July 30, 2012

The Honorable Max S. Baucus
The Honorable Dave Camp
Chairman
Chairman
Senate Committee on Finance
House Committee on Ways & Means
219 Dirksen Senate Office Building
1102 Longworth House Office Building
Washington, DC 20510-6200
Washington, DC 20515

The Honorable Orrin G. Hatch
The Honorable Sander Levin
Ranking Member
Ranking Member
Senate Committee on Finance
House Committee on Ways & Means
219 Dirksen Senate Office Building
1102 Longworth House Office Building
Washington, DC 20510-6200
Washington, DC 20515

Re: Options for Tax Reform in the Area of Tax-Exempt Financing

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform in the area of tax-exempt financing. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

William M. Paul
Chair, Section of Taxation

Charles H. Egerton
Last Retiring Chair, Section of Taxation

Enclosure

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
Honorable Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
These options for tax reform (“Options”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

Principal responsibility for preparing these Options was exercised by Frederic L. Ballard, Jr. and Todd L. Cooper of the Committee on Tax-Exempt Financing. Substantive contributions were made by Ronald A. Bell, Faust Bowerman, Todd L. Cooper, Matthias M. Edrich, Edwin G. Oswald, Jeremy A. Spector, John Swendseid, Stefano Taverna, and Carla Ann Young. The Options were reviewed by John O. Swendseid, Chair of the Committee, Peter J. Connors of the Section’s Committee on Government Submissions and by Andrew J. Dubroff, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Options have clients who might be affected by the federal tax principles addressed by these Options or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

Contact: Frederic L. Ballard, Jr. Todd L. Cooper
Phone: (202) 661-2210 (513) 361-1239
Email: flb@ballardspaehr.com todd.cooper@squiresanders.com
Date: July 30, 2012
Executive Summary

These Options are intended to achieve simplification and reform of provisions of the Internal Revenue Code of 1986 relating to tax-exempt financing. The Options are summarized as follows.¹

1. If an existing tax-exempt or tax-credit bond is refinanced on a current basis, provided the issue price and weighted average maturity of the newly issued bonds (the “refunding bonds”) do not exceed the remaining principal amount and weighted average maturity of the original bonds (the “refunded bonds”), treat the refunding bonds as a continuation of the refunded bonds for purposes of sections 103 and 141 through 150, without loss of tax exemption or tax credit.²

2. Revise the rules for bank qualified bond financing by (1) increasing the threshold for determining whether an issuer is a “small” issuer of bank qualified bonds, (2) applying the threshold for bank qualification at the borrower level in conduit financings, and (3) unifying the determination of small issuer status for arbitrage rebate and bank qualification purposes.

3. Eliminate the existing confusion that arises from different treatment of categories of tax-exempt bonds by uniformly exempting all tax-exempt bonds from the alternative minimum tax and from the adjustment to corporate earnings in determining alternative minimum taxable income.

4. Repeal the 5% limit on proceeds of governmental bonds that may be used for unrelated or disproportionate nongovernmental purposes, so that all nongovernmental uses are subject to a single 10% limit.³

5. Repeal the requirement that prepayments on mortgages financed by mortgage revenue bonds be used to retire bonds if received more than ten years after the date of their issuance (or the issuance of the original refunded bonds in the case of refinancing).

6. Repeal the 25% limit on directly related and ancillary costs in small issue private activity bonds for manufacturing facilities, and reenact the “functionally related

¹ Unless otherwise indicated, references herein to “section” are to a section of the Internal Revenue Code of 1986, as amended (“Code”), references to “Treasury Regulation” and “Reg. §” are to the Treasury Regulations promulgated thereunder, and references to “Service” are to the Internal Revenue Service.


7. Reenact provisions for Build America Bonds at the 28% subsidy payment rate with expanded authorization to include ref financings, governmental working capital financings, and financings for section 501(c)(3) nonprofit entities.4

8. Extend to tax-exempt bonds the three-year spending exception from arbitrage rebate for tax-credit bonds and simplify the exception.5

9. Increase the small issuer exception from rebate to $10 million, index it for inflation, and remove the general taxing power eligibility requirement.6

10. Allow all yield restrictions, including advance refunding escrows, to be satisfied by yield reduction payments calculated similarly to arbitrage rebate.7

11. Repeal the $150 million non-hospital bond limitation on all qualified 501(c)(3) bonds (already repealed in 1997 for new construction financing).

---

4 A similar proposal appears in President Obama’s 2013 Budget and also the 2012 Budget. See 2013 General Explanations, p. 11, and 2012 General Explanations, p. 20.

5 A similar proposal appears in President Obama’s 2013 Budget and also the 2012 Budget. See 2013 General Explanations, p. 183, and 2012 General Explanations, p. 93.

6 A similar proposal appears in President Obama’s 2013 Budget and also the 2012 Budget. See 2013 General Explanations, p. 183, and 2012 General Explanations, p. 94.

7 A related proposal appears in President Obama’s 2013 Budget. See 2013 General Explanations, p. 183.
Options for Tax Reform in the Area of Tax-Exempt Financing

1. If existing tax-exempt or tax-credit bonds are refinanced on a current basis, provided the issue price and weighted average maturity of the refunding bonds do not exceed the remaining principal amount and weighted average maturity of the refunded bonds, treat the refunding bonds as a continuation of the refunded bonds for purposes of sections 103 and 141 through 150, without loss of tax exemption or tax credit.

Present Law. Tax-exempt governmental bonds generally may be issued for a wide range of governmental functions ranging from bridges and schools to municipal power plants.\(^8\) Tax-exempt private activity bonds may be issued to finance an array of quasi-governmental facilities and functions such as ports, airports, low and moderate income housing projects, single family mortgages, student loans, small manufacturing facilities, and obligations for the benefit of section 501(c)(3) organizations.\(^9\) In recent years, Congress has introduced several new financing tools for state and local governments.\(^10\) One new category of financing tools consists of “tax-credit bonds,” which generally provide an annual tax credit to the holders of the bonds in lieu of tax-exempt interest.\(^11\) Several tax-credit bond programs also permit the issuer to receive a direct cash payment from the Treasury equal to the amount of the interest rate subsidy in lieu of providing a tax credit to the bondholder.\(^12\) Tax-credit bonds, like the majority of qualified private activity bonds, generally are subject to volume cap and are limited to financing a limited range of purposes.\(^13\) Tax-credit bonds include New Clean Renewable Energy Bonds, Recovery Zone Economic Development Bonds, Qualified Energy Conservation Bonds, Qualified Zone Academy Bonds and Build America Bonds. Tax-credit bonds generally provide an interest rate subsidy to state and local government issuers ranging from 35% to 100%.

All types of tax-exempt bonds generally can be refunded if the proceeds are used to retire the refunded bonds within 90 days of the date of issue of the refunding bonds. Similarly, tax-credit bonds (which are generally structured with bullet principal maturities) generally can be refunded with tax-exempt bonds, but it is unclear whether tax-credit bonds can be refunded with newly issued tax-credit bonds.

A “refunding,” for this purpose, is the common form of refinancing in which the proceeds of “refunding bonds” are used to retire “refunded bonds.” A “current refunding” is a refunding in which the refunded bonds are retired within 90 days after the issuance of the refunding bonds.

---

\(^8\) See section 103.

\(^9\) See sections 103 and 142 through 145.

\(^10\) See sections 54 through 54F, 1394, 1397C through 1397F, 1400A, 1400L through 1400N, and 1400T through 1400U-3.

\(^11\) Id.

\(^12\) See sections 54AA(g)(1), 1400U-2, and 6431.

\(^13\) Id.
If the refunded bonds are not retired until after the 90-day period following issuance of the refunding bonds, the refunding is an “advance refunding.” Advance refundings typically occur either because the bond terms do not permit retirement within 90 days or because retirement within 90 days is not financially desirable. Advance refundings, in which by definition both the refunding bonds and the refunded bonds will be in the hands of bondholders for an extended period, present more difficult policy questions than current refundings and are more heavily regulated. The Option we are presenting does not apply to advance refundings.

**Reasons for Change.** A refinancing through the issuance of refunding bonds constitutes a “new” debt issue for federal tax purposes.\(^\text{14}\) In the municipal market, a new debt issue will trigger several compliance responsibilities for the state and local government issuer and generate several costs. For example, issuing refunding bonds requires a new approving opinion and tax opinion of bond counsel, significant due diligence (and related matters) must be undertaken by the issuer and other municipal professionals, the issuer must file a new Form 8038-G (“Information Return for Tax-Exempt Governmental Obligations”) or the equivalent form for private activity bonds with the Service, a final arbitrage rebate report for the refunded bonds must be generated, and any rebate owing to the U.S. Treasury Department must be paid.

The principle that a refunding bond is a continuation of the refunded bond has been recognized in analogous contexts of municipal bonds. For example, Treasury Regulations generally treat a refunding bond as a continuation of the refunded bond for purposes of measuring private use,\(^\text{15}\) and the Code generally treats a refunding bond as a continuation of the refunded bond for purposes of public approval for private activity bonds if there is no extension of weighted average maturity.\(^\text{16}\) Treating refunding bonds more generally as a continuation of the refunded bonds would relieve the issuer of a range of costs and expenses, administrative staffing and time. For example, there would be no need to file a report for issuance of the refunding bonds or to make a final arbitrage rebate payment with respect to the refunded bonds.

The current economic environment of significant governmental budget constraints at both the state and Federal level enhances the need for clear rules facilitating the refinancing of tax-credit bonds with tax-credit bonds, tax-exempt bonds with tax-credit bonds, and tax-credit bonds with tax-exempt bonds, because these refinancing methods conserve scarce resources by lowering the debt service costs for all types of tax-subsidized bonds.

**Option for Consideration.** Under the Option presented, if existing, tax-subsidized bonds are current refunded, with no increase in the weighted average maturity of the bonds or their principal amount, the refunding bonds would be treated as a continuation of the refunded bonds for purposes of sections 103 and 141 through 150, without loss of tax exemption or tax credit.\(^\text{17}\)

\(^{14}\) See section 1001 and Reg. §1.1001-3.

\(^{15}\) See section 141 and Reg. § 1.141-13; see also Notice 2012-3, 2012-3 I.R.B. 1.

\(^{16}\) See section 147(1)(2)(D).

\(^{17}\) A similar provision appears in President Obama’s 2013 Budget. See 2013 General Explanations, p. 54.
This option would be limited to current refundings and would therefore permit the refunding bonds and the refunded bonds to be simultaneously outstanding for no more than 90 days. The double benefit of tax-exempt interest on both issues for the 90-day period is permitted by present law as part of a current refunding. It could be dealt with in a “continued indebtedness” regime by providing expressly that tax benefits during the 90-day period would be allowable on both the refunding bonds and the refunded bonds.

2. Revise the rules for qualified bond financing by (1) increasing the threshold for determining whether an issuer is a “small” issuer of bank qualified bonds, (2) applying the threshold for bank qualification at the borrower level in conduit financings, and (3) unifying the determination of small issuer status for arbitrage rebate and bank qualification purposes.

Present Law. No deduction is generally allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is tax-exempt. The deduction is generally disallowed only if the taxpayer has a purpose of using proceeds of the indebtedness to purchase or carry tax-exempt obligations, with the taxpayer’s purpose determined based on all of the facts and circumstances. In the absence of direct evidence linking an individual taxpayer’s indebtedness with the purchase or carrying of tax-exempt obligations, the Service takes the position that it ordinarily will not infer that a taxpayer’s purpose in borrowing money was to purchase or carry tax-exempt obligations if the taxpayer’s investment in tax-exempt obligations is “insubstantial.” The Recovery Act provided for a 2% safe harbor for this purpose with respect to any bonds originally issued during 2009 and 2010, and any refunding bonds with respect to original bonds.

In addition, financial institutions may deduct interest expense allocable to investments in “qualified tax-exempt obligations” (“QTEOs”), subject to a 20% disallowance. QTEOs are bonds that are so designated (or deemed designated in the case of certain refinancings) by an issuer of tax-exempt obligations that are issued for “governmental” or section 501(c)(3) purposes to the extent that the issuer reasonably expects that the amount of its tax-exempt obligations to be issued in a calendar year will not exceed $10 million. Among various clarifications and modifications, the Recovery Act temporarily increased the $10 million limit to $30 million, and applied the increased limit at the borrower level in the case of conduit financings (in which the bond issuer lends the proceeds of the bonds to a borrower such as a section 501(c)(3)

---

18 See section 265(a)(2).


20 Id.

21 See Pub. L. No. 111-5, §1501(a) (2009) (enacting section 265(b)(7)).

22 See sections 265(b) and 291(a)(3) and (e)(1).

23 See section 265(b)(3).
For example, if a bank purchases $10 million or less (taking into account other bonds issued by the same issuer in the calendar year) of tax-exempt bonds issued to construct a city office building, the nondeductibility of interest on indebtedness incurred to carry the bonds does not apply, but if the bank purchases $10.1 million (or if the issuer previously issued bonds that, together with the office building bonds, exceed $10 million), the issuer will likely encounter difficulty marketing the bonds to a bank because the nondeductibility of interest makes them less attractive to banks as potential purchasers.

Reasons for Change. The purpose of the small issuer bank purchase exception is to preserve the ability of small issuers, with limited access to the capital markets, to place bonds with local banks without undue complexity. The $10 million limit has not been increased since its enactment in 1986, and the cost of capital projects has increased dramatically since then. The Recovery Act’s temporary increase of the limit has expired. The Recovery Act’s temporary application of the increased limit at the borrower level in the case of a conduit financing that expands access to capital for meritorious projects has similarly expired. Finally, continuing the small issuer requirements for bank qualification to those for the small issuer exception for the arbitrage rebate rules would be a significant simplification because the slight differences in the requirements are a trap for the less sophisticated issuers for whom the provisions were designed and a single definition of a “small” issuer for both rules would simplify their operation.25

Arguably the small issuer bank purchase exception is no longer necessary because of the access to capital markets provided by state-level bond banks and pooled loan programs.26 But pool programs are not available in all states and where they are available, they may not be available for all governmental purposes. Thus, many small issuers remain dependent on local banks as their main source of financing. More generally, many municipal issuers have struggled in accessing the tax-exempt market in a cost-efficient manner since the economy began receding in 2007, and the Recovery Act’s temporary increase in the $10 million limit to $30 million generated significant cost savings for many issuers of tax-exempt obligations by increasing their liquidity. Because banks and other financial institutions will remain subject to the disallowance of 20% of their interest deductions, the Option presented will simply reduce the costs of governmental operations rather than produce an unfair advantage for financial institutions vis-a-vis other corporate investors.27

Liberalizing the deductibility of interest expense will simplify the ability of section 501(c)(3) organizations, such as schools, to access banks for tax-exempt financing of projects. The current limitations create an incentive – in some cases a practical necessity – for the

---


25 To illustrate the problem, the size limit in small issuer arbitrage rebate exemption in section 148(f)(4)(D) allows the issuer to disregard any bonds issued in a current refunding. The equivalent provision in the QTEO limit of section 265(b)(3) applies to refundings only if they conform with a maturity limit of 30 years or less in some circumstances.

26 See section 149(f) for relatively elaborate restrictions on the use of pooled financing bonds.

27 See section 291(a)(3).
borrowing organization to access tax-exempt financing by obtaining a letter of credit from a bank to support a variable rate bond offering, and to subject the financing to periodic mandatory tender during the term of the letter of credit and at its expiration, when the bonds can be remarketed with a new letter of credit if one is available. The borrowing organization will typically seek to protect itself from interest rate risk through an interest rate hedge agreement (e.g., an interest rate swap), a financially sound arrangement that is far more complex than simply placing the bonds directly with a bank. The tax laws should not force section 501(c)(3) organizations to go into the public securities markets with these complex, and to some extent financially risky, arrangements when a bank financing would make more sense if permitted by the tax laws.

Current law makes the situation even worse by applying the QTEO dollar limit, small as it is, at the level of the issuer rather than the borrower. This feature of current law, which the Option presented would change, means that once the dollar limit has been used up for the year by the issuer or by other issuers considered related to it, potential borrowers have no ability to use QTEO financing by that issuer. These borrowers then are forced to seek other issuers who have not used up their limit, leading to a bizarre situation in which needless legal analysis goes into determining which issuers are related and therefore should be aggregated for purposes of the limit. This regrettable situation, creating needless practical complexity for the very borrowers that the QTEO provisions were intended to help, could be substantially mitigated by applying the QTEO limit at the borrower level. The Option presented would simplify the practical application of the tax laws in this area by relieving the pressure imposed on the current QTEO limits by the need of small borrowers to have access to bank financing through QTEOs as distinguished from the public bond markets.

**Options for Consideration.** Make permanent the Recovery Act’s temporary increase of the “small” issuer exemption to $30 million and its application at the borrower level in conduit financings, and conform the determination of small issuer status for arbitrage rebate and bank qualification purposes.

3. Uniformly exempt all tax-exempt bonds from alternative minimum tax and from the adjustment to corporate earnings in determining alternative minimum taxable income.

**Present Law.** An alternative minimum tax (“AMT”) is imposed on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. The tentative minimum tax is computed based upon a taxpayer’s alternative minimum taxable income (“AMTI”). AMTI is the taxpayer’s taxable income modified by certain preferences and adjustments. One of the preference items is tax-exempt interest on “private activity bonds” other than qualified 501(c)(3) bonds, or bonds issued prior to August 8, 1986 (or refinancing of such pre-1986 bonds).28 For example, without exemption, a holder of qualified tax-exempt private activity bonds receiving $100,000 of interest on the bonds would exclude that amount from federal adjusted gross income for computing the federal regular

\[28\] See section 57(a)(5).
income tax, but would add it to federal adjusted gross income in determining AMT. In the case of a corporation, another adjustment is required based on current earnings and it is determined, in part, by taking into account 75% of items, including tax-exempt interest, that are excluded from AMTI but included in the corporation’s adjusted current earnings (“ACE”).

The Recovery Act excluded tax-exempt interest on private activity bonds issued in 2009 and 2010 (and any refunding bonds with respect to bonds issued in 2009 and 2010) from tax preference for purposes of the AMT and from corporate current earnings for purposes of ACE. Also, the Housing Assistance Tax Act of 2008 provided similar, permanent relief for private activity bonds for rental or owner-occupied housing.

**Reasons for Change.** Repealing the AMT’s application to tax-exempt qualified private activity bonds would simplify the tax-exempt interest exclusion, eliminate confusion among potential purchasers of tax-exempt bonds, enhance market demand for these bonds, and increase market efficiency. In the municipal market, private activity bonds subject to AMT carry a higher interest rate. This adds to federal tax expenditures without a corresponding increase in federal tax revenues because investors subject to the AMT generally do not purchase these bonds.

Repealing the AMT’s application to tax-exempt bonds would have increasing market significance as more taxpayers become subject to the AMT in future years. The Option presented should increase the demand for tax-exempt private activity bonds, and in turn lower the interest rates on private activity bonds. This decrease should also reduce the burden on the tax-exempt bond market and increase federal revenues. Moreover, in the case of a multi-year large project, which began during 2009 and 2010 and requires the issuance of new bonds, it should unify the tax cost of private activity bonds issued in 2009 and 2010 (and any such applicable refinancing) and bonds issued thereafter.

Theoretically the simplification objective could be met as well by eliminating the AMT exemption altogether. We suggest, however, that other policy considerations militate against a total repeal of the exemption. Specifically, this action would amount to a selective tax increase on one sector of the economy (state and local governments), for whom an increase in borrowing costs would necessitate either an increase in state and local taxes, a curtailment in services, a reduction in positive credit status, or an increase in negative credit status. Simplification could be better accomplished (if and to the extent desired) by modification of other, more direct relationships between the Federal government and state and local governments.

**Option for Consideration.** Uniformly exempt all tax-exempt bonds from AMT and from the adjustments to corporate earnings in determining AMT.

---

29 See section 56(g)(4)(B).

30 See Pub. L. No. 111-5, §1503(a) and (b) (2009) (enacting sections 56(g)(4)(B)(iv)) and 57(a)(5)(C)(vi)).

31 See Pub. L. No. 110-289, §3022(a) (2008) (enacting sections 56(g)(4)(B)(iii) and 57(a)(5)(C)(iii)).
4. Repeal the 5% limit on proceeds of governmental bonds that may be used for unrelated and disproportionate nongovernmental purposes, so that all nongovernmental uses are subject to a single 10% limit.

**Present Law.** If private business use is not related, or is disproportionate to, the governmental use of tax-exempt bond proceeds, then a 5% private business use restriction applies to tax-exempt governmental bonds instead of the general 10% private business use restriction on such bonds.\(^32\) For example, if a governmental bond is issued to finance a courthouse facility, which includes a staff cafeteria operated by a private business, a 10% private business use restriction applies to such bond issue because the cafeteria use is treated as related to the courthouse use, but if a governmental bond is issued to finance a courthouse, which includes office space for lawyers, a 5% private business use restriction applies to the bond issue because the law office use is treated as unrelated to the governmental courthouse use.

**Reasons for Change.** The unrelated or disproportionate use test is cumbersome, inappropriately intricate, and difficult to understand and to apply. The determination of whether a particular use is related or unrelated to a governmental use, or whether a use is proportionate or disproportionate to a governmental use, can be vague and arbitrary. Application of the test is especially complex in the case of bond issues financing multiple facilities. Out of an abundance of caution, some issuers automatically reduce their otherwise-permitted level of private business involvement from 10% to 5% in governmental tax-exempt bond issues to avoid the interpretative difficulties. Because the penalty for an erroneous determination is loss of tax exemption for the entire bond issue, the general 10% private business use limit effectively polices excess private business use.

The Option presented would, in substance, eliminate the separate treatment of unrelated business use and related but disproportionate business use, making them subject to the 10% limit imposed by section 141 on private business use generally. Theoretically an equivalent element of simplification could be achieved by subjecting all categories of business use to some other percentage tests, e.g., 5% as currently applies to unrelated business use or disproportionate business use, and 25% as applied to all forms of business use before 1986. However, the use of a general 10% standard was selected by Congress as a policy matter in 1986, and the relatively specialized problem of unrelated business use and disproportionate business use does not seem a reason to disturb it.

**Option for Consideration.** Repeal the 5% limit on unrelated or disproportionate use so that nongovernmental uses are subject to a single 10% limit.\(^33\)

5. Repeal the requirement that prepayments on mortgages financed by mortgage revenue bonds be used to retire bonds if received more than ten years after the date of their issuance (or the refunded bonds in the case of refinancing).

\(^{32}\) See section 141(b)(3).

\(^{33}\) A similar proposal appears in President Obama’s 2013 Budget and also the 2012 Budget. See 2013 General Explanations, p. 186, and 2012 General Explanations, p. 96.
Present Law. Qualified mortgage bonds are tax-exempt bonds used to finance owner-occupied residences. They are subject to income and purchase price limitations, as well as a requirement that the homebuyer not have an ownership interest in a principal residence in the preceding three years. The annual volume limitations imposed on most qualified private activity bonds limit the aggregate amount of, among others, qualified mortgage bonds that may be issued.

Except for a $250,000 de minimis amount exception, repayments of principal of mortgage loans funded by qualified mortgage bonds received after 10 years from the date of issue of the bonds must be used to retire the bonds not later than the close of the first semiannual period beginning after the date the prepayment (or complete repayment) is received (the “10-Year Rule”). In the case of a refunding, the 10 years is measured from the issue date of the original refunded bonds. The 10-Year Rule generally applies to qualified mortgage bonds issued after December 31, 1988, and (under a transition rule) with respect to a post-1988 refinancing of pre-1989 qualified mortgage bonds, only to repayments received on or after the issue date of the refunding bonds, including payments on mortgage loans purchased before the issue date of the refunding bonds. An internally inconsistent aspect of the 10-Year Rule results from the Code’s use of the terms (italicized above) repayments, prepayment and complete repayment, seemingly overlooking principal repayments that are neither prepayments nor complete repayments, but the legislative history to the 10-Year Rule appears to indicate that the 10-Year Rule applies to regular mortgage loan repayments and prepayments.

Qualified mortgage refunding bonds are permitted provided they are current refunding bonds (i.e., refunding bonds issued not more than 90 days before retirement of the refunded bonds). The refunding bonds do not require a new allocation of volume cap upon the satisfaction of certain requirements: (1) the maturity date of the refunding bond must be not be later than the later of (i) the average maturity date of the refunded bonds, or (ii) the date 32 years after the date on which the refunded bonds were issued (or, in the case of a refinancing, the date on which the original refunded bonds were issued); and (2) the amount of the qualified mortgage refunding bonds must not exceed the outstanding amount of the refunded bonds.

The intent of the 10-Year Rule is to permit issuers of qualified mortgage bonds to “recycle” all mortgage loan principal repayments and prepayments (i.e., originate additional mortgage loans) for 10 years after the issuance of the bonds. Refinancings of qualified mortgage bonds after the initial origination period also recycle payments to originate additional mortgage loans by using scheduled mortgage principal repayments, which otherwise would be used to pay

---

34 See section 143(d), (e) and (f).

35 See section 143(a)(2)(iv).

36 Id.


maturing bond principal or redeem bonds, and mortgage principal prepayments, which would otherwise be used to redeem bonds, to acquire additional mortgage loans. In other words, one of the universally accepted “sources” of refunding may be bonds scheduled to mature or bonds to be redeemed from repayments and prepayments (subject to the 10-Year Rule). Following the refinancing, the monies that would have been used to pay principal on the refunded bonds are used to make new mortgage loans that secure and provide a source of revenue to pay debt service on the refunding bonds. Simply stated, repayments and prepayments of one qualified mortgage bond issue become the lendable transferred proceeds of another qualified mortgage bond issue, namely, a refinancing issue. This is accomplished without increasing the long-term amount of bonds outstanding. The 10-Year Rule has a substantial impact on the ability of issuers to engage in such recycling refinancings, which are also known as “replacement refundings” or “prepayment refundings.”

For example, if a replacement refunding bond is issued in 1994 to refinance one or more pre-1988 qualified mortgage bond issues, beginning in calendar year 1998 all principal receipts on mortgage loans attributable to the 1994 refinancing issue are deemed allocated by the 10-Year Rule to issues more than 10 years old and none of the 1994 issue may now be refinanced as a means to generate funding authority for additional mortgage loans. In contrast, a refinancing would be permitted if it was intended to save interest costs as compared to costs on the refunded bonds, but all mortgage loan repayments and prepayments received would be required to be used to redeem the refinancing issue. Also, after the 10-year period, issuers are effectively neither permitted to “cross-call” (i.e., retire) bonds of one issue from principal repayments and prepayments on mortgage loans funded by another issue nor permitted to use principal repayments and prepayments allocable to tax-exempt qualified mortgage bonds for paying principal on any paired taxable bonds.

**Reasons for Change.** The 10-Year Rule reduces an issuer’s ability to recycle principal repayments and prepayments into new mortgage loans and, in turn, reduces the issuer’s funding authority for mortgage loans and ability to reduce mortgage loan interest rates for program mortgagors to competitive levels. Replacement refundings are affected by variables such as the availability of volume cap and declining interest rates. In a market where volume cap is scarce, a replacement refunding, subject to the 10-Year Rule, can provide additional monies to finance new mortgage loans without requiring a volume cap allocation, but the 10-Year Rule requires increasing amounts of volume cap in order for issuers to continue operating their single-family programs.

Tracing the chronology of all post-1988 replacement refundings is complex and costly, and the resulting tax compliance and administrative burdens have led to only a fraction of post-1988 issues being refinanced. A typical issue of qualified mortgage bonds may refinance portions of several different prior issues, each of which may itself have refinanced portions of prior issues. Issuers generally trace the use of proceeds of the refinancing bonds back to the original financing bonds on a proportionate basis and then assign separate 10-year dates to various percentages of the refinancing bonds. This table of dates and percentages determines what percentage of the repayments and prepayments received in any particular period must be used for retirement and what percentage is available for new loans. Once the refinancing bonds are issued, the analysis is used to determine which prepayments are available for future loans and retirement. The difficulties in applying the 10-Year Rule become apparent under the typical
bond indentures for more than one series of outstanding qualified mortgage bonds, requiring revenues to be applied on a parity basis, and new mortgage loans may be made from numerous sources of funds. Moreover, most issuers combine new money and refinancings in one qualified mortgage bond issue and the 10-Year Rule is most difficult and time consuming when, as typical for state housing issuers, tracing to ascertain applicable restrictive dates involves multigenerations of qualified mortgage bond issues, each which may have refinanced portions of multiple prior issues.39

Recycling, including replacement refunding, provides additional funding authority for mortgage loans to satisfy demand for mortgage loans to low and moderate income first-time homebuyers without overburdening the tax-exempt bond market. Recycling during the 10-year period results in qualified mortgage bonds remaining outstanding no longer than the period of time for which they were structured. Recycling through a replacement refunding results in refunding bonds which are subject to certain maturity limits, merely replace refunded bonds, dollar for dollar, and remain subject to certain maturity limitations applicable to the refunded bonds.

In summary, over several years, the lost funding authority for mortgage loans by state housing issuers eliminates opportunities to make thousands of mortgage loans with no increase in the amount or extension of the life of bonds.

**Option for Consideration.** Repeal the 10-Year Rule.

6. **Repeal the 25 percent limit on directly related and ancillary costs in small issue private activity bonds for manufacturing facilities, and reenact the Recovery Act’s “functionally related and subordinate” test.**

**Present Law.** A manufacturing facility is eligible for the qualified small issue bond provisions of the Code if, among other things, it is used in the “manufacturing or production of tangible personal property.”40 Facilities that are “directly related and ancillary to a manufacturing facility” are considered a part of the manufacturing facility and may also be financed with qualified small issue bonds if: (1) they are or will be located on the same site as the manufacturing facility (the “location requirement”); and (2) not more than 25% of the net proceeds of the issue will be used to provide such facilities (the “25% limitation”).41 For bonds issued in 2009 and 2010, the Recovery Act temporarily replaced the 25% limitation with a

39 Elimination of the 10-Year Rule would not lead to refundings intended to capitalize on existing transitional exemptions from the income and purchase price limitations. The Tax Reform Act of 1986 imposed these limitations on all mortgage loans, including those related to recycling or replacement refundings. See Pub. L. No. 99-514, §1313(d) (1986).

40 See section 144(a)(12)(C)(i).

41 See section 144(a)(12)(C)(ii).
requirement that the facilities be “functionally related and subordinate” to the actual manufacturing facility (the “functionally related and subordinate test”).

For example, if a municipal issuer issued bonds to finance the acquisition of a manufacturing facility, including forklift trucks used to move raw material or the products resulting from the manufacturing process, and more than 25% of the net proceeds of the bonds was allocated to purchasing the forklifts, the bonds could not be qualified small issue bonds because the 25% limitation is exceeded. Under the Recovery Act, this use of proceeds did not automatically disqualify the bonds if the functionally related and subordinate test was satisfied. Or, assume that the building housing the manufacturing facilities also included a room that held computers used to process orders, calculate raw material needed to fill the orders, and prepare billings for the items manufactured to fill the orders. It is unclear whether this portion of facilities is “directly related” and therefore could be financed with qualified small issue bonds subject to the 25% limitation, or is merely “functionally related” and therefore not eligible to be financed with qualified small issue bonds.

Reasons for Change. The “directly related and ancillary” rule has historically been difficult to apply, in part because of inconsistent drafting, legislative interpretation and application. Before its enactment in 1988, practitioners relied on Treasury Regulations governing qualified facility bonds (and before that, qualified industrial development bonds), which had included as part of “qualified facilities,” facilities that were functionally related and subordinate to the qualified facilities themselves. The 1988 legislative history indicates that enactment of the phrase “directly related and ancillary” was intended to distinguish between: (1) core manufacturing facilities (i.e., facilities actually causing the transformation or processing of the manufactured product); (2) facilities that are subordinate and integral to the core manufacturing facilities (i.e., facilities essential for the core manufacturing process to operate); and (3) ancillary facilities (e.g., facilities not integral to the core manufacturing or production process). The location requirement is understood to have been intended to apply only to subordinate and integral facilities as well as to ancillary facilities, and the 25% limitation was intended to apply only to ancillary facilities, but the 1988 legislative history nevertheless equates ancillary facilities with subordinate and integral facilities, and thereby appears to misinterpret Congressional intent.

Eliminating the 25% limitation and retaining only the functionally related and subordinate test that applied under the Recovery Act to qualified small issue bonds until December 31, 2010, should not lead to indiscriminate financing of non-core manufacturing facilities, any more than permitting the financing of functionally related and subordinate facilities has led to non-core manufacturing facilities. There still must be a financing of a

---

42 See section 144(a)(12)(C)(iii)(II).
43 See Reg. §1.103-8(a)(3).
45 Id.
manufacturing facility to which the functionally related and subordinate facility is an adjunct. Furthermore, qualified small issue bonds continue to be subject to both the limits on the overall size of a small issue bonds and on capital expenditures. Finally, small issue bonds, like qualified exempt facility bonds, are also subject to the overall state volume cap limitations.

**Options for Consideration.** Repeal the 25% limit on directly related and ancillary facilities and permanently adopt the Recovery Act’s “functionally related and subordinate” test.

7. **Reenact provisions for Build America Bonds at a 28% subsidy payment rate with expanded authorization to include current refinancings, governmental working capital financings and financings for section 501(c)(3) nonprofit entities.**

**Present Law.** Under the refundable tax credit Build America Bonds program, which expired on December 31, 2010, state and local governments were able to issue taxable bonds and elect to receive payments (the refundable tax credits) in the amount of 35% of their interest costs. Use of Build America Bond proceeds was generally limited to financing public capital projects for which the issuer could otherwise have issued tax-exempt “governmental bonds.”

For example, assume a municipal issuer issued bonds in 2010 to construct a new courthouse. If the bonds had been issued as tax-exempt bonds, interest on the bonds would generally have been excludable from gross income of the registered owners of the bonds for federal income tax purposes. But, if the bonds had been issued as refundable tax credit Build America Bonds, interest would have been payable based on taxable bond rates and would not have been excludable from gross income. Instead, over the term of the bonds, the issuer would receive taxable payments from the U.S. Treasury Department equal to 35% of the interest on the bonds.

**Reasons for Change.** Build America Bonds were a new financing vehicle for state and local issuers. By offering refundable tax credits in lieu of tax-exempt interest, they opened up the municipal securities market to nontraditional investors (e.g., pension funds, life insurance companies and foreign investors) that do not benefit from tax-exempt interest. This contributed to stabilizing the demand for state and local debt and improved the under-capitalization of the tax-exempt market by increasing the demand for tax-exempt bonds and lowering borrowing costs. At the same time, access to a robust conventional tax-exempt market remains necessary as an alternative to Build America Bonds. Allowing tax exemption as an alternative to refundable tax credits provides issuers with alternatives for the best place to sell their bonds, and it represents a financing method that may be more viable in the case of smaller financings where the compliance costs of reporting and claiming the refundable tax credits can be disproportionate.

---

46 See section 54AA(g)(1).

47 See also 2013 General Explanations, p. 11-12, and 2012 General Explanations, pp. 20-21, pointing out that Build America Bonds deliver federal subsidies directly to state and local governments while traditional tax-exempt or tax-credit bonds generate subsidies indirectly through third-party investors.
Offering direct payment through the refundable tax credits enables the Service to resolve compliance issues directly with the bond issuer, as opposed to the system for tax-exempt interest that requires dealing with the issuer or conduit borrower instead of the bondholder. Tax-exempt interest presents considerable inefficiency on both sides—the Service and counsel for the issuer or borrower—in addressing, or discussing with each other or with the bondholders, the bondholder effect of a proposed disqualification of the bonds. In the case of refundable tax credits, the Service can deal directly with the party who would suffer the economic burden of a disallowance (the issuer), creating a simpler alignment of interests and analysis.

The direct relationship between the real parties in interest in Build America Bonds has been evident in audit activity by the Service relating to the price at which the bonds are issued, which relates directly to the amount of the credit payment based on interest. Issuers have raised the question of whether these audits have lost sight of the fact that the majority of the interest cost is borne by the issuers themselves, so that the credit mechanism has a built-in limitation on the issuers’ incentive to artificially increase the interest rate. The point remains that the Build America Bonds enable the Service to deal directly with the issuer in carrying out the Service’s perception of needed enforcement activity. At the same time, the current controversy about audit practices respecting Build America Bonds reinforces the need for preservation of conventional tax-exempt bonds as a market alternative.

*Option for Consideration.* Reenact the provisions for Build America Bonds at a 28% subsidy payment rate with expanded authorization to include current refinancings, governmental working capital financings and financings for section 501(c)(3) entities.48

8. **Extend to tax-exempt bonds the three-year spending exception from arbitrage rebate provided for tax-credit bonds, and modify the exception in technical respects.**

*Present Law.* Generally, interest income on investments of tax-exempt bond proceeds in excess of the bond yield must be rebated to the federal government.49 Spending exceptions permit an issuer to avoid rebate on construction fund moneys if spent within 6-month, 18-month and 2-year periods.50 The 2-year spending exception is available only for governmental and qualified 501(c)(3) bonds issued to finance certain construction projects.51 The 2-year exception

---

48 A similar proposal appears in President Obama’s 2013 Budget and also the 2012 Budget. See 2013 General Explanations, p. 11, and 2012 General Explanations, p. 21. The budget proposal would permanently resurrect Build America Bonds at a lower 28% direct-payment rate, which is designed to be approximately revenue neutral in comparison to the federal tax expenditures from traditional tax-exempt bonds, and would expand the eligible uses for Build America Bonds to include current refinancings of prior public capital project financings for interest cost savings, governmental working capital financings, subject to a 13-month maturity limitation, and financing for section 501(c)(3) nonprofit entities, such as nonprofit hospitals and universities.

49 See section 148(f).

50 See section 148(f)(4)(B) and (C) and Reg. §1.148-7.

51 See section 148(f)(4)(C) and Reg. §1.148-7(e) through (i).
is complicated to apply, with semi-annual spending targets, rules that require an issuer to exclude non-construction expenditures, and complex penalty elections that are rarely used.

Similarly, interest income on investments of tax credit bond proceeds in excess of the bond yield must be rebated to the federal government. A spending exception from yield restriction and rebate applies if the issuer reasonably expects to spend 100% of the proceeds within 3 years of the date of issue and enters into a binding commitment with a third party to spend at least 10% of the proceeds within 6 months of the date of issue. The 3-year spending period can be extended by the Service if the issuer establishes that the failure to spend is due to reasonable cause and the projects will continue to proceed with due diligence. To the extent that 100% of the proceeds are not spent within the 3-year period (or the end of any period for which the Service grants an extension), the unspent proceeds must be used to retire bonds within 90 days of the end of the period.

For example, assume $40 million of tax-exempt bonds are issued by a local school district to construct a public school, the issuer plans to use the 2-year rebate spending exception and has sized the issue to meet the spending benchmarks, including expenditure of all investment earnings, and the issuer meets the first two semiannual spending benchmarks, but unusually inclement weather causes the issuer to fall short of the third benchmark. The issuer loses the entire benefit of the rebate exception and must rebate any excess investment earnings over the yield on the tax-exempt bonds to the federal government despite having sized the issue to spend all earnings on the project. Further, if the school district additionally finances costs that are not construction expenditures (e.g., land acquisition and equipment for the school), the issuer is not entitled to the 2-year exception if the land acquisition and equipment exceed 25% of the issue. If these costs are less than 25%, the issuer is required to make a complex election to divide the issue into construction and non-construction components and separately analyze each for rebate purposes.

By contrast, assume $40 million of qualified school construction tax-credit bonds are issued by a local government to acquire land on which it will construct and equip a public school, where the issuer has sized the issue with the expectation that it will spend all sale proceeds, including expected investment earnings, within 3 years of the date of issue, and the issuer enters into a construction contract pursuant to which it agrees to spend more than 10% of the proceeds within 6 months of the date of issue of the bonds, and in fact spends 100% of the proceeds including investment income within 2 ½ years of the date of issue. The issuer is not subject to yield restriction or rebate. Alternatively, if unusually inclement weather results in the issuer spending only 90% of the proceeds (including expected investment income) by the end of the 3-year period, but the issuer expects to spend all amounts within the following year, the

---

52 See section 54A(d)(4).
53 See section 54A(d)(2).
54 See section 54A(d)(2)(B)(iii).
55 See section 54A(d)(2)(B)(i).
issuer has two options for maintaining the status of the bonds as tax-credit bonds: (1) it can use the unspent proceeds to retire bonds, which could result in insufficient funds to complete the construction; or (2) it can file a ruling request with the Service requesting an extension of the 3-year period, which is a time-consuming and expensive process.

**Reasons for Change.** The 2-year rebate spending exception imposes unrealistic spending periods, complex bifurcation procedures, difficult and repetitive computations, and unclear multipart definitions. The exception could be simplified in its application and permit issuers and conduit borrowers three years (rather than two) to meet the applicable spending requirements. In addition, it could be expanded to include both private activity bonds and governmental bonds, as well as to include bonds for any capital project (encompassing both acquisition and construction purposes).

The simplification of this provision could be accomplished by providing all tax-exempt bonds with a 3-year rebate exception similar to the one available for tax-credit bonds, with certain modifications to further simplify its application. Improved spending benchmarks could (1) include a de minimis exception (e.g., 5%) that would cover the many circumstances in which minor amounts of bond proceeds remain unspent for bona fide reasons, (2) defer imposition of the yield restrictions and rebate requirements of an issuer who otherwise expected to meet the spending benchmarks, but fails to do so, until the end of the 3-year period, rather than requiring the use of unspent proceeds to retire bonds, and (3) conform the tax credit bond spending exception to include a similar de minimis exception and remove the retirement requirement in order to simplify and conform the application of spending exceptions for issuers who issue both tax-exempt bonds and tax-credit bonds.

The Options presented would provide meaningful administrative relief from complex arbitrage calculations to a broad number of tax-exempt bond issuers. The 3-year spending exception should apply as broadly as possible, because limited arbitrage potential exists for short-term investments in most long-term tax-exempt bond issues. But the spending exception should be limited to fixed rate tax-exempt bonds to address one area in which some arbitrage potential may exist under a 3-year spending period in normal yield curves, which involves tax-exempt floating rate bonds with short-term tender options. We also recommend that the spending exception be limited to fixed-rate bonds with a minimum weighted average maturity of at least 5 years, and that it exclude bonds issued mainly for advance refundings and working capital.

**Option for Consideration.** Extend the 3-year spending exception for tax credit bonds to tax-exempt bonds and modify the exceptions in technical respects.56

---

56 A similar proposal appears in President Obama’s 2013 Budget and also the 2012 Budget. See 2013 General Explanations, p. 183, and 2012 General Explanations, p. 94. The budget proposed spending benchmarks would include a 5% de minimis exception, to broaden the availability of the exception, would limit the spending exception to fixed-rate bonds with a minimum weighted average life of at least 5 years, and would exclude bonds issued mainly for advance refunding and working capital.
9. Increase the small issuer exception from rebate to $30 million, index it for inflation and remove the general taxing power eligibility requirement.

**Present Law.** The excess of (1) the amount earned by an issuer of tax-exempt bonds that invests the proceeds over (2) the amount which would have been earned if those proceeds had been invested at a yield equal to the yield on the tax-exempt bonds is arbitrage. Arbitrage generally must be rebated to the U.S. Treasury Department.\(^{57}\) Under the small issuer exception, the rebate requirement does not apply to governmental units with general taxing powers if the amount of bonds issued by the unit in the calendar year is not reasonably expected to exceed $5 million (excluding private activity bonds and most current refunding bonds with a principal amount not exceeding that of the principal amount of the refunded bonds).\(^{58}\)

For example, if an issuer with general taxing powers issues bonds to construct a library, and if the principal amount of bonds is $5 million or less (taking into account other bonds issued by the issuer in the calendar year), the rebate requirement is inapplicable. But, if the principal amount of bonds is $5.1 million (or if the issuer lacks general taxing powers, such as a public building authority which is an instrumentality of a governmental unit with general taxing powers), then the rebate requirement applies.

**Reasons for Change.** With one exception, the small issuer exception to the rebate requirement has remained at $5 million since its enactment in 1986. While all costs associated with capital expenditures (construction, acquisition, administrative, etc.) have increased, the $5 million limitation has remained fixed. Increasing the amount and providing for future inflation adjustments could broaden the utility of this exception and alleviate administrative burdens on small issuers. Equating the amount of the exception with the bank qualified exception would avoid confusion and make the definition of small issuer uniform for both exceptions. See Option No. 2 above.

The exception’s general taxing power requirement could be eliminated. A governmental unit authorized to issue bonds should be eligible for the exception even if it lacks general taxing powers. Requiring general taxing powers unfairly narrows the exception, because state and local governments commonly use public instrumentalities lacking general taxing powers to carry out tax-exempt bond programs, and these issuers should also be eligible for the exception if their bond issuance otherwise satisfy the requirements.

**Options for Consideration.** Increase the small issuer exemption to $30 million (or otherwise to some other inflation-appropriate amount) indexed for inflation and eliminate the general taxing power eligibility requirement.\(^{59}\)

---

\(^{57}\) See section 148(f)(1) and (2).

\(^{58}\) See section 148(f)(4)(D).

\(^{59}\) A similar proposal appears in President Obama’s 2013 Budget and also the 2012 budget. See 2013 General Explanations, p. 183, and 2012 General Explanations, p. 94. Increasing the small issuer exception is characterized as substantially reducing the administrative burden imposed on a large number of small issuers by the rebate requirement while affecting a disproportionately smaller amount of tax-exempt bond dollar volume.
10. Allow all yield restrictions, including advance refunding escrows, to be satisfied by yield reduction payments calculated similarly to arbitrage rebate.

**Present Law.** The yield on investments of tax-exempt bond proceeds is generally subject to certain arbitrage yield limitations.\(^60\) If the yield on investments exceeds the limitations, the bonds may be characterized as arbitrage bonds, resulting in elimination of the bonds’ favorable tax status, unless an exception is found or corrective steps are taken.\(^61\)

An issuer may make yield reduction payments to the U.S. Treasury Department to the extent necessary to reduce the yield to or below the yield limitations, but yield reduction payments are permitted only for “covered investments.”\(^62\) For this purpose, covered investments include: (1) certain nonpurpose investments (e.g., money market funds) allocable to tax-exempt bond proceeds that qualified for an applicable temporary period (none of which applies to advance refunding bond proceeds, the temporary period for which is only 30 days); (2) purpose investments and nonpurpose investments for certain variable yield tax-exempt bonds; (3) purpose investments allocable to certain student loan bonds; and (4) nonpurpose investments allocable to transferred proceeds of (i) a current refunding bond issue to the extent necessary to reduce the earnings yield to satisfy the limitations, or (ii) an advance refunding bond issue to the extent that investment of the escrows allocable to the proceeds, other than transferred proceeds, of the refunding issue in zero-yielding nonpurpose investments is insufficient to satisfy the arbitrage yield limitations.\(^63\) Yield reduction payments for the benefit of an advance refunding issue cannot eliminate excess yield issues for investments allocable to the gross proceeds except for (1) nonpurpose investments allocable to the transferred proceeds described in the preceding sentence, (2) nonpurpose investments allocable to replacement proceeds of the refunded bond issue because of the application of the universal cap rules to amounts in a refunding escrow, and (3) nonpurpose investments allocable to transferred proceeds in a fund that, except for its failure to satisfy the size limitation for reasonably required reserve or replacement funds (“4R fund”), would qualify as a 4R fund, but only if certain conditions are satisfied.\(^64\)

For example, assume that a local government issued tax-exempt governmental bonds in 2001 to finance the construction of a new school building, which bonds are not callable until the last calendar quarter of 2012, but current market rates drop so the issuer desires to refinance the 2001 bonds in 2011 with fixed rate bonds (the “2011 bonds”), and the issuer issues the 2011 bonds in the third quarter of 2011 and establishes an advance refunding escrow to retire the 2001 bonds in 2012. If the yield on investments available (i.e., Treasury securities) for the refunding escrows financed with 2011 bond proceeds exceed the yield on the 2011 bonds by more than the

\(^{60}\) See sections 103(b)(2) and 148(a).

\(^{61}\) See section 148(f) and Reg. §§1.148-3 regarding payment of arbitrage rebate and Reg. §1.148-5(c) regarding yield reduction payments.

\(^{62}\) See Reg. §1.148-5(c)(3)(i).

\(^{63}\) Id.

\(^{64}\) See Reg. §1.148-5(c)(3)(ii).
allowable spread and the purchase of United States Treasury Obligations – State and Local Government Series ("SLGS") would not create sufficient earnings to meet the debt service payments on the 2001 bonds, yield reduction payments would not be permitted to reduce the yield on the refunding escrow to the allowable limit if open market U.S. Treasury securities were purchased to fund the refunding escrow. The issuer would have to either accept the negative arbitrage from the SLGS investment, increase the size of its borrowings to make sure the refunding escrow is sufficiently funded to retire the 2001 bonds in 2012, or take other allowable action.

**Reasons for Change.** For state and local governmental issuers and section 501(c)(3) exempt organizations, debt service represents one of the most significant operating expenses. These issuers must manage their debt service burden on bonds issued to finance significant capital investments, such as roads, schools, hospitals, universities, transit systems, and other types of infrastructure. When possible, they may elect to refinance their debt if market interest rates decline to restructure the timing of debt service payments to better coincide with available revenue flows, take advantage of more modern financing techniques, or incorporate more flexible financial and legal covenants. The ability to maintain tax-exempt interest rates is often critical to the economic viability of the projects being financed.

The current restrictions limit and unnecessarily complicate the steps issuers must take to satisfy the arbitrage yield limitations for their advance refundings. More broadly permitting yield reduction payments would simplify the ability to comply and increase certainty in compliance and maintenance of tax-exempt interest rates, thereby minimizing borrowing costs.

**Option for Consideration.** Permit all yield restriction requirements to be satisfied by yield reduction payments similar to rebate.65

11. **Repeal the $150 million nonhospital bond limitation on all qualified 501(c)(3) bonds (already repealed in 1997 for new construction financing).**

**Present Law.** The Taxpayer Relief Act of 1997 partially repealed the $150 million limitation on qualified 501(c)(3) bonds used to finance facilities besides hospitals for section 501(c)(3) nonprofit organizations.66 Vestiges of the $150 million limit survive, including: (1) outstanding bonds issued on or before August 5, 1997 for capital expenditures; (2) certain refinancings of those bonds; and (3) nonhospital bonds issued after August 5, 1997 where more than 5% of the net proceeds were used for working capital expenditures.67

For example, if bonds were issued in 1996 to construct a section 501(c)(3) university building, the bonds remain subject to the $150 million limitation. Also, certain bonds now issued to refinance those bonds are subject to the limitation. If $50 million of bonds are now

65 A related proposal appears in President Obama’s 2013 Budget. See 2013 General Explanations, p. 183.

66 See Pub. L. No. 105-34, §222 (1997) (enacting section 145(b)(5)).

67 See section 145(b).
issued to finance a section 501(c)(3) university classroom building and more than $2.5 million (5% of $50 million) of proceeds are used for working capital, those bonds are also subject to the $150 million limitation.

**Reasons for Change.** The complex analysis and monitoring requirements for tracking the surviving vestiges of the $150 million limitation undermine the tax policy inherent in the predominant repeal of the provision. Many universities and other section 501(c)(3) nonprofit organizations have issued bonds in furtherance of their charitable purposes at the lowest possible cost. Vestiges of the limitation may limit the ability to refinance those bonds to reduce cost (i.e., a borrower may not have room under the limitation for advance refunding bonds subject to the limitation) or limit the ability to combine with other organizations having outstanding bonds subject to the limitation (i.e., two organizations might be unable to merge if the resulting organization exceeds the limitation). The bifurcation regime of pre-August 6, 1997 bonds subject to the limitation and post-August 5, 1997 bonds exempt from the limitation, creates undue tax complexity without discernible benefit.

**Option for Consideration.** Repeal all remaining application of the $150 million nonhospital bond limitation on all qualified section 501(c)(3) bonds.