U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF TREASURY ASSISTANT SECRETARY FOR TAX POLICY ERIC SOLOMON BEFORE THE HOUSE OVERSIGHT SUBCOMMITTEE ON DOMESTIC POLICY ON TAX EXEMPT BOND FINANCING

Washington, DC— Chairman Kucinich, Ranking Member Issa, and distinguished Members of the Subcommittee:

I appreciate the opportunity to appear before you today to discuss certain Federal tax issues regarding the use of tax-exempt bond financing. The Administration recognizes that tax-exempt bond financing plays an important role as a source of lower-cost financing for State and local governments. As a nation, we are focusing on the critical need to support capital investment in public infrastructure. The Federal government provides an important Federal subsidy for tax-exempt bond financing through the Federal income tax exemption for interest paid on State or local bonds under Section 103 of the Internal Revenue Code (the "Code"), which enables State and local governments to finance public infrastructure projects and other public-purpose activities at lower costs.

The cost to the Federal government of tax-exempt bonds is significant and growing. Unlike direct appropriations, however, the cost of this Federal subsidy receives less attention because it is not tracked annually through the appropriations process. In addition, it also is important to recognize that the Federal subsidy for tax-exempt bonds is less efficient than that for direct appropriations because of the inefficiency of pricing in the tax-exempt bond market. In this regard, since some bond purchasers have higher marginal tax rates than those of the bond purchasers needed to clear the market, tax-exempt bonds cost the Federal government more in foregone revenue than they deliver to State and local governments in reduced interest expenses. The steady growth in the volume of tax-exempt bonds reflects the importance of this incentive in addressing public infrastructure and other needs. At the same time, it is appropriate to review the tax-exempt bond program to ensure that it is properly targeted and that the Federal subsidy is justified in light of the lost Federal revenue and other costs imposed.

My testimony covers four main issues. First, my testimony provides an overview of the legal framework for tax-exempt bonds. Second, it discusses the use of tax-exempt bonds to finance public infrastructure projects and stadium projects under the existing legal framework. Third, my testimony

comments on certain tax policy and regulatory authority considerations. Finally, it provides certain statistical data on tax-exempt bonds for background.

Overview of Legal Framework for Tax-Exempt Bonds

A. Introduction

In general, there are two basic types of tax-exempt bonds: Governmental Bonds and Private Activity Bonds. Bonds generally are classified as Governmental Bonds if the proceeds are used for State or local governmental use or the bonds are repaid from State or local governmental sources of funds. Bonds generally are classified as Private Activity Bonds if they meet the definition of a Private Activity Bond under the Code, based on specified levels of private business involvement. In general, the interest on Private Activity Bonds is taxable unless the bonds meet qualification requirements for financing certain projects and programs specifically identified in the Code.

B. Governmental Bonds

State and local governments issue Governmental Bonds to finance a wide range of public infrastructure projects. The Code does not provide a specific definition of "Governmental Bonds." Instead, bonds are generally treated as Governmental Bonds if they avoid classification as Private Activity Bonds, as defined in the Code, by limiting private business use or private business sources of payment or security, and also by limiting private loans. Here, it is important to appreciate that bonds can qualify as Governmental Bonds if they are either used predominantly for State or local governmental use or payable predominantly from State or local governmental sources of funds, such as generally applicable taxes. Stated differently, under the current legal framework, Governmental Bonds can be used to finance a project that has significant private business use or that are payable from significant private business sources of payment, but not both.

In order for the interest on Governmental Bonds to be excluded from the bond holder's gross income for Federal tax purposes, a number of general eligibility requirements must be met. Requirements generally applicable to all tax-exempt bonds include arbitrage restrictions, bond registration and information reporting requirements, a general prohibition on Federal guarantees, advance refunding limitations, restrictions on unduly long spending periods, and pooled financing bond limitations.

C. Private Activity Bonds

1. In General

Under section 141 of the Code, bonds are classified as Private Activity Bonds if more than 10 percent of the bond proceeds are both:

(1) used for private business use (the "private business use limitation"); and

(2) payable or secured from payments derived from property used for private business use (the "private payments limitation").

Bonds also are treated as Private Activity Bonds if more than the lesser of $5 million or 5 percent of the bond proceeds are used to finance private loans, including business and consumer loans. The permitted private business thresholds are reduced from 10 percent to 5 percent for certain private business use that is "unrelated" to governmental use or that is "disproportionate" to governmental use financed in a bond

issue. These tests are intended to identify arrangements that have the potential to transfer the benefits of tax-exempt financing to nongovernmental persons.

2. Projects and Programs Eligible for Tax-Exempt Private Activity Bond Financing

Private Activity Bonds may be issued on a tax-exempt basis only if they meet the requirements for qualified Private Activity Bonds, including targeting requirements that limit such financing to specifically defined facilities and programs. Under present law, qualified Private Activity Bonds may be used to finance eligible projects and activities, including the following: (1) airports, (2) docks and wharves, (3) mass commuting facilities, (4) facilities for the furnishing of water, (5) sewage facilities, (6) solid waste disposal facilities, (7) qualified low-income residential rental multifamily housing projects, (8) facilities for the local furnishing of electric energy or gas, (9) local district heating or cooling facilities, (10) qualified hazardous waste facilities, (11) high-speed intercity rail facilities, (12) environmental enhancements of hydroelectric generating facilities, (13) qualified public educational facilities, (14) qualified green buildings and sustainable design projects, (15) qualified highway or surface freight transfer facilities, (16) qualified mortgage bonds or qualified veterans mortgage bonds for certain single-family housing facilities, (17) qualified small issue bonds for certain manufacturing facilities, (18) qualified student loan bonds, (19) qualified redevelopment bonds, (20) qualified 501(c)(3) bonds for the exempt charitable and educational activities of Section 501(c)(3) nonprofit organizations, (21) certain projects in the New York Liberty Zone, and (22) certain projects in the Gulf Opportunity Zone.

Qualified Private Activity Bonds are subject to the same general rules applicable to Governmental Bonds, including the arbitrage investment limitations, registration and information reporting requirements, the Federal guarantee prohibition, restrictions on unduly long spending periods, and pooled financing bond limitations. In addition, most qualified Private Activity Bonds are also subject to a number of additional rules and limitations. One notable additional rule limits the annual amount of these bonds that can be issued in each state (the "bond volume cap" limitation) under section 146 of the Code. Another notable additional rule prohibits advance refundings for most Private Activity Bonds under section 149(d)(2) (other than for qualified 501(c)(3) bonds). Further, unlike the tax exemption for interest on Governmental Bonds, the tax exemption for interest on most qualified Private Activity Bonds is generally treated as a preference item under the alternative minimum tax ("AMT"), meaning that the benefit of an exclusion from income for interest paid on these bonds can be taken away by the AMT.

The current legal framework for Private Activity Bonds was enacted as part of the Tax Reform Act of 1986. The basic purpose of the Private Activity Bond limitations was to limit the ability of State and local governments to act as conduit issuers in financing projects for the use and benefit of private businesses and other private borrowers except in prescribed circumstances. Prior to the Tax Reform Act of 1986, the predecessor legal framework had more liberal rules regarding the use of tax-exempt bonds for the benefit of private businesses (then called "industrial development bonds"), including a more liberal 25-percent limitation on permitted private business use and private payments (as compared to the present 10-percent private business and private payment limitations), and it did not include bond volume cap limitations on private activity bonds.

Prior to the Tax Reform Act of 1986, stadiums were on the list of eligible facilities that could be financed with tax-exempt industrial development bonds. Stadiums were removed from the list of facilities eligible for tax-exempt Private Activity Bond financing in 1986, but stadiums remain eligible for Governmental Bond financing notwithstanding the substantial private business use of these facilities if they meet the requirements for Governmental Bonds. Under current law, these requirements can generally be met when State and local governments subsidize the projects with governmental revenues or generally applicable taxes.

3. The Private Business Use Limitation

In general, private business use of more than 10 percent of the proceeds of a bond issue violates the private business use limitation. Private business use generally arises when a private business has legal rights to use bond-financed property. Thus, private business use arises from ownership, leasing, certain management arrangements, certain research arrangements, certain utility output contract arrangements (e.g., certain electricity purchase contracts under which private utilities receive benefits and burdens of ownership of governmental electric generation facilities), and certain other arrangements that convey special legal entitlements to bond-financed property.

Various exceptions and safe harbors apply with respect to the private business use limitation, which allow limited private business use of property financed by Private Activity Bonds in prescribed circumstances. Exceptions to the private business use limitation include exceptions for use in the capacity as the general public, such as use by private businesses of public roads ("general public use"), certain very short-term use arrangements, certain de minimis incidental uses, certain uses as agents of State and local governments, and certain uses incidental to financing arrangements (e.g., certain bondholder trustee arrangements). In addition, safe harbors against private business use apply to certain private management and research arrangements. Thus, for management contracts, in Rev. Proc. 97-13, 1997-1 C.B. 632, the IRS provided safe harbors that allow private businesses to enter into certain qualified management contracts with prescribed terms and compensation arrangements without giving rise to private business use to accommodate public-private partnerships for private management of public facilities. For research contracts, in Rev. Proc. 2007-47, 2007-29 I.R.B. 108 (July 16, 2007), the IRS provided updated safe harbors that allow certain research contract arrangements with private businesses at tax-exempt bond financed research facilities without giving rise to private business use (e.g., certain Federally sponsored research).

4. The Private Payments Limitation

In general, private payments aggregating more than 10 percent of the debt service on a bond issue (on a present value basis) violates the private payments limitation. The private payments limitation considers direct and indirect payments with respect to property used by private businesses that represent sources of payment or security for the debt service on a bond issue. For example, if a private business pays rent for its use of the bond-financed property, the rent payments give rise to private payments. Various limited exceptions apply for purposes of the private payments limitation.

5. The Generally Applicable Taxes Exception to the Private Payments Limitation

A notable exception to the private payments limitation applies to payments from generally applicable taxes. In the legislative history to the Tax Reform Act of 1986, Congress indicated its intent to exclude revenues from generally applicable taxes from treatment as private payments for purposes of the private payments limitation. The Conference Report to the Tax Reform Act of 1986 included the following statement:

> *Revenues from generally applicable taxes are not treated as payments for purposes of the security interest test*; however, special charges imposed on persons satisfying the use test (but not on members of the public generally) are so treated if the charges are in substance fees paid for the use of bond proceeds.[1]

[1] H. Rep. No. 99-841, 99th Cong. 2d Sess. at Page II-688, 1986-3 C.B. Vol. 4 688 (1986) (emphasis added).

Consistent with this legislative history, Treasury Regulations define a generally applicable tax as an enforced contribution imposed under the taxing power that is imposed and collected for the purpose of raising revenue to be used for a governmental purpose. A generally applicable tax must have a uniform tax rate that is applied equally to everyone in the same class subject to the tax and that has a generally applicable manner of determination and collection. By contrast, a payment for a special privilege granted or service rendered is not considered a generally applicable tax. Special assessments imposed on property owners who benefit from financed improvements are also not considered generally applicable taxes. For example, a tax that is limited to the property or persons benefiting from an improvement is not considered a generally applicable tax. Although taxes must be determined and collected in a generally applicable manner, the Treasury Regulations permit certain agreements to be made with respect to those taxes. An agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose is such a permissible agreement. Thus, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

In addition, the Treasury Regulations treat certain "payments in lieu of taxes" and other tax equivalency payments ("PILOTs") as generally applicable taxes.[2] Under the current Treasury Regulations, a PILOT is treated as a generally applicable tax if the payment is "commensurate with and not greater than the amounts imposed by a statute for a tax of general application." For instance, if the payment is in lieu of property tax on the bond-financed facility, it may not be greater in any given year than what the actual property tax would be on the property. In addition, to avoid being a private payment, a PILOT must be designated for a public purpose and not be a special charge. Under this rule, a PILOT paid for the use of bond-financed property is treated as a special charge.

In 2006, the Treasury Department and the Internal Revenue Service (IRS) published Proposed Regulations to modify the standards for the treatment of PILOTs to ensure a close relationship between eligible PILOT payments and generally applicable taxes. Under the Proposed Regulations, a payment is commensurate with general taxes only if the amount of the payment represents a fixed percentage of, or a fixed adjustment to, the amount of generally applicable taxes that otherwise would apply to the property in each year if the property were subject to tax. For example, a payment is commensurate with generally applicable taxes if it is equal to the amount of generally applicable taxes in each year, less a fixed dollar amount or a fixed adjustment determined by reference to characteristics of the property, such as size or employment. The Proposed Regulations permit the level of fixed percentage or adjustment to change one time following completion of development of the property. The Proposed Regulations also provide that eligible PILOT payments must be based on the current assessed value of the property for property taxes for each year in which the PILOTs are paid, and the assessed value must be determined in the same manner and with the same frequency as property subject to generally applicable taxes. A payment is not commensurate if it is based in any way on debt service with respect to an issue or is otherwise set at a fixed dollar amount that cannot vary with the assessed value of the property. The Treasury Department and the IRS are in the process of reviewing the public comments on the Proposed Regulations regarding the treatment of PILOTs.

Governmental Bonds for Public Infrastructure Projects and Private Stadiums Under the Existing Legal Framework

A. Public Infrastructure Projects

[2] In general, the treatment of payments, including PILOTs, as taxes based on their substance is grounded in longstanding Federal income tax principles. *See, e.g.*, Rev. Rul. 71-49, 1971-1 C.B. 103 (PILOTs treated as taxes in substance for purposes of deductibility of taxes under Code Section 164).

For public infrastructure projects, qualification for Governmental Bond financing focuses on limiting private business use to not more than 10-percent private business use under the first prong of the Private Activity Bond definition. In general, Governmental Bonds are an important tool that State and local governments use to finance public infrastructure projects to carry out traditional governmental functions, such as providing public roads, bridges, courthouses, and schools. Typically, State and local governments finance public infrastructure projects with Governmental Bonds based on predominant State or local governmental use of the projects and limited private business use within the permitted 10-percent private business use limitation for Governmental Bonds. Often, State and local governments finance public infrastructure projects with Governmental Bonds based in part on reliance on the general public use exception to private business use. Thus, for example, public roads may be financed with Governmental Bonds even if private businesses use them in the same way as individual members of the general public.

The tax policy justification for a Federal subsidy for tax-exempt bonds is strongest in circumstances where State or local governments use Governmental Bonds to finance public infrastructure projects and other traditional governmental functions to carry out clear public purposes.

B. Private Stadiums

For stadium projects that are acknowledged to exceed the 10-percent private business use limitation, qualification for Governmental Bond financing depends on limiting private payments to comply with the 10-percent private payments under the second prong of the Private Activity Bond definition. Here, it is important to recognize that, under the existing legal framework, bonds are classified as Private Activity Bonds only if they exceed *both* the 10-percent private business use limitation and the 10-percent private payments limitation. Thus, a State or local government may issue tax-exempt Governmental Bonds to finance a project that is 100-percent used for private business use, such as a stadium that a private professional sports team uses 100-percent for private business use, provided that the issuer does not receive private payments from the team or elsewhere that in the aggregate exceed the 10-percent private payments limitation. Alternatively, a State or local government may issue tax-exempt Governmental Bonds to finance a stadium to be used for private business use if it subsidizes the repayment of the bonds with State or local governmental funds, such as generally applicable taxes. For example, a city could pledge revenues from a city-wide sales tax, hotel tax, car tax, property tax, or other broadly based generally applicable tax to pay the debt service on Governmental Bonds to finance a stadium.

The tax policy justification for a Federal subsidy for tax-exempt bonds is weaker when State or local governments use Governmental Bonds to finance activities beyond traditional governmental functions, such as the provision of stadiums, in which the public purpose is more attenuated and private businesses receive the benefits of the subsidy.

Certain Tax Policy and Regulatory Authority Considerations Regarding Tax-Exempt Bond Financing

A. Targeting the Federal Subsidy for Tax-Exempt Bonds in General

In general, it is important to ensure that the Federal subsidy for tax-exempt bonds is properly targeted and justified. A rationale for a Federal subsidy for tax-exempt bonds for State and local governmental projects and activities exists when they serve some broader public purpose. The tax policy justification for a Federal subsidy for State or local governmental projects and activities is clearest in the case of traditional public infrastructure projects to carry out traditional governmental functions where the public purpose is clear, particularly when the Federal subsidy is necessary to induce the projects to be undertaken.

The tax policy justification for this Federal subsidy becomes weaker, however, in circumstances that are more attenuated from traditional State or local governmental activities, such as circumstances that lack a clear public purpose justification, provide significant benefits to private businesses, or involve projects that might have been undertaken in any event without the benefit of the Federal subsidy.

In addition, it also is important to recognize that, in general, the Federal subsidy for tax-exempt bonds is less efficient than that for direct appropriations because of the inefficiency of pricing in the tax-exempt bond market. In this regard, since some bond purchasers have higher marginal tax rates than those of the bond purchasers needed to clear the market, tax-exempt bonds cost the Federal government more in foregone revenue than they deliver to State and local governments in reduced interest expenses. Thus, for example, if taxable bonds yield 10 percent and equivalent tax-exempt bonds yield 7.5 percent, then investors whose marginal income tax rates exceed 25 percent will derive part of the Federal tax benefits, resulting in a subsidy to the State and local governmental issuer that is less than the reduction in Federal revenue.

At the same time, it is important to point out that tax-exempt bond financing has advantages over the use of appropriated funds by government agencies. The involvement of private investors in the decision-making process for infrastructure investment can bring with it greater sensitivity to actual project costs and returns than in public sector investment decision-making. In some cases, this enhanced sensitivity to project costs and returns may compensate for the somewhat lower tax efficiency of tax-exempt bonds and lead to a more efficient investment outcome overall. In 2005, the Administration supported legislation that extended Private Activity Bond authority to qualified highway and surface freight transfer facilities in the highway and transit reauthorization based in part on these considerations.

B. Certain Tax Policy Considerations regarding Tax-Exempt Bond Financing of Stadiums

From a tax policy perspective, the ability to use Governmental Bonds to finance stadiums with significant private business use when the bonds are subsidized with State or local governmental payments, such as generally applicable taxes, arguably represents a structural weakness in the targeting of the Federal subsidy for tax-exempt bonds under the existing legal framework.

At the same time, the tax policy justification in favor of the existing two-pronged Private Activity Bond definition is that it gives State and local governments appropriate flexibility and discretion to finance with Governmental Bonds a range of projects in public-private partnerships with significant private business use when the projects are sufficiently important to warrant subsidizing them with State and local governmental funds, such as generally applicable taxes. Here, political constraints against commitment of such governmental funds ordinarily serve as a sufficient check against excess financing of such projects. An argument can be made, however, that this justification may be debatable in certain cases, such as in the case of certain stadium financings.

Several options could be considered to address the possible structural weakness in the targeting of the tax-exempt bond subsidy relative to tax-exempt Governmental Bonds for stadium financings.

First, Congress could consider repealing the private payments prong of the Private Activity Bond definition for stadiums only. This possible change would prevent use of tax-exempt Governmental Bonds to finance a stadium whenever the stadium has more than 10 percent private business use, as would typically be the case with any professional sports stadium. This option would preserve the ability of State and local governments to use Governmental Bonds to finance stadiums used primarily for governmental use (e.g., stadiums for state universities or city-sponsored amateur sports). This option would ensure targeting of the Federal subsidy for tax-exempt Governmental Bonds to circumstances

involving predominant State or local governmental use of stadiums. In its Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05, January 27, 2005), the Congressional Joint Committee on Taxation included this option to repeal the private payments limitation for stadium financings.

Second, Congress could consider combining the first option described above with an amendment to Section 142 of the Code to allow the use of tax-exempt Private Activity Bonds to finance stadiums used primarily for private business use within the constraint of the annual State tax-exempt Private Activity Bond volume caps. This measured option would constrain stadiums to compete with other eligible projects for allocations of this bond volume cap.

Third, Congress could consider banning tax-exempt bond financing for stadiums altogether. In 1996, Senator Patrick Moynihan sponsored a widely-publicized legislative proposal to this effect, which was never enacted into law.

Fourth, Congress could consider a broader option to repeal the private payments prong of the Private Activity Bond definition altogether. This possible change would treat bonds as Private Activity Bonds whenever private business use exceeded the 10 percent private business use limitation. This broader option would have an effect well beyond stadiums. This broader option would affect all types of projects with significant private business use that otherwise could be financed currently with Governmental Bonds based on payments from governmental funds. In its 2005 tax compliance options mentioned above, the Joint Committee on Taxation also discussed this broader option to repeal the private payments limitation altogether.

At this time, the Administration does not take a position on any specific policy option with respect to possible legislative changes to the tax-exempt bond provisions relative to stadium financings. This topic raises difficult questions which require balancing the interests of State and local governments in flexibility to finance projects they deem sufficiently important to subsidize with governmental funds and the Federal interest in ensuring effective targeting of the Federal subsidy for tax-exempt bonds. The Administration recognizes that review of this important Federal subsidy may be appropriate in considering ways more generally to simplify this area and to ensure effective targeting of this subsidy for public infrastructure in order to justify its cost.

C. Certain Regulatory Authority Considerations

The question has been raised whether the Treasury Department has the regulatory authority to restrict the use of tax-exempt bond financing for professional sports stadiums. The existing legal framework allows the use of Governmental Bonds to finance professional sports stadiums when the bonds are payable from governmental sources of funds, such as generally applicable taxes. In the legislative history to the present tax-exempt bond provisions of the Code, Congress clearly stated its intent to allow Governmental Bonds when secured by generally applicable taxes. The Treasury Department's and the IRS's roles in providing regulatory guidance are to interpret the Code in a manner consistent with Congressional intent.

Therefore, while the Treasury Department and the IRS have broad regulatory authority to interpret the Code, neither the Treasury Department nor the IRS has regulatory authority so broad as to read the private payments limitation out of the Private Activity Bond definition under Section 141 of the Code or to disregard Congress' expressed intent to exclude generally applicable taxes from private payments for this purpose. Thus, we do not believe the Treasury Department has the regulatory authority to prohibit use of Governmental Bonds to finance stadiums under the existing statutory structure.

Certain Statistical Data on Tax-Exempt Bonds

The Treasury Department estimates that Federal tax expenditures for the Federal subsidy for tax-exempt bonds grew from about $26 billion in 1998 to about $30.9 billion in 2006. This tax expenditure is estimated to grow to about $41.1 billion in 2012. Attached to my testimony is certain statistical data on tax-exempt bonds. One chart provides information on long-term new money (versus refinancing) tax-exempt bond issuance from 1991-2005, derived from IRS Statistics of Income data, and shows that annual total tax-exempt bond issuance grew from about $100 billion in 1991 to over $200 billion in 2005. Two additional charts provide breakdowns of the types of projects financed with Governmental Bonds and Private Activity Bonds from 1991-2005.

Although the Treasury Department has no specific data on tax-exempt bond usage for stadiums, in a U.S. Government Accounting Office ("GAO") Report entitled "Federal Tax Policy: Information on Selected Capital Facilities Related to the Essential Governmental Function Test" (GAO-06-1082, dated September 2006), the GAO estimated that, during the period from 2000 through 2004, approximately $5.3 billion in tax-exempt bonds were issued in about 119 bond issues to finance stadiums and arenas.

Conclusion

The Administration recognizes the important role that tax-exempt bond financing plays in providing a source of lower-cost financing for critical public infrastructure projects and other significant public purpose activities. It is important to ensure that the tax-exempt bond program is properly targeted so that it works most effectively and that the Federal subsidy for tax-exempt bonds is justified in light of the revenue costs and other costs imposed. The Administration would be pleased to work with the Congress in reviewing possible options to try to improve the effectiveness of this important Federal subsidy.

Thank you again, Mr. Chairman, Ranking Member Issa, and other Members of the Subcommittee for the opportunity to appear before you today. I would be pleased to answer any questions.

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