the dollar volume of those bond issues was only about \$16.6 billion out of \$286.6 of total tax-exempt bond volume, representing only about 6% of tax-exempt bond volume.[15] At the \$10 million small issuer level, the difference between covered bond issues (38%) and affected tax-exempt bond volume (6%) is compelling in its disproportionate effect.

We urge Treasury to review any available economic data on tax-exempt bond volume by smaller issuers and to suggest increasing the small issuer rebate exception to the highest optimum level that still would have a tolerably small impact on affected tax-exempt bond volume. Although we cannot cite you to specific supporting data, we believe that the data should support an increase in the small issuer rebate exception to \$25 million with a reasonably and disproportionately small effect on tax-exempt bond volume.

We further recommend unifying and simplifying the eligibility requirements for the small issuer arbitrage rebate exception under Section 148(f)(4)(D) and the small issuer bank purchase exception under Section 265(b)(3). As background, in the 2001 Joint Tax Study, the Joint Tax Committee recommended repealing the small issuer qualified bank purchase exception under Section 265(b)(3). In part, the Joint Tax Committee's rationale for this suggestion was a view that the "proliferation of State bond pools has made the qualified small issuer exception largely irrelevant."[16]

We respectfully suggest and emphasize strongly that a large number of small issuers continue to rely significantly on simpler transactions involving selling their bonds to their local banks outside of pools. The smaller the transaction, the more likely it is that the local bank is the buyer. Moreover, many States do not have State bond banks or State pooled financing vehicles, and this exception correspondingly has a widespread use in those States. In addition, although we recognize the legitimate and important function served by many State bond banks and other pooled financing issuers, at the same time, we have some concerns about undue reliance on the role of pooled bond financings. The IRS has longstanding concerns about the potential for abuse in pooled bond financings and continues to target this area in IRS audits.

We recommend that better tax simplification and better tax policy would be to unify the "small issuer" eligibility requirements for the small issuer arbitrage rebate exception under Section 148(f)(4)(D) and the small issuer bank purchase exception under Section

[15] The Bond Buyer at Page 4A (February 19, 2002) (Source: Thomson Financial Securities Data as of January 13, 2002).

[16] 2001 Joint Tax Study at Volume II, Page 526.

265(b)(3). Presently, these two small issuer exceptions have similar but not identical eligibility requirements. We specifically recommend excluding current refundings from the counting process under both of these exceptions. We also recommend removing the general taxing power requirement from the small issuer arbitrage rebate exception.[17] In addition, we suggest that the rules on subordinate governmental units under these exceptions should be both unified and simplified.

3. Further Integrate Arbitrage Rebate and Yield Restriction in Most Circumstances (Except for Advance Refunding Escrows)Through Primary Reliance on Rebate or Quasi-Rebate Payments.

a. In General.

One achievable tax simplification recommendation for the arbitrage area is to consider integrating the arbitrage rebate and yield restriction rules further by regulation.[18] We note that, for the most part, the 1993 Treasury Regulations on the arbitrage restrictions have gone a long way towards this integration. Our main specific recommendation here is to reverse the presumptions and to consider expanding Treas. Reg. §1.148-5(c) to permit the quasi-rebate "yield reduction payments" to satisfy yield restriction in most circumstances, absent a specific exception. We further recommend a specific exception for investments of advance refunding escrows. Specific exceptions also could be considered for other specifically-identified areas of concern. The goal here would be to have a system that relies on arbitrage rebate as the principal way to control arbitrage investment incentives. As between arbitrage rebate and yield restriction, rebate arguably provides a better incentive for fair market value purchases of investments.

For advance refundings, we recommend retaining yield restriction for investments of advance refunding escrows. In advance refundings, issuers overwhelmingly seek to use fixed rate bonds and to achieve certainty on the level of economic savings at closing. Thus, the investment portfolios for advance refundings generally are fixed at closing. The recently-streamlined special Treasury State and Local Government Series ( "SLGs") investment program generally provides a workable investment vehicle for yield restriction of advance refunding escrows.

[17]In 1990, the House Ways and Means Committee Staff made this recommendation in its 1990 House Ways and Means Committee Study.

[18]In the 1990 House Ways and Means Committee Study and in the 1990 Joint Tax Study, these committee staffs expressed support integrating arbitrage rebate and yield restriction in various ways.

b. Clear Broad Regulatory Authority.

We believe that Treasury has clear broad regulatory authority to integrate arbitrage rebate and yield restriction further to the extent it deems necessary or appropriate. Regarding the general breadth of Treasury's regulatory authority, Section 148(i) of the Code provides Treasury a broad grant of legislative regulatory authority (beyond its standard administrative regulatory authority under Section 7805(a)) to issue all regulations "necessary or appropriate to carry out the purposes" of the arbitrage provisions in Section 148. Moreover, to underscore the breadth of this regulatory authority, in 1988[19] Congress deleted and reinserted the term "necessary" from this provision to "clarify that Treasury's regulatory authority is to be interpreted broadly, rather than in a literal, dictionary manner as was done by the Court of Appeals in the *City of Tucson* case."[20]

In addition, in the predecessor version of the arbitrage yield restriction provision originally in Section 103(d) of the Internal Revenue Code of 1954 (the "1954 Code") enacted in 1969,[21] the original Section 103(d)(5) of the 1954 Code provided Treasury a broad legislative grant of regulatory authority under Section 103(d)(5) to issue all regulations "necessary to carry out the purposes" of the arbitrage provision.

Conceptually here, absent statutory changes, we believe that Treasury has sufficient regulatory authority to integrate arbitrage rebate and yield restriction further, not by reading yield restriction out of the Code but by defining yield restriction by regulation in a way that allows rebate-like payments to satisfy yield restriction. For example, in the case of small issuers exempt from arbitrage rebate, it may be appropriate to retain a yield restriction requirement after expiration of a temporary unlimited investment period, but it equally may be appropriate to allow such a small issuer to satisfy that yield restriction requirement with a yield reduction payment for excess yield. Since 1969, Treasury has provided virtually all of the details of the definitions of "yield" and "materially higher yield" by regulation. In addition, since the implementation of the 1993 Treasury Regulations on the arbitrage restrictions which largely integrated arbitrage rebate and yield restriction with the yield reduction payment concept, we are unaware of any challenge or question regarding Treasury's exercise of its regulatory authority.

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[19]See Technical and Miscellaneous Act of 1988, P.L. 100-647, at §363(b) (1988) (the "1988 Tax Act").

[20]See H.R. Rep. 100-795, 100th Cong. 2d Sess., at Pages 327-328 (July 26, 1988) (the "1988 Act House Report") and S.Rep.100-445, 100th Cong. 2d Sess., at Pages 347-348 (August 3, 1988) (the "1988 Act Senate Report").

[21]See the Tax Reform Act of 1969, P.L. 91-172, at §601(1969)

4. Provide an Arbitrage Rebate Exception for 10% Equity-Funded Debt Service Reserve Funds.

In brief, presently issuers can use tax-exempt bond proceeds to fund debt service reserve funds up to 10% of the principal amount of the tax-exempt bonds, but those reserve funds are subject to arbitrage rebate. The idea here is to reverse that by giving issuers an incentive not to issue tax-exempt bonds to finance these reserve funds in the form of an arbitrage rebate exception for 10% equity-funded reserve funds.

In particular, in this regard, State and local governments now can issue tax-exempt bonds to fund a reserve or replacement fund from bond proceeds in an amount up to 10% of the principal amount of the bonds under Section 148(d)(2). Also presently, for a large number of tax-exempt bond issues in which issuers meet one of the prompt spending exceptions to arbitrage rebate, the only significant remaining funds that are subject to arbitrage investment tracking and arbitrage rebate are bond proceeds used to fund reasonably required debt service reserve funds.

We recommend providing an arbitrage rebate exception for reasonably required debt service reserve or replacement funds that meet two conditions. First, a covered reserve fund would be required to be funded from sources other than tax-exempt bond proceeds, such as equity or taxable bonds (together referred to as an "equity-funded reserve fund). Second, the amount of a covered reserve fund would be required to be sized at a level not in excess of 10% of the original principal amount of the tax-exempt bond issue or issues that its secures.

A tax policy case can be made in support of this recommendation. This suggestion would reduce administrative arbitrage tracking burdens because it would eliminate the main remaining funds (*i.e.*, standard debt service reserve funds) that remain subject to arbitrage rebate in traditional bond issues in which issuers otherwise have met prompt spending exceptions to arbitrage rebate. Moreover, it is important to keep in mind that the overriding focus of the arbitrage restrictions is not the arbitrage-it is controlling against overburdening the tax-exempt market. We believe that this suggestion potentially could reduce the burden on the tax-exempt market because it would provide an incentive to issuers to fund their standard debt service reserve funds from sources other than tax-exempt bonds. As a limitation, we recommend a size constraint because at some level the indirect effect of arbitrage on pledged otherwise-equity replacement proceeds may be inappropriate.

5. Provide an Arbitrage Rebate Exception for All Short-Term Bona Fide Debt Service Funds.

We recommend providing an arbitrage rebate exception for “bona fide debt service funds” under Treas. Reg. §1.148-1(b). Virtually no arbitrage potential exists with these short-term debt service matching funds that generally must be depleted annually. Indeed, this simplifying recommendation should a positive Federal revenue impact because these low-yielding bona fide debt service funds generally have the opposite economic effect of blending down and lowering the aggregate yield on investments subject to arbitrage rebate. Presently, only certain bona fide debt service funds are exempt from arbitrage rebate under Section 148(f)(4)(A), including those used with tax-exempt governmental bonds with a fixed interest rates and average five-year maturities and those with gross annual earnings of less than $100,000.

## V. Other Selected Tax Simplification Recommendations for Tax-Exempt Bonds.

### A. Repeal the Vestige of the $150 Million Nonhospital Bond Limitation on Qualified Section 501(c)(3) Bonds Under Section 145(b).

We concur with the Joint Tax Committee's significant recommendation in the 2001 Joint Tax Study to eliminate the vestige of the $150 million nonhospital bond limitation on qualified 501(c)(3) bonds issued to finance capital expenditures under Section 145(b). In 1997, this limitation was repealed partially and prospectively for tax-exempt bond issues issued after August 5, 1997 in which at least 95% of the proceeds are used to finance capital expenditures incurred after that date.[22] Unfortunately, that partial repeal left in place a vestige of considerable complexity for qualified Section 501(c)(3) bonds in a fair range of circumstances that remain subject to this restriction.

In particular, this $150 million nonhospital bond limitation continues to affect qualified Section 501(c)(3) bonds in circumstances such as the following: (i) outstanding bonds issued before August 5, 1997 to finance capital expenditures; (ii) refundings of outstanding bonds issued before August 5, 1997 to finance capital expenditures; and (iii) any nonhospital bonds issued at any time in which more than 5% of the net proceeds of the bonds are used for working capital expenditures for a Section 501(c)(3) exempt purpose.

Moreover, two further factors exacerbate the continuing impact of the complex $150 million nonhospital bond limitation. One factor is the significant consolidation trend in the nonprofit health care industry. Over 500 affiliations, mergers, or consolidations have occurred since the 1997 effective date of the prospective repeal of this limitation.[23] A second factor is that this limitation provides inappropriate backwards incentives that discourage economic cost-saving trends in the health care industry away from acute hospitals and towards more cost-effective, less acute care nursing, intermediate, and assisted living health

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[22] See Taxpayer Relief Act of 1997, P.L. 100-647, at §222 (the "1997 Taxpayer Relief Act").

[23] See Modern Healthcare (January 8, 2001).

care facilities. This second factor also presents many tax issues associated with tracking the $150 million nonhospital bond limitation whenever a Section 501(c)(3) exempt organization effects a "change of use" of an acute care hospital facility to a less acute form of health care facility under Sections 145 and 150.

One technical issue is that the Joint Tax Committee's recommendations in this area would not repeal the vestige of this limitation for qualified 501(c)(3) bonds in which more than 5% of the proceeds are or were used for working capital expenditures. Although this should not have a significant impact, it would be more simplifying to repeal the entire vestige of this limitation. Another technical issue is whether any repeal of this limitation should cover tax-exempt refundings of previous taxable nonhospital bonds. Again, it obviously would be preferable to repeal the entire vestige of this limitation without conditions, but a restriction against covering tax-exempt refinancings of previous taxable bonds may be an appropriate constraint. This issue would seem to be more of a revenue impact question in the legislative process.

B. <u>Repeal Various Subsidiary Requirements for Small Issue Bonds Under Section 144(a) and Provide a Simpler, More Modern Definition of Eligible Facilities</u>.

In general, we believe that you could eliminate a large number of the eligibility requirements for small issue bonds under Section 144(a) without undue tax policy concern because these bonds would remain fully subject to competition for private activity bond volume cap allocations. Most of the eligibility requirements for small issue bonds represent either deadwood or interim provisions that were aimed at controlling tax-exempt small issue bond volume before the enactment of the private activity bond volume cap. Despite the unduly complex program eligibility requirements and the acknowledged private business character of the financed projects, the small issue tax-exempt bond program remains popular with State and local governments and Congress alike as an economic development incentive.

One way to simplify the small issue bond provision significantly would be to repeal the $10 million capital expenditures limitation under Section 144(a)(4) and the $40 million aggregate small issue bond limitation per principal user entirely. These changes would produce much simplification because they would eliminate a lot of administrative complexity associated with determining, measuring, and monitoring ongoing local capital expenditures, principal user determinations, and national allocations of aggregate outstanding small issue bonds per principal user.

Alternatively, if a policy determination is made to retain a feature to target the small issue bond program only to small businesses, a much simpler way to target this provision to small businesses would be to determine whether a business was sufficiently "small" for eligibility purposes based on a one-time, issue date determination that looked at some specified level of revenues or assets of the business (in lieu of the existing tracking of local capital expenditures and outstanding small issue bonds nationally by principal users)

Another way to simplify the small issue bond provision would be to provide a simpler, more modern definition of eligible facilities. From a tax policy perspective, in the larger context, the main Congressional purposes for targeting small issue bonds to manufacturing facilities were to promote industrial production facilities, and correspondingly, to restrict financing of retail-type facilities. Beyond that policy focus, it seems unnecessary to micromanage the manufacturing definition through excessive subsidiary requirements in the definition. The existing definition of eligible "manufacturing facility" under Section 144(a)(12)(C)[24] employs a vague standard with ambiguous and unworkable subsidiary aspects of the definition. Eligible related facilities presently must be "directly related and ancillary" to the manufacturing facility. Confusing legislative history contributes to the ambiguity of this standard.

Thus, in general, we recommend simplifying the definition of an eligible manufacturing facility to provide more flexibility to finance storage, design, research, development, office, and other support facilities that are reasonably related to an industrial or manufacturing process. One possible way to simplify this standard would be to employ an alternative standard of "functionally related and subordinate" facilities that is more commonly used for various exempt facilities in the tax-exempt bond area.

In addition, we recommend modernizing the statutory definition of manufacturing facility to provide more flexibility to finance high technology facilities and computer software-focused facilities involving intangible property that are an increasingly important part of our service economy. Moreover, a modernized definition of manufacturing facility should include flexibility to finance storage, design, and research facilities that are reasonably related to the manufacturing process.

C. <u>Eliminate Specific Identification Requirements for Section 146(f) Volume Cap Carryforwards</u>.

We recommend eliminating the specific identification requirements regarding facilities and purposes for private activity bond volume cap carryforwards under Section 146(f). The Section 146(f) carryforward provision involves undue complexity regarding the

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[24]NABL's General Tax Committee has a significant comment project led by Jeannette M. Bond on the manufacturing definition for small issue bonds under present law that is nearly complete and should be submitted to you in the near future.

requirement to identify specific carryforward purposes. In addition, this provision has been the subject of a number of private letter ruling requests on how to apply it. Issues have arisen on how to apply address the irrevocable aspect of carryforward elections in circumstances involving changes in the nature of facilities covered by carryforward elections and various monitoring problems encountered by States in tracking expirations of carryforward elections for particular facilities under the "first-in-first-out" carryforward stacking principle. Identification of the total amount of unused private activity bond volume in a particular year should suffice.

D. Provide More Uniform Targeting Rules and Incentives for Economically Distressed Areas.

Although we have no specific recommendations on the targeting rules for economically distressed areas, we endorse a theme expressed by the Joint Tax Committee in the 2001 Joint Tax Study. In this regard, it would advance the cause of simplification to use uniform definitions and targeting rules for economically distressed areas. Present law in this regard is just a swamp of complexity and different programs (enterprise zones, empowerment zones, enterprise communities, renewal communities, and the like). On one limited point, we note that Section 144(d) on qualified redevelopment bonds safely could be repealed because it is rarely used due to its excessive requirements. Tax increment bonds perform a comparable function.

E. Combine and Simplify the Section 149(f) Pooled Bond Restrictions and the Section 149(g) Hedge Bond Restrictions in a Single Provision on Maximum Spending Periods.

We recommend combining and simplifying the existing Section 149(f) pooled bond restrictions and Section 149(g) in a single provision on maximum spending periods. There is no need for two separate statutory provisions that both address the same basic tax policy purpose of providing maximum expected spending periods for tax-exempt bond proceeds in slightly different contexts. Consideration should be given to changing any provisions for pooled bonds to focus on expenditures not just to make loans, but on ultimate spending by borrowers to carry out governmental purposes. Consideration possibly could be given to changing the standard for testing compliance with the spending period targets from a "reasonable expectations" test to a tighter "actual expenditures" test that would be more administrable from the IRS's perspective. Although such a change would be more restrictive, it could reduce administrative disputes between issuers and the IRS on the reasonable expectations test. It would be important to couple any further restriction of that type to a statutory intermediate sanctions principle that permitted issuers to cure any failure to meet the outside spending restrictions by redeeming only the affected underspent portion of the tax-exempt bonds.

F. Consider Simplified Recordkeeping Requirements.

In general, we recommend consulting with State and local governments to develop simplified recordkeeping requirements for tax-exempt bonds. Tax-exempt bond issuers face unique recordkeeping challenges. Unlike most taxpayers whose recordkeeping requirements are tied to the three-year statutes of limitation on their Federal tax returns, tax-exempt bond issuers may need to demonstrate the tax-exempt status of their bonds for the entire term of the bonds, which may last 30 years. Consideration should be given to approving streamlined procedures that would allow State and local governments to rely on tax certificates and summaries of certain records, such as expenditure records, after some reasonable number of years, such as after the associated arbitrage rebate five-year installment computation date.

VI. Selected Demand-Side Recommendations for Tax-Exempt Bonds.

A. Principal Recommendation: Repeal the Alternative Minimum Tax Preference on Tax-Exempt Private Activity Bonds.

We recommend repealing the AMT preferences on tax-exempt private activity bonds to simplify this area, improve market efficiency, and enhance market demand. Both the Joint Tax Committee and the American Bar Association urged complete repeal of the alternative minimum tax (the "AMT") as one of their highest priorities.

In contrast to the perceived prohibitive Federal revenue cost of repealing the AMT generally, we believe that repeal of the AMT preference on tax-exempt private activity bonds should have a minimal Federal revenue impact or conceivably a positive Federal impact. The AMT preference on tax-exempt private activity bonds appears to have a punitive economic effect in that it causes an interest rate penalty of roughly 10 to 25 basis points on tax-exempt AMT bonds without anything close to corresponding Federal revenue gained from this particular AMT preference. Anecdotally, some argue that the AMT preference on tax-exempt bonds generates little Federal revenue because those investors who think they will be subject to the AMT simply decline to buy AMT Bonds. We recommend reviewing any available income tax data on the effect of the AMT preference on tax-exempt bonds.

B. Repeal Other Special Rules That Treat Otherwise Tax-Exempt Interest as Taxable in Assorted Narrow Circumstances.

Similar to our recommendation to repeal the AMT preference on tax-exempt private activity bonds (but with significantly less impact on tax-exempt bond interest rates), we recommend repealing the host of other narrow rules that add back otherwise-tax-exempt income into income for various narrow prescribed purposes and categories of taxpayers (*e.g.*, individual recipients of Social Security and railroad retirement benefits, persons eligible for earned income tax credits, property and casualty insurance companies, and the like). These narrow provisions are complex, require inordinate tax disclosure in tax-exempt bond offerings, and surely have a minor revenue impact.

C. Consider Providing a Clear Regulatory Method for Converting Fixed Rate Bonds into Variable Rate Investments in the Secondary Market Under Section 1286 to Promote Uniformity.

In general, State and local governments prefer to issue fixed rate tax-exempt bonds in the primary market. At the same time, a large class of money market mutual fund investors prefer to purchase short-term floating rate tax-exempt bonds (*e.g.*, floating rate bonds with 7-day put options). To address this supply-demand mismatch, participants in the secondary market seek to create synthetic floating rate tax-exempt bonds out of existing fixed rate tax-exempt bonds.

We recommend that Treasury consider providing a clear, uniform regulatory method to create synthetic floating rate tax-exempt bonds in the secondary market from existing fixed rate tax-exempt bonds based on the bond coupon stripping principles under Section 1286. The intent here is to provide a clearer and more efficient way to create synthetic floating rate tax-exempt bonds in the secondary market than presently can be done through partnership structures. Partnerships can be an awkward method for stripping cash flows because of various partnership equity, accounting, and other requirements. At a macroeconomic level, this recommendation attempts to address in a more efficient way the significant supply-demand mismatch between State and local governmental issuers who conservatively prefer to issue fixed rate tax-exempt bonds in the primary market and mutual fund investors who have significant on-going demands for short-term floating rate tax-exempt bonds (*e.g.*, floating rate bonds with 7-day put options). For rough illustrative purposes, in 2001, State and local governments issued about $45 billion in floating rate short-term (or short put option) tax-exempt obligations[25] and money market mutual funds held approximately $272.4 billion in floating rate tax-exempt obligations.[26]

[25]See The Bond Buyer at Page 4A (February 19, 2002) (Source: Thomson Financial Securities Data) (2001 tax-exempt bond volume statistics).

[26]See Investment Company Institute, Mutual Fund Fact Book at Page 88 (2002 Edition).

VII. Offer to Provide Technical Assistance Regarding Offsetting, Revenue-Raising Legislative Limitations to Support Tax-Exempt Bond Simplification.

We intend for our tax simplification recommendations to be considered as serious proposals for the tax-exempt bond area. We fully recognize that, outside of the legislative budget reconciliation process, any tax legislative changes that have a potential liberalizing or revenue-losing effect must be offset and paid for with corresponding limiters or revenue-raising legislative changes. In the context of active legislative consideration of tax-exempt bond simplification, we offer to provide technical assistance to Treasury and the legislative tax committees regarding offsetting, revenue-raising legislative limitations on tax-exempt bonds to support legislative proposals to simplify the tax-exempt bond area.

VIII. Selected Discrete Recommended Changes for Tax-Exempt Bonds.

A. Introduction.

Set forth below are a number of mostly-simplifying, discrete guidance suggestions for the tax-exempt bond area. We would be glad to provide further technical analysis of any of the listed ideas.

B. Selected Discrete Bullet-Point Ideas.

1. Section 141 private activity bond tests: provide a more workable proportionate measure of nonqualified bonds (versus present highest one-year private business use percentage) for change of use remedies under Treas. Reg. §1.141-12 that is more consistent with the statute.

2. Section 141 private activity bond tests: provide a simplified rule for large governmental multi-purpose programs under Treas. Reg. §1.141-2(d)(5) and consider adding simplified safe harbors for smaller issuers.

3. Section 141 private activity bond tests: provide flexible accounting rules to accommodate public-private partnerships in mixed use facilities and to permit flexible allocations of equity to nonqualified uses.

4. Section 141 private activity bond tests: simplify the vague, indirect private payments/security test.

5. Section 142(d) qualified residential rental projects: provide a safe harbor one-year transition period to allow conversion of acquired market rent multifamily housing projects into qualified low-income residential rental projects.

6. Section 143(e)(2) qualified mortgage bonds: the IRS should re-commence publishing annual average area purchase price information, using Federal Housing Finance Board data with a simplifying assumption to adjust for VA and FHA-insured mortgages.

7. Section 143 qualified mortgage bonds: curtail excessive information reporting under Treas. Reg. §1.103a-2(k)(2).

8. Section 145 qualified 501(c)(3) bonds: eliminate restrictions on financing residential rental property for family units under Section 145(d), which require fine distinctions in the area of health-care service intensive housing and nursing facilities.

9. Section 148 arbitrage: change the special rule for premium bond yield computations under Treas. Reg. §1.148-4(b)(3)(ii)(b) from a "lowest yield on the issue" test to a simpler individual premium bond test to eliminate inordinate mathematical computations with limited consequences.

10. Section 148 arbitrage: remove the restriction on financing a working capital reserve fund under Treas. Reg. §1.148-1(c)(4)(ii)(a), which has a one-time effect, unduly penalizes the neediest issuers, and introduces a third sizing constraint into already restrictive working capital rules.

11. Section 148 arbitrage: clarify that fair market valuation under Treas. Reg. §1.148-5(d)(3) prevails over present valuation for first allocations of investments to tax-exempt bond issues and that present value always applies to subsidized purpose investments.

12. Section 148 arbitrage: clarify the treatment of accrued interest on IRS Form 8038s and eliminate the choice of including or excluding accrued interest in yield calculations for simplification purposes.

13. Section 148 arbitrage: provide guidance on whether payments of principal and interest on purpose investments are sale or investment proceeds (analytically sound) or excluded from the definition of proceeds altogether (vastly simpler).

14. Section 148 and section 141: clarify the extent to which an issuer must "look through" expenditures for bond proceeds used to make "grants" for arbitrage purposes (*e.g.*, to characterize the nature of the grant as a capital expenditure or working capital) or for private business use purposes (*e.g.*, to determine whether a grant is used for private business use purposes).

15. Section 148 arbitrage: absent elimination of yield restriction, provide more simplified, consolidated temporary periods for unrestricted investment, including express periods for issuance costs, grants, and extraordinary working capital expenditures.

16. Section 150: clarify the treatment of taxable bonds under the definitions of "bond," "obligation," "issue," and the reimbursement bond rules.

17. Section 150 issue definition: provide a unified "issue" definition that follows Treas. Reg. §1.150-1(c) and remove the conflicting issue definition under Treas. Reg. §149(e)-1(e)(2). In addition, provide a definition for "draw-down" loans.

## IX. Conclusion: Reiterate Strong Support for Tax Simplification Initiatives.

In conclusion, we reiterate our strong support for tax simplification initiatives. We would be pleased to provide further technical analysis on any tax-exempt bond simplification proposals discussed herein or otherwise under consideration.