



Memorandum

March 29, 2007

TO: House Oversight and Government Reform Committee
Attention: Jaron Bourke

FROM: Steven Maguire
Analyst in Public Finance
Government and Finance Division

SUBJECT: Public Purpose of Sports Stadiums for Purposes of the Private Activity Bond Security Test

This memorandum responds to your request for a discussion of two private letter rulings (PLRs) issued by the Internal Revenue Service in 2006.¹ The PLRs were requested by two professional sports teams regarding the use of payments in lieu of taxes (PILOTs) that would be used to repay bonds issued by a governmental agency. The bond proceeds would be used to construct a stadium for professional sports teams. The PLRs issued by the IRS ruled that the PILOTs

...are being used to pay the debt service on the Bonds which were issued specifically for the purpose of financing the stadium to promote and encourage economic development and recreational opportunities in the City.

In our phone conversation, you requested that I compare this ruling to the language in the explanation of the Tax Reform Act of 1986 (P.L. 99-514, the 1986 Act). This memorandum discusses whether the PLRs' conclusions are consistent with the policy expressed in the explanation and does not provide a legal analysis as to whether they are permissible interpretations of the law as written. The 1986 Act was intended, in part, to further restrict the issuance of tax-exempt bonds for private purposes. This assessment suggests that some commentators will maintain that the PLRs are at odds with the what JCT identified as a rationale behind the tax-exempt provisions included in the 1986 Act. Specifically, the JCT stated in the "Reasons for Change" section that:

Congress was concerned that, under prior law, a significant amount of bond proceeds from governmental issues was being used to *finance private activities* [emphasis added] not specifically authorized to receive tax-exempt financing. Abuses were noted whereby governmental bond issues were structured intentionally to maximize private use without

¹ All references to PLRs in this memo are to the following two PLRs: P.L.R. 200640001 (July 11, 2006) and P.L.R. 200641002 (July 19, 2006).

violating the 25-percent private use limit of prior law. Other bond issues *were intentionally structured to “fail” the prior-law IDB security interest test* [emphasis added], when the bonds otherwise would be considered IDBs or would not qualify for tax-exemption.²

A full discussion requires a brief description of the somewhat complicated rules governing tax-exempt bonds used for private activities. For this case in particular, the critical element of current law appears to be the application of the “two-part” test, which the 1986 Act made more restrictive. Following is a brief description of the “two-part” test and how it was interpreted in the two PLRs at issue.

The two professional sports teams, reportedly the New York Yankees and the New York Metropolitanans, asked for the ruling because bonds issued for private activities, such as sports stadiums, are taxable if they “pass” both elements two-part test. Bonds are *private activity bonds* and **not** tax-exempt if both of the following conditions are met:³

- [use test] more than 10% of the proceeds of the issue are to be used for any *private business use*,... [and]
- [security test] if the payment on the principal of, or the interest on, more than 10% of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly secured by any interest in (1) property used or to be used for a private business use, or (2) payments in respect to such property. Or [if the payment is] to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Professional sports stadiums would likely pass the use test as the primary use is professional sporting events. The teams conceded that the project passed the first test and were concerned that the PILOTs used to retire the bonds could be held to violate the security test, thus making the bonds taxable. According to the PLRs, however, PILOTs would be acceptable (meaning they would *not* be considered secured by the property) under existing Treasury regulations if they simply substituted for “generally applicable taxes,” e.g., property taxes.⁴ Specifically, the PLRs state that current Treasury regulations provide that PILOTs could be considered generally applicable taxes if

- (i) they are commensurate with and not greater than the amounts imposed by a statute for a tax of general application and (ii) they *are designated for a public purpose* [emphasis added] and do not constitute a special charge.

To satisfy part (i), the PLRs interpret “commensurate” such that the structure of the PILOTs are acceptable. Some could and will likely argue that the PILOTs are not “commensurate” with existing property taxes on all other City property.

² U.S. Congress, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st sess. (Washington: GPO, 1987), p. 1152.

³ 26 U.S.C. 141(b)

⁴ 26 C.F.R. 1.141-4(e)(5).

To satisfy part (ii), the requirement that PILOTs are designated for *public purpose*, the PLRs rely on the stated purpose that the payments are for “economic development and recreational opportunities in the City” that would be generated by using the PILOTs to retire the bonds used to build professional sports stadiums. Aside from the extensive academic literature maintaining that stadiums do not generate economic development, commentators might challenge the implicit expansion of “public purpose” to include not only the facility itself, but any activity indirectly associated with the facility.⁵ An argument might be made that the conclusions in the PLRs are at odds with the intent of Congress to reign in the expanding use of tax-exempt bonds for private activities. Enacted tax-exempt bond legislation, beginning with the Revenue and Expenditure Control Act of 1968 (P.L. 90-364) and culminating in the 1986 Act, have sought to curb the use of federally subsidized public debt for what would otherwise be considered private activity.

The JCT identified the following specific concerns about tax-exempt bonds issued for private activities:⁶

- the bonds represent “an inefficient allocation of capital”;
- the bonds “increase the cost of financing traditional governmental activities”;
- the bonds allow “higher-income persons to avoid taxes by means of tax-exempt investments”;
- and
- the bonds contribute to “mounting [federal] revenue losses.”

The inefficient allocation of capital contention arises from the economic finding that additional investment in tax-favored private activities will necessarily come from investment in other public projects. For example, if bonds issued for mass commuting facilities did not receive special tax treatment, the bond funds could be used for other government projects such as schools or other public infrastructure.

The greater volume of tax-exempt private activity bonds then leads to the second Joint Committee on Taxation concern, a higher cost of financing traditional government activities. Investors have limited resources, thus, when the supply of tax-exempt bond investments increases, issuers must raise interest rates to lure them into investing in competing government activities. In economic terms, issuers raising interest rates to attract investors is analogous to a retailer lowering prices to attract customers.

The final two points are less important from an economic efficiency perspective but do cause some to question the efficacy of using tax-exempt bonds to deliver a federal subsidy. Tax-exempt interest is worth more to taxpayers in higher brackets, thus, the tax benefit flows to higher income taxpayers, which leads to a less progressive income tax regime.

The revenue loss generated by tax-exempt bonds also expands the deficit (or shrinks the surplus). A persistent budget deficit ultimately leads to higher interest rates as the

⁵ For one review of the literature surrounding the debate over the economic development spurred by professional sports stadiums, see Roger G. Noll and Andrew Zimbalist, *Sports, Jobs and Taxes: The Economic Impact of Sports Teams and Stadiums* (Washington D.C: Brookings Institutions Press, 1997).

⁶ U.S. Congress, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st sess. (Washington: GPO, 1987), p. 1151.

government competes with private entities for scarce investment dollars. Higher interest rates further increase the cost of all debt financed state and local government projects.

Supporters of tax-exempt bonds for private activities counter that the benefit from tax-exempt bonds exceeds both the explicit (the revenue loss) and implicit (the inefficient allocation of capital) costs of the tax-exemption.

If you have any questions about this memorandum or tax-exempt bonds more generally, please call me on extension 7-7841 or e-mail me at smaguire@crs.loc.gov.