

## RESTRICTIONS ON MUNICIPAL FINANCING OF HOME PURCHASES AND PRIVATE ACTIVITIES: THE DEFICIT REDUCTION ACT OF 1984

State and local governments historically have utilized tax-exempt bond proceeds for the purchase or construction of needed public and commercial facilities.<sup>1</sup> The federal government previously recognized that the tax-exempt status of state-issued obligations satisfied both the state's need for low-cost financing and the federal government's desire to subsidize worthy state programs such as housing, business and employment.<sup>2</sup> As a result of the increasing misuse of bond proceeds by issuing governmental units,<sup>3</sup> however, the federal government has reduced some of the privileges<sup>4</sup> of the tax-exemption. In response to

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1. The basic exemption for interest received on "obligations of a State, or Territory, or a possession of the United States, or any political subdivision of any of the foregoing" derives from the exclusion of such interest in a taxpayer's income. I.R.C. § 103(a)(1) (1984). See Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1040-49 (1983) (describing the basic funding mechanism and cost savings in tax-exempt financing).

2. Gillette, *supra* note 1 at, 1035-49. The federal government sustained the tax-exemption for bonds that financed "traditional" state activities and concerns, for example, housing, business and employment. *Id.* at 1032.

3. Due to its inherent tax savings, tax-exempt bonds usually will provide a borrower with lower cost financing than financing from taxable bonds. Thus, cost-conscious borrowers always search for tax-exempt financing to lessen their costs. State and local governments may issue the tax-exempt financing at a very small administrative cost. In fact, the allowed arbitrage earned by the state on the bond proceeds will negate most of its issuance costs and may result even in a profit. As a result of the low cost to the issuing state, combined with interstate competition for domesticated businesses, state governments have reduced greatly the standards for tax-exempt financing. See generally, *Trends in Municipal Financing and the Use of Tax Exempt Bonds to Finance Private Activities: Hearings Before the House Comm. on Ways and Means, 98th Cong., 1st Sess. 7* (1983) (statement of John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury) [hereinafter *Private Activities Hearings*]. See also Grubisich, *Industrial Loans Subsidize Array of Virginia Farms*, Wash. Post, Sept. 17, 1980, at A1, col. 6 (tax-exempt bonds used to finance activities ranging from banks to massage parlors).

4. See *infra* notes 7-18 and accompanying text.

large federal deficits, inflated tax-exempt bond rates and decreased cost-effectiveness of federal subsidies through tax-exempt bonds,<sup>5</sup> Congress passed the Deficit Reduction Act of 1984 (1984 Act),<sup>6</sup> which further restricts the benefits and the availability of tax-exempt financing.

The Act affects tax-exempt financing in two ways. First, the Act imposes tighter restrictions on the financing of private activities with tax-exempt bonds. Private activities are the commercial and industrial projects of the private sector. State and local governments often provide financial aid in the form of Industrial Development Bonds (IDB) in order to lure potential private business activity into the locality. Second, the Act extends the expiration date or "sunset date" for the period in which a state or locality may issue tax-exempt Mortgage Subsidy Bonds (MSB) to finance the purchase of personal residences by targeted home purchasers. In addition to the subsidized lower interest rates that the MSBs provide, the Act provides an optional federal tax credit for targeted home purchasers. The Act also tightens the reporting restrictions on the issuance of such bonds.

## I. MORTGAGE SUBSIDY BONDS

Under the Mortgage Subsidy Bond Tax Act of 1980 (1980 Act),<sup>7</sup>

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5. See generally H. REP. NO. 98-432, 98th Cong., 1st Sess. 375-76 (1983).

6. Pub. L. No. 98-369, §§ 611-14, 621-32, 98 Stat. 494 (1984) (codified at I.R.C. §§ 103, 103A and 168 (West Supp. 1985)) [hereinafter cited as 1984 Act].

7. Pub. L. No. 96-499, §§ 1101-04, 94 Stat. 2660-82 (1981) (codified at I.R.C. §§ 103(b)(4)(A), (6)(J) and 103A (1982)) [hereinafter cited as 1980 Act].

In 1968 Congress amended Internal Revenue Code § 103, which provides tax-exempt status for state and locally issued bonds, to curtail state use of tax-exempt bond proceeds to finance private activities. See Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 107(a), 82 Stat. 251, 266-68 (current version at I.R.C. § 103(b), (1984)). When Congress enacted the limitations, it retained tax-exempt financing of residential real property for family units. Most of the residential financing at that time was for low-income, multifamily rental projects. State housing agencies slowly took advantage of the residential housing exception and issued mortgage subsidy bonds for owner-residence financing. See *Hearings on S. 137 and S. 106 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance*, 98th Cong., 1st Sess. 21, 22 (1983) (statement of John E. Chapoton, Assistant Secretary for Tax Policy, Dept. of the Treasury) [hereinafter cited as *S. 137 Hearings*].

The volume of MSBs rapidly expanded from \$1 billion in 1977 to \$10.5 billion in 1980. *Id.* at 28. The volume of tax-exempt owner occupied housing as a percentage of total tax-exempt financing grew from 3% to 20% in the same period. *Id.* Congress responded with the Mortgage Subsidy Bond Tax Act of 1980, which substantially restricted the free use of tax-exempt financing for owner-occupied residences. See *infra* notes 8-11.

Congress granted state and local governments the right to issue federally tax-exempt bonds to finance mortgages on owner-occupied residences.<sup>8</sup> A state or local government that issues an MSB, lends the bond proceeds to an individual purchaser of a single-family residence. The tax-exempt status of the MSB allows a state or local government to issue such bonds at a rate lower than the taxable bond market rate.<sup>9</sup> As a result of the lower bond interest rate, the recipient of the MSB proceeds pays a lower interest charge on the debt service of their mortgage loan.<sup>10</sup> Under the 1980 Act, however, the tax-exempt status of MSBs expired for issuances made after December 31, 1983.<sup>11</sup>

To qualify an MSB issue for tax-exempt status, only a state or political subdivision may issue the MSB<sup>12</sup> and the issue must meet the requirements of section 103A<sup>13</sup> of the Internal Revenue Code. Furthermore, an issuer must use at least ninety percent of the bond issue proceeds to finance owner-occupied residences<sup>14</sup> and must com-

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8. The Internal Revenue Code defines an owner-occupied residence as a single-family residence that the mortgagor will occupy as his or her principal residence within a reasonable time after financing is provided. I.R.C. § 103A(d) (1984). A "single-family residence" includes two, three and four family residences if the units first were occupied at least five years before the mortgage is executed and at least one unit in the residence is occupied by the owner of the units. Treas. Reg. § 6a.103A-1(b)(6)(1984).

9. Tax-exempt bonds generally pay lower interest rates than taxable bonds. Notwithstanding other market factors such as risk and general economic conditions, the difference between the interest rates of tax-exempt bonds and taxable bonds reflects the tax savings inherent in tax-exempt interest received by the bondholder.

10. Most issuers charge recipients of MSB proceeds approximately the same rate of interest as the interest paid to the MSB holders. In effect, the interest and principal paid on the home owner's debt funds the debt-service payments on the bonds. Issuers may not charge the mortgagor with an effective interest rate greater than 1.125% above the yield on the related MSB issue. I.R.C. § 103A(i) (1984). See *infra* note 18 (discussing arbitrage limitations).

11. I.R.C. § 103A(c)(1)(B) (1984).

12. *Id.* at § 103A(c)(2)(A).

13. *Id.* at § 103A(c)(2)(A)(ii).

14. *Id.* at § 103A(c)(2)(A)(i).

The 1980 Act required the issuer to use all of the lendable proceeds of the MSB issue to finance the residences of individuals who had not had a prior ownership interest in a principal residence at any time during the preceding three years ("first-time home-buyer requirement"). *Id.* at § 103A(e)(1). The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248 § 220(c), 96 Stat. 324 (codified at I.R.C. § 103A(e)(1) (1983)), reduced the percentage of bond proceeds an issuer must use in satisfying the three-year requirement to 90%. Within certain exceptions, all issue proceeds must finance new mortgages rather than existing mortgages. I.R.C. § 103A(j)(1)(A). The exceptions permit replacement of construction loans, other temporary initial financing and certain rehabilitation loans. *Id.* at § 103A(j)(1)(B). Fur-

ply with the Act's homeowner targeting requirements.<sup>15</sup> To limit the federal revenue loss from the further issuance of MSBs, Congress capped the aggregate amount of a state's issuance of MSBs in any one year.<sup>16</sup> Additionally, the 1980 Act limited the amount of arbitrage profit<sup>17</sup> that an issuer could earn from such tax-exempt financing.<sup>18</sup>

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thermore, the purchase price of an eligible residence could not exceed 90%, subsequently changed by TEFRA to 110%, of the average purchase price for single-family residences located in the area of the purchased residence. I.R.C. § 103(f) (1984).

15. The issuer must make available at least 20% of an issue's proceeds for owner-financing of "targeted area residence." I.R.C. § 103A(h). A "targeted area" includes a "qualified census tract" or an "area of chronic economic stress." *Id.* at § 103A(k)(1). Section 103A defines a "qualified census tract" as a census tract in which at least 70% of the families have an income no greater than 80% of the statewide median income. *Id.* at § 103A(k)(2). An "area of chronic economic distress" must meet certain economic conditions that demonstrate its need for subsidized housing and its expected benefit from such assistance. *Id.* at § 103A(k)(3). Purchasers of targeted area residences do not have to comply with the "first-time home buyer requirement," *Id.* at § 103A(e)(2)(A), and may purchase residences with prices of 110%, TEFRA increased this to 120%, of the average area purchase price. *Id.* at § 103A(f)(5).

16. The 1980 Act imposed a state ceiling equal to the greater of: (1) nine percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family owner-occupied residences located within the state, or (2) \$200 million. *Id.* at § 103A(g)(4).

17. An issuer earns arbitrage profit when the effective yield on its mortgage loans and nonmortgage investments exceeds the yield of the MSB issue. The Act limits the amount of arbitrage profit an issuer may earn and still qualify the MSB issue as tax-exempt. *Id.* at § 103A(i)(2)A-C.

18. The effective rate of interest on mortgages that issuers make pursuant to an MSB issue cannot exceed the yield on the issue by more than one percentage point-TEFRA changed this to 1.125 percentage points. *Id.* at § 103A(i)(2). The issuer must make the determination on a composite basis for all mortgages under the issue. *Id.* This composite determination would permit some individual mortgages to exist with effective yields in excess of the 1.125 limitation.

The 1980 Act also limits the amount of arbitrage profit earned by an issuer on nonmortgage investments. *Id.* at § 103A(i)(3). Nonmortgage investments include any investment by the issuer other than a qualified mortgage. Treas. Reg. § 6A.103A-2(i)(3)(iv) (1984). The amount of proceeds invested in nonmortgage investments from MSB issue proceeds cannot exceed 150% of the debt service of the issue for the year. I.R.C. § 103A(i)(3)(A)(i) (1984). The issuer must promptly and appropriately reduce the invested nonmortgage amount as the owners repay the mortgages. *Id.* at 103A(i)(3)(A)(ii) (1984). Issuers must pay or credit any arbitrage profit earned on nonmortgage investments to the mortgagors or the federal government. *Id.* at §§ 103A(i)(4)(A), (D).

The 1980 Act provides an exception to the 150% rule for proceeds that the issuer invests for a temporary initial period until it needs the invested proceeds to fund mortgages. *Id.* at § 103A(i)(3)(B). In addition, Congress recognized that the issuer might suffer losses on nonmortgage investments held in a reserve for debt service if the MSB restrictions required the issuer to dispose the investments as it reduced the needed debt

Proponents of the legislation to repeal the MSB sunset date faced their strongest opposition from the federal government. The Department of the Treasury and the General Accounting Office (GAO) described MSBs as ineffective means to subsidize owner-occupied housing.<sup>19</sup> The Department of the Treasury estimated that only two-thirds of the cost of the MSB program inured to the targeted homeowners and that the remaining one-third benefited bond holders and intermediaries.<sup>20</sup> The Treasury also exhibited concern for the bond market which, due to the flood of MSBs into the market, had improperly inflated the yields on other conventional forms of tax-exempt financing.<sup>21</sup> The inflated yields on other conventional forms of tax-exempt bonds resulted in increased financing costs to state and local governments.<sup>22</sup> In addition, the federal government asserted that the MSB program aided those homeowners who did not need federal assistance<sup>23</sup> and voiced concern over the net costs of the program in

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service. Thus, if the sale of any investment would result in a loss exceeding the amount the issuer was otherwise required to pay or credit to the mortgagors, the issuer may retain the investment until such a loss would not occur. TEFRA, *supra* note 15 at § 220(b) (codified at I.R.C. § 103A(i)(3)(D) (1984)).

19. *See generally, Private Activities Hearings, supra* note 3.

20. *Id.* at 8. (statement of John E. Chapoton, Assistant Secretary for Tax Policy, Department of Treasury). Intermediaries benefit by making commissions from the purchase and sale of the tax-exempt bonds.

21. *Id.* at 7-8. The Treasury Department projected an increase in MSB financing from issuances of \$10.3 billion in 1984 to \$13 billion in 1985, \$16.9 billion in 1986, \$20.5 billion in 1987 and \$23.6 billion in 1988. *Id.* at 44-45.

22. *Id.* at 7. Tax-exempt financing had risen to yields of only a few percentage points difference from the yields of taxable bonds. *Id.* This difference did not correctly reflect the inherent tax-exempt status of the bonds. *Id.*

23. *Id.* at 24. The Department of Housing and Urban Development (HUD) asserted that the significant increase in new housing starts in 1982 signified that federal housing subsidies no longer were necessary. *Id.* (statement of Anthony J. Sulvetta, Deputy Assistant Secretary-Designate for Economic Affairs, HUD). HUD noted that from the inception of the MSB program in 1980, to 1983, 84% of MSB issue proceeds financed home purchasers who were between the ages of 20 and 35. *Id.* Also, over two-thirds of the purchasers benefiting from MSBs earned annual incomes between \$20,000 and \$60,000. *Id.* These factors, coupled with the fact that 61% of the home purchasers using MSB financing were for single or two-person households, indicated that the MSB program did not assist those home buyers in need of financial assistance, but merely accelerated the purchase date of those families that eventually would buy a home without a subsidy. *Id.* *See also id.* at 120-21 exhibits 12-13 (statement of Baltas E. Cirle, Dep. Dir. for Operational Resources, Community and Economic Development Division, U.S. General Accounting Office (GAO), that 88% of the MSB home buyers could have purchased a home without the subsidy).

The GAO also reported that the vast majority of states allowed families with income

light of needed deficit reduction measures.<sup>24</sup>

Proponents of the MSB aggressively challenged the Treasury Department's and the GAO's cost-effectiveness findings and market condition assumptions.<sup>25</sup> These proponents also asserted that the federal government should continue to support urban renewal by subsidizing home ownership for those who otherwise could not afford to purchase homes.<sup>26</sup> Without MSBs such assistance would virtually disappear,

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ranges above "low and moderate levels" to receive MSB assistance. *See generally id.* at 101-38. During the period from 1981 to 1982, some states did not put a maximum income level limit on home purchasers using MSB financing. *Id.* at 123 exhibit 15. Furthermore, all states that issued MSBs in the same time period allowed families with income in excess of the state's median family income to receive MSB proceeds. *Id.* Thus, the GAO argued that the MSB program did not benefit targeted groups of low and moderate income. *But see infra* note 25 and accompanying text (opposition to the GAO's testing methods and income level descriptions); *Cf. Gillette, supra* note 1, at 1032 (noting that even though the MSB program may benefit families with unusually high income levels, "the rationale for such bond issuers includes revitalizing city neighborhoods and expanding the issuer's tax base"). Furthermore, the GAO stated that those families using MSB financing alternatively could have used Federal Housing Assistance (FHA) financing. *Private Activities Hearings, supra* note 3, at 137-38.

24. "Even a short extension of the MSB sunset will increase the deficit." *Private Activities Hearings, supra* note 3, at 24 (statement of Anthony J. Sulvetta, Dept. of HUD). The GAO projected that the long-term revenue loss to the U.S. Treasury would exceed the benefit provided to home-buyers by four times. *Id.* The Treasury estimated that a one-year and three-year extension of the MSB program would result in the federal government losing \$4 and \$15 billion dollars respectively. *Id.* at 10 (statement of John E. Chapoton, Dept. of Treasury).

25. One academician denied the Treasury Department's report that only two-thirds of the cost of the MSB program benefited the home purchaser and instead, asserted that 93% of the program's cost benefited home purchasers. *Id.* at 415-16 (statement of Roger Kormendi, Associate Professor of Economics, University of Chicago). Kormendi argued that the Treasury incorrectly assumed that investors in tax-exempt bonds liquidated investments that produced taxable income in order to finance the tax-exempt bond purchase. *Id.* Rather, investors usually liquidate equity holdings, which do not produce taxable income, to purchase tax-exempt bonds. Thus, no resulting tax revenue loss occurs. *Id.*

Proponents of the MSB program defended the purpose of the program as one to benefit those who could not afford a home. The program did not intend to base its benefits on the vague GAO terms of "low - and - moderate - incomes." *See id.* at 414 (statement of John Ritchie, President, Council of State Housing Agency). In fact, proponents argued, the high interest rates in 1982 priced most families out of the home-buyers market. The high cost of homes, even with the MSB assistance, allowed only high income families to purchase. Thus, the GAO incorrectly assumed that most home purchasers could have bought a home in 1982 without MSB assistance. *See id.* at 402, 410.

26. *See id.* at 146 (statement of Robert Knight, Commissioner, Wichita, Kansas and Co-chair of Municipal Bond Task Force, The National League of Cities).

and many first-time home purchasers would be confronted once again with formidable interest rates.<sup>27</sup>

A congressional debate on the value of MSBs resulted in a compromise extension of the sunset date to December 31, 1987.<sup>28</sup> Congress, however, followed the Treasury Department's recommendations and attempted to increase the cost-effectiveness of the MSB program by providing states with the option to issue Mortgage Credit Certificates (MCC) in lieu of MSBs. Additionally, to ensure that the proceeds from MSB issues reached the targeted groups of potential homeowners, Congress mandated that state and local governments issuing MSBs comply with various periodic reporting requirements.<sup>29</sup>

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27. The proponents of MSBs argued that a strong need for MSB financing existed within the housing market. Normal mortgage-interest tax deductions benefit only high-income level homeowners. *Id.* at 413 (statement of John Ritchie, Council of State Housing Agency). In 1982 greater than 75% of those taxpayers availing themselves of the federal interest deduction had incomes in excess of \$30,000. Less than the majority of home purchasers utilizing MSB financing had incomes as large. *Id.* Also, less than one-half of MSB home buyers had incomes of less than \$23,000 in 1982, which was \$10,000 less than the median income for FHA financing. *Id.* at 414. Thus, FHA does not provide sufficient housing aid, especially when one notes that Congress only provides loan security through the FHA and not loan assistance. *Id.*

28. 1984 Act, *supra* note 6, at § 611(a) (amending I.R.C. § 103A(c)(1)).

29. The Treasury suggested that Congress require reporting measures, similar to those for private purpose bonds under TEFRA, for MSB issuances if it extended the MSB program. *Private Activities Hearings, supra* note 3 at 16 (statement of John E. Chapoton). The proposed information requirements would help the federal government monitor the targeted groups receiving MSB aid more efficiently. *Id.* Veteran's mortgage subsidy bonds, which help finance mortgage loans to veterans, must also meet the same reporting requirements. *Id.*

The 1984 Act requires the following reporting disclosures by MSB issuers. Within two and one-half calendar months after the quarter containing the MSB issuance date, the issuer must file a report with the IRS. 1984 Act, *supra* note 6, at § 611(b)(2) (codified at I.R.C. § 103A(j)(3)(A)). The report must contain the name and address of the issuer, the date of issue, the amount of lendable proceeds of the issue, the stated interest rate, term and face amount of each obligation contained in the issue. In addition, the report must state any information that the IRS requires to determine if the issuer lends the bond proceeds to low-income individuals. *Id.*

To qualify a bond's interest as tax-exempt, a designated state official, or the government if the state has not designated one, must certify prior to bond issuance that the issue meets the limitations on the aggregate amount of bonds that the state may issue under current law. *Id.* (codified at I.R.C. § 103A(j)(4)(A) (West Supp. 1985)). The designated official must make the certification and submit the certification with the above-mentioned report. *Id.* (codified at I.R.C. §§ 103A(g), 103A(j)(4)(B)).

In addition to reports on specific bond issues, Congress requires the governmental unit responsible for the MSB issuance to submit an annual report to the Treasury Department after a public hearing. The annual report summarizes the policies followed by the governmental unit with respect to housing and low-income housing distribution

Mortgage Credit Certificates provide states with the option of foregoing the issuance of MSBs; MCCs enable states to directly subsidize low income home buyers with income tax credits.<sup>30</sup> The state issues MCCs to target low-income home buyers.<sup>31</sup> The certificates grant the home buyers a specified amount of credit<sup>32</sup> against their federal income taxes.<sup>33</sup> For homeowners with certificate rates of greater than twenty percent, the credit may not exceed \$2000 per year,<sup>34</sup> and the home

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assistance. The annual report must assess the success of the issuer in meeting the above policies in the prior year, as well as the issuer's success in meeting congressional intent to subsidize low-income families before assisting high-income families. *Id.* (codified at I.R.C. §§ 103A(j)(5)(A), (B)).

Congress codified its policy underlying the MSBs by requiring mandatory reports from issuers relating to the issuers' subsidizing of low-income families. *Id.* The codified policy does not bind governmental units but will aid the Treasury Department in its completion of a report to Congress on the performance of the MSB program.

The new MSB reporting requirements apply to obligations issued after December 31, 1984, and issuers must submit their first annual report by December 31, 1984, for bonds issued in 1985. *Id.* at § 611(d)(2).

30. The direct issuance of credit certificates to the targeted home buyers allows the state to determine directly the subsidy amount by adjusting the certificates' credit percentage. The MSB program utilizes the difference between the taxable and tax-exempt bond rates to determine the amount of the subsidy. The volatile conditions of the tax-exempt market determine the spread between taxable and tax-exempt bonds. Thus, the MCC program avoids reliance on an arbitrary market to determine the allowed subsidy. See *Hearings on S. 1598 Before the Senate Comm. on Finance (Mortgage Tax Credit)*, 98th Cong., 1st Sess. 1, 16 (1983) (statement of John E. Chapoton, Assistant Secretary for Tax Policy, Department of Treasury) [hereinafter *MCC Hearings*].

31. Home buyers may avail themselves of the certificate benefit by utilizing the credit against only indebtedness they utilize to acquire a "principal residence" (as defined in I.R.C. § 1034) or to finance other home improvement loans. 1984 Act, *supra* note 6, at § 612(a) (codified at I.R.C. § 25(b)(2) (West Supp. 1985)). The issuer of the MCCs has the power to determine the eligibility requirements for recipients of the certificates. *Id.* (codified at I.R.C. § 25(e)(5)).

32. The issuer may grant a credit rate of up to 50%, but never lower than 10%. *Id.* (codified at I.R.C. § 25(d) (West Supp. 1984)). The recipient of the MCC then multiplies the amount of his home purchase indebtedness by the MCC credit rate. The home buyer uses the resulting product as a credit against his federal income taxes. The home buyer then must reduce the amount of the allowable home interest deduction by the amount of credit taken. *Id.* at § 612(c) (codified at I.R.C. § 163(g) (West Supp. 1985)).

33. Taxpayers obtain greater benefits from tax credits, which directly reduce tax liabilities dollar-for-dollar, than from interest tax reductions, which only reduce the tax base on which the taxpayer applies the applicable tax rate. Compared to the interest tax deduction, the tax credit is particularly beneficial to low-income individuals because the amount of tax benefit from an interest tax deduction reflects only the marginal rate of the taxpayer. Low-income home buyers have low marginal tax rates to which the above-the-line deduction provides very little tax benefit.

34. 1984 Act, *supra* note 6, at § 612(a) (codified at I.R.C. § 25(a)(2)(A)).



buyer may not receive a refund for any portion of the unused portion of the credit.<sup>35</sup> As a further check on the program's deficit producing impact, Congress required that for every twenty cents of MCC issuance authority a state desires, it must surrender one dollar of authority to issue MSBs.<sup>36</sup>

The MCCs provide Congress with a solution to both the cost effectiveness problems of the MSB program and the MSB program's failure to aid only targeted groups.<sup>37</sup> Because the MCC is issued directly to the home buyer, the subsidy is not undermined by the cost-inefficient involvement of bond purchasers and intermediaries.<sup>38</sup> In comparison, the costs of the MCC program work to benefit only the recipient of the MCC in the form of a tax credit. A state has greater control over the amount of benefit that the MCC holder receives through its power to adjust the credit rate of the certificate.<sup>39</sup>

MCC issuances must meet substantially the same requirements as MSB issuances.<sup>40</sup> The holder may only utilize the certificate against indebtedness used for the purchase or rehabilitation of a principle residence.<sup>41</sup> Furthermore, a home buyer may not finance a residence with MCC financing in combination with either MSB or Veterans Mortgage

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35. The taxpayer, however, may carry the credit forward three years. *Id.* (codified at I.R.C. § 25(e)(1)).

36. *Id.* at § 612(b) (codified at I.R.C. § 25(d)(2)). Congress arrived at the one-to-five, MCC-to-MSB ratio by multiplying the usual percentage amount of MSB issue proceeds that the issuer lends to the home buyer (87%), by the usual MSB subsidy of the percentage difference in yields between tax-exempt and taxable bonds (21%), by an increased MCC subsidy of 110% ( $87\% \times 21\% \times 110\% = 20\%$ ). See *MCC Hearings*, *supra* note 30, at 118.

37. The Treasury Department greatly favored the more cost-effective MCC program as an alternative to MSBs. The Treasury Department also favored the MCCs lack of bond issuance, which results in no additional dilution or alteration of the tax-exempt bond market. *Id.* at 15-16. (statement of John E. Chapoton, Dept. of Treasury).

38. *Id.* The Treasury Department estimated that the MCC program would result in cost savings of \$600 billion over five years. *Id.*

39. 1984 Act, *supra* note 6, at § 612(a) (codified at I.R.C. § 25(d)(1) (West Supp. 1985)).

40. *Id.* (codified at I.R.C. § 25(c)A). MCC issuances must relate to indebtedness used for the purchase of certain "first-time owner" residences that fall within a designated price range. All MCC requirements mirror the MSB issuance requirements except that states must issue MCCs exclusively to home buyers having no present ownership interests in their housing within the three-year period prior to purchase. *Id.* (codified at I.R.C. § 25(c)(2)(B)(iii)). Issuers of MSBs may distribute up to 10% of the bond proceeds to home buyers with a prior ownership interest. I.R.C. § 103(e) (1985).

41. 1984 Act, *supra* note 6, at § 612(a) (codified at I.R.C. § 25(c)(2)(A)(iii) (West Supp. 1985)).

### Bond financing.<sup>42</sup>

Although the MCC program appears to avoid some of the disadvantages experienced with the MSB program, Congress did not mandate the use of MCCs under the 1984 Act. Rather, Congress merely provided states with the MCCs as an alternative to MSBs.<sup>43</sup> The 1984 Act does not provide any incentive for states to utilize the credit certificates in lieu of the MSB issuances. For example, while the MSBs allow issuers to utilize a level of arbitrage profit<sup>44</sup> to fund their program administrative costs, the MCC program currently does not provide for any such method to recover costs.<sup>45</sup>

## II. PRIVATE ACTIVITY BONDS

Because the MCC program did not completely satisfy the Department of the Treasury,<sup>46</sup> which desired a greater reduction in tax-exempt financing of private activities, additional attention was given to the Industrial Development Bond Program.<sup>47</sup> Under certain conditions, state and local governments may finance business development with IDBs, whose interest is tax-exempt.<sup>48</sup> Congress, alarmed by the

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42. *Id.* (codified at I.R.C. § 25(c)(A)(iv)).

43. *Id.* at § 612(b) (codified at I.R.C. § 103A(g)(8)).

44. For a discussion of arbitrage profit, see *supra* notes 17-18 and accompanying text.

45. The Treasury Department, however, has authority to issue regulations that will pass the administrative costs of the MCC program on to the home buyer. 1984 Act, *supra* note 6, at § 612(b) (codified at I.R.C. § 103A(g)(8)).

46. See *supra* note 30 and accompanying text.

47. Similar to the reasons it disapproved the MSB program, the Treasury Department viewed the current Industrial Development Bond Program as a back door use of tax-exempt financing to obtain federal subsidies. A substantial portion of the benefits from private activity bond tax-exemptions flow to the bond investor, who as in MSB financing, provides an inefficient subsidy to the recipient of the proceeds. H. REP. NO. 98-432, 98th Cong., 1st Sess. 375 (1983). Secondly, the increase of private activity bonds saturates the tax-exempt bond market and inflates tax-exempt interest rates. The inflated interest rates increase the costs of state and local borrowing for traditional public purposes such as schools and roads. *Id.* Finally, the availability of tax-exempt financing for certain projects tends to encourage investment in such projects without regard to the project's economic value. *Id.* Some states have approved IDBs for liquor stores and luxury sky boxes for sports stadiums. *Private Activities Hearings, supra* note 3, at 4 (statement of Dan Rostenkowski, Chairman of the House Ways and Means Committee).

48. IDBs help states generate capital to spur investment and development in targeted areas. The state issues the IDB and then uses the proceeds to purchase or construct a facility. Next, the state leases the facility to a business that had agreed prior to the IDB issuance to accept the lease. The terms of the lease usually provide for lease

large increase in IDB financing,<sup>49</sup> agreed<sup>50</sup> with the Treasury Department's concerns and included provisions in the 1984 Act that severely limited a state's right to issue IDBs as well as provisions that discouraged the state's use of IDBs as a method of financing capital projects.

### A. Prior Law

Prior to the 1984 Act a state could issue only private activity bonds for certain specified purposes in order to avail itself of the tax exemption of section 103A.<sup>51</sup> If the IDB funded certain specified tax-exempt functions, the issue received tax-exempt status.<sup>52</sup> If the issuer did not

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payments approximately equal to the debt service on the bonds. The issuer acts as a conduit and funnels the lease payments to the IDB holders as interest and principal payments.

The Internal Revenue Code, which generally provides taxpayers with a tax-exemption for interest received on state issued obligations, curtails the use of the tax-exemption for IDBs. See *infra* notes 51-54 for a discussion of the restrictions an IDB issue must meet to invoke § 103A tax-exemption. Once an IDB issue fulfills the tax-exempt requirements, the state must provide the facility's lessee with lease payments approximately equal to the tax-exempt debt service payments on the bond. Consequently, lower tax-exempt interest payments result in lower lease payments. Investors, therefore, find the IDB tax-exempt interest attractive and businesses that develop or lease the IDB facility benefit from the lower lease payments.

49. The volume of state issued bonds used to finance private activities rose from \$6.2 billion in 1976 to \$44 billion in 1982. During the same period, private activity bonds increased from 21% of total state borrowing in 1975 to 51.7% in 1982. H. REP. No. 98-432, 98th Cong., 1st Sess. 375 (1983).

50. See *Private Activities Hearings, supra* note 3, at 11 (remarks of Chairman Rosentkowski and of John E. Chapoton, Department of the Treasury).

51. In general, interest on state and local obligations receives tax-exempt status from the Internal Revenue Code. I.R.C. § 103(a) (1984). The tax-exempt status, however, does not extend to IDBs unless the issue meets certain specifications. *Id.* at § 103(b)(1). See *infra* notes 52-53 (discussing the code required specifications). The Code defines an IDB as any obligation "which is issued as part of an issue all or a major portion of which are to be used in any trade or business carried on by a nonexempt person and the payments of principal or interest, on which is derived from, or secured by, money or property used in a trade or business." *Id.* at § 103(b)(2).

52. Section 103(b)(4) designates IDBs as tax exempt if the recipient of the proceeds "substantially uses the proceeds for the following exempt facilities": 1) Residential real property, if at least 20%, 15% for targeted areas, of the projects' units have low- or moderate-income; 2) sports facilities; 3) convention or trade show facilities; 4) certain transportation facilities; 5) sewerage disposal and energy facilities; 6) pollution control facilities; 7) certain hydroelectric plants; 8) certain mass commuting vehicles; or 9) local district heating or cooling facilities. *Id.* at § 103(b)(4). In addition, the Code provides an exemption for IDBs that fund the acquisition or development of land for an industrial park. *Id.* at § 103(b)(5).

The regulations under § 103 define the phrase "substantially uses all the proceeds for

use IDBs for financing such exempted functions, but used the bonds for financing the acquisition, construction, or improvement of land or depreciable property, then the issue received tax-exempt status if the aggregate amount of the issue did not exceed one million dollars.<sup>53</sup> In addition to IDBs, a tax-exempt corporation could issue Scholarship Bonds. These bonds receive tax-exempt status if the corporation uses the proceeds to fund student loans.<sup>54</sup>

### B. IDB and Student Bond Cap

Beginning with bonds issued after 1983,<sup>55</sup> states must limit the total dollar amount of their IDBs and student loan<sup>56</sup> issuances per calendar

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the following exempt facilities." An IDB issue meets the "substantially all" test when the exempt facility receives 90% or more of the bond's proceeds. Treas. Reg. § 1.103-8(a)(1)(i) (1984). The ultimate use of the IDB proceeds must end with the exempt facility. *Id.* at § 1.103-8(a)(4).

53. I.R.C. § 103(b)(6) (1984). The aggregate face amount of the issue, referred to as "small issue IDB," may not exceed \$1 million or, in the alternative, the aggregate face amount of the issue plus the related capital expenditures during the six-year period beginning three years before the date of issue and ending three years after the date, may not exceed \$10 million. *Id.* at § 103(b)(6)(A), (D). The aggregate IDB amount includes all prior issues and, in the case of the \$10 million exception, capital expenditures an issuer makes with respect to the facility. *Id.* The facilities for which an issuer makes capital expenditures include: 1) facilities located in the same incorporated municipality or county, and 2) the principal user of which is, or will be, the same person, or two or more related persons. *Id.* at § 103(b)(6)(E).

"Related persons" generally include family members, fiduciaries and corporations subject to common control. *Id.* at § 103(b)(6)(C). If unrelated parties principally use the facility, then the Internal Revenue Service (IRS) provides that each unrelated person owns his or her own facility. Thus, prior to the 1984 Act, the IRS permitted the division of one facility, an office building for example, into separate facilities, each with values of \$10 million or less. Rev. Rul. 78-63, 1978-1 C.B. 125.

54. I.R.C. § 103(a)(2) (1984).

55. The private activity bond cap applies to bonds issued after December 31, 1984. 1984 Act, *supra* note 6, at § 63(a). See also Proposed Treas. Reg. § 1.103(n) (reprinted in 192 BNA Daily Tax Reports J-17 (October 3, 1984)). The limitation does not include bonds that a state issues for projects pursuant to an inducement resolution, or other comparable preliminary approval, adopted prior to June 19, 1984, and subsequent issuance prior to January 1, 1985. 1984 Act, *supra* note 6, at § 63(a)(2). The 1984 Act states that the facility for which the state issues the IDBs must not have changed materially in either form or value subsequent to June 19, 1984, in order for the issuer to claim that it issued the obligation pursuant to an inducement resolution in existence before that date. *Id.* Furthermore, the same or related owner of the facility prior to June 19, 1984, must receive the proceeds of the subsequent issue. *Id.*

56. To qualify as a student loan bond, the recipient of the bond's proceeds must use a major portion of the proceeds to finance loans to individuals for educational expenses. 1984 Act, *supra* note 6, at § 621 (codified at I.R.C. § 103(n)(8)).

year to the greater of the product of \$150 multiplied by the issuing state's population<sup>57</sup> or \$200 million.<sup>58</sup> A state does not include in its aggregate limit IDBs issued to finance either certain state owned transportation facilities<sup>59</sup> or multifamily residential rental property.<sup>60</sup> Finally, by using rules similar to those used for the allocation of MSB authority within a state,<sup>61</sup> a state allocates its annual private activity bond limitation among state and local issuers.<sup>62</sup>

If a state does not utilize its full limitation on private activity bonds for a calendar year, it may carry forward the unused amount to the next three years.<sup>63</sup> The carry-forward provision does not apply to small issue IDBs.<sup>64</sup> The 1984 Act provides a two-year phase-in for states that have exceeded their applicable statewide limitations for 1983.<sup>65</sup>

### C. Small Issue IDBs

To curtail the rapid growth of small issue IDBs, Congress included provisions in the 1984 Act that restrict the benefits that any small issue individual beneficiary can receive.<sup>66</sup> For obligations issued after

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57 In computing this alternative limitation, the issuing state must use the most recent census estimate of its resident population published by the Bureau of Census prior to the beginning of the calendar year of limitation. *Id.*

58 *Id.* (codified at I.R.C. § 103(n)(4)).

59 If the IDBs finance convention or trade show facilities, airports, docks, wharves, and certain other mass commuting facilities and the state or local government owns the facilities, then the issuer does not include the IDB amount in its limitation. In addition, the state or local government owner may not front-load the rent charges to receive a benefit greater than straight line rent. *Id.* (codified at I.R.C. § 103(n)(7)(C)). The 1984 Act also provides that ownership of the facility resides in the governmental unit regardless of the lease ownership rules based on the lease term found in the other areas of the Code. The lessee, however, must irrevocably elect not to claim depreciation or investment tax credit with respect to such property. *Id.*

60 *Id.* (codified at I.R.C. § 103(n)(7)(B)).

61. *See supra* note 12-13.

62. *See* 1984 Act, *supra* note 6, at § 621 (codified at I.R.C. §§ 103(n)(2), (3) and (6) (West Supp. 1985)).

63. *Id.* (codified at I.R.C. § 103(n)(10)).

64. *Id.* (codified at I.R.C. § 103(n)(10)(E)).

65 If a state had an "excess bond amount" for 1983, the 1984 limitation equals the state cap as calculated pursuant to § 103(n)(4)(A) plus 50% of the excess bond amount. *Id.* (codified at I.R.C. § 103(n)(4)(B)). The "excess bond amount" equals the aggregate amount of private calendar year 1983 multiplied by 4/3, less the 1984 state cap as determined by § 103(n)(4)(A). *Id.*

66. The Treasury projected the growth of small issue IDBs to increase from \$19.4

1983,<sup>67</sup> the 1984 Act limits the aggregate total of small issue IDB financing allocated to one beneficiary.<sup>68</sup> The Code utilizes a test period to compute the aggregate limitation.<sup>69</sup> The test period is comprised of a three-year period beginning at the later of either the date the financed facility was placed in service, or the issuance date of the small issue IDB.<sup>70</sup>

The 1984 Act aggregates and treats as one single issue all of the small issue IDBs issued with respect to a single building, an enclosed shopping mall, or a strip of offices, stores or warehouses using substantially the same facilities.<sup>71</sup> If a person meets the Code definition for a principal user of the proceeds of any individual small issue, the new provisions attribute to him the status of principal user with respect to the aggregated issue.<sup>72</sup> By enacting the new rule, Congress intended to disallow the prior practice of avoiding the limitations on small issue IDBs by dividing the ownership of a single project.<sup>73</sup>

#### D. Other Limitations and Restrictions

The 1984 Act eliminates a variety of tax benefits that taxpayers previously obtained from combining the tax-exemption of certain private activity bonds with other tax saving measures. For example, except for multifamily housing projects, all projects financed with tax-exempt bonds that were depreciated by the accelerated cost recovery method

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billion in 1984 to \$34.7 billion in 1986. *Private Activities Hearings, supra* note 3, at 44. Congress retained the sunset provision that terminates the tax-exempt status of small issue IDBs issued after December 31, 1986. *See* I.R.C. § 103(b)(6)(N) (1984). Congress did, however, provide a two-year extension of the sunset date to 1988 for small issue IDBs issued with respect to manufacturing facilities. 1984 Act, *supra* note 6, at § 630 (amending I.R.C. § 103(b)(6)(N) (West Supp. 1984)).

67. 1984 Act, *supra* note 6, at § 631(c). Transition rules, similar to those for the state cap on private activity bonds, apply to bonds issued before January 1, 1985, to finance a project for which the beneficiary adopted an inducement resolution prior to June 19, 1984. *Id.*

68. *Id.* at § 623 (codified at I.R.C. § 103(b)(15)). The beneficiary receives an allocation of all IDBs that finance facilities he actually, or constructively through a related party, owns or of which he is a principal user. *Id.*

69. *Id.* (codified at I.R.C. § 103(b)(15)).

70. *Id.*

71. *Id.* at § 628(c) (amending I.R.C. § 103(b)(6)).

72. *Id.* The regulations define "principal user" as any nonexempt person who regularly uses a part of the facility in his trade or business. Treas. Reg. § 103-11(b) (1982).

73. H. REP. NO. 98-432, 98th Cong., 1st Sess. 369 (1983).

must now be depreciated by the straight line method.<sup>74</sup> Congress also eliminated the double subsidy that occurred for tax-exempt bonds that received federal guarantees.<sup>75</sup> Subject to specified exceptions,<sup>76</sup> all qualified tax-exempt bonds issued after 1983 that are also guaranteed by the federal government will lose their tax-exempt status.<sup>77</sup> Finally, the 1984 Act expanded the definition of a "substantial user" of the bond financed property.<sup>78</sup> As before, a substantial user who also holds

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74. Prior to the 1984 Act, few tax-exempt financed facilities could utilize the Accelerated Cost Recovery (ACR) method. The ACR method applies to almost all depreciable property put into service by taxpayers after 1980. I.R.C. § 168 (1984). The ACR method classifies property into three, five, ten and eighteen year estimated lives. Each year that the property is in service, the Code permits the taxpayer to recover a statutory percentage of the assets' costs as a depreciation deduction. *Id.* The statutory percentages greatly accelerate the depreciation deductions normally permitted under the straight-line method. The Code only granted this right to low-income rental housing projects, municipal sewerage or solid waste facilities, air or water pollution control facilities, and certain urban development action grant facilities. I.R.C. § 103(f)(12) (1984). Congress, on reconsideration of the facility exceptions to the straight line method of recovery, determined that the combined benefits of IDB tax-exemption and ACR for the facilities provided too large of a federal subsidy. H. REP. NO. 98-432, 98th Cong., 1st Sess. 377 (1983). Congress considered the need of a federal subsidy for multifamily housing projects and excepted it from the straight line provision. 1984 Act, *supra* note 6, at § 628(b) (amending I.R.C. § 168(f)(12) (West Supp. 1984)).

75. Under prior law, state and local governments could funnel tax-exempt bond proceeds into activities that the federal government guaranteed. Thus, tax-exempt financed projects such as pollution control facilities, housing projects and student loans could also obtain federal guarantees. The guarantee, combined with the bond's tax-exemption, made the bond a more attractive investment than U.S. Treasury securities, which result in taxable income, or state obligations without federal guarantees. The double federal subsidy thus made it difficult for federal and state governments to raise needed funds. H. REP. NO. 98-432, 98th Cong., 1st Sess. 376.

76. The 1984 Act treats certain bonds as not federally guaranteed if any guarantee originates from: 1) the Federal Housing Administration, Veterans Administration, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation or Government National Mortgage Association; 2) the Small Business Administration for certain contracts for pollution control facilities; and 3) the Bonneville Power Authority. 1984 Act, *supra* note 6, at § 622 (amending I.R.C. § 103(h) (West Supp. 1984)). In addition, the 1984 Act excludes from the federal guarantee limitations, bonds that issuers invested under the following circumstances: 1) for an initial temporary period until the facility requires the use of the proceeds; 2) in a bona fide debt service fund; 3) in a reserve or replacement fund under § 103(c)(4)(B); 4) in obligations issued by the U.S. Treasury; and 5) other investments for which the regulations will provide. *Id.* Other exceptions exist in regard to certain bonds issued for housing purposes pursuant to § 103(h)(3)(B) and bonds issued to make loans for financial institutions. *Id.*

77. *Id.*

78. Prior to the 1984 Act, the regulations defined a "substantial user" as a nonexempt person who held the issued bonds and substantially used the property financed with the bonds, or a "related party" to such substantial user. Treas. Regs. § 1.103-11(a)

the issued bonds destroys the bonds' tax exemption.

The 1984 Act limits many of the uses to which issuers may apply tax-exempt bond proceeds. Structures such as gambling facilities and health clubs no longer may receive IDB financing;<sup>79</sup> nor may tax-exempt bonds provide funds for consumer loans.<sup>80</sup> The new law, however, permits the use of tax-exempt bonds to finance acquisitions of agricultural land, unless the beneficiary uses twenty-five percent or more of issue's proceeds for the acquisition of nonagricultural land.<sup>81</sup> Similarly, Congress revoked tax-exempt financing for the purchase of existing facilities.<sup>82</sup> The 1984 Act provides further restrictions on the amount of arbitrage that an issuer may generate without causing a revocation of the bond's tax-exemption.<sup>83</sup>

The 1984 Act severely restricts state and local governments' ability to finance governmental activities through the issuance of tax-exempt bonds. The legislation manifests Congress' intent to take drastic steps at reducing federal deficits and removing cost-inefficient public programs from federal subsidy. The new restrictions will provide the federal government with greater control over the determination of the recipients of tax-exempt financing, but will diminish previously available funds for necessary state projects.

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(1984). A "substantial user" either derives more than five percent of the total revenue received by all users of such facility, or occupies more than five percent of the facility's total area. *Id.* at § 1.103-aa(b). "Related parties" include family members, an individual and a controlled corporation or a controlled partnership, and corporations and partnerships subject to common control. I.R.C. § 103(b)(6)(C) (1984). Pursuant to the 1984 Act, "related parties" now include a partnership and each of its partners, and their spouses and minor children, and an S-corporation and each of its shareholders. 1984 Act, *supra* note 6, at § 628(c) (amending I.R.C. § 103(b)(6)(C) (West Supp. 1984)).

79. 1984 Act, *supra* note 6, at § 627(c) (codified at I.R.C. § 103(b)(18) (West Supp. 1985)). In addition, bond proceeds may not fund airplanes, sky boxes or liquor stores. *Id.*

80. *Id.* at § 626(a) (amending I.R.C. § 103(o)).

81. *Id.* at § 627(a) (codified at I.R.C. § 103(b)(16)).

82. *Id.* at § 627(b) (codified at I.R.C. § 103(b)(17)).

83. *See id.* at §§ 624-25.