New York State Bar Association Tax Section

Report on Simplification of the Internal Revenue Code: Tax-Exempt Bonds

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This report is part of a series of reports the Tax Section is preparing as part of its ongoing effort to identify areas of the federal income tax law that warrant examination in the simplification process.[1] The purpose of this report is to provide recommendations concerning simplification of the rules applicable to tax-exempt bonds issued by state and local governments under Section 103.[2]

The tax-exempt bond area is governed by extremely complex provisions, several of which overlap and serve similar purposes, and others which have become outdated with the passage of time. Some of our recommendations are intended to reduce the amount of time and resources that tax-exempt bond issuers must commit in complying with the multitude of rules imposed in the Code and Treasury Regulations ("Regulations").

In presenting our recommendations we will be making frequent reference to portions of an earlier report produced by the JCT Staff addressing the same subject. In April 2001, JCT Staff issued a detailed study (the "JCT Staff Study")[3] of the federal tax system and recommendations for simplification. The JCT Staff Study included a number of recommendations pertaining to the simplification of the law governing tax-exempt bonds. We commend the Joint Committee on the proposed simplification measures. This report will attempt to avoid duplication of discussion of observations made by the JCT Staff with which we concur. Accordingly, in a number of instances we briefly describe a particular issue and indicate our agreement with the JCT Staff's conclusions.

This report is divided into three parts. The first part describes simplification that can be attained in the law governing private activity bonds. This portion of the report will detail why

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[1] See New York Bar Association Report No. 1007 (March 18, 2002). This report was prepared by the Committee on Tax Exempt Bonds. John T. Lutz, Stuart L. Rosow and Brad E. Berman were the principal authors. James R. Eustis, Jr., Henry S. Klaiman, Carol Olson and Joseph P. Rogers, Jr. also contributed to the report. Helpful comments were received from Andrew N. Berg, David S. Miller, Samuel J. Dimon , Kimberly S. Blanchard and Michael Schler.

[2] Unless otherwise indicated, all "Section" references are of the Code.

[3] Staff of the Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, JCS-3-01, April 2001. All references to the JCT Staff Study are to Volume II, pp. 516-530, Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System.

consolidation of certain duplicative provisions should be considered, while continuing to maintain an effective set of standards controlling the use of tax-exempt bond proceeds.

The second part of the report focuses on the revision of the rules intended to limit arbitrage associated with the investment of tax-exempt bond proceeds. These rules, which present a very complex set of compliance requirements, are in need of meaningful simplification.

The third part of the report concentrates on simplification of the Code by removing or revising provisions which, because of the passage of time or because of intervening events, have become outdated or "deadwood" provisions.

I. PRIVATE BUSINESS USE

Under current law, Section 103 provides the basic framework for state and local governmental bonds. It recognizes the principle that when bond proceeds are used exclusively for traditional governmental purposes, the interest earned on the bonds is excludable from the holder's gross income. Private activity bonds are issued by governments and generally are not tax-exempt unless they are "qualified bonds" used for certain specified purposes as described in Part B below. Under Section 141, a private activity bond is issued by a government or agency thereof to finance various private or nongovernmental trade or business activities or to finance private loans. In order to be classified as a qualified private activity bond, the bond must be part of an issue that (i) meets the private business use test and the private security or payment test, (ii) meets the private loan financing test, or (iii) is used to acquire nongovernmental output property. We believe that the rules governing this area frequently overlap and also contain some ambiguous provisions making it difficult for tax-exempt issuers to comply.

A. Unrelated and Disproportionate Use Limit

Current Law. The rules governing whether a bond constitutes a private activity bond are complex. In general, a bond is a private activity bond if (1) more than 10 percent of the bond proceeds are to be used in a trade or business of any person other than a state or local government unit ("private business use") and (2) more than 10 percent of debt service payments on such bond is derived from payments made in respect of property used for private business use, or is secured by any interest in property used for private business use (or payments made in respect of such property) (the "10-Percent Limitation").[4]

Currently, the 10-Percent Limitation is further restricted by reducing "10 percent" in both (1) and (2) above to 5 percent if the amount of proceeds which are to be used for private business use that is "unrelated" or "disproportionate" to the governmental use of the bond proceeds exceeds 5 percent of such bond proceeds (the "Unrelated and Disproportionate Use Test").[5] In describing whether funds are put to an "unrelated use," the Regulations state that whether a private business use is related to a government use financed with the proceeds of an issue is

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[4] Section 141(a).

[5] Section 141(b)(3) and Regulations Section 1.141-9.

determined on a case-by-case basis, emphasizing the operational relationship between the government use and the private business use. The Regulations go on to provide that, in general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.[6] The disproportionate use prong of the test applies only where the private business use of bond proceeds is related to the governmental use thereof. Both the statutory and the regulatory definitions of disproportionate use are confusingly circular. To define "disproportionate use" the Regulations state that "a private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use."[7]

Recommendation. The JCT Staff recommended that the Unrelated and Disproportionate Use Test should be eliminated. We agree.

Discussion. The Unrelated and Disproportionate Use Test adds complexity to the law governing the issuance of tax-exempt bonds by state and local governments. The current structure of the test causes significant uncertainty for those issuers attempting to determine if the 10 percent threshold must be reduced to 5 percent as a result of an activity being unrelated or disproportionate to the government purpose being financed with the bond issue. In order to apply the test, difficult judgments as to whether a project is "related" to the governmental purpose must be made. Such a determination requires interpreting all of the facts which in many cases will not lead to a readily apparent answer. Despite the uncertainty, the penalty for an erroneous determination under this test is the loss of tax-exemption for the entire bond issuance.

As is explained in the JCT Staff Study, the general 10 percent and 5 percent private business use limit, combined with similar limits on private loan financing and with the state private activity bond volume limit requirement for larger issues, effectively controls excess private business use of governmental bond proceeds without the factual determination required by the Unrelated and Disproportionate Use Test. While it is open to debate as to whether the general 10 percent and 5 percent tests are sufficient to ensure proper use of tax-exempt bonds proceeds, we are convinced that the current formulation of the Unrelated and Disproportionate Use Test should be significantly changed or repealed. The overall definitional ambiguity involved in the test is the major cause of complexity. This complexity may cause many state and local governments to limit otherwise permitted 10 percent private business involvement to 5 percent across the board because of the uncertainty of the scope of the test. Additionally, the current ambiguity may cause state and local governments to take a highly conservative approach in allocating money for private business use because the penalty imposed for noncompliance is so severe.

The ambiguity of the Unrelated and Disproportionate Use Test and the difficult factual determinations that must be made by issuers of tax-exempt bonds is best illustrated by the examples provided in the Regulations. One example provides:

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6 Regulations Section 1.141-9(b)(1).

7 Regulations Section 1.141-9(c)(1).

> City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($32 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y's use of $3 million for the privately operated cafeteria does not meet the unrelated or disproportionate use test because these expenditures are neither unrelated use nor disproportionate use.[8]

This example is clearly meant to show that the privately operated cafeteria is related and not disproportionate. However, under other facts it is often still unclear whether the test would cease to be met in certain circumstances. For example, one might ask whether the cafeteria would be considered "related" if it happened to be located across the street. At least one example in the Regulations concludes that bond proceeds used to finance renovations to a privately operated cafeteria at a remote site constitutes unrelated use, at least when bond proceeds are not also used for the building in which the cafeteria is located.[9] How would the cafeteria be categorized if it was located one city block from the courthouse? Several city blocks from the courthouse? These kinds of determinations increase complexity by leaving unclear whether "proximity" to the governmental use is the appropriate analysis or if "proximity" to other bond proceeds is the critical factor.

Another example illustrating the difficulty in applying this test is where a physical therapy group or radiology group is affiliated with a hospital but is not located in the main hospital building. In determining whether the use of bond-financed facilities by the physical therapy or radiology group is "related," would it depend on how close the building is to the main hospital building or whether it is on the same campus? The location on the same campus in a rural or suburban setting may pose an easier set of facts but it is entirely unclear as to how to apply the test if the building was located within some distance of the main hospital building in an urban setting. These determinations are plagued with uncertainty. Accordingly, repeal of the Unrelated and Disproportionate Use Test would achieve technical and operational simplicity for tax-exempt bond issuers.

B. Prohibition on Use of Qualified Bond Proceeds for Certain Business Purposes

Current Law. As noted above, interest on private activity bonds is generally taxable unless the bond is a qualified bond.[10] The Code currently provides for several different

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[8] Regulations Section 1.141-9(e) Ex. 2.

[9] Regulations Section 1.141-9(e) Ex. 1.

[10] Even if a private activity bond is a qualified bond, interest thereon (with the exception of interest on qualified 501(c)(3) bonds) will generally constitute an item of tax preference under the Code's alternative minimum tax provisions. *See,* Section 57(a)(5).

categories of qualified bonds including “general private activity bonds,” “qualified section 501(c)(3) bonds,” “qualified redevelopment bonds,” “enterprise zone facility bonds,” and “qualified small-issue bonds.” Different restrictions apply to the uses of the proceeds from each category of bonds, resulting in significant technical complexity. This complexity motivates issuers to formulate their projects carefully so that they can fit within the category that is most amenable to their financing needs.[11] Further complexity exists as a result of the detailed specific project or program targeting requirements for each type of qualified bond.

Recommendation. In the JCT Staff Study, the Joint Committee recommended that the prohibitions on using private activity bond proceeds for certain businesses should be conformed for all such bonds and consolidated into one Code section. Further, the Joint Committee stated its position that the Code would be simplified by consolidating into one section the list of businesses for which private activity bond proceeds cannot be used. Under the JCT Staff Study proposal, there would be one consolidated list of prohibited businesses for all private activity bonds. Financing for the following businesses would be prohibited: golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other facilities used primarily for gambling, health club facilities, skyboxes or private luxury boxes, airplanes, or stores, the principal business of which is the sale of alcoholic beverages for consumption off premises.

We generally support the JCT Staff’s efforts at simplification through consolidation in this complex area and support the implementation of one general list of prohibited activities with respect to private activity bonds. However, we urge the government to consider preserving some of the current distinctions in a few special cases. One example, discussed below, involves health club facilities, which seem worthy of qualification in certain settings, *e.g.*, hospitals.

Discussion. We support the Joint Committee’s position that simplification of the rules governing qualified private activity bonds is needed. Aside from being quite complicated, the current formulation of the rules, whereby several categories of qualified bonds are subject to their own specific requirements, results in issuers carefully formulating their projects to fit within the category most amenable to their financing needs. Substantial simplification can be achieved by consolidating these rules and by having one provision listing the prohibited uses. However, although we agree that substantial simplification can be achieved through having uniformity in

[11] For example, a general rule prohibits the proceeds from issuing private activity bonds being used to finance an airplane, a skybox (or other private luxury box), a health club facility, a facility primarily used for gambling, or a store the principal business of which is the sale of alcoholic beverages for consumption off premises. Section 147(e). By exception contained in Section 147(h)(2), the proceeds from qualified 501(c)(3) bonds may be used to finance a health club facility. Proceeds from qualified redevelopment bonds may not be used for a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a racetrack or other gambling facility, or a store the principal business of which is the sale of alcohol beverages for consumption off premises, and no more than 25 percent of the proceeds can be used to provide a retail food and beverage facility, an automobile sales and service facility, a recreation or entertainment facility, a tennis club, a skating facility, or a racquet sports facility. Enterprise zone facility bonds are not subject to the foregoing 25 percent restrictions. A separate set of restrictions apply to qualified small-issue bonds.

the treatment of private activity bonds, we also believe that there should be certain narrowly tailored exceptions.

Some of the existing exceptions available to only one or to a few types of qualified bonds serve valid policy purposes. For example, the adoption of a general prohibition on bond financing for health club facilities may advance the cause of tax simplification but may not always result in the most ideal outcome. While, in many cases, the financing of health club facilities ought to be restricted or prohibited, there are certain circumstances under which tax-exempt bond financing for a health club facility should be considered entirely appropriate. If a tax-exempt hospital decided at some point that it would like to operate an exercise facility for purposes of rehabilitating patients who have undergone various procedures, there should not be significant financing obstacles imposed. As long as the use of the health club facility by the hospital is consistent with its Section 501(c)(3) and the current Internal Revenue Service rules regarding operation of exempt health club facilities, then tax-exempt bond financing should be available.[12] While the rules should ensure that a tax-exempt entity is not operating a facility for purposes unrelated to its exempt purposes, we believe the law can retain sufficient flexibility to make exception for these special types of situations while still achieving the overall objective of simplification.

II. ARBITRAGE REBATE

Tax-exempt bonds enable state and local governments to borrow at lower interest rates in order to finance their governmental activities at a significantly lower cost. However, the lower interest rates also provide the potential to benefit from tax arbitrage by investing proceeds of the bonds in higher yielding taxable investments.

The principal purpose of Section 148 is to eliminate significant arbitrage incentives to issue more bonds, to issue bonds earlier, and to leave bonds outstanding longer than necessary to carry out the governmental purpose of the tax-exempt issue. The rules intend to minimize the tax arbitrage benefit associated with investing proceeds of the bonds in taxable investments, and thereby target the tax benefits to the activities for which the tax exemption is provided. While arbitrage rules are important for protecting the fisc, their current level of complexity is considerably greater than necessary to achieve this objective.

A. Arbitrage Yield Restrictions and Arbitrage Rebate

Current Law. There are two statutory regimes that are intended to limit arbitrage. The arbitrage yield restriction set forth in Section 148(a) and the arbitrage rebate requirement set forth in Section 148(f). Both provisions address the tax policy objective of controlling arbitrage. The two regimes overlap significantly, except with respect to advance refundings (which, as a practical matter, are subject only to the arbitrage yield restriction). These overlapping rules result in a great deal of technical and compliance complexity.

[12] Tax-exempt bond financing requires that 95 percent of the net proceeds be used for exempt purposes.

Recommendation. Although certain specific changes to the arbitrage rules were addressed in the JCT Staff Study, we recommend even further streamlining. The arbitrage rules are extraordinarily complex and we believe that a thorough review is warranted. The current regime, consisting of separate arbitrage yield limitation rules and arbitrage rebate rules, causes difficulty and confusion in compliance. Moving toward a more unified regime would achieve significant simplification and increase compliance efficiency. We urge that the arbitrage rules be significantly modified so that, in general, the yield restriction rules are abandoned in favor of the arbitrage rebate provisions. Only where necessary, such as in the case of advance refundings, should the yield restriction rules be preserved.

Discussion. The two sets of arbitrage restrictions are duplicative in many respects. Section 148(a) imposes limitations against investing tax-exempt bond proceeds at an effective interest rate or yield over the term of the bonds that is materially higher than the yield on the bonds themselves. Section 148(f) requires the rebate of certain excess earnings above the yield on the bonds to the federal government, even if Section 148(a) permitted a greater yield in the first instance. The Section 148(a) yield restriction rules were enacted in 1969 and the rebate provisions were extended to all tax-exempt bonds in 1986. The two regimes have evolved largely independent of one another, thereby creating unnecessary complexity.

The Regulations already simplify matters to a certain extent, by partially integrating the separate regimes. The Regulations provide coordination of the rules on yield restriction and rebate, certain unified definitions, and general anti-abuse rules in lieu of numerous special rules and clarification of ambiguous areas. Much of the simplification provided in the Regulations has come as a result of their heavy reliance on the general anti-abuse rules and through the allowance of yield reduction payments. Although developments in the Regulations have done much to simplify the arbitrage rules, considerable compliance burdens and complexity remain.

We recommend the government consider implementation of a system based almost exclusively on the rebate rules, since the yield restriction and rebate rules are clearly targeted at achieving the same policy goals. Although certain issues, such as advance refundings, require the preservation of the yield restriction rules, the rebate rules could be implemented in most situations where arbitrage is of major concern. In making its analysis, the government should consider the incentives that arise out of each limitation regime. We believe that the implementation of an almost exclusively rebate based regime will not only simplify the Code but will eliminate the so-called "yield-burning" in the open-market purchase of Treasury investments (caused in part by yield restriction requirements and the inability to find efficient open-market investments).

B. Two-Year Rebate Exception for Construction Projects

Current Law. Pursuant to Section 148(f)(4)(C), in the case of a construction issue, if an issuer expends its "available construction proceeds" according to a prescribed time schedule (generally within two years), the proceeds are exempt from the arbitrage rebate requirement. Issuers that exceed these limits are required to track temporary investments and to compute and pay an arbitrage rebate.

Recommendation. The Joint Committee recommended that the two-year construction period spend-down exception be expanded to 36 months with prescribed intermediate targets. We agree that expanding this rebate exception to allow for somewhat longer construction projects would achieve some degree of simplification by reducing the number of issuers required to track temporary investments and to compute arbitrage rebates. In addition, we believe that expanding the rebate exception would not create excessive incentives to issue bonds for arbitrage purposes (*e.g.,* issuing more bonds than necessary, issuing bonds earlier than necessary, or issuing bonds to invest the proceeds for profit). We also urge the government to consider simplifying the statutory and regulatory regime that imposes complex requirements to comply with the two year spend-down rule.

Discussion. As the JCT Staff Study explains, any loosening of the arbitrage rules must always be weighed against the financial incentive for tax-exempt entities to issue bonds earlier and in larger amounts than necessary for the governmental projects to be financed. In this case, the extension of the spend-down rule from two years to three years should not introduce significantly increased arbitrage incentive.

We agree with the observation contained in the JCT Staff Study that during construction, periodic payments are made to contractors and the periodic nature of the payments made at prompt intervals limits the arbitrage opportunities and incentives. Further, as the Joint Committee has recognized, the construction of governmental facilities often requires more than two years. This extension of the spend-down period will more realistically accommodate these longer term projects.

While the extension of the two year period to a three year period will ease the compliance burden, the existing statutory and regulatory regime for the construction spending exception would remain technically and computationally complex (involving determinations of eligibility, bifurcation, and penalties). A simplification in these underlying computational rules coupled with the extension of the spend-down period could potentially result in further simplification of the arbitrage rules.

C. Small Issuer Rebate Exception

Current Law. Section 148(f)(4)(D) provides, in general, that no rebate is required with respect to tax-exempt bonds issued to finance local governmental activities of the issuer so long as the face amount of all outstanding tax-exempt bonds of the issuer is not reasonably expected to exceed $5 million in the calendar year.

Recommendation. The JCT Staff Study suggests increasing the small issuer rebate exception from $5 million to $10 million. We support the Joint Committee's recommendation to raise the small issuer rebate exception limit.

Discussion. The $5 million limit has not been increased since the inception of the rule in 1986. We believe that the simplification benefits of an increase in the limit to reflect the changes in the circumstances since this provision was first enacted will significantly outweigh any revenue costs. The financial resources expended by small governmental issuers to employ

accountants and advisors to monitor arbitrage rebate compliance often exceed any financial benefit to the federal government from the arbitrage rebate payments or policy benefit for ensuring compliance with the arbitrage rebate requirement.

In addition to an increase in the $5 million limit, we recommend integration of the small issuer rebate exception with the bank-qualified bond provision in Section 265(b)(3), discussed below.

III. OBSOLETE AND NEAR-OBSOLETE PROVISIONS

A. Consolidation of Qualified Mortgage Revenue Bonds and Qualified Veterans Mortgage Revenue Bonds

Current Law. Mortgage revenue bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement or rehabilitation of owner-occupied single family residences. In general, mortgagors must be first time homebuyers to qualify for a mortgage under a qualified mortgage revenue bond program. A separate statutory regime permits tax-exempt financing to provide mortgage financing for owner-occupied single-family residences for veterans. Qualified veterans mortgage bonds may be issued only by states that issued such bonds before June 22, 1984. Mortgage loans financed with the proceeds of these bonds may be made only to veterans who served on active duty at some time before 1977 and who apply for a mortgage within 30 years of leaving active service.

Recommendation. The Joint Committee concluded that the consolidation of the qualified mortgage revenue bond provisions with the qualified veterans mortgage revenue bond provisions would reduce the need for duplicative administrative efforts and eliminate potential confusion among mortgagors and lenders. Further, the JCT Staff Study considers the veterans program to be nearing deadwood status. While we agree that having one mortgage revenue bond regime in place could bring simplification to the area, we recommend that the government consider integrating certain aspects of the program for veterans with the first time home buyer program rather than discarding the veterans program in its entirety.

Discussion. We believe that consolidation of these two programs into one will simplify the law in several respects. The administrative burden will be reduced and confusion among mortgagors and lenders as to their reporting requirements would decrease. These mortgagors and lenders would no longer have difficulty determining which program they need to comply with.

We urge the government, in contemplating the consolidation of these mortgage provisions into one section, to consider several factors. We note that there is a good reason for distinguishing veterans from first time home buyers, given the significant likelihood of involuntary relocation. We think this distinction is worth preserving, but nonetheless can be accommodated within one section.

The government may also want to consider whether the income limitations applicable to the qualified mortgage revenue bond provisions should be applicable to veterans. It is also worth

considering that it may be worthwhile to maintain the veterans program within one qualified mortgage revenue bond regime since it would ease implementation difficulties should Congress eventually decide to expand program eligibility to veterans serving on active duty post-1977.[13]

B. The $150 Million Section 501(c)(3) Nonhospital Bond Limitation

Current Law. Section 145(b) prohibits the issuance of qualified 501(c)(3) bonds to the extent that the aggregate amount of nonhospital bonds, including the new issue, from which any Section 501(c)(3) organization benefits, exceeds $150 million (the "$150 Million Limitation"). The Taxpayer Relief Act of 1997 (the "1997 Act") added Section 145(b)(5) to the Code, which provides that the $150 Million Limitation does not apply to bonds issued after August 5, 1997 if at least 95 percent of the net proceeds of the bonds are used to finance capital expenditures incurred after such date.

The $150 Million Limitation continues to apply in certain circumstances. For example, a qualified 501(c)(3) bond issued to advance refund a nonhospital bond issued prior to the 1997 Act continues to count against the $150 Million Limitation. The same holds true for a "new money" bond that fails to satisfy the 95 percent test. The conference report to the 1997 Act expressly acknowledged that these refinancings and new money bonds would continue to count against the $150 Million Limitation.

Recommendation. We are in agreement with the policies underlying the Joint Committee's proposal to repeal the $150 Million Limitation for capital expenditures incurred before the effective date of the 1997 Act.

Discussion. The rules applicable to the $150 Million Limitation, particularly in the related-party context, have created burdensome interpretive problems and complexity for purposes of determining which bonds count against the limitation. The analysis must be applied to any financing that a Section 501(c)(3) organization may ever have benefited from, because certain activities may trigger reactivation of particular "testing periods." Similarly, most if not all nonprofit hospitals have financed their activities with the proceeds of tax-exempt bonds.

Given that at least 95 percent of the proceeds of an issue of bonds must be used with respect to a hospital in order for the bonds to qualify as qualifying hospital bonds, compliance with the $150 Million Limitation has created insurmountable interpretative problems for nonprofit hospitals in the world of increased mergers and consolidations in the healthcare industry, particularly where local law and other regulatory schemes applicable to such institutions have required debt consolidation. Accordingly, we endorse in concept the Joint Committee's recommendation that the $150 Million Limit for nonhospital bonds be repealed retroactively. As a cautionary note, we observe that repeal of the $150 Million Limitation may allow the refinancing of taxable debt used by Section 501(c)(3) organizations to finance pre-1997 Act capital expenditures. We do not know what the potential revenue loss would be as a result of such refinancings, but obviously this is a factor to consider if repeal is to be retroactive.

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[13] See H.R. 1742, 108th Cong. (1st Sess.).

C. The Bank-Qualified Bond Provision (Section 265(b)(3))

Current Law. Section 265(b) generally disallows a portion of a financial institution's interest expense allocable to tax-exempt interest. The disallowed portion equals the financial institution's interest expense multiplied by a fraction, the numerator of which is the financial institution's average adjusted bases of tax-exempt obligations acquired after August 7, 1986 and the denominator of which is the average adjusted bases of all its assets.[14] Section 265(b)(3) provides a limited exception to this general rule for certain governmental bonds issued after August 7, 1986 by a "qualified small issuer" (generally, an issuer that reasonably expects to issue no more than $10 million of qualified tax-exempt obligations during the calendar year).

Recommendation. The JCT Staff Study advocates the repeal of the Section 265(b)(3) exception.

Discussion. The JCT Staff notes that the proliferation of state bond pools has made the qualified small issuer exception less important. The report goes on to point out that today it is easier and cheaper for small issuers to borrow through the state bond pools rather than arranging a separate or private placement. Finally, the Joint Committee Staff recognizes that The Community Reinvestment Act requires banks to invest in local projects without regard to subsidies such as that provided by Section 265(b)(3). The JCT Staff concludes that the elimination of this exception would help streamline the Section 265 rules without disadvantaging qualified small issuers.

While we commend the Joint Committee in its effort to simplify these provisions, we note that in certain circumstances the Section 265(b)(3) exception is not necessarily deadwood. Even with the expanded use of bond banks and revolving pools, smaller governmental units often have limited access to capital. Many states still do not have bond banks and revolving pools. Despite the proliferation of these bond banks and revolving pools, it is often difficult for smaller governmental units in rural areas to have access to financing. Even in states with bond banks and revolving pools, small borrowers are often required to apply to their local banks for financing of capital expenditures (*e.g.,* fire engines, telephone systems, *etc.*), generally in the form of a simple sale and purchase of bonds not involving bond banks and revolving pools. For bond insurance and other market reasons, many bond banks and revolving pools only service larger governmental units.[15] For these reasons we believe that the Section 263(b)(3) exception continues to serve an important purpose in providing access to government financing by small governmental units.

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[14] Tax-exempt obligations acquired by banks on or before August 6, 1986, were subject to a different set of rules. Section 265 generally did not apply to banks. Between 1982 and 1984, there was a limited disallowance of interest deduction through a cutback of corporate preference items under Section 291 in an amount equal to a portion of the interest expense of the bank.

[15] Although the bond banks and revolving pools serve an important function, there are some concerns about undue reliance on the role of the revolving pool arrangements, as evidenced by the Internal Revenue Service's long-standing concerns about the potential for abuse in certain pool financings. See Susanna Duff Barnett, "IRS: Florida Pooled Bonds Broke Rules," The Bond Buyer, August 25, 2003, at 1; State of Florida Auditor General Performance Audit Report – Local Government Bond Pools, May 22, 2003.

D. Public Notice Requirement

Current Law. In very general terms, Section 147(f) provides that interest on a qualified private activity bond is not tax-exempt unless the bond is approved by voter referendum or by public officials after a public hearing, following reasonable public notice. Special rules apply to refunding bonds, airport bonds, high-speed intercity rail bonds, scholarship funding bonds and volunteer fire department bonds. The Treasury has not promulgated regulations addressing this public approval requirement. Temporary provisions promulgated under prior law provide that "reasonable public notice" is limited to notices published in a newspaper. These public notice requirements impose some compliance complexity on the issuance of private activity bonds and are rigid in their compliance requirements. The rules often necessitate multiple public approvals because of violation of a minor, insignificant component of the rule.

Recommendation. The Joint Committee recommended that the public notice requirement be satisfied by publication in other media if the objective of reasonable coverage of the population is met. The Joint Committee gives as examples notice by Internet, radio, or television. The Joint Committee also recommends that, in lieu of a public hearing, the public comment requirement should be satisfied by written response and Internet correspondence. We agree that these proposals would reduce the compliance burden by offering issuers less costly and possibly more effective ways to obtain public scrutiny of proposed bond issues, and would not impair any substantive policies.

Discussion. While the public notice requirement process serves a very useful purpose, it could benefit a great deal from simplification. We feel that the public notice provisions should be modified significantly but must maintain the important role that public notice and public comments play in the issuance of qualified private activity bonds. The public notice requirements ensure that such bonds are subject to adequate public exposure and the rules should require that reasonable coverage of the population be achieved.

We believe that a wide variety of methods should be available in order to satisfy the public notice requirements. Specifically, we strongly support the JCT Staff's suggestion to permit the public notice and hearing requirements to be satisfied via electronic means.

We observe anecdotally that in the experience of many practitioners in this area the public hearings are rarely attended. The issuer must nonetheless incur the cost not only of the notice of the hearing, but of legal representation at the hearing. We are reluctant to propose eliminating the hearing requirement since, as a general matter, public hearings provide an element of "sunshine" that ought not lightly be disregarded. We do however urge that serious consideration by given to alternative means of satisfying both the public notice and the hearing requirement. For example, advertisements on local television and radio stations or internet postings on the local government's website should be considered.