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TAX POLICY

Tax-Exempt Status of Certain Bonds Merits Reconsideration, and Apparent Noncompliance with Issuance Cost Limitations Should Be Addressed

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Highlights

Highlights of GAO-08-364, a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

The outstanding amount of state and local government tax-exempt bonds has increased over the years. Congress is interested in whether the bonds are used for appropriate purposes since the federal government forgoes billions in tax revenues annually by excluding the bonds' interest from investors' federal gross income. Questions also exist over the bonds' borrowing costs as they can divert funds from the funded projects.

This report (1) describes recent trends in tax exempt bonds, (2) provides information on the types of facilities financed with tax-exempt bonds, and (3) discusses borrowing costs considering the methods of selling bonds and compares issuance costs paid from bond proceeds for governmental and qualified private activity bonds. In addition to interviewing relevant officials, we analyzed IRS's Statistics of Income (SOI) data and data from Thomson Financial to address these objectives.

What GAO Recommends

Congress should consider whether facilities, including hotels and golf courses, that are privately used should be financed with tax-exempt governmental bonds. GAO also recommends that IRS clarify how bond issuers report issuance costs and develop methods to detect and address apparent noncompliance with limits on using bond proceeds for issuance costs.

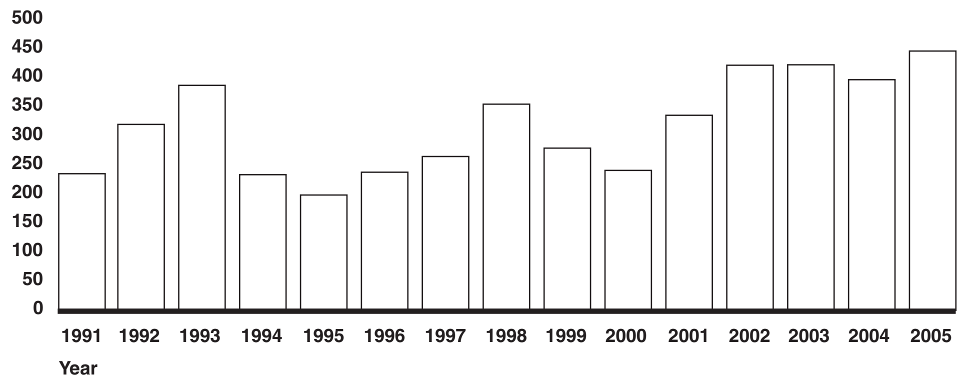
In response, the Acting IRS Commissioner agreed with our recommendations and outlined the actions IRS would take.

To view the full product, including the scope and methodology, click on GAO-08-364. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

In recent years, the volume of tax-exempt bonds issued annually for both governmental and private activity bonds has reached historically high levels. Generally, the volume of new money bond issues has been greater than bonds issued for refunding purposes. The volume of tax-exempt bonds issued, particularly bonds issued for refunding, tends to be highest when interest rates decline. Because the interest earned by investors who purchase tax bonds is generally excluded from federal income taxes, the federal revenue losses amount to billions of dollars annually.

Total Dollar Amount of All Long-term, Tax-Exempt Bonds Issued Annually, 1991 through 2005
Dollars in billions (constant 2007 dollars)



Source: GAO analysis of IRS's Statistics of Income Division data.

Note: Amounts include governmental and qualified private activity bonds for new money and refunding bonds. Calendar year 2005 is the most recent available IRS data.

Tax-exempt governmental and private activity bonds are used to finance a wide range of projects and activities, with bonds issued for "educational purposes" generally being the largest category of governmental bonds annually. Nonprofit organizations are the largest issuers of qualified private activity bonds. Previous legislation prohibited using qualified private activity bonds for certain facilities, including professional sports stadiums, hotels, and private golf courses. However, many of these types of facilities are still being financed with tax-exempt governmental bonds. Congress has held hearings on this issue primarily focusing on sports stadiums.

Although the evidence is not definitive, studies have generally shown that interest costs are lower for bonds sold when competition between underwriters exists compared to when bond sales are negotiated with underwriters after controlling for other factors. About half of all issuers of qualified private activity bonds reported paying issuance costs from bond proceeds from 2002 to 2005. IRS's guidance does not indicate what to report when no issuance costs are paid from bond proceeds. Of those reporting issuance costs, some private activity bond issuers reported paying issuance costs from bond proceeds that exceed statutory limits.