



National Association
of Bond Lawyers

PHONE 202-503-3300 601 Thirteenth Street, NW
FAX 202-637-0217 Suite 800 South
www.nabl.org Washington, D.C. 20005

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Tax Tools to Help Local Governments

March 11, 2021

Ways & Means Select Revenue Measures Subcommittee Hearing

U.S. House of Representatives

Statement for the Record of Teri M. Guarnaccia President, National Association of Bond Lawyers

Submitted: March 25, 2021

OVERVIEW

The National Association of Bond Lawyers (NABL) is a specialty bar association of approximately 2,500 bond 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. In connection with the House Ways and Means Committee Select Revenue Measures Subcommittee hearing on *Tax Tools to Help Local Governments*, NABL has prepared for your consideration the attached recommendations for revisions to the Internal Revenue Code (the “Code”) concerning state and local bonds and other state and local debt obligations (“state and local bonds”). We previously submitted a similar Statement for the Record in connection with a January 29, 2020 Ways and Means Committee hearing entitled, *Paving the Way for Funding and Financing Infrastructure Investments*. We believe that such recommendations have become even more relevant as our country looks forward to recovery this year.

Three-fourths of all public infrastructure in this country is financed by state and local governments¹. State and local bonds are fundamental to building and maintaining this infrastructure, and are used to 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; affordable housing; and small manufacturing facilities.

Tax-exempt financing is a partnership between the federal government and state and local governments that has many advantages in financing infrastructure. Projects are proposed and pursued at the local level, within the parameters permitted by federal law. Because they are subject to public input and scrutiny, state and local governments and other entities that finance these public-interest projects have a strong interest in putting forward necessary and well-vetted projects. Similarly, the tax-exempt bond market is a well-developed and sophisticated market that brings investors together with projects state and local governments want to finance. Private-sector investors analyze the viability of many of these projects before investing their money, providing an additional check on projects.

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. In this way, federal assistance is limited to the revenue foregone on the untaxed interest, which is estimated to be approximately \$50 billion per year on approximately \$3.8 trillion of outstanding state and local tax-exempt bonds. The cost savings realized through the issuance of tax-exempt state and local bonds are critical to continued investment in public infrastructure while maintaining affordable taxes, fees, and other charges associated with those infrastructure projects.

We respectfully provide the following recommendations as you consider changes to the Code. Thank you for your consideration.

¹ Municipal Securities Rulemaking Board, 2019, [Municipal Securities: Financing the Nation’s Infrastructure](#)

SUMMARY OF INCLUDED TAX PROPOSALS

1. Restore the ability of state and local governments to issue tax-exempt advance refunding bonds.
2. Provide a new direct-pay alternative to tax-exempt financing.
3. Provide additional volume cap for tax-exempt private activity bonds.
4. Create a new category of qualified private activity bond for public roads, tunnels, and bridges.
5. Update and expand the small borrower exception to tax-exempt interest expense allocation rules.
6. Eliminate the unrelated or disproportionate use rules of the private business use test and the dollar limits on private business use.

LIST OF RECOMMENDED LEGISLATIVE TAX PROPOSALS TO FACILITATE PUBLIC INFRASTRUCTURE IMPROVEMENTS

1. RESTORE THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO ISSUE TAX-EXEMPT ADVANCE REFUNDING BONDS.

Current Law

The 2017 Tax Cuts and Jobs Act (“TCJA”) eliminated all authority to issue tax-exempt advance refunding bonds (e.g. bonds issued to refund outstanding bonds where the refunding bonds are issued more than 90 days prior to the redemption of the refunded bonds.)

Reason for Change

Prior to the TCJA, advance refundings were permitted only in certain circumstances: only one tax-exempt advance refunding was allowed (i.e., tax-exempt bonds could not be issued to advance refund an issue that was itself a tax-exempt advance refunding), advance refundings were not permitted at all for private activity bonds other than 501(c)(3) bonds, and regulations provided safeguards in place to prevent abuse. The elimination of tax-exempt advance refundings by the TCJA has resulted in substantial financial costs on states and local governments.

Proposal

Reinstate the authority for state and local governments to issue tax-exempt refunding bonds subject to the same rules and restrictions that existed prior to the adoption of the TCJA. This can be accomplished by passing H.R. 2772, the Investing in our Communities Act, into law. This law will

permit state and local governments to take advantage of billions of dollars in savings, allowing them to provide more comprehensive services, including infrastructure projects, at a lower cost to their citizens.

2. PROVIDE A NEW DIRECT-PAY ALTERNATIVE TO TAX-EXEMPT FINANCING.

Current Law

Direct-pay bonds (also known as direct-subsidy bonds) have been widely accepted by financial markets. Interest paid on direct-pay bonds is taxable, but 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 the project funded by 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% of the interest on such bonds. 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 the expanded investor base lowered the costs of the infrastructure financed with the bonds – both to the issuers of the bonds and to the federal government.

The subsidy paid to issuers of direct-pay bonds, however, has been reduced because the payments have been subject to sequestration under the Balanced Budget and Emergency Deficit Control Act of 1985. As a result, many state and local government officials have expressed skepticism over using direct-pay bonds in the future because of the uncertainty sequestration introduced into long-term financing costs.

Reason for Change

One of the most effective ways to provide federal support to infrastructure investment is to increase the federal subsidy to state and local issuers of bonds by reducing the interest cost to the issuers of the bonds. Expanding the direct-pay bond program and making such bonds available for the same purposes as tax-exempt bonds will allow for issuers to take advantage of an expanded market. To further the acceptance of the direct-pay program by issuers and stabilize the infrastructure financing source, payments to issuers should not be subject to sequestration.

Proposal

Create a new version of Build America Bonds or new type of direct-pay bond as an additional alternative to tax-exempt bonds. These bonds 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 or, alternatively, equal to a fixed percentage of principal amount of the bond during the period they are outstanding. The new direct-pay bonds could be

issued for any purpose for which tax-exempt bonds can be issued. New direct-pay bonds issued for governmental or qualified 501(c)(3) bond purposes (as discussed later) would not be subject to a volume cap limit (consistent with the treatment of governmental and qualified 501(c)(3) tax-exempt bonds). New direct-pay bonds 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.

To encourage an increase in infrastructure investment, the payment rate for the new direct-pay bonds issued during the first 10 years of the program would be 40% of the interest payable on the bonds or a payment rate equal to a fixed percentage of 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 a revenue-neutral rate. Payments to bond issuers would not be subject to sequestration. In addition, one benefit of the direct-pay model is that it accommodates different subsidy levels for different types of projects, if that is a policy objective.

In creating the new direct-pay bonds, we suggest Congress build on the Build America Bond model, but improve it in several notable ways:

- Permit the new direct-pay bonds to be issued for any purpose for which tax-exempt bonds could be issued.
- Provide de minimis flexibility for requirements to spend proceeds on designated purposes (for example, a requirement to spend 95% of proceeds on a designated purpose rather than 100%).
- Make the new direct-pay bond provisions permanent.
- Consider providing an enhanced subsidy rate for specified types of facilities or governmental purposes.
- Protect the direct-pay subsidy of new direct-pay bonds against the effects of budgetary sequestration pursuant to the Balanced Budget and Emergency Deficit Control Act of 1985 or the Statutory Pay-As-You-Go Act of 2010 (or future legislation having similar effect.)
- Consider providing for proportionate remedies for noncompliance (rather than a harsh “all or nothing” rule).

3. PROMOTE CONSTRUCTION AND RENOVATION OF INFRASTRUCTURE AND EDUCATIONAL FACILITIES WITH PRIVATE SECTOR INVOLVEMENT THROUGH AN 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

“qualified private activity bonds.” Qualified private activity bonds are issued by state and local governments in order to finance certain types of specified facilities that are treated as used by private users, such as corporations, airlines, certain freight transfer facility operators, and solid waste disposal facility owners.

The amount of qualified private activity bonds that may be issued by a state each calendar year is generally determined to be an amount which is the greater of (a) an amount equal to \$110 multiplied by the state population (for 2021), or (b) \$324,995,000 (for 2021), adjusted each year for increases in the cost of living (the “volume cap.”) Certain qualified private activity bonds used for infrastructure are exempt from the volume cap requirement, including bonds for airports and docks and wharves. However, qualified private activity bonds for water and sewer facilities, affordable housing, small manufacturing, and other facilities, are not currently exempt from the volume cap requirement, thus constraining the ability of state and local issuers to finance a number of otherwise qualifying infrastructure projects. In a number of communities, this constraint is significant and delays many projects. An increase in the amount of volume cap would allow a significant number of projects to proceed.

In addition, many of the bonds issued under Section 142(d) for qualified residential rental projects (i.e., affordable multifamily housing) are paid off as soon as the bond-financed project is placed-in-service, which is often as short as 18 months after issuance. While there are provisions in place under Section 146(i) to allow some recycling of volume cap used for bonds issued under Section 142(d) that are repaid within a few years after issuance, the rules are not as flexible as they could be and therefore do not make the most effective use of the amount of volume cap recycled.

Reason for Change

Qualified 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, mass commuting facilities, water and sewer facilities, and gas and electric facilities. In addition to encouraging further private investment in the above essential facilities by increasing the volume cap, Congress would aid critically needed infrastructure improvements if it exempted certain qualified private activity bonds, such as 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. Furthermore, volume cap used for qualified residential rental projects would produce more affordable housing units if such volume cap initially used only for short-term bonds could be recycled more efficiently.

Proposal

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 2022), or (b) \$330 million (for 2022), in each case increased annually for cost-of-living adjustments. In addition, provide an exemption from the volume cap for qualified water and sewer facilities. Revise Section 146(i) to

allow for more efficient recycling of volume cap used initially for short-term bonds that financed qualified residential rental projects.

S. 1703, the Affordable Housing Credit Improvement Act of 2019, will help achieve our desired goal. The legislation modifies the tax code to expand the recycling of qualified private activity bonds. By doing this, Congress can help generate the maximum possible impact from each year's volume cap allocation.

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

Current Law

Exempt facility bonds under Section 142(a) of 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.

Reasons For Change

Public roads, tunnels, and bridges are essential infrastructure, but many are in poor repair and are inadequate for current transportation demands. Many such projects can be facilitated by public private partnerships that may not be permitted for "governmental bonds."

Congress can lower costs of constructing, expanding, and rehabilitating essential infrastructure improvements by expanding exempt facility transportation bonds to include more types of transportation facilities including roads, tunnels, and bridges, with fewer restrictions than currently exist.

The proposal below requires that (i) the facilities be open to the public and (ii) 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 mimic the public ownership and control of certain other transportation facilities for which tax-exempt financing is presently possible.

Proposal

Add a new category of exempt facility bonds for transportation facilities, including qualified road, tunnel, and bridge facilities, 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 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 facilities include new roads, tunnels, bridges, and toll facilities and expansions and rehabilitations of and additions to existing roads, tunnels, and bridges. If proceeds of the bonds are used to acquire an existing transportation facility, bond proceeds must also be used to fund a substantial rehabilitation of that transportation facility. For this purpose, “substantial rehabilitation” means rehabilitation expenditures made with respect to the acquired transportation facility in an amount equal to at least 25% of the net proceeds of the bonds.

Qualified 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 or to a limitation on land acquisition. 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.

5. MODIFICATION OF SMALL BORROWER 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. Generally, the 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. In the case of a bank or other financial institution, the Code generally disallows a proportionate share of all the taxpayer’s interest expense based on a ratio of its basis in tax-exempt investments to its basis in all its assets.

This general rule does not apply to “qualified tax-exempt obligations,” commonly called “bank qualified bonds,” held by banks or other financial institutions. Instead, only 20% 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 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.

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.

Reason 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. Many local governments may not have effective access to bank financing because of the \$10 million limit. This limitation may be a particular problem for participation in tax-exempt financing by community banks and other small banks.

In addition, 501(c)(3) organizations often have difficulty borrowing from banks using bank qualified bonds because the actual issuer (often a state agency) is not a qualified small issuer.

Moreover, 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.

Proposal

Increase from \$10 million to \$30 million the annual limit for qualified small issuers and index the limit for inflation. This can be accomplished by passing H.R. 3967, the Municipal Bond Market Support Act of 2019, into law. That measure will serve small local governments or health care organizations, education institutions, or other non-profits who want to borrow for a new project by providing an alternative financing mechanism for small borrowers who often discover that the costs of issuance and delay involved in a public offering may outweigh the interest rate advantage of tax-exempt bonds.

In addition, in the case of a “qualified financing issue,” this 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.

6. STREAMLINE 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 (or private security or payments) sufficiently to avoid treatment as private activity bonds. Bonds generally are classified as qualified private activity bonds under a two-part test if more than 10% 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 5% 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, and transmission and distribution facilities, but excluding water facilities). 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.

Reason for Change

The 5% 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. The test also requires difficult factual determinations regarding the relationship of private business use to governmental use in financed projects. Guidance from the Internal Revenue Service on what constitutes unrelated use is incomplete. The consequence is that the 5% 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 and 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. The \$15 million limit is 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.

Proposal

Repeal the 5% 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).