WRITTEN TESTIMONY
OF
STEPHEN LARSON
ASSOCIATE CHIEF COUNSEL
FINANCIAL INSTITUTIONS AND PRODUCTS
INTERNAL REVENUE SERVICE
BEFORE
DOMESTIC POLICY SUBCOMMITTEE
OVERSIGHT AND GOVERNMENT REFORM COMMITTEE

"THE STATE OF URBAN AMERICA AND THE USE OF TAX- EXEMPT BONDS"

Thursday, September 17, 2008
2154 Rayburn HOB
10:00 a.m.

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 Steve Larson, and I am the Associate Chief Counsel, Financial Institutions and Products for the Internal Revenue Service (IRS). The office of the Chief Counsel acts as 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. The Chief Counsel's office also provides legal guidance and interpretative advice to the IRS, Treasury Department, and the taxpaying public in general.

Before discussing the specific issues that are the focus of this hearing, it is important to emphasize two critical points. First, the IRS' mission is to oversee our nation's tax administration system. It does not develop tax policy proposals or take a position on them as part of the legislative process. Questions on tax policy issues are better addressed to the Treasury Department's Office of Tax Policy. In the tax policy area, the role of the IRS is limited to advising on the administrative issues that might arise from proposed tax legislation.

Second, in order to carry out its mission, taxpayer privacy is of critical importance. This is not just an internal mandate, but it is required by Section 6103 of the Internal Revenue Code (the Code), which prohibits the sharing of taxpayer information except in very limited circumstances identified in the Code. As a result, the IRS cannot respond to any question that could result in, or be perceived to result in, the sharing of confidential taxpayer information.

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 IRS recognizes 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 Code provisions and the Congressional intent in enacting those provisions of the Code.

This morning I will discuss private activity bonds, recent private letter rulings, and regulations that have been proposed to deal with issues associated with the issuance of tax exempt bonds.

Private Activity Bonds

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 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 percent of the bond proceeds are used to finance private loans, including business and consumer loans. These tests are intended to identify arrangements that have the potential to transfer the benefits of tax-exempt financing to non-governmental 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-percent for private business, 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 private payments that the issuer receives from the team or from other private businesses do not in the aggregate exceed the private payments test (i.e., 10 percent). 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.

The Private Business Use Test

The private business use test is met if a private business uses more than 10 percent 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.

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 that has a generally applicable manner of determination and collection.

Treasury Regulations provide that generally applicable taxes do not include "special charges" for special privileges granted or services rendered. Examples of special charges include payments for special privileges granted or regulatory functions (e.g., license fees), services rendered (e.g., sanitation fees), uses of property (e.g., rent), or special assessments to finance capital improvements that are imposed on a limited class of persons based on benefits received from the capital improvements financed with the assessments.

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.

Recent Private Letter Rulings and Proposed Regulations

Difficult interpretative issues arise when a payment is imposed in a customized fashion on a private business that uses bond-financed property. In these cases, the Office of Chief Counsel must determine 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 should be treated 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 crafted for the transaction and essentially results in debt service being fully paid by the private business.

In July of 2006, 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 would constitute 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. We 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 of 2006, the Treasury Department and the IRS published Proposed Regulations to clarify and to tighten the standard for determining 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. Accordingly, the Proposed Regulations would essentially eliminate the ability of a State or local government to set PILOTs at fixed amounts that do not fluctuate with changes in the underlying taxes on which the PILOT is based.

The Proposed Regulations further 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 Proposed Regulations also eliminate the sentence in the existing regulations that provides as an example of a special charge a PILOT paid in consideration for the use of property financed with tax-exempt bonds. This proposed change represents a technical clarification rather than a substantive change. A payment made "in consideration for the use of property" is more properly characterized as rent or an installment sale payment. Such a payment for the use of property is treated under the "special charge" limitation on generally applicable taxes. In addition, the reference to tax-exempt bond financing in this example caused confusion because the presence or absence of tax-exempt bond financing is irrelevant to the determination of whether a payment, in substance, is in the nature of a special charge for the use of property or a generally applicable tax.

The Office of Chief Counsel and Treasury Department have received numerous public comments on the Proposed Regulations. We have included the finalization of the Proposed Regulations on the 2008-2009 Priority Guidance Plan, which was released on September 10, 2008. We plan to issue final regulations soon on the treatment of PILOTs, with appropriate modifications based on the public comments received.

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. 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 will answer any questions that you may have.