WRITTEN TESTIMONY OF
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SUBCOMMITTEE ON DOMESTIC POLICY
HEARING ON
THE STATE OF URBAN AMERICA AND THE USE OF TAX-EXEMPT BONDS

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Good morning Chairman Kucinich, Ranking Member Issa and Members of the Subcommittee. Thank you for the opportunity to be here this morning to discuss some of the uses of tax-exempt bonds by State and local governments.

My name is Don Korb and I am Chief Counsel for the Internal Revenue Service. The Chief Counsel is appointed by the President of the United States with the advice and consent of the U.S. Senate. My position and that of the Commissioner of Internal Revenue are the only two positions at the Internal Revenue Service that are so appointed.

The Chief Counsel is the legal advisor to the IRS Commissioner on all matters pertaining to the interpretation, administration and enforcement of the Internal Revenue laws, as well as all other legal matters. My office also provides legal guidance and interpretative advice to the IRS, Treasury and to the taxpaying public in general.

Before discussing the specific issues that are the focus of this hearing, it is important to emphasize that the Office of Chief Counsel assists and advises the IRS in its mission of overseeing our nation's tax administration system; neither our Office nor the IRS itself develops tax policy proposals or takes a position on them as part of the legislative process. Questions on tax policy issues are better addressed to Secretary of the Treasury or the Assistant Secretary for Tax Policy in the Treasury Department. In the tax policy area, the role of the IRS and the Chief Counsel's Office is limited to advising on the administrative issues that might arise from proposed tax legislation.

Tax-exempt bond financing plays an important role as a source of financing to State and local governments for public infrastructure projects and other significant public purpose activities. The Office of Chief Counsel and the IRS recognize the importance of interpreting and administering the law with respect to this significant Federal subsidy in a fair and equitable manner to ensure appropriate targeting of this subsidy consistent with the relevant Internal Revenue Code provisions and the Congressional intent in enacting those provisions of the Code.

Background

The Internal Revenue Code provides an exclusion from income for interest paid on State and local bonds. In essence, this exclusion provides a Federal subsidy to enable State and local governments to finance needed public infrastructure and other State and local governmental activities at lower interest costs. For example, State and local governments issue tax-exempt bonds to obtain low-cost financing for traditional governmental functions, such as roads, schools, libraries and firehouses. In some cases, State and local governments find it necessary or efficient to involve private parties in a particular governmental project. For example, a State may need to hire experts to design and build its roads, or a food service company to manage a lunchroom in its courthouse.

The Code also permits State and local governments to use tax-exempt financing to subsidize certain activities of private business. Here again, a State and local government may have valid governmental reasons for providing this subsidy. For example, a State and local government might pass the subsidy of tax-exempt bonds on to a private business to encourage that business to build a power plant that will provide energy to the community.

But, over time, Congress has put limits on State and local governments subsidizing private business activities with tax-exempt bonds. Currently, a bond that subsidizes a private business may not benefit from the tax exemption unless the proceeds of that bond are used for certain specified purposes.

In general, there are two basic types of tax-exempt bonds: "governmental bonds" and "qualified private activity bonds." Bonds generally are classified as governmental bonds if the proceeds are used to carry out governmental purposes and the bonds are repaid from governmental funds. Bonds generally are classified as private activity bonds if they meet the definition of a private activity bond in the Code based on specified levels of private business involvement, as I will further discuss. The interest on a private activity bond is taxable unless the bond is a "qualified private activity bond," which is a permitted type of financing for certain Congressionally-specified projects and programs.

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." Bonds basically are treated as governmental bonds if they avoid classification as private activity bonds, as defined in the Code, by limiting private business use and private business sources of payment or security, and also by limiting private loans.

In order for the interest on all State and local bonds, including governmental bonds, to be excluded from gross income (i.e., not taxed), 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 bond limitations.

Private Activity Bonds

In General

Under section 141 of the Code, bonds are classified as "private activity bonds" if more than 10% of the bond proceeds are both: (1) used for private business use (the "private business use test"); and (2) payable or secured from private business sources (the "private payments test") (together, the "private business tests"). Bonds also are treated as private activity bonds if more than the lesser of $5 million or 5% of the bond proceeds are used to finance private loans, including business and consumer loans. The permitted private business thresholds are reduced from 10% to 5% for certain unrelated or disproportionate private business uses. These tests are intended to identify arrangements that have the potential to transfer the benefits of tax-exempt financing to nongovernmental persons.

Under the private activity bond definition, bonds are not classified as private activity bonds unless the bonds meet both prongs of the private business tests (i.e., both the private business use test and the private payments test). Thus, even if bonds finance a project that is 100%-used for private business use, that private business use will not cause the bonds to be treated as private activity bonds absent sufficient private payments or security to meet the private payments test. For example, a State or local government may issue tax-exempt governmental bonds (which are not classified as impermissible private activity bonds) to finance a stadium that a private professional sports team uses, provided that the issuer receives no private payments from the team or other payments that in the aggregate exceed the private payments test (i.e., 10%). Instead, in these circumstances, the issuer may subsidize this financing by paying the debt service on the bonds with its general governmental funds or generally applicable taxes, which are not treated as private payments.

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. 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, (18) qualified redevelopment bonds, (19) qualified

501(c)(3) bonds for the exempt charitable and educational activities of Section 501(c)(3) nonprofit organizations, (20) certain projects in the New York Liberty Zone, and (21) 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 bond limitations. Most qualified private activity bonds are also subject to a number of additional rules and limitations, including the volume cap limitation under section 146 of the Code.

Unlike the tax exemption for governmental bonds, the tax exemption for interest on most qualified private activity bonds is generally treated as an alternative minimum tax ("AMT") preference item, meaning that the tax preference, or benefit, for these bonds can be taken away by the AMT.

The current private activity bond regime was enacted as part of the Tax Reform Act of 1986 and was designed 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. Prior to enactment of this regime, States and municipalities were subject to the rules for "industrial development bonds," which had more liberal rules as to when tax-exempt bonds could be used for the benefit of private parties. The list of eligible projects and programs for qualified private activity bonds has changed over time and has become more restrictive in certain cases. Prior to the Tax Reform Act of 1986, stadiums and convention centers were on the list of eligible facilities that could be financed with tax-exempt private activity bonds. In 1986, Congress eliminated these projects from the list and at the same time tightened the private activity bond tests.

The Private Business Use Test

The private business use test is met if a private business uses more than 10% of the proceeds of an issue. Private business use generally arises when a private business has legal rights to use the bond-financed property. These legal rights to use bond-financed property that trigger private business use include cases in which a private business owns, leases, manages, enters into an output contract, or enters into certain research agreements or other comparable arrangements that convey special legal entitlements to the financed property.

There are a number of exceptions and safe harbors with respect to the private business use test that allow limited private business use of bond-financed property in prescribed circumstances. For example, certain short-term contracts do not result in private business use. In addition, safe harbors are available under which management contracts or research agreements that meet certain requirements will not give rise to private business use. This means that, by meeting these safe harbors, a State or local government may hire a private business to manage its courthouse restaurant without causing private business use.

The Private Payments Test

The private payments test considers the source of payment on, or nature of the security for, the debt service on a bond issue. In particular, the private payment portion of the test takes into account the payment of debt service that is directly or indirectly derived from payments with respect to property used by a private business. For example, if a private business pays rent for its use of the bond-financed property, the rent payments can give rise to private payments. Just like the private business use test, there are exceptions to the private payments test.

The Generally Applicable Taxes Exception to the Private Payments Test

One exception to the private payments test applies to payments from generally applicable taxes. Congress indicated in the legislative history of the Tax Reform Act of 1986 that revenues from generally applicable taxes should not be treated as private payments for purposes of the private payments test.

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 which has a generally applicable manner of determination and collection.

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. For example, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

In addition, under an exception to the private payments test, the Treasury Regulations treat certain “payments in lieu of taxes” and other tax equivalency payments (“PILOTs”) that closely resemble generally applicable taxes in the same manner as generally applicable taxes. 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 example, 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 payment 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.

Stadium and Similar Financings

As I previously mentioned, the Tax Reform Act of 1986 eliminated the ability to finance stadiums and convention centers, among other facilities, with tax-exempt private activity bonds. As a result, and recognizing that use of stadiums or arenas by a professional sports franchises generally will result in private business use outside any of the safe harbors, State and local governments seeking to finance stadiums intended for such private business use are constrained to issue tax-exempt *governmental* bonds and to subsidize the repayment of those bonds from governmental sources of funds, including generally applicable taxes, in order to fail the private payments test and thereby qualify the bonds as tax-exempt. In layman's terms, this generally means that, for a facility that will be used for private business use, such as a stadium, a State or local government may only issue tax-exempt governmental bonds to finance that facility if it funds the use of the facility with governmental revenues and does not require the private business user, such as a professional sports team, to pay for the use of the facility. The result is that State and local governments now must finance stadiums and similar facilities to be used for private business use by paying debt service on the bonds from governmental sources of payment, including 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 general tax to pay debt service on tax-exempt governmental bonds to finance a stadium, and thus enable the bond issue to avoid being a private activity bond. This is the case even though a professional sports team uses the stadium for its contests.

Similar financing structures may be used for hotels and convention centers that involve otherwise impermissible private business use of bond proceeds. As with stadiums, in these cases, if the State or local government uses governmental sources of funds such as generally applicable taxes to pay the debt service on the governmental bonds used to finance the project, the interest on the bonds will be exempt from tax.

Recent Private Letter Rulings and Proposed Regulations

Difficult interpretative issues arise when a payment purporting to be a generally applicable tax is imposed in a customized fashion on a private business that uses bond-financed property. In these cases, the Office of Chief Counsel must decide whether a payment is a generally applicable tax within the exception from the private payments test, or is instead more like a lease, rent or other payment that Congress intended us to treat as an impermissible private payment under the private payments test. This line becomes particularly difficult to draw when the tax is abated through negotiations or is a PILOT that is specifically crafted for the transaction and essentially results in debt service being fully paid by the private business.

This past July, the Office of Chief Counsel issued two favorable Private Letter Rulings on tax-exempt governmental bond financings for stadiums. The facts in these rulings involved professional teams that were going to use the stadiums, so the private business use test was met. The question presented in the rulings was whether payments to be made by the teams and to be used for debt service on the bonds would constitute PILOTs treated as generally applicable taxes or private payments.

The payments were structured to qualify as PILOTs under State and local law but were set at a fixed amount by agreement between the team and the local government. The fixed amount was expected to exceed the debt service on the bonds, but was not permitted to exceed the amount of property taxes that would be imposed upon the stadium if the stadium were subject to tax. Although we had a concern about whether the PILOTs at issue sufficiently resembled generally applicable taxes, we nevertheless concluded that the existing Treasury Regulations supported a favorable response to the taxpayers. These private letter rulings served to focus our attention on how broadly the existing regulations could be interpreted to permit PILOTs to be used to pay debt service on tax-exempt bonds in situations where the PILOTs bear an insufficient link to the otherwise generally applicable tax, and in fact closely resemble the expected debt service on the bonds.

To address these concerns, in October 2006 the Treasury and the IRS published Proposed Regulations to provide rules explaining when PILOTs would be considered to be commensurate with generally applicable taxes. The basic purpose of these Proposed Regulations was to modify the standards for the treatment of PILOTs as generally applicable taxes to better assure a reasonably close relationship between eligible PILOT payments and generally applicable taxes.

Under the Proposed Regulations, a payment is commensurate 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 on an issue or is otherwise set at a fixed dollar amount that cannot vary with the assessed value of the property. The Office of Chief Counsel and Treasury are in the process of reviewing the public comments on the Proposed Regulations regarding the treatment of PILOTs.

Certain Eligible Issuers of Tax-Exempt Bonds on Behalf of State and Local Governments

Generally, tax-exempt bonds are issued by a State or local government, or any political subdivision thereof. A political subdivision is a division of any state or local government, which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit (generally police, eminent domain and/or taxing powers) (e.g., a city or county).

In addition, other eligible issuers of tax-exempt bonds include entities that issue bonds "on behalf of" a State or local governments or political subdivisions. There are two types of "on behalf of" entities--a constituted authority and a so-called "63-20 corporation." The requirements for both of these entities are very similar.

A constituted authority is a public governmental-type entity formed under state law to issue bonds for a governmental unit for a public purpose. For example, the IRS issued a revenue ruling under which an industrial development board was authorized by state law to promote industry and develop trade. In furtherance of these purposes, the board was authorized to issue bonds. The ruling concludes that the board issued bonds on behalf of a political subdivision, based on the following criteria:

1) The issuance of the bonds was authorized by a specific state statute;
2) The bond issuance had a public purpose;
3) The board was controlled by the political subdivision;
4) The board had the power to acquire, lease, and sell the property and issue bonds in furtherance of this purpose;
5) Earnings of the board could not inure to the benefit of private persons; and
6) Upon dissolution, title to the bond-financed property reverted to the political subdivision.

The criteria in this ruling have generally been looked to for determining whether other entities are considered to be constituted authorities.

A 63-20 corporation is a private non-profit corporation formed under general state nonprofit law that also issues bonds on behalf of a governmental unit. These entities are referred to as "63-20 corporations" after Revenue Ruling 63-20. A valid 63-20 corporation must meet the following requirements:

1) It must engage in activities that are essentially public in nature;
2) It must be organized under the general nonprofit laws of the state;
3) It cannot have any income that benefits or inures to any private person;
4) A governmental unit must have a beneficial interest in the corporation while the bonds are outstanding and must obtain full legal title to the facility when the debt is retired; and
5) The corporation and the specific obligations to be issued must be approved by the government.

We have checked rulings issued recently and believe that there is no instance where we in the Office of Chief Counsel have ruled favorably that tax-exempt bonds can be issued by a 63-20 corporation for the funding of a hotel. Having said that, we can make no representation regarding the existence or scope of any such transactions that may have been consummated without rulings from us.

Summary

Mr. Chairman, I hope my testimony this morning illuminates the IRS role in the issuance of tax-exempt bonds by State and local governments. The issues that I have discussed this morning are particularly complex.

It is important to remember that our role is to administer the tax laws and not to create or advocate policy. We do our very best to apply the laws the Congress passes in a fair and equitable manner consistent with Congressional intent. We recognize the importance of administering the tax law in this area in a manner to ensure appropriate targeting of this significant subsidy consistent with the statute and Congressional intent.

Thank you again for the opportunity to appear this morning and I look forward to answering any questions that you may have.