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**March 30, 2006**

**Statement of Walter J. St. Onge III**

**President, The National Association of Bond Lawyers**

**Submitted to the Subcommittee on Select Revenue Measures  
Committee on Ways and Means  
United States House of Representatives**

**Hearing on Tax-Preferred Bonds**

The National Association of Bond Lawyers is pleased to submit this additional written commentary with respect to the Subcommittee on Select Revenue Measures, Hearing on Use of Tax-Preferred Bond Financing.

The National Association of Bond Lawyers (“NABL”) is a professional association incorporated in 1979 with more than 3,000 members who specialize in municipal bond law. NABL has offices in Chicago and Washington, D.C.

The original statement of purpose of the Association provided, in part, that: “the purpose of the Association shall be to promote the public good by:

- Educating its members and others in the law relating to state and municipal obligations,
- Improving the state of the art in this field, and
- Providing advice and comments at the federal, state and local levels with respect to legislation, regulations, rulings and other action, or proposals, affecting state and municipal obligations.”

NABL remains committed to serving its members and all participants in the municipal bond market by offering input on all matters of interest to our profession and by providing information to assist our members in making sound legal judgments.



The NABL Board of Directors reaffirmed NABL's commitment to improving standards in the municipal bond market when it adopted a vision statement in 2005 to the effect that NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance.

The municipal bond market is a keystone of the United States economy, providing financing for general governmental functions and for the infrastructure that is essential to economic growth and job creation in a manner that promotes state and local self-government and fiscal autonomy. The United States is the only nation that permits autonomous state and local governments direct access to the capital markets to finance state and local infrastructure.

This public financing mechanism underpins our federal system of state and local self-government. Year in and year out, thousands of municipal bond issuers and borrowers across this country, ranging from the largest state governments down to the smallest school or fire or sewer district, evaluate their capital needs and how to best meet those needs. The cumulative effect of those decisions is reflected in the annual issuance of municipal bonds, including over \$400 billion in 2005. The economic impact of these expenditures is obvious and significant. The municipal bond market benefits all of its disparate borrowers by providing them equal access to funding on favorable terms.

The municipal bond market enjoys high levels of investor confidence based on its long history of economic strength, extraordinarily low default rates and the integrity of the market's issuers and professionals. The role of bond counsel is a cornerstone of the efficient operation of the market. The integrity and professionalism of bond lawyers are key to maintaining the high level of investor confidence in the municipal bond market.

### **NABL Activities**

NABL educational efforts promote the continued high standards of practice and integrity of its members and assist practitioners and regulators in advancing the state of the law. These efforts include annual seminars and workshops targeted at different bond counsel experience levels and include meaningful participation by federal government officials and other market participants.

In recent years, we have also conducted numerous teleconferences on various topics, including in particular, ethics matters, Internal Revenue Service (IRS) enforcement topics, and proposed standards of practice for tax lawyers issued by the Treasury Department and the IRS.

Maintaining high professional standards has been a mainstay of NABL educational efforts. NABL members have prepared a number of important documents to assist our members fulfill their professional obligations. These include a document



entitled *The Function and Professional Responsibilities of Bond Counsel*, and more recently an updated *Model Bond Opinion Report*.<sup>1</sup>

Other significant NABL efforts include comment projects on regulatory and legislative matters and guidance requests on particular topics pertaining to the municipal bond area. For example, on September 7, 2005, NABL submitted a detailed letter to the Department of the Treasury regarding the role of municipal bonds in the historic rebuilding efforts required in the wake of Hurricane Katrina.<sup>2</sup> This letter identified potential administrative and legislative actions that could be taken to help alleviate the dramatic effects of Hurricane Katrina in the affected region. We were mindful that the immediate task was emergency assistance for the citizens of that area, but we also recognized the disastrous effects on the state and local governments and their ability to provide not only immediate services, but also longer-term reconstruction activity and normal governmental services. Some of our suggestions were subsequently incorporated in action taken by the Administration and in the Gulf Opportunity Zone legislation enacted by Congress.

### **Tax Simplification**

In 2002, NABL submitted a lengthy report (the “2002 Report”) to the Department of the Treasury regarding tax simplification recommendations for tax-exempt bonds.<sup>3</sup> NABL also submitted a shorter list of simplifications to the Subcommittee on Select Revenue Measures in 2004 (the “2004 Report”).<sup>4</sup> In 2005, NABL resubmitted these recommendations to the President’s Advisory Panel on Federal Tax Reform and to the Department of the Treasury for review and consideration for inclusion in any tax reform proposals.<sup>5</sup>

The simplification proposals include detailed suggestions regarding the rules applicable to tax-exempt bonds issued by state and local governments under section 103 of the Internal Revenue Code (“Code”). As our 2002 Report noted, “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

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<sup>1</sup> The Model Bond Opinion is available on the NABL web site at <http://www.nabl.org/library/comments/MBO/index.html>.

<sup>2</sup> The September 7, 2005, letter to the Department of Treasury regarding Hurricane Katrina is available on the NABL web site at <http://www.nabl.org/library/topicalmats/memberassist/final%20version.pdf>.

<sup>3</sup> The 2002 Report is available on the NABL web site at <http://www.nabl.org/library/comments/taxsimplification/index.html>.

<sup>4</sup> The 2004 Report is available on the NABL web site at <http://www.nabl.org/library/comments/taxsimplification/index2.html>.

<sup>5</sup> The resubmitted recommendation to the President’s Advisory Panel on Federal Tax Reform is available on the NABL web site at <http://www.nabl.org/library/comments/comTaxPanel4-29-05.pdf> and the recommendation letter to the Department of the Treasury is available on the NABL web site at <http://www.nabl.org/library/comments/Snowletter12%2007.pdf>.



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.”

The 2002 Report focused primarily on three aspects of tax-exempt financing rules:

- Ways to simplify the boundary for traditional tax-exempt governmental bonds under the private activity bond definition in Code section 141;
- Ways to reduce the administrative impact of the arbitrage rules applicable to most tax-exempt bond issues; and
- Ways to simplify the common restrictions on most tax-exempt private activity bonds in recognition of the private activity bond volume cap.

*Ways to simplify the boundary for traditional tax-exempt governmental bonds under the private activity bond definition in Code section 141*

The private activity bond status definition under Code section 141 applies broadly to define the scope of the governmental tax-exempt bond sector, which comprises about 90% of the total dollar volume of the overall tax-exempt bond market. These status provisions involve complexity in terms of both the initial classification of bonds at the time they are issued as well as ongoing monitoring of compliance with private business restrictions and associated administrative costs.

Highlighted below are certain of our 2002 recommendations regarding the Code section 141 tax-exempt governmental bond status provisions which may provide broad simplification:

- General recommendation: retain and simplify the private activity bond definition to rely mainly on the basic two-part 10% private business tests under Code section 141(b) to determine tax-exempt governmental bond status. This test requires specified levels of both private use of bond financed property and private payments supporting repayment of the bonds. Maintaining this two-pronged analysis is critical to maintaining flexibility for state and local governments to choose the most cost-effective ways to finance and promote their economic development and fulfill their public purposes.
- Specific recommendations to repeal subsidiary parts of the private activity bond definition:
  - Repeal the Code section 141(b)(3) unrelated or disproportionate use test.
  - Change the Code section 141(c) private loan test from a separate \$5 million test to a straight 10% test.
  - Repeal the Code section 141(b)(4) special \$15 million private business limitation on output facilities and the Code section 141(d) restriction on acquiring nongovernmental output facilities.
- Consider adding a new 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).



The role of government in promoting economic growth has evolved from traditional, fully governmentally owned projects and facilities, to more complex arrangements, such as public-private partnerships and other financing structures with quasi-public or private entities, all with the goal of reducing the total cost of necessary and important public projects for taxpayers and users. NABL's simplification proposals will help attain maximum flexibility for financing the wide range of possible projects within the limits of existing private activity bond principles.

*Ways to reduce the administrative impact of the arbitrage rules applicable to most tax-exempt bond issues*

The simplification proposals represent a comprehensive set of ideas 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. In particular, the arbitrage provisions under Code section 148 have both a broad impact on all tax-exempt bonds and involve considerable complexity in terms of compliance burdens and administrative costs. Our recommendations in this area include the following:

- Provide a 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).
- Increase the small issuer rebate exception from \$5 million to \$10 million or preferably higher, and unify it with the Code section 265(b)(3) bank purchase exception.
- 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.

NABL believes that adopting some or all of these proposals will alleviate administrative burdens without affecting the fundamental goals and limits set forth in current law.

*Ways to simplify the common restrictions on most tax-exempt private activity bonds in recognition of the private activity bond volume cap*

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 technical 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 the following:

- Expanding the list of eligible exempt facilities;
- Giving states the discretion to allocate some percentage (e.g., 25%) of the volume cap to unspecified facilities; or
- Giving states full discretion to allocate their private activity bond volume cap to unspecified types of facilities.

The 2004 Report reiterated a number of proposals from the 2002 Report. It stressed arbitrage and private activity bond related reforms, including a suggestion that the alternative maximum tax preference on tax-exempt qualified private activity bonds be repealed in order to enhance overall market efficiency.

### **Bond Counsel**

The function of bond counsel originated in the 19th century in response to growing investor concern regarding the validity of debt instruments issued by state and local governments. Adverse court decisions led underwriters and bond purchasers to seek legal opinions from lawyers whose objectivity, expertise and perceived independence from the issuer would provide appropriate assurance as to the validity of the debt.

By the early 1900s, the practice of engaging bond counsel to provide an expert and objective legal opinion with respect to the validity of bonds was widespread. Today, the essential components of bond opinions address the validity of the bonds and the tax treatment of interest on the bonds, particularly, the federal tax aspects.

The bond opinion facilitates the sale of the bonds and thereby assists the issuer in carrying out the public purpose for which the bonds are issued. The opinion is based upon an examination of material legal and factual sources (including certifications as to relevant facts provided by persons in a position to have knowledge) and reasonable certainty as to the subjects addressed therein. Constitutional and statutory provisions relating to public purposes and limitations and requirements for the issuance of public debt and applicable case law must be considered in rendering a bond opinion. Federal and applicable state tax laws and regulations must also be considered. Bond counsel also prepares necessary bond and tax documentation, which may range from simply the bond itself and a relatively simple tax agreement containing both general and specific covenants to assure and maintain the tax-exempt status of the bonds, to more complex trust indentures or bond resolutions, often with a corporate trustee to protect the interests of the investors and oversee compliance with the bond terms and other financial and project-related covenants customarily included in the financing documents.

Depending upon the terms of a particular engagement, bond counsel will often provide on-going advice concerning an issuer's capital program and related matters. Bond counsel also often directly participates in the preparation of





disclosure documents to be provided to investors. This will include both primary offering material and continuing disclosure material provided to the secondary market.

In most cases, bond counsel renders an “unqualified opinion” which, according to NABL’s most recent *Model Bond Opinion Report*, essentially means that bond counsel is “firmly convinced that the highest court of the relevant jurisdiction, acting reasonably and properly briefed on the issue, would reach the legal conclusions stated in the opinion.

The “unqualified” bond opinion has become a well-accepted, and in most cases, a required feature of municipal bond issues. While the opinion is not a guarantee, the high standard under which it is issued essentially allows investors to factor out any special risks regarding validity and tax exemption in pricing the bonds. The favorable bond opinion, delivered by recognized bond counsel, promotes the efficiency of the municipal bond market (since bond purchasers rarely feel the need to retain separate, additional counsel) and contributes significantly to the overall successful workings of the market.

### **Municipal Market**

To date, public financing has resulted in over \$2 trillion of valuable state and local infrastructure and other capital projects. Without the municipal bond market, state and local governments would have to look to the federal government to bear a greater share of the infrastructure costs or forego the infrastructure entirely if federal financing were not available.

The municipal bond market serves the needs of state and local governments, educational institutions, charitable organizations and certain qualified private entities by providing efficient access to capital, and addresses the needs of the bond purchasers by providing efficient access to liquid investments. The types of debt issued include traditional general obligation and revenue bonds, so-called private activity bonds for certain purposes and more recently, tax credit bonds for particular, special programs.

The types of debt issued include:

- General obligation bonds, backed by the *ad valorem* taxing power of the particular jurisdiction to finance traditional governmental purposes, such as schools, police and fire facilities and other public works and governmental projects,
- Revenue bonds, backed by a pledge of particular fees or charges, used to finance water and sewer facilities, toll roads, airports, and other similar facilities,
- Private activity bonds issued to finance qualifying projects for Section 501(c)(3) borrowers, such as colleges and universities and other educational entities, hospitals and healthcare systems and cultural institutions, and



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- Private activity bonds subject to the annual state-by state volume cap including purposes such as airports, solid waste disposal facilities, low and moderate income housing projects and single family financings for qualifying homebuyers.

Targeted economic development tax-exempt financings have also been authorized for more specific purposes, including empowerment zone bonds, so-called “green” bonds, the most recent Katrina / Gulf Opportunity bonds, as well as the earlier Liberty Zone bonds. In recent years, tax credit bonds have also been authorized for specific purposes and subject to particular limits, including Qualified Zone Academy Bonds (“QZABs”) and Clean Renewable Energy Bonds (“CREBs”).

The wide range of permitted purposes and issuers of municipal debt also ensures a wide range of complexity in the structure of transactions. However, many aspects of the tax laws applicable to tax-exempt debt generally apply to all transactions or reflect long-standing requirements. This allows bond counsel and other market participants to analyze and structure issues efficiently and permits more effective administration and oversight of transactions. It also enhances the market’s liquidity by allowing investors to effectively take tax risk out of their pricing decisions – assuming, of course, that an “unqualified” bond opinion is being offered as part of the transaction. New forms of tax-favored financing commonly result in increased transaction costs, at least in the short term, as bond counsel and other market participants must familiarize themselves with the nuances of the new product and analyze new legal and financial issues that may arise, as well as educate investors about the new types of projects.

Bond counsel are responsible for reviewing municipal bond transactions to ensure that they are structured consistently, and thereby ensuring compliance with Congress’ legislative intent for tax-exempt bond tax policies. The municipal bond market trusts bond counsel to provide assurance that the municipal bond issue is tax-exempt. The “unqualified” bond opinion provides this assurance. However, the proliferation of single purpose approaches to special programs complicates bond counsel’s job to deliver an unqualified opinion. It may also complicate the market’s ability to assess the risks of the new product and thus to price it appropriately.

Existing tax laws have allowed the municipal bond market to grow and prosper. The cumulative capital spending reflected in the amount of outstanding municipal debt has had a dramatic economic impact across this county. While the 1986 Tax Reform Act imposed significant new restrictions on the municipal bond market, it nonetheless preserved the fundamental access to capital at less expensive rates. NABL believes that any tax reform proposal should promote a more efficient municipal bond market, but should also preserve the ability of local governmental units to make independent decisions regarding the most effective way to serve the needs of their citizens and to promote their growth and economic development.





Simplifying and improving the efficiency of the municipal 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.

Last fall, the President’s Advisory Panel on Federal Tax Reform issued its final report on a wide range of possible tax reforms, including provisions that would adversely affect the municipal bond market. The “Simplified Income Tax Plan” would tax the interest on all otherwise tax-exempt municipal bonds held by businesses. The “Growth and Investment Tax Plan” would eliminate tax on all interest received by businesses. If enacted, both proposals would significantly reduce demand for tax-exempt bonds by corporations and thus dramatically increase interest costs for state and local governments. The proposals would also adversely affect individual investors who hold the remainder of the over \$2 trillion of outstanding tax-exempt bonds, as the value of their bonds will decline in response to a decline in their attractiveness to business.

The municipal bond market has been and remains a vital component in the federal-state relationship by providing infrastructure to the nation through local decision-making and access to the capital markets. Over the years, our members have served as advisors to various market participants to develop successful financing programs that meet the needs of the state and local governments and their constituents and, where appropriate, incorporate innovative financing techniques to assure the most effective capital program for each issuer across the country.

NABL is dedicated to assuring that the market remains confident in the value of the opinions its members render. NABL intends to continue promoting the municipal bond market to ensure that it remains a safe, liquid and transparent market for all of its participants, issuers and investors alike.



## National Association of Bond Lawyers

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### Hearing on Tax-Preferred Bonds

Testimony Before the Subcommittee on Select Revenue Measures  
Committee on Ways and Means  
United States House of Representatives  
March 16, 2006

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