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August 22, 2017

The Honorable Steven Mnuchin, Secretary
The Honorable David Kautter, Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington DC 20220

RE: Proposed Tax Amendments to Build and Maintain Infrastructure

Dear Secretary Mnuchin and Assistant Secretary Kautter:

The National Association of Bond Lawyers has prepared for your consideration the attached memorandum containing recommendations for revisions to the Internal Revenue Code concerning state and local bonds and other state and local debt obligations (hereinafter "state and local bonds").

State and local bonds are fundamental to building and maintaining this country's infrastructure. Three-fourths of all public infrastructure in this country is financed by state and local governments through the issuance of state and local bonds, which are tax-exempt or otherwise tax-advantaged (e.g., tax credit bonds) under the Internal Revenue Code. State and local bonds help finance many types of infrastructure, such as roads; bridges; public buildings; governmental and nonprofit hospitals, schools, colleges, and universities; public power systems; water and sewer systems; ports and airports; low-income housing; and small manufacturing facilities.

Tax-exempt financing has many advantages in financing infrastructure. The tax-exempt bond market is a well developed and sophisticated market that brings investors together with projects that need financing. Decisions about which projects are financed are made at the local, not at the federal, level. State and local governments and other entities that finance these public-interest projects are responsible for repaying all the principal and interest on the state and local bonds. These entities have a strong interest in putting forward necessary and well vetted projects, many requiring approval through public referenda.

Similarly, private-sector investors analyze the financing and viability of such projects before investing their money, providing an additional check on projects. Federal assistance is limited to the revenue foregone on the untaxed interest, estimated to be approximately $50 billion per year on approximately $3.8 trillion of outstanding state and local tax-exempt bonds. That is money well spent. Because the interest on state and local bonds is exempt from federal income tax, investors are willing to accept lower interest payments than they would otherwise. These savings are critical to keeping taxes, fees, and other charges associated with

the infrastructure lower and enabling greater infrastructure investment than would be the case if the interest were federally taxable.

Restricting state and local bonds, or subjecting the bonds to full or partial taxation, would increase the costs of state and local infrastructure investment and result in a combination of reduced infrastructure investment and higher fees, tolls, and taxes. As you consider changes to the Internal Revenue Code, we urge you to consider the attached recommendations in light of the importance of increased infrastructure investment.

The National Association of Bond Lawyers is an organization of approximately 2,700 attorneys and exists to promote the integrity of the municipal securities market by advancing the understanding of and compliance with the law affecting public finance. We respectfully provide these recommendations in furtherance of that mission.

Thank you for your consideration.

Sincerely,

Clifford M. Gerber

Attachment

Identical letters sent to: Senator Orrin Hatch

Senator Ron Wyden

Congressman Kevin Brady

Congressman Richard Neal

The Honorable Gary D. Cohn

Recommended Legislative Tax Proposals to
Facilitate Public Infrastructure Improvements.

The National Association of Bond Lawyers respectfully submits this set of tax proposals for consideration by the Congress of the United States, the United States Department of Treasury and the Internal Revenue Service. All of these proposals relate to tax-exempt bond financing and some have been introduced in the 115th or earlier Congresses. NABL believes that these proposals would improve the efficiency of financing much needed public infrastructure projects, especially through the encouragement of public-private partnerships. NABL has considered both the benefits and the burdens of each of the proposals in this submission, and believes that for each of these proposals, the benefits outweigh the burdens.

For each proposal, we have included proposed statutory language and proposed committee report language.

The enclosed comments were prepared by a working group comprising the individuals listed in the Appendix and were approved by the NABL Board of Directors.

If NABL can provide further assistance, please do not hesitate to call Bill Daly in our Washington, DC, office at (202) 503-3303.

LIST OF INCLUDED TAX PROPOSALS

1. Create a new category of private activity bond for privately-operated roads, tunnels, and bridges.

2. Provide a direct-pay alternative to tax-exempt financing.

3. Increase the dollar limits for bank-qualified bonds and apply the provisions as revised to conduit borrower situations by treating conduit borrowers as issuers.

4. Allow for greater use of tax-exempt bonds for manufacturing facilities.

5. Facilitate charter school financing by eliminating a mortgage prohibition.

6. Allocate additional volume cap for various tax-advantaged bonds and increase volume cap for tax-exempt private activity bonds.

7. Eliminate the unrelated or disproportionate component of the private business use test and the dollar limits on private business use.

8. Permit refunding of bonds where less than 85 percent of proceeds has been spent.

EXECUTIVE SUMMARY

Included are eight separate proposals that can be enacted independently or together.

1. Roads, tunnels and bridges should be financeable with tax-exempt bonds regardless of private business use so long as the state or local government retains control over the setting of tolls. Our proposal would accomplish this in a very direct fashion.

2. Direct-pay bonds give bond issuers, including those making needed investments in infrastructure, access to the same investor groups that are available to corporations and the federal government, including pension funds and other investors that do not pay federal income tax. Affording issuers a choice about the method of subsidy delivery is likely to lower the effective borrowing costs to such issuers without increased cost to the federal government.

3. Banks can be a major source of the funds necessary to finance needed infrastructure improvements. Some banks currently have a limited appetite for the purchase of tax-exempt bonds because of limitations imposed on the bank's interest deductions. Tax-exempt bonds qualifying as "small issuer bank qualified bonds" attract a greater interest from banks and bear correspondingly lower interest rates. Currently such qualifying bonds are limited to issuers that issue no more than $10 million in a calendar year. We propose increasing this limit (and related

limits) to $30 million for years beginning in calendar year 2017. This would provide a significant increase in the ability of local governmental units to take advantage of bank financing. We also recommend that bonds be tested at the borrower level regardless of the quantity of bonds issued by the bond issuer. This will greatly enhance the ability of smaller governments and 501(c)(3) organizations to reduce borrowing costs. Certain conforming amendments are included in our proposal.

4. Tax-exempt financing has been used as a tool to encourage new manufacturing facilities. The current rules for small issue manufacturing bonds have some cumbersome provisions. We believe that an expanded use of this category of bonds will increase employment and manufacturing in the United States. This proposal reduces some of the impediments to the use of small issue manufacturing bonds.

5. Charter schools are generally fully funded through state and local taxes. Current law prevents privately operated charter schools from using tax-exempt bonds to finance school buildings if the privately used buildings are pledged as collateral for the bonds. Our proposed modification would permit the use of tax-exempt financing of privately used schools so long as the schools are fully funded with taxes of general applicability. This would allow charter schools to use management contracts and other business approaches without forcing compliance with arcane tax law restrictions.

6. There are currently several categories of tax-advantaged bonds for which the dollar limits on issuance have been exhausted. We propose increasing these limits, including the general limit on private activity tax-exempt bonds.

7. There are a number of complex rules currently limiting private business use of tax-exempt financed facilities. We propose streamlining these rules and eliminating what seem to be unnecessary requirements that make bond issuance difficult, especially for infrastructure financing. This proposal is particularly appealing because it reduces undue complexity.

8. Current law limits the situations when bonds can be refinanced when less than 85 percent of bond proceeds has been spent. This limitation introduces unnecessary complexity and reduces the occasions when bonds can be refinanced, which in turn reduces the opportunities for issuers and the federal government to realize savings.

1. EXPAND EXEMPT FACILITY BONDS FOR TRANSPORTATION FACILITIES TO INCLUDE ROADS, TUNNELS, AND BRIDGES.

Current Law

Exempt facility bonds under Section 142(a) of the Internal Revenue Code of 1986 (the *"Code"*) may be issued to finance certain transportation facilities including airports, docks and wharves, mass commuting facilities, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities (collectively *"Exempt Facility Transportation Bonds"*). These types of facilities provide certain types of public transportation and freight infrastructure; however, they only provide limited authority for roads, tunnels and bridges.

Mass commuting facilities are limited to real property, improvements to real property and personal property, such as machinery, equipment, and furniture serving the general public commuting on a day-to-day basis by bus, subway, rail, ferry, or other conveyances which move over prescribed routes. Qualified highway or surface freight transfer facilities are limited to projects which receive Federal assistance under title 23 of the United States Code or, in the case of freight transfer facilities, titles 23 or 49 of the United States Code.

Reasons For Change

Roads, tunnels and bridges are essential infrastructure. Many roads, tunnels, and bridges are in poor repair and are inadequate for current transportation demands. In addition, new roads, tunnels, and bridges, including lanes added to existing roads, tunnels, and bridges, are needed to meet transportation demands and to provide safe and efficient transportation. Transportation infrastructure with sufficient capacity to meet the needs of businesses, workers, and the public in general will reduce costs of doing business through increased efficiency, provide more jobs, and increase the quality of life for Americans.

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, PL 109-59, added qualified highway or surface freight transfer facilities as a category of exempt facility bond. These bonds are limited to projects receiving federal assistance under titles 23 or 49 of the United States Code and are subject to a separate volume cap.

An expansion of exempt facility bonds to include more types of roads, tunnels and bridges with fewer restrictions will increase incentives and lower costs of constructing, expanding, and rehabilitating these essential infrastructure improvements.

All of these eligible facilities are open to the general public. The proposal described below requires that the facilities be open to the public and that the charges for public use of the financed facilities be subject to approval by a state or local governmental unit. These two features (availability to the general public and state or local approval of rates or charges) are the salient features that should make tax-exempt financing possible.

Proposal

A new category of exempt facility bonds for qualified road, tunnel and bridge facilities is added to Section 142(a) of the Code. These exempt facility bonds can be used to finance the construction, expansion, or rehabilitation of any new or existing road, tunnel, or bridge that is available for public use. Qualified road, tunnel, and bridge facilities are subject to the same public use requirement applicable to other exempt facility bonds. For this purpose, roads, tunnels, or bridges that serve common carriers or the general public meet the public use requirement.

Qualified road, tunnels, and bridge facilities include new roads, tunnels, and bridges; toll facilities; expansion of existing roads, tunnels, and bridges; addition of new lanes; and the rehabilitation of an existing road, tunnel, or bridge with or without expansion of the capacity of the road, tunnel, or bridge. If proceeds of the bonds are used to acquire an existing road, tunnel, or bridge, the road, tunnel, or bridge must be substantially rehabilitated. For this purpose *"substantial rehabilitation"* means rehabilitation expenditures made with respect to the acquired road, tunnel, or bridge in an amount equal to at least 25 percent of the net proceeds of the bonds.

Qualified road, tunnel, and bridge facilities also include functionally related improvements such as entrance and exit ramps, overpasses, turnouts, public parking areas, public restroom facilities, drainage, landscaping, lighting and signage (not including commercial advertising), and similar improvements. These bonds are not subject to a volume cap, to a limitation on land acquisition or to a limitation on acquisition of existing property. Regulation of tolls, rates or charges for use of these facilities is by the state or appropriate local jurisdiction in which such facilities are located.

These bonds may be refunded on a current basis (*i.e.*, the refunded bonds retired within 90 days of the issuance of the refunding bonds) but not advance refunded.

The amendments of this section apply to bonds issued on or after the date of enactment.

Proposed statutory language adding qualified road, tunnel, and bridge facilities as exempt facility bonds (Double underlining denotes amendments):

Section 142

(a) **General rule**. For purposes of this part, the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide--

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(16) qualified road, tunnel and bridge facilities.

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(n) **Qualified Road, Tunnel and Bridge Facilities**

(1) **In general.** For purposes of subsection (a)(16), the term "qualified road, tunnel and bridge facilities" means any project for the construction, expansion or rehabilitation of a road, tunnel or bridge, including any functionally related facilities, that will for the entire life of the bonds

financing the facility be available for use by the general public for charges approved by a governmental person.

(2) **Rehabilitation Requirement For Acquisitions of Existing Facilities.** If proceeds are used to acquire an existing facility, the acquired facility must be substantially rehabilitated. A facility is substantially rehabilitated if rehabilitation expenditures are made with respect to the facility in an amount not less than 25 percent of the net proceeds of the bonds. All required rehabilitation expenditures must be paid within 5 years of the date of issue of the bonds.

(3) **Definitions.** For purposes of this subsection--

(A) **Functionally related facilities.** The term "functionally related facilities" means any facilities or improvements that are customarily part of a road, tunnel or bridge facility. Such facilities and improvements include entrance and exit ramps, turnouts, overpasses, public parking areas, public restroom facilities, drainage, landscaping, lighting and signage (not including commercial advertising).

(B) **Rehabilitation expenditures.** The term "rehabilitation expenditures" means any expenditures properly chargeable to capital account and which increase the reasonably expected economic life of the facility by at least 20 years.

Section 146

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(g) **Exception for certain bonds.** Only for purposes of this section, the term "private activity bonds" shall not include--

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(3) any exempt facility bond issued as part of an issue described in paragraph (1), (2), (12), (13), (14), ~~or~~ (15) or (16) of section 142(a), and

Section 147

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(h) **Certain rules not to apply to certain bonds.**

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(4) **Exempt facility bonds for qualified road, tunnel and bridge facilities.** Subsections (c) and (d) shall not apply to any exempt facility bond issued as part of an issue described in section 142(a)(16) (relating to qualified road, tunnel and bridge facilities).

2. ENHANCED INFRASTRUCTURE BONDS

Current Law

Tax-exempt Bonds. Approximately 75 percent of the public infrastructure in the United States is financed by state and local governments with the proceeds of tax-exempt bonds. Interest paid to the private-sector investors who purchase these bonds is exempt from federal income tax. The proceeds raised from the sale of these bonds are used to build a wide range of infrastructure, including roads, bridges, schools, drinking water systems, waste water systems, public and non-profit hospitals, public power systems, public and non-profit colleges and universities, airports and seaports. Even in the areas where federal assistance is the greatest – transportation and water infrastructure – more than 60 percent of the infrastructure financing comes from state and local governments, not the federal government. The private sector also invests in particular types of infrastructure that are considered to have an important public purpose (such as low-income rental housing or airports and seaports), which are permitted to use tax-exempt financing.

Tax-exempt financing has many advantages. It is a well developed and sophisticated market that brings investors together with projects that need financing. The decisions about which projects are financed are made at the local level, not at the federal level. The state and local governments or public-interest projects, like non-profit hospitals, are responsible for repaying all the principal and all the stated interest. Thus, they have a strong interest in putting forward necessary and well-vetted projects, many requiring approval through public referendums. Similarly, private-sector investors analyze the financing and viability of such projects before investing their money, providing an additional check on projects. Federal assistance is limited to the revenue foregone on the untaxed interest, estimated to be approximately $50 billion per year on approximately $3.8 trillion of outstanding state and local tax-exempt obligations. This is money well spent. Because the interest is exempt from federal income tax, investors are willing to accept lower interest payments than they would otherwise. That savings makes the infrastructure projects more affordable to state and local governments, keeping taxes, fees and other charges associated with the infrastructure lower and enabling greater infrastructure investment than would be the case if the interest were federally taxable.

Tax Credit Bonds. Congress has authorized other types of tax-advantaged bonds. Tax-credit bonds provide taxable interest on bonds, but also provide the investor with a federal income tax credit. These tax-credit bonds were designed to provide a greater federal interest subsidy than the tax exemption, sometimes being designed to provide a credit worth as much as 100 percent of the interest expense, though the state or local government is responsible for paying the principal. The theory behind these bonds was that investors would require even less interest from the state or local government and this would result in greater infrastructure investment. Tax-credit bonds, however, have not been widely accepted by the financial markets.

Direct-Pay Bonds. Direct-pay bonds (also known as direct-subsidy bonds) have been widely accepted by the financial markets. Like tax-credit bonds, direct-pay bonds pay taxable interest on the bonds but, instead of a tax credit to investors, the federal government pays an amount equal to a percentage of the interest payable on the bonds directly to the issuer of the bonds, effectively reducing the financing cost of these bonds. The percentage paid to the issuer varies depending on

the category of direct-pay bond issued. The most utilized type of direct-pay bond has been the build America bond, where the direct payment is equal to 35 percent of the interest on such bonds. This rate was higher than the Treasury-estimated revenue-neutral rate of 28 percent in order to encourage investment in infrastructure. Direct-pay build America bonds were issued in 2009 and 2010 and were widely accepted in the financial markets. From April 2009 to December 2010, more than $185 billion in direct-pay build America bonds were issued, even though the purposes for which these bonds could be issued were narrower than for traditional tax-exempt bonds. Underlying the success of the bonds was that the investor base was expanded to include entities that would not be interested in tax-exempt bonds because they are not subject to federal income tax, such as endowment funds, pension funds, and foreign investors. The competition among these additional investors lowered the costs of the infrastructure financed with the bonds – both to the issuers of the bonds and to the federal government. The costs of financing were also lowered by combining direct-pay bonds for longer maturities and tax-exempt bonds for shorter maturities because this mix provided the lowest overall cost to state and local governments and also to the federal government.

However, the percentages of interest paid to issuers have been substantially reduced because the payments became subject to sequestration under the Balanced Budget and Emergency Deficit Control Act of 1985, which led some issuers to be skeptical of direct-pay bonds going forward because of the uncertainty it introduced into their net interest costs. Also, the Internal Revenue Service ruled in 2014 that some provisions that apply to tax-exempt bonds, such as the reissuance rules under Treasury Regulations Section 1.1001-3(e)(5)(ii)(B) regarding defeasance of the bonds, do not apply to direct-pay bonds, thus placing direct pay bonds a disadvantage compared to traditional tax-exempt bonds.

Reason for Change

In order to increase infrastructure investment, additional federal support is required. One of the most effective ways to provide that support is to increase the federal subsidy to state and local issuers of bonds by reducing the interest cost to the issuers of the bonds through a direct payment of a percentage of the interest paid on taxable bonds. These bonds should be available for the same purposes as tax-exempt bonds, and should be treated the same as tax-exempt bonds for all substantive purposes under Internal Revenue regulations and guidance – *e.g.*, the reissuance rules. To ensure stability to the infrastructure financing, payments to issuers should not be subject to sequestration.

Description of Proposal

The proposal would create a new category of bonds, Enhanced Infrastructure Bonds (*"EIBs"*). EIBs would be an alternative to tax-exempt bonds. EIBs would be taxable bonds issued by state and local governments, and the federal government would make payments to issuers equal to a percentage of the interest payable on the bonds. EIBs could be issued for any purpose for which tax-exempt bonds can be issued except to advance refund tax-advantaged bonds. Bonds issued for governmental or qualified 501(c)(3) bond purposes would not be subject to a volume limit. EIBs issued for private activity (other than 501(c)(3)) purposes would count against the volume cap limit set forth in section 146 of the Code to the same extent as tax-exempt private activity bonds

issued for such purpose. Payments made to issuers with respect to EIBs would not be subject to sequestration. Rules applicable to tax-exempt bonds, such as defeasance rules, would apply to EIBs.

To encourage an increase in infrastructure investment, the payment rate for EIBs issued during the first 10 years of the program would be 40 percent of the interest payable on the bonds. This rate will increase the investment by state and local governments in infrastructure by providing enhanced federal support for the 10-year period. For bonds issued after the first 10 years of the program, the rate would be reduced to the revenue-neutral rate of 28 percent. The vehicle for the payment would be a refundable tax credit paid to issuers of EIBs.

The proposal would be effective for bonds issued on or after the date of enactment.

Proposed Statutory Language adding Enhanced Infrastructure Bonds:

Section 54G ENHANCED INFRASTRUCTURE BONDS

(a) In general

On each interest payment date, an issuer of a Enhanced Infrastructure Bonds shall be allowed a credit as provided in section 6431 equal to the credit determined under subsection (b) with respect to such date.

(b) Amount of credit

(1) For any Enhanced Infrastructure Bonds issued after [Date of Enactment] and prior to January 1, 2028, the amount of the credit determined under this subsection with respect to any interest payment date for a Enhanced Infrastructure Bonds is 40 percent of the amount of interest payable by the issuer with respect to such date.

(2) For any Enhanced Infrastructure Bonds issued after December 31, 2027, the amount of the credit determined under this subsection with respect to any interest payment date for a Enhanced Infrastructure Bonds is 28 percent of the amount of interest payable by the issuer with respect to such date.

(c) Enhanced Infrastructure Bonds

(1) In general

For purposes of this section, the term “Enhanced Infrastructure Bonds” means any obligation if--

(A) the interest on such obligation would (but for this section) be excludable from gross income under section 103, and

(B) the issuer makes an irrevocable election to have this section apply.

(2) Applicable rules

For purposes of applying paragraph (1) --

(A) for purposes of section 149(b)

(i) Enhanced Infrastructure Bonds shall not be treated as federally guaranteed by reason of the credit allowed under subsection (a) or section 6431, and

(ii) an obligation the interest on which is excludable from gross income under section 103 and is secured on a parity basis with Enhanced Infrastructure Bonds shall not be treated as federally guaranteed solely by reason of the credit allowed on the Enhanced Infrastructure Bonds under subsection (a) or section 6431, and

(B) a bond shall not be treated as a Enhanced Infrastructure Bond if the issue price has more than a de minimis amount (determined under rules similar to the rules of section 1273(a)(3)) of premium over the stated principal amount of the bond.

(d) Interest payment date

For purposes of this section, the term "interest payment date" means each date on which interest is payable by the issuer under terms of the bonds.

(e) Interest on Enhanced Infrastructure Bonds includible in gross income for Federal income tax purposes.

For purposes of this title, interest on any Enhanced Infrastructure Bond shall be includible in gross income.

(f) Regulations

The Secretary may prescribe such regulations and other guidance as may be necessary or appropriate to carry out this section and section 6431. The Secretary shall apply the rules and regulations applicable to tax-exempt bonds to Enhanced Infrastructure Bonds except where doing so would conflict with the purposes of this section.

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6431 Credit for Qualified Bonds Allowed To Issuer

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(g) Application of Section to Qualified Tax Credit Bonds. In the case of a Enhanced Infrastructure Bond (as defined in section 54G) –

(1) such bond shall be treated as a qualified bond for purposes of this section,

(2) subsection (a) shall be applied without regard to the requirement that the qualified bond be issued before January 1, 2011,

(3) the amount of the payment determined under subsection (b) shall be equal to the amount determined under section 54G(b),

(4) any payment under subsection (b) shall not be includible as income for purposes of this title, and

(5) the deduction otherwise allowed under this title to the issuer of such bond with respect to interest paid under such bond shall be reduced by the amount of the payment made under this section with respect to such interest.

(h) No payment under this section shall be reduced because of the application of the Balanced Budget and Emergency Deficit Control Act of 1985.

3. MODIFICATION OF SMALL ISSUER EXCEPTION TO TAX-EXEMPT INTEREST EXPENSE ALLOCATION RULES FOR FINANCIAL INSTITUTIONS (SEC. 265(b)).

Current Law

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax. In general, an interest deduction is disallowed if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.

Financial institutions

In the case of a bank or other financial institution, the Code generally disallows a proportionate share of all of the taxpayer's interest expense based on a ratio of its basis in tax-exempt investments to its basis in all its assets. Tax-exempt obligations acquired on or before August 7, 1986, are not treated as tax-exempt investments for this purpose.

Exception for certain obligations of qualified small issuers

The general rule in section 265(b), denying financial institutions' interest expense deductions allocable to tax-exempt obligations, does not apply to "qualified tax-exempt obligations." Instead, only 20 percent of the interest expense allocable to "qualified tax-exempt obligations" is disallowed. A "qualified tax-exempt obligation" is generally a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond other than a qualified 501(c)(3) bond as defined in section 145, (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b), and (4) generally is not part of an issue larger than $10 million.

A "qualified small issuer" is an issuer that issues $10 million or less of tax-exempt obligations during a calendar year. The Code specifies the circumstances under which separate issuers are aggregated. An issuer is not allowed to designate more than $10 million of tax-exempt bonds in a calendar year.

Composite issues qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue), and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue). Thus, a composite issue may qualify for the exception only if the composite issue itself in the aggregate does not exceed $10 million. Bonds that are not part of the same issue under the formal regulatory definition of an issue may nonetheless be treated as part of a composite issue if the sales of such bonds are related.

When bank qualified bonds are issued to benefit governmental or 501(c)(3) borrowers, the bonds are tested for compliance with the bank qualification rules by reference to the conduit issuer of the bonds.

Reasons for Change

The $10 million limitation has not been increased since the provision was enacted in 1986, except temporarily in 2009 and 2010. Banks have increasingly become important lenders to local units of government, and reducing the expense of lending will encourage local government infrastructure financing.

501(c)(3) organizations often have difficulty borrowing from banks via bank qualified bonds because the actual issuer (often a state agency) is not a qualified small issuer. Some otherwise qualified small issuers refrain from issuing tax-exempt bonds for 501(c)(3) organizations located in their jurisdiction because the issuance of such bonds might prevent the local government from being a qualified small issuer. Essentially, current law does not recognize that bonds issued for conduit borrowers are accessing the capital markets for the conduit borrower.

Proposal

The proposal increases from $10 million to $30 million the annual limit for qualified small issuers and indexes the limit for inflation.

In addition, in the case of a "qualified financing issue," the proposal applies the $30 million annual volume limitation at the conduit borrower level (rather than at the level of the conduit issuer). Thus, for the purpose of applying the requirements of the section 265(b)(3) qualified small issuer exception, the portion of the proceeds of a qualified financing issue that is lent to a "qualified borrower" that participates in the issue is treated as a separate issue with respect to which the qualified borrower is deemed to be the issuer. In addition to giving each qualified borrower its own $30 million limit, this rule would permit an issuer to issue bonds on a non-conduit basis to finance its own projects without having to count bonds issued for the benefit of a conduit borrower.

A "qualified financing issue" is any composite, pooled or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers all of whom are qualified borrowers. A "qualified borrower" means (1) a state or political subdivision of a state, or (2) an organization described in section 501(c)(3) and exempt from tax under section 501(a). Thus, for example, a $100 million pooled financing issue could qualify for the section 265(b)(3) exception if the proceeds of such issue were used to make four equal loans of $25 million to four qualified borrowers. However, if (1) more than $30 million were lent to any qualified borrower, (2) any borrower were not a qualified borrower, or (3) any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to such borrower, fail to meet any of the other requirements of section 265(b)(3), the entire $100 million pooled financing issue would fail to qualify for the exception.

To determine whether qualified 501(c)(3) bonds are bank qualified, such bonds are treated as if issued by the conduit borrower and not the conduit issuer. In addition, in the case of a 501(c)(3) organization, the requirements for "qualified financing issues" shall be applied as if the section 501(c)(3) organization were the issuer. Thus, an organization described in section 501(c)(3) and exempt from taxation under section 501(a) shall be limited to the $30 million per issuer per calendar year cap for qualified tax exempt obligations described in section 265(b)(3).

The proposal would be effective for bonds issued on or after the date of enactment.

Proposed statutory language amending Section 265(b)(3) of the Code:

PERMANENT MODIFICATION OF SMALL ISSUER EXCEPTION TO TAX-EXEMPT INTEREST EXPENSE ALLOCATION RULES FOR FINANCIAL INSTITUTIONS.

(a) Permanent Increase in Limitation. – Subparagraphs (C)(i), (D)(i), and (D)(iii)(II) of section 265(b)(3) of the Internal Revenue Code of 1986 are each amended by striking "$10,000,000" and inserting "$30,000,000."

(b) Permanent Modification of Other Special Rules. – Section 265(b)(3) of such Code is amended —

(1) by redesignating clauses (iv), (v), and (vi) of subparagraph (G) as clauses (ii), (iii), and (iv) of such subparagraph, respectively, and

(2) by striking so much of subparagraph (G) as precedes such clauses and inserting the following:

"(G) Qualified 501(c)(3) bonds treated as issued by exempt organization. — In the case of a qualified 501(c)(3) bond (as defined in section 145), this paragraph shall be applied by treating the 501(c)(3) organization for whose benefit such bond was issued as the issuer.

"(H) Special rule for qualified financings. –

"(i) In general. – In the case of a qualified financing issue —

"(I) subparagraph (F) shall not apply, and

"(II) any obligation issued as a part of such issue shall be treated as a qualified tax-exempt obligation if the requirements of this paragraph are met with respect to each qualified portion of the issue (determined by treating each qualified portion as a separate issue that is issued by the qualified borrower with respect to which such portion relates)."

(c) Inflation Adjustment. – Section 265(b)(3) of such Code, as amended by subsection (b), is amended by adding at the end the following new subparagraph:

"(I) Inflation adjustment. – In the case of any calendar year after 2016, the 30,000,000 amounts contained in subparagraphs (C)(i), (D)(i), and (D)(iii)(II) shall each be increased by an amount equal to —

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year, determined by substituting 'calendar year 2016' for 'calendar year 1992' in subparagraph (B) thereof. Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $100,000."

(d) Effective Date. — The amendments made by this section shall apply to obligations issued after the date of the enactment of this Act.

4. PROMOTE DOMESTIC MANUFACTURING BY CLARIFYING, SIMPLIFYING, AND UPDATING RULES AND LIMITS FOR ISSUING SMALL ISSUE TAX-EXEMPT MANUFACTURING BONDS.

Current Law

Tax-exempt bonds to finance manufacturing facilities (*"Manufacturing Bonds"*) may be issued under Section 144(a) of the Code.

A "manufacturing facility" means any facility that is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property). A manufacturing facility includes facilities that are directly related and ancillary to a manufacturing facility, but only if (a) such facilities are located on the same site as the manufacturing facility, and (b) not more than 25 percent of the net proceeds of the issue are used to provide such facilities. A manufacturing facility does not include a facility that is used in the creation or production of intangible property.

Section 144(a) of the Code provides that the aggregate authorized face amount of an issue of Manufacturing Bonds may not exceed $1 million. Upon election by the issuer, the aggregate authorized face amount may be increased up to $10 million. The $10 million limit, however, is reduced to the extent the borrower has made capital expenditures (other than from proceeds of Manufacturing Bonds) in excess of $20 million during a six-year period (the "Six-Year Period") which begins three years prior to the issuance of the bonds.

Section 144(a) of the Code also permits the issuance of tax exempt bonds ("Beginning Farmer Bonds") for certain financings of farmland. The proposals described below are not intended to change the law relating to Beginning Farmer Bonds.

Reasons for Change

Manufacturing Bonds promote sustainability and growth of small to mid-sized manufacturers operating in the United States and assist with efforts to expand the economy. Manufacturing Bonds provide low-cost financing that is used to acquire, construct, and expand manufacturing facilities and to purchase equipment for use in manufacturing processes. Maintaining and expanding manufacturing operations means that new jobs are created and ensures that existing jobs are kept in America rather than lost to foreign competition. Manufacturing Bonds are also helpful tools for small and mid-size cities and rural areas to create new jobs.

However, current law concerning the definition of a manufacturing facility has made it difficult to determine whether and to what extent tax-exempt financing is available to manufacturers. As a result, the Internal Revenue Service has taken positions in tax-exempt bond examinations that unfairly restrict the availability of Manufacturing Bonds and that are inconsistent with the legislative history underlying these types of tax exempt bonds. Congress recognized this problem when it passed the American Recovery and Reinvestment Act of 2009 (the *"Recovery Act"*). The Recovery Act included a temporary provision that removed the difficult test for determining whether facilities are "directly related and ancillary" with a more straightforward test that looks to whether facilities are functionally related and subordinate. Such test is consistent with the tests used for other types of tax-exempt bonds under the exempt facility provisions in Section 142 of

the Code. The temporary provision introduced by the Recovery Act expired at the end of 2010. By permanently revising the definition of "manufacturing facility" to reflect the clarification provided by the Recovery Act and by eliminating the artificial category of "directly related and ancillary" facilities, the proposal below provides a clarification that will help facilitate correct application of the law.

In addition, current law does not consider the creation or production of intangible property (in contrast to tangible property) to be "manufacturing." This emphasis on tangible property reflects an outdated approach to manufacturing that should be modernized. Today's manufacturers encompass more modern, high-tech and intangible manufacturing practices such as bio-technology, energy generation, food processing, software design and formula development, and intellectual property. Congress recognized this evolution when it passed the Recovery Act. By permanently removing the requirement that manufacturing must only involve the manufacturing or production of tangible property, Congress would simplify the application of tax laws and encourage increased investment in modern manufacturing facilities in America.

The current issuance limit for Manufacturing Bonds was established more than three decades ago with an increase in the limit from $5 million to $10 million, effective in 1979. This limit has not been increased or adjusted for inflation or to reflect increased labor and material costs despite the fact that, as a result of inflation, $10 million dollars in 1979 equates to more than $35 million in 2017. Inflation and increased costs have, therefore, progressively reduced the benefit and utility of Manufacturing Bonds. The proposal to increase the issuance limit would restore the utility of Manufacturing Bonds.

The latest update to the restriction on capital expenditures for Manufacturing Bonds was introduced by the American Jobs Creation Act of 2004. The expanded $10 million capital expenditure rule for bonds issued after 2006 effectively allows a manufacturing facility to have capital expenditures (paid from tax-exempt bond proceeds or otherwise) during the Six-Year Period of up to $20 million. A manufacturer with capital expenditures during this period in excess of $20 million will not be able to benefit from Manufacturing Bonds. As a result of inflation and increased labor and material costs, the current capital expenditure restriction has increasingly limited the pool of manufacturers that may be eligible for Manufacturing Bonds. Furthermore, small and mid-size companies are experiencing greater capital needs to compete internationally and to acquire new technologies that are required in modern manufacturing processes. For these reasons, the proposal below updates the capital expenditure limitation and provides an annual adjustment for inflation.

Proposal

The Code should be amended to clarify the definition of "manufacturing facility" by replacing the concept of "directly related and ancillary" facilities with the concept of "functionally related and subordinate" facilities that is used in other contexts relating to tax-exempt bonds and eliminating the current 25 percent cap on such expenditures.

The definition of "manufacturing facility" should be simplified by removal of the distinction between tangible and intangible personal property. A facility would qualify as a manufacturing

facility whether the facility is used for the manufacturing or production of tangible personal property or the creation or production of intangible property.

To better reflect the economies of current manufacturing facilities, the bond issuance size limit would be updated to reflect an increase to $30 million and the capital expenditure restriction to $40 million. Such limits would be adjusted annually for inflation.

Suggested revisions to Sections 144(a)(4) and 144(a)(12)(C) of the Code are attached to reflect this proposal.

The proposal would apply to bonds issued on or after January 1, 2017.

Proposed statutory language clarifying, simplifying, and updating Sections 144(a)(4) and 144(a)(12)(C) of the Code (Double underlining denotes additions and strike through denotes deletions):

(a) Qualified small issue bond

*****

(4) $10,000,000 or $30,000,000 limit in certain cases

(A) In general

At the election of the issuer with respect to any issue, this subsection shall be applied—

(i) by substituting "$10,000,000" for "$1,000,000" (or, for bonds issued after December 31, 2016, by substituting "$30,000,000" for "$1,000,000") in paragraph (1), and

*****

(G) Additional capital expenditures not taken into account

(i) With respect to bonds issued after December 31, 2006 and before January 1, 2017, in addition to any capital expenditure described in subparagraph (C), capital expenditures of not to exceed $10,000,000 shall not be taken into account for purposes of applying subparagraph (A)(ii).

(ii) With respect to bonds issued after December 31, 2016, in addition to any capital expenditure described in subparagraph (C), capital expenditures [of not to exceed $30,000,000] shall not be taken into account for purposes of applying subparagraph (A)(ii).

(H) Cost-of-Living Adjustment

In the case of bonds issued in a calendar year after 2017, the $30,000,000 limits set forth in subparagraphs (A)(i) and (G)(ii) shall be increased to an amount equal to such dollar amount

multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting “calendar year 2016” for “calendar year 1992” in subparagraph (b) thereof.

*****

(12) Termination dates

*****

(C) Manufacturing facility

For purposes of this paragraph, —

(i) In general

the term “manufacturing facility” means any facility which—

(I) is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property),

(II) is used in the creation or production of intangible property which is described in section 197(d)(1)(C)(ii), or

(III) is functionally related and subordinate to a facility described in subclause (I) or (II) if such facility is located on the same site as the facility described in subclause (I) or (II).

A rule similar to the rule of section 142(b)(2) shall apply for purposes of the preceding sentence.

~~(ii) Certain facilities included~~

~~Such term includes facilities which are directly related and ancillary to a manufacturing facility (determined without regard to this clause) if—~~

~~(I) such facilities are located on the same site as the manufacturing facility, and~~

~~(II) not more than 25 percent of the net proceeds of the issue are used to provide such facilities.~~

(ii) Subclauses (II) and (III) of clause (i) shall not apply to any bond issued on or before the date of enactment, or to any bond issued to refund a bond issued on or before such date (other than a bond to which clause (iii) of this subparagraph (as in effect before the date of enactment) applies), either directly or in a series of refundings.

****

5. PROMOTE CHARTER SCHOOLS BY SIMPLIFYING RULES FOR PRIVATE ACTIVITY BONDS.

Current Law

Interest on bonds issued by (or on behalf of) states and political subdivisions is generally excludable from gross income unless the bond is a private activity bond (other than a qualified private activity bond), an arbitrage bond, or a bond that otherwise fails to meet the requirements for tax exemption. Private activity bonds are defined in Code Section 141(a) to include any bond that is part of an issue that that meets the private loan financing test or meets both the private business use test and either the private payment test or the private security test. The private security test is met if either the bonds are secured by any interest in payments in respect of privately used bond-financed property or if the bonds are secured by any property used or to be used in a private business use.

Under current law, a bond can be a tax-exempt governmental bond even if the bond proceeds are used by a private business so long as there are no payments with respect to the bond-financed property received by the issuing governmental unit or otherwise available for the payment of debt service and the bonds are not secured by such payments or by property that is privately used (e.g., through a mortgage on the bond financed property). Taxes of general applicability are not treated as private payments.

Code section 141(b)(2)(A) provides the security interest test. A bond can be privately secured either under section 141(b)(2)(A)(i) if it is secured by property that is privately used (*e.g.*, a mortgage on a bond financed building) or under section 141(b)(2)A(ii) if it is secured by cash flow generated by privately used property. For projects funded with taxes of general applicability (such as many charter schools), only section 141(b)(2)(A)(i) causes difficulties for tax-exempt financing.

Depending on the nature of a charter school operator and the terms of any management contract, a charter school may be treated as used in a private business. However, charter schools generally do not charge tuition and are typically funded entirely from public revenues. Therefore, absent a lease on the financed property or a mortgage on the bond financed property securing the bonds, a bond issue for a charter school could be tax-exempt even if operated by a private corporation. The economics of charter schools are such that it is difficult to sell bonds backed solely by the promise of the public revenues supporting the school without a mortgage on real property or some other type of credit support.

Reasons for Change

Charter schools are increasingly important alternatives to traditional governmental public schools. Charter schools are sometimes operated by private for-profit operators. In order to use tax-exempt financing (whether in the form of governmental bonds or qualified 501(c)(3) bonds), such schools are constrained by current rules that provide that leases and certain management contracts result in private business use. This limits the ability of charter schools to use private operators, which bring valuable knowledge and expertise.

An alternative under current law would be for the issuance of tax-exempt bonds payable solely from and secured solely by the revenues derived from taxes and provided by the local school district. However, since payments to the charter school operator are generally tied to student enrollment and charter schools are by their nature uncertain ventures, it is difficult to market bonds without additional credit support. Sometimes the only asset available for such support is the financed school building.

If Code section 141(b)(2)(A)(i) did not apply to charter schools, the private security test would be met only if privately derived revenues were pledged to the bonds. Since there are often no revenues derived from privately used property in the operation of a charter school, there would then be no impediment to financing such a charter school with tax-exempt bonds.

Proposal

To eliminate the complexity of the private security test as it applies to financing of charter schools, current Code Section 141(b)(2)(A) should be modified to eliminate the private security test as it relates to property used or to be used as a charter school. This would have the effect of retaining the private security test as it relates to bonds secured by privately generated revenues, but would eliminate the test as it relates to privately used property.

Suggested revisions to Sections 141(b)(2) are attached to reflect this proposal. The amendments made by this provision shall apply to obligations issued on or after the date of enactment.

Proposed statutory language amending Section 141(b)(2) of the Code:

Section 141(b)(2)(A)(i) is revised and new section 141(b)(2)(A)(iii) is added as follows:

(b) Private Business Tests

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(2) Private Security or Payment Test

*****

(A) secured by any interest in --

(i) property used or to be used for a private business use (except for property used or to be used as a charter school), or

*****

(iii) Charter school defined – A charter school is a public school operating under an agreement between the school and a state or local authorizing agency.

6. PROMOTE CONSTRUCTION AND RENOVATION OF INFRASTRUCTURE AND EDUCATIONAL FACILITIES WITH PRIVATE SECTOR INVOLVEMENT THROUGH ALLOCATIONS OF TAX-ADVANTAGED BONDS AND INCREASED PRIVATE ACTIVITY VOLUME CAP.

Current Law

The Code limits the volume of certain categories of state and local bonds. Pursuant to Section 146 of the Code, volume limitations are set for each state with respect to issuance of most types of "private activity bonds" ("Private Activity Bonds"). Private Activity Bonds are issued by state and local governments for the benefit of private users, such as corporations, airlines, certain freight transfer facility operators and solid waste disposal facility owners.

In addition, the Code allows tax-advantaged bonds to be issued for certain energy projects and public school facilities, which are also subject to volume limits. These bonds include New Clean Renewable Energy Bonds ("NCREBs"), Qualified Energy Conservation Bonds ("QECBs"), Qualified Zone Academy Bonds ("QZABs") and Qualified School Construction Bonds ("QSCBs" and with NCREBs, QECBs and QZABs, "Advantaged Bonds").

The amount of Private Activity Bonds that may be issued by a state each calendar year is determined to be an amount which is the greater of (a) an amount equal to (a) $100 multiplied by the state population (for 2017), or (b) $305,315,000 (for 2017), adjusted each year for increases in the cost of living (the "Volume Cap"). Certain private activity bonds used for infrastructure are exempt from the volume cap requirement, including bonds for airports and docks and wharves. However, private activity bonds for water and sewer facilities are not currently exempt from the requirement.

Pursuant to Section 54C of the Code, proceeds of NCREBs may be used by mutual or cooperative electric companies or governmental bodies to provide wind facilities, biomass facilities, geothermal or solar energy facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, refined coal production facilities and certain hydropower facilities. The limitation on issuance of NCREBs was set at $1.6 billion in 2009. Authority to issue these bonds is awarded based on applications made by borrowers to the Treasury Department for specific qualified projects.

Pursuant to Section 54D of the Code, proceeds of QECBs may be used by state or local governmental bodies to provide energy conservation facilities, including energy efficient windows, solar energy facilities and heating and air conditioning facilities. The limitation on issuance of QECBs was set at $3.2 billion in 2009. Authority to issue these bonds was allocated to large local governmental units and to the states. The states then administer the allocation of such bonds to local governmental units within the state.

Pursuant to Section 54E of the Code, proceeds of QZABs may be used to for certain capital and limited working capital expenditures of public schools in economically disadvantaged areas. Limitations on the issuance of QZABs were as follows: (a) $400 million for 2008; (b) $1.4 billion for 2009 and 2010; and (c) $400 million for 2011, 2012, 2013, 2014, 2015 and 2016. Allocations of authority to issue QZABs were awarded to states based on their respective populations below the poverty line (as defined by the Office of Management and Budget).

Pursuant to Section 54F of the Code, proceeds of QSCBs may be used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed. The limitations on the issuance of QSCBs were set in 2009 as follows: (a) $11 billion for 2009; and (b) $11 billion for 2010. Allocations of the authority to issue QSCBs were awarded among the states in proportion to the respective amounts each state is eligible to receive under section 1124 of the Elementary and Secondary Education Act of 1965.

An issuer of Advantaged Bonds can elect to either treat the Advantaged Bonds as (a) "direct-pay" bonds where the issuer receives a payment from the Treasury Department in an amount equal to a percentage of the interest payable, or (b) bonds pursuant to which the holders thereof receive tax credits on a quarterly basis. However, the direct-pay option is no longer available for QZABs, because the last QZAB volume allocation that qualified for the direct-pay option was for 2010. In addition, payments to issuers for those bonds that were issued as direct-pay bonds have been reduced under sequestration.

Reasons for Change

Advantaged bonds provide subsidies for important infrastructure projects that in some instances cannot be funded with tax-exempt bonds because of private entity involvement. These Advantaged bonds permit the use of public-private partnerships. Additionally, they provide subsidies that in some cases are greater than the subsidy provided through tax-exempt bonds.

The direct-pay option enhances marketability of Advantaged Bonds to endowment funds, pension funds, and foreign investors that do not pay federal income tax because of the higher taxable interest rates. The tax credit option provides domestic investors incentive to purchase these types of Advantaged Bonds. Giving issuers flexibility to elect either option with respect to Advantaged Bonds allows issuers to react appropriately to market demand. No strong secondary market has developed for the sale of tax credit bonds. Accordingly, Advantaged Bonds not using the direct pay option have mostly been limited to direct private placements rather than publicly offered bonds.

Private Activity Bonds provide private users and entities serving public purposes with lower-cost access to capital markets through tax-exempt borrowings. In recent years, the rate at which each state's Volume Cap has been utilized has accelerated due to favorable market conditions and demand for single-family and multifamily housing, manufacturing, solid waste facilities, port facilities, mass commuting facilities, water and sewer facilities, and gas and electric facilities. In addition to encouraging further private investment into the above essential facilities by increasing the Volume Cap, Congress would aid critically needed infrastructure improvements if it exempted private activity bonds for water and sewer projects from the volume cap limitation. This would put water and sewer financing on par with airport and dock and wharf financing.

The volume limitations for the Advantaged Bonds and the Volume Cap should be increased to encourage infrastructure investment, incentivize alternative energy production, promote economic development and job growth and assist public schools. Further, water and sewer facilities are so vital that bonds financing these projects should no longer be subject to the Volume Cap.

Current law restricts the amount of Advantaged Bonds that can be issued and thereby restricts the number of borrowers that can access capital markets for the important projects detailed above. Additional volume cap authority for issuance of the Bonds (other than QZABs) has not been authorized since 2009.

The amendments proposed below would increase the various volume limitations for Advantaged Bonds and permit a direct-pay option, in order to encourage capital investment. To ensure stability to the infrastructure financing, payments to issuers should not be subject to sequestration.

Proposal

- Update the NCREBs volume cap limit to authorize an additional $1.6 billion of issuing authority to be allocated based on project applications to the Treasury Department.
- Update the QECBs volume cap limit to authorize an additional $3.2 billion of issuing authority to be allocated to the states in proportion to the state population.
- Update the QZABs volume cap limit to authorize $400 million in 2017, 2018, 2019 and 2020 to be allocated based on each states' population below the poverty line (as defined by the Office of Management and Budget).
- Update the QSCBs volume cap limit to authorize $11 billion for 2017 to be allocated among the states in proportion to the respective amounts each state is eligible to receive under section 1124 of the Elementary and Secondary Education Act of 1965.
- For each type of Advantaged Bonds, authorize a direct-pay option and exempt the payments to issuers from reductions under a sequester.
- Update the volume cap to increase the state ceiling applicable each calendar year to be an amount equal to the greater of (a) $120 multiplied by the state population (for 2018), or (b) $325 million (for 2018), in each case increased annually for cost-of-living adjustments.
- Exempt water and sewer facilities from the Volume Cap.

Proposed statutory language increasing allocations and updating Sections 54C, 54E, 54F and 146 of the Code (Double underlining denotes amendments):

§54C New Clean Renewable Energy Bonds

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(c) Limitation on amount of bonds designated.

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(5) Further Limitation. The national new clean renewable energy bond limitation shall be increased by $1,600,000,000 for bonds issued after 2016. Such increase shall be allocated by the secretary consistent with the rules of paragraphs (2) and (3).

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§54D Qualified Energy Conservation Bonds

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(d) National Limitation on Amount of Bonds Designated – There is a national qualified energy conservation bond limitation of $3,200,000,000. For bonds issued in 2017 or later the national qualified energy conservation bond limitation is increased by an additional $3,200,000,000.

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§54E Qualified Zone Academy Bonds.

*****

(c) Limitation on amount of bonds designated.

(1) National Limitation. – There is a national zone academy bond limitation for each calendar year. Such limitation is $400,000,000, $1,400,000,000 for 2009 and 2010, and $400,000,000 for 2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018, 2019, and 2020, and except as provided in paragraph (4), zero thereafter.

*****

§54F Qualified School Construction Bonds.

*****

(c) National limitation on amount of bonds designated. There is a national qualified school construction bond limitation for each calendar year. Such limitation is –

*****

(2) $11,000,000,000 for 2010, ~~and~~

(3) ~~except as provided in subsection e, zero after 2010.~~ $11,000,000,000 for 2017,

(4) $11,000,000,000 for 2018, and

(5) except as provided in subsection (e), zero after 2018.

*****

§146 Volume Cap

*****

(d) State Ceiling. For purposes of this section –

(1) In general. The state ceiling applicable to any state for any calendar year shall be the greater of

(A) an amount equal to $120 multiplied by the state population ($100 for 2017), or

(B) $325,000,000 ($305,315,000 for 2017)

(2) Cost of living adjustment.

In the case of a calendar year after 2018, each of the dollar amounts contained in paragraph (1) shall be increased by an amount equal to

(A) such dollar amount multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "calendar year 2018" for "calendar year 1992" in subparagraph (B) thereof.

*****

(g) Exception for certain bonds. Only for purposes of this section, the term "private activity bond" shall not include –

(3) any exempt facility bond issued as part of an issue described in paragraph (1), (2), (4), (5), (12), (13), (14), or (15) of section 142(a), and

*****

§6431 Credit for qualified bonds allowed to issuer.

*****

(f) Application of Section to Certain Qualified Tax Credit Bonds. –

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(3) Specified Tax Credit Bond. – For purposes of this section, the term "specified tax credit bond" means any qualified tax credit bond (as defined in section 54A(d) if –

(A) such bond is –

*****

(iii) a qualified zone academy bond (as defined in section 54E) determined without regard to any allocation relating to the national zone academy bond limitation for years 2011 through 2016 or any carryforward of any such allocation, or

*****

(h) No payment under this section shall be reduced because of the application of the Balanced Budget and Emergency Deficit Control Act of 1985.

7. STREAMLINE AND BROADEN PRIVATE ACTIVITY LIMITS ON GOVERNMENTAL BONDS

Current Law

Section 141 of the Code treats bonds issued by State and local governments as tax-exempt bonds if the issuer limits private business use and other private involvement sufficiently to avoid treatment as "private activity bonds." Bonds generally are classified as private activity bonds under a two-part test if more than 10 percent of the bond proceeds are both (1) used for private business use (*"private business use limit"*), and (2) payable or secured from property or payments derived from private business use (*"private payment or security limit"* and, together with the private business use limit, the *"private business limits"*).

Additional restrictions further reduce the permitted thresholds of private involvement for governmental bonds in several ways. Section 141(b)(3) imposes five-percent unrelated or disproportionate private business limits. Section 141(b)(4) imposes a $15 million per project (which may include multiple bond issues) private business limit for governmental output facilities (such as electric, gas, or other output generation, transmission and distribution facilities, but excluding water facilities). Section 141(c) imposes a private loan limit equal to the lesser of five percent or $5 million of bond proceeds. Section 141(b)(5) requires a volume cap allocation to the extent that a private business limit of $15 million is exceeded in larger transactions that otherwise comply with the private business limits.

Reasons for Change

The five-percent limit on unrelated or disproportionate private business use has injected undue complexity, a narrow disqualification trigger, and attendant compliance burdens for State and local governments. This five-percent unrelated or disproportionate private business use test requires difficult factual determinations regarding the relationship of private business use to governmental use in financed projects. Guidance from the IRS on what constitutes unrelated use is incomplete. The consequence is that the five-percent test is often applied to private uses for which the related or unrelated nature is unclear. Recent allocation and accounting rules make no distinction between related and unrelated use, further complicating the application of those rules.

The $15 million private business limit on output facility projects treats output facilities more restrictively than other types of facilities for purposes of the private business limits on governmental bonds. This $15 million limit per project aggregates amounts from different bond issues that are used for the same output project. Because the test is applied to a project that could include bonds from multiple bond issues, application is very complex. This $15 million test impedes needed energy infrastructure investment.

The $15 million limit applicable to all governmental bonds under section 141(b)(5), which requires an issuer to obtain an allocation of volume cap to the extent the "nonqualified amount" exceeds $15 million, is also susceptible to becoming unduly complex. This is in part a result of an arguable disconnect between the proper interpretation of the term "nonqualified amount," defined in section 141(b)(8), and the customary use of issue price in determining the amount of volume cap an issuer needs to obtain. The application of this rule becomes even more complex in attempting to apply

the $15 million limit of section 141(b)(5) to an advance refunding, where the refunding bond issue size in a high-to-low refunding will exceed the amount of bonds being refunded (even excluding issuance costs).

Proposal

The proposal would repeal the five-percent unrelated or disproportionate private business use test under section 141(b)(3), as well as the $15 million private business limits on nongovernmental output facilities under section 141(b)(4) and on larger financings under section 141(b)(5).

The amendments would apply to bonds issued on or after the date of enactment.

Proposed statutory language streamlining private activity limits on governmental bonds:

Code Section 141
Section 141 is revised by deleting paragraphs (b)(3), (b)(4), (b)(5) and (b)(8) and renumbering accordingly.

8. Permit Refunding of Bonds Where Less Than 85 Percent of Proceeds Has Been Spent.

Current Law

Section 149(g) of the Code provides that bonds are "hedge bonds" unless, among other things, the issuer reasonably expects to spend 85 percent of the spendable proceeds of the issue to carry out the governmental purposes of the issue within the three-year period beginning on the date the bonds are issued.[1] Unless certain additional requirements are met, the interest paid with respect to hedge bonds is taxable. However, if at least 95 percent of the proceeds of a bond issue are invested in tax-exempt bonds that are not subject to the alternative minimum tax, the bonds are not considered hedge bonds. Section 149(g)(3) further provides that a refunding bond shall be treated as meeting the requirements of Section 149(g) only if the original bond met such requirements.

Reasons for Change

Bonds are most commonly refunded for the purpose of reducing interest costs on outstanding bonds. Such reductions in interest costs not only save issuers money, but also reduce the revenue loss to the federal government. In addition, the use of unspent proceeds of the prior bonds to redeem or defease those bonds results in a reduction in the amount of outstanding bonds, further reducing the cost to issuers and to the federal government.

Because of the difficulty of determining at the time of a refunding whether an issuer's expectations were reasonable at the time the prior bonds were issued, a refunding in which less than 85 percent of the net sale proceeds of the prior bonds was spent within three years from prior bond issuance may not be possible even when only a small additional amount was needed to reach the 85 percent spending requirement. In addition, the use of unspent bond proceeds of the prior bond issue to redeem the prior bonds (and reduce the amount of any refunding bonds) will not be treated as using the bond proceeds for the governmental purpose of the prior issue under Section 149(g) and, under current law, will not cure any potential hedge bond problem. The inability to refund bonds that have unspent proceeds accordingly can result in substantial costs to both issuers and the federal government. Permitting an issuer to use unspent proceeds to redeem prior bonds in connection with a refunding, thereby reducing the overall amount of bonds outstanding, is a better solution for both the issuer and the federal government than investing proceeds in tax-exempt bonds.

Proposal

Section 149(g) is amended to clarify that an otherwise permitted refunding of a prior issue will not be treated as a hedge bond issue if (a) the issuer will realize present value debt service savings, and (b) any remaining unspent proceeds of the prior bonds are used, together with refunding bond proceeds, to redeem or defease the prior bonds.

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[1] Section 1.149(g)-1(a) of the Treasury Regulations provides that the spendable proceeds of the bonds should be interpreted to mean the "net sale proceeds" of the bonds within the meaning of Treas. Reg. Sec. 1.148-1.

Proposed statutory language clarifying hedge bond classification of refunding bonds. (Double underlining denotes amendment):

Section 149(g)(3)(C)

(C) Exception for refunding bonds.

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(iv) **Refunding for savings.** Notwithstanding clause (i) above, a refunding bond will not be treated as a hedge bond if—

(I) the issuer will realize present value debt service savings, and

(II) any remaining net sale proceeds of the prior bonds (other than amounts in a reasonably required reserve or replacement fund that will fund a reasonably required reserve or replacement fund for the refunding bonds) are used to redeem or defease the prior bonds.

APPENDIX
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