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March 1, 2005

The Honorable Charles Grassley
Chairman
Senate Finance Committee
The United States Senate
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Senate Finance Committee
The United States Senate
Washington, DC 20510

Dear Chairman Grassley and Ranking Member Baucus:

The Bond Market Association is pleased to provide the following comments on certain proposals in the Joint Committee on Taxation's recent report to the Senate Finance Committee, *Options to Improve Tax Compliance and Reform Tax Expenditure*. The report identified dozens of changes to the U.S. Tax Code (the "Code") estimated to generate new tax revenue for the federal government. The Association has identified eight of these provisions as having a significantly negative effect on the market for tax-exempt municipal bonds. If these provisions were to be enacted, the result would range from an increase in the cost of capital for the state and local governments who issue municipal bonds to a limiting effect on the ability of some states and localities to carry out their stated mission. The Bond Market Association opposes all of the proposals which, for reasons we articulate below, represent bad public policy.

Background on the Municipal Bond Market

Municipal bond issuance by American cities dates to the 1700s. In 1812, New York City issued the first publicly recorded municipal bond to finance the construction of a canal. Recorded issuance grew in the years that followed. In 1843, U.S. cities had issued a total of \$25 million to finance mainly transportation infrastructure. It was not until 1913, however, that the tax-exempt status was conferred on municipal bonds with the creation of the federal income tax. Municipal bond yields immediately fell in relation to corporate bonds as investors recognized the economic advantage of owning tax-exempt securities.

Congress has made numerous changes to the Code since 1913—including the Tax Reform Act of 1986 (TRA) that imposed new restrictions on the market—but the tax exemption has remained intact. One of the principal reasons Congress has maintained the

special status of municipal bonds is the role they play in financing public projects. These include schools, roads, hospitals, government buildings, low-income housing and many more. In short, tax-exempt municipal bonds represent an efficient means of conferring federal assistance on state and local capital investment.

The decisions regarding which project to fund with municipal bonds are appropriately made at the state or local level and often by voters themselves through referenda or by a political body—a state legislature or city council. In making the determination to issue municipal bonds, governments typically analyze other funding options such as raising fees or taxes. The process provides a political test that judges the importance of the project to the community. This is a solely local consideration that does not rely on input from or the approval of the federal government. In addition, all municipal bond offerings face a market test. Issuers are subject to the scrutiny of professional investors and credit rating agencies that review offering disclosure and verify the obligation is backed by sufficient taxing power or revenues.

The Tax Code changes proposed in the JCT report would all, in one way or another, mitigate the fundamental strengths of the municipal bond market. The Association's detailed objections to each proposal are discussed below.

1. Disallow Deduction for Interest on Debt Allocable to Tax-Exempt Bonds

Individuals and most corporations are denied a deduction for any interest expense on “indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt” from federal income taxation.¹ For banks and securities firms, the rules governing interest expense and tax-exempt bonds are particularly strict. Banks and securities firms lose a portion of their interest expense deduction for every dollar of tax-exempt interest they earn. In order to help small communities that sometimes have a particularly hard time accessing the capital markets, banks may purchase bonds issued by entities who borrow less than \$10 million per year in tax-exempt municipal bonds without penalty. This is known as the small issuer exemption.

Corporations other than banks and securities firms must demonstrate their tax-exempt holdings are not tied to borrowing in order to claim the interest income tax free. This is known as the tracing rule. Because of corporations' complex borrowing patterns, the IRS in 1972 promulgated Revenue Procedure 72-18, which contains the 2 percent *de minimis* rule as a safe harbor from the tracing rule. The *de minimis* rule provides that as long as a corporation's tax-exempt bond portfolio does not exceed 2 percent of its total assets, the IRS generally will not inquire whether any of the borrowings of the investor were incurred for the purpose of purchasing or carrying municipals. It is important to note that the 2 percent rule does not provide corporations with immunity from the

¹ Internal Revenue Code of 1986 as amended, §265(a).

restrictions on borrowing to finance tax-exempt holdings. The deduction of interest expense on debt incurred for the true purpose of investing in municipal securities is prohibited even under Rev. Proc. 72-18. Rather, the real goal of the *de minimis* rule is to protect corporate investors from unreasonable levels of proof of lack of intent by accountants and IRS auditors and to simplify compliance. It is for this reason that most non-financial corporations scrupulously observe the *de minimis* rule, even when they can conclusively show that a borrowing was not incurred for the purpose of purchasing or carrying municipals.

JCT Proposal

The JCT report proposes to apply the *pro rata* interest expense disallowance associated with buying or holding tax-exempt bonds currently applicable to broker-dealers and financial institutions to all corporations. The small-issuer exemption for financial institutions would not be available to other corporations. The *pro rata* disallowance would be applied to all members of the same affiliated group as the entity earning tax-exempt interest. Both the tracing rule and the 2-percent *de minimis* rule would be repealed. The proposal would apply to tax-exempt bonds acquired after the date of enactment.

Tax Policy Concerns

The JCT report argues the 2 percent *de minimis* rule provides opportunities for tax arbitrage, but there is no evidence to suggest that corporations are engaging in abusive, arbitrage-motivated transactions. Non-financial corporate holdings of municipal bonds as of the third quarter of 2004 were 0.38 percent of total financial assets and 0.23 percent of non-financial assets—levels that have remained consistent over time.² If corporations on a widespread basis were borrowing to finance tax-exempt holdings in order to take advantage of the simplification provided by the 2 percent rule, these levels would be much higher.

Effects on Corporate Investment Decisions

The proposal would affect corporate decisions to invest in municipals in two ways. First, as the JCT report acknowledges, many corporations with debt outstanding would simply stop buying municipal bonds due to the complexity of the computations and additional compliance costs. Second, among those companies willing to wade through the complexity of the *pro rata* disallowance provision, corporations whose debt capitalization ratio exceeds the level where investment in municipals makes sense would also stop buying municipal bonds.

² Figures are taken from the Federal Reserve Board's *Flow of Funds* (November 2004).

For those corporations that have no debt outstanding — and there are a small number of corporations that invest short-term cash in municipals but which incur no debt — the proposal would have no effect on their investment behavior, for the obvious reason that restrictions on the deductibility of interest expense would not apply to them. For the vast majority of corporations, however, the proposal would dramatically change investment behavior. Many corporations would simply avoid the municipal market altogether on the reasonable grounds that computing the interest expense disallowance would not be worth the trouble.

Under current law, for any corporation that observes the 2 percent *de minimis* rule, the “break-even tax-exempt/taxable yield ratio”—the ratio of tax-exempt yields to taxable yields at which the investor is indifferent between owning a municipal bond or a taxable bond—is one minus the tax rate, or 65 percent. The administration’s proposal would change the break-even tax-exempt/taxable yield ratio at which a corporation would be induced to purchase municipal bonds. Under the proposal, the break even ratio would be a function of a corporation’s total debt to its total capitalization. The higher a company’s debt to total capitalization, the higher municipal yields would have to move relative to taxable yields to induce the corporation’s investment in the municipal market. Thus, for a corporation with debt equal to 25 percent of its total capitalization, municipal interest rates would have to rise to 73.8 percent of taxable rates. For a company with 50 percent debt, the break-even yield ratio would have to rise to 82.5 percent. More generally, any time that tax-exempt rates equaled the break even ratio for a particular corporate investor, the corporation’s after-tax return on its municipal investment would exactly equal its comparable after-tax return on a taxable investment. However, at the break even level, the corporation is, in effect, merely raising the tax-exempt interest rate to a level necessary to compensate it for the interest expense deduction disallowance.

Effects on Specific Classes of Corporate Investors

Non-financial Corporate Businesses

Non-financial corporations directly hold approximately \$45³ billion in municipal securities, both directly and through mutual and money-market funds. Most non-financial corporate investment in the municipal market is in very short-term securities with maturities of less than one year and in variable-rate municipal bonds whose cash flows are designed to mimic short-term securities. These investors purchase short-term municipal securities if the short-term tax-exempt rates are equal to or greater than 65 percent of comparable taxable rates.

The importance of corporations in the short-term municipal market extends beyond their share of total holdings, however. They are, in effect, buyers of last resort that prevent excessive interest rate volatility. At certain times of the year such as the

³ *ibid.*

weeks preceding federal tax payment due dates, tax-exempt money-market funds tend to sell large blocks of securities to meet shareholder redemptions. Short-term tax-exempt interest rates tend to rise, inducing corporations that have excess cash available to purchase the municipal paper. Thus, corporations are a major force in helping to keep short-term tax-exempt rates stable. In their absence, short-term tax-exempt rates may have to rise in times when other short-term investors are net sellers. It is due almost entirely to corporate participation in the short-term municipal market that the tax-exempt/taxable yield ratio for shorter maturities has historically remained stable at 64-66 percent while the ratio for longer maturities is much more volatile. (This ratio has crept higher in recent years solely because of unusually low short-term interest rates. As short-term rates rise, the ratio is beginning to drop again.) Non-financial corporations would not be major buyers of short-term municipals in the future under the proposal.

In recent years, market participants have created a new instrument, tender option bonds (TOB), that broaden the market for long-term municipal bonds by converting them into variable-rate securities favored by corporate investors. TOBs help address a mismatch in the tax-exempt bond market between the supply and demand for liquid, variable rate securities. Municipalities favor issuing long-term fixed-rate bonds because they typically finance long-term assets such as bridges, roads and schools. In a TOB transaction, a market participant buys a quantity of fixed-rate municipal bonds and deposits them into a trust in exchange for interests in the trust. The trust interests pay interest at a variable rate and typically include a liquidity feature, i.e., they can be sold back to a dealer or other buyer at par on a periodic basis. By better matching the needs of issuers with investors, TOBs help keep borrowing costs low for state and local governments. TOBs permit them to issue longer term and still meet the short-term investing needs of corporations who are so critical to an efficient market. The \$50 billion TOB market is particularly effective at reducing volatility and increasing liquidity for fixed-rate municipal bonds with maturities in the range of ten years, which are typically issues to fund a wide variety of traditional public investment. By limiting corporate demand for TOBs, the JCT proposal would not only raise the cost of short-term borrowing, but long-term financing as well.

Government-sponsored Enterprises

Together, Fannie Mae, Freddie Mac, Sallie Mae and other government agencies hold about \$48 billion of outstanding municipals. These entities invest primarily in state and local housing bonds (Fannie Mae and Freddie Mac) and student loan bonds (Sallie Mae). Given the highly leveraged nature of their balance sheets—Fannie Mae's debt to total capitalization ratio is about 98 percent—their break even tax-exempt/taxable yield ratio would be over 98 percent. They would simply stop buying municipals under the proposal. Fannie Mae and Freddie Mac purchase approximately 40 percent of all housing bonds, principally maturities of 20 years and longer. Rates for those longer maturities would increase substantially if Fannie Mae and Freddie Mac were not purchasers.

‘Fiduciary’ Municipal Investors

Some companies participate in the municipal market as “fiduciary” investors who essentially hold municipal securities on behalf of others. These investors include, for example, travelers’ check and money order companies. These companies are required by state law to hold reserves against the entire amount of their liabilities. Their permitted investments are restricted, but generally include most municipal securities. Consequently, these corporations invest heavily in the municipal market. They are not burdened by current-law restrictions on corporate investment since it is clear that their municipal holdings are not financed with borrowed funds. However, under the “affiliated companies” provision of the JCT proposal, these companies, most of which file consolidated tax returns with corporations that do borrow and incur interest expense, would divest much of their municipal bond portfolio.

Effect on Municipal Borrowing Costs

A loss of such a substantial source of demand in the municipal market will inevitably cause borrowing rates to rise for states and localities throughout the country. The market, to an even greater degree than it is today, would become a market of individuals—acting directly or through intermediaries such as mutual funds. State and local governments would become captive to individual investor sentiment and fund flows. Thus, municipal rates would become much more volatile and would remain substantially higher than under current law. Specifically, short-term rates would be more volatile, particularly when, for seasonal reasons, individuals are net sellers of municipals. Because of the rise of tender-option programs in recent years—and the result that by buying tender-option securities, corporations are now a source of indirect demand for longer-term, fixed-rate tax-exempt bonds—the effect of the loss of corporate demand would be felt outside the short-term and variable-rate sector. Housing and student loan bond rates would also increase significantly with the loss of demand from Fannie Mae, Freddie Mac and Sallie Mae.

While nominally a proposal to amend the taxation of corporations, virtually all the tax burden imposed by the JCT proposal would be borne by state and local government, not corporate taxpayers. Corporate investors in the municipal market would pass on to state and local bond issuers 100 percent of the costs imposed by the proposal. In effect, the proposal represents a tax on municipal bond interest that state and local governments would pay in the form of higher borrowing rates. In reality, the “tax” imposed on the municipalities would be much higher than the revenue collected by the federal government. Municipal investors not directly affected by the proposal would earn higher rates of return—at a greater cost to the Treasury—than if corporations were allowed to invest in the municipal market without the fear of the economic penalty.

The additional reliance on individual investors brought about by the loss of corporate demand for tax-exempt securities would increase distribution and selling costs

for bond underwriters since these bonds would have to be marketed much more aggressively in the absence of corporate buyers. Such costs would ultimately be borne by state and local bond issuers.

Any time an investor is denied an otherwise legitimate deduction as a result of the receipt of tax-exempt income, the denial of the deduction is, in effect, a tax on the tax-exempt interest. The tax eventually must be reflected in increased borrowing costs of state and local governments.

2. Disallow Deduction for Interest Debt Allocable Tax-Exempt Income of P&Cs

Property and casualty insurance companies (P&Cs) are permitted a deduction for contributions to loss reserves. This deduction is reduced, however, by an amount equal to 15 percent of their “proration income,” which includes tax-exempt bond interest. Under this rule, P&Cs lose 15 cents of an otherwise allowable deduction for every dollar of tax-exempt interest they earn. Assuming a federal income tax rate of 35 percent, the deduction limitation amounts to a 5.25 percent tax on tax-exempt income earned by P&Cs.

The JCT proposal would apply to P&Cs the *pro rata* interest expense disallowance currently applicable to banks and broker-dealers in lieu of the current 15 percent proration rule. The *pro rata* disallowance would be applied with respect to all tax-exempt interest, the deductible portion of dividends received and the annual increase in the cash value of life insurance, annuity and related products.

Tax Policy Concerns

P&C holdings of tax-exempt securities are funded entirely from loss reserves. No portion of their investment in the municipal market is financed, directly or indirectly, through borrowing. There is simply no evidence that tax arbitrage brought about by borrowing takes place with respect to P&Cs, including none cited in the JCT report. P&Cs are highly regulated corporations whose balance sheets must contain specified levels of high-quality capital to satisfy regulatory capital guidelines set by state insurance commissioners. Generally, the state regulators apply the standardized guidance provided by the National Association of Insurance Commissioners (NAIC), and under these rules P&Cs’ face a higher capital charge for leveraging their loss reserve portfolios. The P&C business model also discourages debt. P&Cs invest premiums to build reserves that will eventually be used to pay claims. Borrowing would effectively use one liability to offset another and is not a sustainable business practice. Of the 3,000 P&C companies in the NAIC database, only 100 companies had debts totaling \$2.2 billion compared to an industry capitalization of \$360 billion. Tax arbitrage opportunities with tax-exempt interest do not exist if there is no interest deduction to begin with.

The regulated nature of P&Cs also negates the JCT argument that subjecting them to the *pro rata* rules would provide uniformity among all corporate purchasers of tax-exempt bonds. P&C are unique among such municipal bond purchasers and deserve unique treatment under the Code. Moreover, in its report, the JCT argues that P&C purchases of municipals using loss reserves, contributions to which are partially deductible, is problematic. The JCT proposed restriction, however, relates not to deductions for contributions to loss reserves, but to interest expense deductions related to borrowing. It is unclear how the *pro rata* interest expense proposal relates to so-called “tax arbitrage” associated with loss reserves.

P&Cs are the single largest corporate investors in municipal bonds. Creating a disincentive to continue investing in tax-exempt securities would have an effect on the P&C demand similar to that discussed under the previous proposal. P&Cs held \$246 billion, or 12 percent, of outstanding municipal securities at the end of 2004. Their holdings are not concentrated among short-term and variable-rate securities, as with general corporations. P&Cs tend to buy long-term, fixed-rate municipal bonds, the types of securities most directly associated with the most basic state and local investment in assets like public schools, transportation, water and sewer systems and other basic, public infrastructure. Inhibiting such a large source of demand would cause borrowing rates in the municipal market to rise. The cost of borrowing for state and local governments, as a result, would also rise as investors would demand a higher yield premium.

3. Eliminate Advance Refunding of Governmental Bonds and 501(c)(3) Bonds

JCT Proposal

The JCT report proposes to eliminate the ability of governmental and 501(c)(3) tax-exempt bond issuers to “advance refund” outstanding bonds in order to save debt service costs when interest rates fall. This proposal would eliminate a powerful financial management tool that state and local governments use to minimize financing costs for their taxpayers and free up debt capacity for additional borrowing.

Background

When interest rates fall, it is common for homeowners to refinance their home mortgages in order to save on interest costs. During the historically low interest rate environment of the past several years, mortgage refinancings have put billions of dollars of interest savings into the pockets of homeowners and have made a significant contribution to the nation’s economic recovery from the recession of 2001. In much the same way that homeowners refinance mortgages, state and local governments commonly refinance, or refund, their outstanding debt in order to save on interest expense for taxpayers.

The problem faced by state and local governments is that unlike home mortgages, most tax-exempt bonds may not be paid off at any time at the option of the borrower. Most tax-exempt bonds include a “call provision” which allows them to be redeemed early only after a specified period of time. If interest rates fall before that period has expired, the only way states and localities can take advantage of the lower rates is through an advance refunding. In an advance refunding, a state or local government issues new, lower-interest rate bonds before the old, higher interest rate bonds are callable, or before they can be redeemed. The proceeds of the new bonds are then placed in an escrow account. The escrow is used to pay the interest payments on the old, higher-rate bonds and to redeem the old bonds when they become callable. The ability to advance refund outstanding bonds has saved state and local governments billions of dollars in recent years by taking advantage of historically low interest rates to reduce debt service expenses. This savings, in turn, has become available to help pay for investment in vital new infrastructure such as schools, roads, water and sewer systems, mass transit facilities, hospitals and other projects.

Advance refundings can also be used in other ways. For example, it is sometimes the case that due to legal, economic or financial changes in a tax-exempt bond-financed project, the state or local government needs to revise the bond indenture—the contract governing the terms of the outstanding bond. In most cases, the only way to revise an indenture is to refund the outstanding bond with a new bond that has different terms, and in many cases this requires an advance refunding.

Tax Policy Concerns

The problem with advance refundings for the federal government, as the JCT report recognizes, is that for some period of time—while the proceeds of the refunding bonds are in escrow until the call date on the old bonds—there are two bond issues outstanding for the original project. In order to minimize the cost to the federal government, Congress and the IRS have imposed significant restrictions on advance refundings. These restrictions help ensure that advance refundings are as efficient as possible.

First, in TRA, Congress restricted the number of advance refundings for governmental and 501(c)(3) bonds and entirely eliminated the ability to advance refund private-activity bonds. This restriction, while significantly limiting the flexibility of state and local governments, represented a compromise between the debt management needs of states and localities and the fiscal concerns of the federal government.

Second, restrictions on the ability of state and local governments to earn arbitrage on the investment of bond proceeds include a provision known as the “transferred proceeds rule.” Arbitrage rules in general prohibit states and localities from investing the proceeds of any tax-exempt bond issue in materially higher yielding investments. The transferred proceeds rule stipulates that in an advance refunding, the yield limit for the

investment of the escrow is not the higher yielding bonds being refunded, but the lower yielding refunding bonds. This provision, although again limiting states and localities, helps minimize the federal cost of advance refundings.

Third, rules governing advance refundings mandate the old bonds being refunded must be redeemed at the first possible call date. This helps ensure that multiple bonds are outstanding for the shortest time possible.

In addition to these restrictions, advance refundings actually provide the federal government with a degree of financial benefit. It is almost always the case that escrows associated with advance refundings are invested in Treasury securities known as State and Local Government Series (SLGS). SLGS are special Treasury securities available only to state and local governments which are designed specifically for tax-exempt bond escrows. SLGS are structured so that their yield is at least five basis points (0.05 percentage point) lower than current yields on comparable marketable Treasury securities and in some cases, pay no interest at all. Every SLGS security issued actually saves the federal government at least five basis points on its borrowing rate versus market yields. As of December 31, 2004, there were \$161 billion of SLGS outstanding.

In two notable instances in recent years, members of Congress have recognized the importance of advance refundings to state and local governments. First, in 2002, Congress passed the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), legislation designed to provide financial assistance to New York City in recovering from the September 11, 2001 terrorist attacks. An important provision in this bill conferred on the city and certain other area bond issuers the ability to engage in a second advance refunding of some outstanding bonds. In adopting this provision, Congress recognized how vital it is for local governments to be able to refund outstanding debt to conserve taxpayer resources.

Second, lawmakers have introduced legislation to permit all state and local governments the ability to engage in a second advance refunding for all bonds originally issued for “essential government functions” in each of the past two Congresses. In the 106th Congress, S.1446 attracted 17 cosponsors from both parties. In the 108th Congress, S. 271 had a total of 28 cosponsors. The senators who cosponsored the bill recognized how much states and localities depend on advance refundings in their financial management.

In its report, the JCT criticizes advance refundings as an inefficient subsidy. Since the adoption of reduced tax rates on stock dividends and capital gains, however, tax-exempt bonds in general have actually become a much more efficient subsidy. In evaluating the tax expenditure associated with tax-exempt bonds, the traditional methodology has been to assume that every dollar of tax-exempt interest paid to investors displaced a dollar of taxable interest paid on a corporate bond and that the displaced taxable interest would have been taxed at a rate in the range of 30-35 percent. However,

the appropriate substitute investment for most tax-exempt bond investors is not taxable corporate bonds, but dividend-yielding preferred stock. Since 2003, stock dividends have been taxed not at a taxpayer's marginal rate, but at a reduced 15-percent rate. The reduction in the dividend tax rate and the predisposition of most tax-exempt bond investors towards investments with favorable tax treatment help improve the efficiency calculation for tax-exempt bonds in general, including advance refunding bonds.

The JCT also argues in its report that if state and local governments were prohibited from using advance refundings, they could simply issue bonds with little or no call protection—the period before bonds become callable and during which advance refundings take place—and use current refundings if interest rates fall. Given the nature of tax-exempt bond investors, however, this alternative would not be available to many issuers and to others would come at a very high cost. Bonds with little or no call protection impose a high degree of interest rate risk on investors. When bonds are called, investors' bonds are redeemed earlier than anticipated leaving them to invest their redeemed proceeds at lower prevailing yields. As compensation for this risk, investors would demand significantly higher yields on bonds they buy, which translates into higher interest costs for states and localities. In practice, if they lose the ability to advance refund their debt, states and localities would likely issue long-term bonds with no call options whatsoever. While this would lower the nominal rates state and local governments would pay on their borrowing, it would completely restrict any ability to refinance their debt at lower rates if interest rates fall. Again, the result would be higher costs for state and local governments and their citizens.

The JCT's proposal would result in significant new costs for states and localities and as a result, would reduce their ability to invest in new schools, roads and other vital infrastructure. For this reason, Congress should reject the proposal.

4. Require Allocation of Volume Cap to Mortgage Credit Certificates

Mortgage revenue bonds (MRB) are private-activity bonds issued by state housing finance agencies (HFAs) to fund mortgages for qualifying homebuyers. By statute, qualifying homebuyers must be low- and moderate-income earners as defined by the median income in a given area. Under the right interest rate conditions, the ability to issue tax-exempt debt permits HFAs to offer mortgages significantly below prevailing market rates. Under current law, HFAs also have the option to provide homebuyers with mortgage credit certificates (MCCs) as a form of assistance instead of below-market mortgages. MCCs permit qualified homeowners an annual federal income tax credit, limited in some circumstances to \$2,000,⁴ to subsidize the cost of conventional (non-MRB) mortgage loans.

Under the JCT proposal, HFAs would be required to allocate private-activity

⁴ The \$2,000 limit applies only if the credit rate specified in the certificate exceeds 20 percent. See IRC §25(a)(2).

volume cap to MCCs in an amount which would permit issuance of one dollar of MCCs for each four dollars of MRBs issued. Since MCCs may be issued in amounts up to 25 percent of the amount of allocated volume cap, the proposal would, in effect, require allocation of one dollar of volume cap to MCCs for every one dollar of MRBs issued.

Tax Policy Concerns

In principle, the JCT proposal represents an encroachment on the ability of state and local governments to determine in what manner they wish to use private-activity bond authority under the volume cap. The cap limits the volume of private-activity bonds a state can issue according to a population-based formula. State governments allocate available volume cap among competing qualified uses. This decision is, and should be, made at the state level. By mandating that a portion of the volume cap be directed toward MCCs if MRBs are issued, the JCT proposal would limit the ability of a state government to make an important public policy decision.

If implemented, the JCT proposal would also limit the ability of HFAs to fulfill their statutory mission of providing low-cost mortgages and mortgage assistance for low- and moderate-income individuals. Contrary to the JCT claim that requiring greater use of MCCs would better target the subsidy, such a policy would in fact skew the benefits toward higher-income homebuyers. Because the credit is nonrefundable, individuals with limited tax liability cannot benefit from them. The JCT has observed that the use of MCCs is larger in some states than others. Generally, these states have higher average home prices and qualifying homebuyers who have higher tax liabilities and who can better realize the benefit of the MCC. The JCT also argues that mandating the use of MCCs would “extend the subsidy” to homeowners who do not itemize deductions. That subsidy is available only to certificate holders with tax liabilities at least equal to the credit provided by the MCC. In contrast, the subsidy provided by mortgage loans funded by MRBs is provided directly to each mortgagor through a direct reduction in the cost of housing, regardless of the tax position of the mortgagor in any particular tax year. Moreover, homeowners who incur mortgage interest and property tax deductions would, in most cases, be better off itemizing their deductions.

The JCT also suggests that HFAs tend to prefer MRBs over MCCs because MRBs provide HFAs with a source of funds—the spread between the bond rate and the mortgage loan rate—to help defray the administrative costs of housing assistance programs. While this may be true, the JCT offers no suggestions as to how HFAs would make up the lost administrative cost assistance arguably provided by MRBs. Moreover, if MCCs truly are less expensive to administer than MRBs, as the JCT argues, then HFAs would not be so predisposed towards MRBs, as the JCT argues they are.

The JCT also argues that MCCs are more attractive than MRBs because the subsidies delivered by MCCs are less sensitive to interest rates. While it tends to be true that MRBs are less valuable to homeowners in conditions of very low interest rates such

as the environment of the past several years, this feature arguably is a benefit of MRBs. Over the past several years, MRBs issuance has fallen because the differential between conventional mortgages and those financed with MRBs has been minimal. Because low- and moderate-income homebuyers have been better able to qualify for conventional mortgage loans, the demand for MRB-financed loans has been reduced. Arguably, this is precisely how subsidy programs such as MRBs should work. Because target beneficiaries have had less need for the subsidy provided by MRBs, issuance—and importantly, the tax expenditure incurred by the federal government—has been lower. As interest rates rise and the difference between the rates on conventional and MRB-financed mortgage loans widens, low- and moderate-income homebuyers will have greater need for subsidized loans, and MRBs will gain in popularity once again. In such a circumstance, the level of subsidy provided by the program directly matches the need for the subsidy among target beneficiaries. This feature is not available with MCCs.

HFAs do not issue MRBs to avoid the MCC program, but rather choose to apply the MCC program under the circumstance in which it can be used most efficiently.

5. Impose Loan and Redemption Requirements on Pooled Financing Bonds:

States, cities, towns and counties issue municipal bonds as do a variety of other political subdivisions of the state such as special services districts, school districts, park districts and many others. In total, there are approximately 86,000 municipal bond issuers ranging in size from the State of California to school districts that might serve only a few hundred students. The larger an issuer, the easier and more efficiently it is to tap the bond markets for financing. Smaller issuers face obvious disadvantages in accessing the bond markets. They are not as well known to credit rating agencies and investors and have less internal expertise on how to interact with the bond markets. It is also relatively more expensive for smaller governmental entities to issue bonds.

As a result of this disadvantage, smaller issuers often borrow on a pooled basis. In a pooled financing, a single entity acts as the nominal issuer of tax-exempt bonds on the behalf of smaller borrowers such as school or park districts or small local governments themselves. The bond proceeds are raised by the pool issuer and loaned to the governmental borrowers participating in the pool. Without conduit issuance, many smaller governments would find it more difficult to benefit from the lower borrowing costs provided by the municipal bond market. In addition, many state programs such as state revolving fund programs and bond banks issue bonds to fund loans to a number of local borrowers.

The JCT proposal would add tough new restrictions to the conduit borrowing process. Pool bond issuers would be required to obtain written loan commitments prior to issuing a bond and nonrefundable loan commitment fees from borrowers. At least 50 percent of the proceeds would be required to be loaned within the first year and 95

percent within three years or the issuer would be required to redeem some of its bonds. In addition, the conduit issuer would no longer be exempt from the small-issuer exception from the arbitrage rebate rules.

Tax Policy Concerns

Pooled financing involves the grouping of separate borrowers who want to finance distinct projects. As noted above, many of the beneficial borrowers are relatively small entities. It is reasonable that among a collection of disparate borrowers, some may face project delays, planning interruptions or political obstacles that affect their need to draw on requested funds within the prescribed time period. It is not uncommon for borrowers to incorrectly anticipate the need for borrowing when presented with a window of opportunity to access lower-cost financing. The requirement that borrowers sign a binding loan agreement as the JCT proposes—as the JCT acknowledges—would eliminate the ability of some smaller entities to take part in pool financing programs, effectively precluding them entirely from accessing tax-exempt financing as cheaply as possible because they cannot agree to the loan commitment in advance. The proposal, according to the JCT report, would provide “assurance” that pooled financing bonds are only issued for current needs. This assurance, however, would come at the cost of some small issuers with limited resources facing a higher cost of capital as they cannot participate in pooled tax-exempt financing.

The JCT proposal would also require the pool issuer to redeem that portion of 50 percent of the bond proceeds that has not been lent after a one-year period. Such a restrictive redemption policy would effectively limit the size of pools as issuers hedge against the various uncertainties faced by participating borrowers. With smaller amounts available to lend, the frequency of pooled borrowings is likely to increase creating inefficiencies as issuers pay more in transaction costs for the same amount of financing. Borrowing costs would rise as the flexibility of pooled bond programs is diminished.

Application of such restrictions to programs such as revolving funds established pursuant to federal mandate or state bond banks seems particularly unwarranted. To our knowledge, none of the concerns expressed by the Report relate to these types of programs.

6. Eliminate Private-Payment Test for Stadium Bonds

Tax-exempt private-activity bonds are those that are nominally issued by a state or local government but whose proceeds benefit a private party. The tax-exemption on municipal bond interest only applies to private-activity bonds that meet certain tests and are used for qualified purposes as set out in the Code and which do not include stadiums, a provision adopted in the TRA. The tests applied in the Code require that more than 10 percent of bond proceeds are used to finance a private business and that more than 10 percent of the repayment of principal and interest is derived from private parties. These

are known as the “private-use” and “private payment” tests. Issues must satisfy both tests in order to be considered private-activity bonds. (An alternative test designates bonds from which more than 5 percent of proceeds are lent to a private party as private activity as well.)

This proposal would effectively prohibit all tax-exempt financing for professional sports stadiums by eliminating the private payment test for stadium transactions only. The private-activity test for stadium bonds would be limited to the private use test.

Tax Policy Concerns

In the TRA, Congress established a two-part test of private activity specifically to allow states and localities to finance with public sources of funds projects dedicated predominantly to private use. Congress wisely established this definition of private-activity bonds to allow states and localities the flexibility to dedicate public debt capacity to otherwise private projects to meet local demands and still retain the tax-exemption. Even though Congress eliminated *private* tax-exempt financing of stadiums in 1986, the Congress, in establishing a two-part test of private activity, arguably foresaw projects where state or local governments desire to dedicate public resources and retain tax-exempt financing, such as with stadiums as they are currently financed.

The JCT report claims that Congress’ intent with the TRA was to eliminate *all* tax-exempt financing for professional sports stadiums, not simply private-activity bonds. Under current law, state and local governments are free to issue tax-exempt bonds whose repayment is secured by a public source of funds and then allow the proceeds to be used to finance stadium construction. Congress, in fact, did not create a legal barrier to municipal stadium financing using public resources. In a private-activity bond transaction, the municipality acts only as the nominal issuer. The bond offering does not pledge any public source of funds as the source of repayment for the bond. Investors who purchase private-activity bonds understand the security does not legally represent an obligation of the municipality but of the entity generating the revenue pledged as the bond’s source or repayment. The choice on the part of a state and local government to use its debt capacity to finance sports stadiums was not addressed by Congress in the TRA. Enactment of the JCT’s proposal would effectively usurp the tax-exempt financing authority of state and local governments provided in the Code.

The JCT also claims stadiums deserve unique treatment under the private-activity test because the scarcity of professional sports teams allows team owners to pressure state or local government to provide an economic benefit to the team. However, this is the type of decision that is appropriately made by the governing entities whose bonding capacity is being utilized. Judgments about who benefits most in municipal stadium financing transactions are subjective. Sports teams can generate employment and other economic development whose benefits can multiply throughout a city or region in ways that cannot be obviously quantified. Ultimately, it is the role of local—not federal—

government to decide whether the benefit of public, not private, stadium financing is worth the associated cost without loss of tax-exempt financing.

7. Amend Information Reporting Requirements to Include Interest on Tax-Exempt Bonds

This proposal is presented as two options. Under the first, issuers would have to file information reports annually specifying the amount of interest paid as well as the name, address and TIN for all investors to whom tax-exempt interest is paid. Under the second option, issuers would not have to file this information annually, but would be required to provide it to the IRS on demand.

Tax Policy Concerns

The JCT proposal would require issuers to supply information they do not possess and could not collect—whether internally or through a third party—without significant time and expense. Bonds issuers typically advance interest and principal payments to a trustee who then forwards the payment to a clearing firm. The clearing firm sends the payment to the broker-dealer with whom an investor maintains their account and individual accounts are credited. Per the instructions of the broker-dealer, the clearing firm provides investors with the appropriate tax-reporting information or else broker-dealers provide the forms. At no point in this process, however, does the issuer have possession of the information the JCT proposal suggests it provide. In order to file the information described in the proposal with the IRS, the issuer would need to obtain the payee information from the clearing firm via the broker-dealer. Building such a database, or contracting with a third party for the services, would be a significant expense for issuers. The need to keep up with the changes in bondholder identity as a result of secondary market trading would further complicate the arrangement.

Issuers would face this new record-keeping burden under either of the options proposed in the JCT report. The added expense would increase borrowing costs for state and local governments and could prove overwhelmingly complex or expensive for smaller issuers. It is also highly likely that the money recovered by the IRS as a result of such a database is eclipsed by the actual cost the IRS would incur to establish the capability to receive the information. The JCT estimates the proposal would generate less than \$10 million in revenue over a 10-year period.

8. Clarify Limitations on Indian Tribes' Use of Tax-Exempt Bond Proceeds

Indian tribes have the authority to issue tax-exempt bonds similar to that granted to state and local governments. Such bonds may be issued only for essential government functions and, to a very limited degree, certain manufacturing facilities. Indian tribes can also be the beneficiaries of tax-exempt bonds that are arranged through a conduit issuer.

The JCT proposal claims that Indian tribes have been engaging in conduit borrowing and using the proceeds to finance non-governmental facilities such as gambling casinos. To remedy this, the JCT proposal would clarify that the limitation on borrowing for Indian tribes applies whether the tribe is the direct issuer or a conduit borrower.

Tax Policy Concerns

The JCT report cites news reports that Indian tribes have used the proceeds of conduit financing for gambling casinos. Market participants report, however, that no Indian casinos have been financed by tax-exempt bonds to their knowledge. The article⁵ cited by the JCT is inaccurate. Tax-exempt conduit financing has been used to fund only economic development projects for tribes such as infrastructure and convention centers—facilities that are routinely built with tax-exempt financing by non-tribal governments. In these cases, the non-tribal conduit issuers make the determination on the question of “essential government functions.” An example of this type of guidance is provided by the California Statewide Communities Development Authority which makes it clear it will not issue bonds to fund gaming facilities.⁶

The JCT claims conduit borrowing is used to avoid the limitation created by the Indian Tribal Government Tax Status Act of 1982 on tribal borrowing in the tax-exempt market to “essential government functions.” The Omnibus Budget Reconciliation Act of 1987 (OBRA), which sought to clarify that “essential government function” did not include commercial purposes, stated that tribal governments have the authority to issue tax-exempt bonds to finance activities “customarily performed” by state and local governments. The legislative history of OBRA makes it clear that Congress did not want tribal governments to issue tax-exempt debt for purely “commercial” activities, such as cement plants located miles from the reservation. It is not clear, however, that Congress intended to prohibit tribal governments from issuing tax-exempt bonds to finance “essential governmental functions” even if those functions served economic development provided those activities were customarily performed by state and local governments.

The legislative history to OBRA did criticize then existing Treasury regulations that seemed to allow tax-exempt bonds to be issued by tribes for almost any purpose, and the legislative history indicates that “isolated instances” do not establish that the activity is customarily performed by cities and counties. The IRS in audits, however, appears to have taken the position that any activity that could raise revenue for the tribe, for example golf courses, hotels, convention centers, certain water and sewer facilities that may generate fees, are not to be considered “essential governmental functions.” These activities clearly would be considered an “essential governmental function” for other sections of the Code and financings of these activities by cities and counties are not “isolated.”

⁵ *\$145.5M Cabazon Deal Under Scrutiny, IRS Steps Up Probes Of Indians*, The Bond Buyer, August 6, 2004.

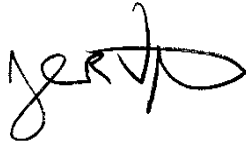
⁶ see the CSCDA website at: <https://secure.cacommunities.com/cacomm/apps/nativeAm/>

Conclusion

The preceding proposals taken independently would raise borrowing costs and reduce market efficiency and taken collectively could have a destabilizing effect on the municipal market. The \$2 trillion municipal bond market provides financing for vital state and local needs that cannot be found elsewhere. The streets, schools and other investments financed by bonds provide the foundation of our strong and vibrant economy. The efficiency of the tax exemption as a form of federal assistance is ensured by a competitive and transparent marketplace that is the subject of robust regulatory oversight.

Thank you for your consideration. We hope the Senate Finance Committee will reject the JCT proposals that will do damage to our nation's system of public finance.

Sincerely,

A handwritten signature in black ink, appearing to read 'J. R. Vogt', with a stylized flourish at the end.

John R. Vogt
Executive Vice President