REPORT # 530

TAX SECTION

New York State Bar Association

Comments on Section 802(e)

May 30, 1986

Table of Contents

Cover Letter iii

INTRODUCTION.......... 2

SUMMARY.......... 3

(1)$10 Million Limit.......... 3

(2)Qualified 501(c)(3) Bonds.......... 3

(3)Qualified Project Bonds.......... 4

4. Qualified Tax Anticipation Notes.......... 4

5. Secondary Purchases.......... 4

6. Financial Institutions.......... 5

7. Effective Dates.......... 5

COMMENTS.......... 5

$10 Million Limitation Per Calendar Year 5

Qualified 501(c)(3) Bonds 8

Qualified Project Bonds 9

Qualified Tax Anticipation Notes 12

Secondary Market Purchases 13

Limitations as to Financial Institutions 14

Effective Dates 15

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Attached letter dated 5/30/86 enclosing report commenting on Subsection 802(e) of H.R. 3838 sent to the following:

The Honorable Dan Rostenkowski
cc: The Hon. John J. Duncan
Robert J. Leonard Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
United States Treasury

The Honorable Daniel P. Moynihan
U.S. Senate

William Wilkins, Esq.
Minority Chief Counsel

Kenneth Kies, Esq.
Minority Tax Counsel
House Ways & Means Committee

Mr. Bruce Davie
Longworth, House Office Building

H. Ben Hartley, Esq.
Joint Committee on Taxation

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May 30, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

I enclose a report of the New York State Bar Association Tax Section on subsection 802(e) of H.R. 3838, as passed by the House of Representatives on December 17, 1985.

Section 802 of H.R. 3838 provides generally that interest payments allocable on a pro rata basis to tax-exempt obligations held by banks and other financial institutions will no longer be deductible. Subsection 802(e) provides a temporary exception to this rule for “qualified tax-exempt obligations”.

Although the Report of the House Ways and Means Committee is somewhat ambiguous on this point, subsection 802(e) was apparently intended to permit small municipal issuers of obligations issued for purely governmental or charitable purposes to privately place such obligations. The issuer would thereby avoid the high costs associated with public offerings.

What may be a technical drafting error in subsection 802(e) would apparently allow even large issuers of municipal obligations to take advantage of the exception for up to $10,000,000 per year of obligations even though the exception was probably

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only intended to benefit small issuers. In addition, several technical requirements of the subsection are exceedingly difficult to apply in the context of those small municipal issuers who customarily take advantage of bank borrowings for general municipal purposes. The report urges that the rules be clarified so that compliance may be more readily ascertained by the small issuers intended to benefit from the exemption.

I hope the report will be useful to you.

Sincerely,

Richard G. Cohen

Enclosure

cc: The Hon. John J. Duncan) with
Robert J. Leonard, Esq.) enclosure

REPORT #530

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Tax-Exempt Bonds[1]

Comments on Subsection 802(e) of H.R. 3838, Regarding the Deductibility of Interest Paid by Financial Institutions Aquiring Qualified Tax-Exempt Obligations

May 1986

[1] The principal authors of this Report were Jackson B. Browning, Jr. and Dennis R. Deveney, Cochairmen of the Committee on Tax-Exempt Bonds. Helpful comments were received from Dale S. Collinson, James H. Andrews and William H. Conner.

INTRODUCTION

Under present law, a financial institution is, as a practical matter, generally immune from the restriction of section 265 on the deductions of interest allocable to tax-exempt income but under section 291 can deduct only 80 percent of such interest expense. The allocable interest expense is, unless the institution can establish otherwise (under regulations to be prescribed), the amount obtained by multiplying the otherwise allowable interest deduction by the ratio of the financial institution's average adjusted basis of certain tax-exempt obligations to its average adjusted basis for all assets held during the year in question.[2]

Section 802 of the Tax Reform Act of 1985, as passed by the House of Representatives on December 17, 1985 (hereinafter referred to as “H.R. 3838”),[3] would change current law by removing the practical immunity of financial institutions from the provisions of section 265, thus disallowing 100 percent (rather than 20%) of the allocable interest with respect to most tax-exempt obligations acquired after 1985. A financial institution would, therefore, generally be denied any deduction for interest expense allocable to tax-exempt income derived from obligations acquired by the financial institution after December 31, 1985 in taxable years ending after that date.

[2] § 291(e)(1)(B)(ii) of the Internal Revenue Code of 1954, as amended (the “Code”).

[3] All references herein are to provisions of H.R. 3838 unless otherwise noted.

However, subsection 802(e) of H.R. 3838 provides a temporary exception to that 100 percent disallowance with respect to “qualified tax-exempt obligations” acquired by a financial institution after December 31, 1985 and before January 1, 1989. Thus, the financial institution would be subject to the current 20 percent disallowance, rather than the 100 percent disallowance that would generally be required under section 802, with respect to those obligations. Qualified tax-exempt obligations are, generally, “essential function bonds”[4] and “qualified 501(c)(3) bonds”[5] issued in 1986, 1987 or 1988 which are acquired by a financial institution authorized to do business in the state of the bond issuer and which are either “qualified tax anticipation notes” having a term of 12 months or less or “qualified project bonds” comprising part of an issue of $3 million or less

SUMMARY

This report contains the following comments:

(1) $10 Million Limit.

(a) The $10 million limit on obligations designated for purposes of paragraph 802(e)(3) does not literally prevent the issuance of bonds aggregating more than $10 million, with the excess being “undesignated”.

(b) On balance, a $10 million aggregate limit on designated and undesignated obligations should apply, and Section 802(e)(3) should be clarified to so provide.

(2) Qualified 501(c)(3) Bonds.

Each section 501(c) (3) organization (or group of such organizations under common management or control)

[4] Code § 141(a), as added by Section 701(b) of HR 3838.

should enjoy a separate $10 million limit, even though a single issuer might issue bonds benefitting separate organizations.

(3) Qualified Project Bonds.

(a) It is questionable whether there should be a $3 million per project limitation in addition to the overall $10 million limitation.

(b) A definition of “project”, or some guidance in the legislative history as to its meaning, should be provided.

(c) Undesignated obligations issued after the issuance of qualified project bonds, though for the same project, should not disqualify the earlier bonds even though the total project cost exceeds $3 million, if the later bonds finance unanticipated project cost overruns.

(d) The $3 million limitation should apply to the project cost, not bonds issued, so as to avoid counting against the limitation both construction financing (bond anticipation notes) and the long-term financing into which it is rolled over.

4. Qualified Tax Anticipation Notes.

(a) The term should include revenue anticipation notes and grant anticipation notes.

(b) Anticipation notes should not be limited to 12-month maturities.

5. Secondary Purchases.

[5] Code § l44(b), as added by Section 701(b) of HR 3838.

A question is raised whether the benefits of the exemption for qualified tax-exempt obligations is intended to apply to purchases other than on original issue.

6. Financial Institutions.

A question is raised whether financial institutions are limited to deposit-taking entities and if so whether the institution must accept deposits in the state issuing the bonds.

7. Effective Dates.

If the effective date of Section 802(e) is to be before the effective date of the addition of rules on “non-essential function bonds”, the latter term's definition should nevertheless apply for purposes of Section 802(e) from its effective date.

COMMENTS

$10 Million Limitation Per Calendar Year

In order to be a qualified tax-exempt obligation, the issue must be “designated by the issuer for purposes of [paragraph 802(e)(3)].”[6] In this connection, subparagraph 802(e)(3)(F) provides that “[n]ot more than $10,000,000 of obligations issued by an issuer during any calendar year may be designated by such issuer for purposes of [paragraph 802(e)(3)].” However, subparagraph 802(e)(3)(C) further provides that an obligation “shall not be treated as a qualified tax-

[6] § 802(e)(3)(B)(iv).

exempt obligation unless . . . the reasonably anticipated amount of qualified tax-exempt obligations which will be issued by such issuer during such calendar year does not exceed $10,000,000.” (emphasis added)

Thus, an issue is not “qualified” until it is expressly designated as such by the issuer pursuant to subparagraph 802(e)(3)(B)(iv). In addition, however, an issuer must reasonably anticipate issuing no more than $10 million of qualified tax-exempt obligations during the calendar year. A literal reading of subsection 802(e) would therefore indicate that an issuer which reasonably anticipated issuing substantially more than $10 million of otherwise qualified tax-exempt obligations during the calendar year could “qualify” up to $10 million by designation and still meet the “reasonable anticipation” requirement of subparagraph 802(e)(3)(C) by simply failing to designate the remaining tax-exempt obligations. Stated another way, the $10 million designation limit of subparagraph 802(e)(3)(F) renders the “reasonable anticipation” test essentially meaningless because that test could never be failed without the issuer intentionally violating the $10 million designation limit.

Under a literal reading, therefore, the benefits of subsection 802(e) would be available to any municipality designating up to $10 million of obligations which met the other requirements for qualification even if the municipality issued more than $10 million of such types of obligations during the calendar year (the excess over $10 million being undesignated). This result is not inconsistent with a statement in the Report of the House Ways and Means Committee on H.R. 3838 (hereinafter, the

"Committee Report")[7] that the exception allows "up to $10 million in bonds per local issuer to be exempt from the 100 percent disallowance rule."[8] The availability of the exception in this type of situation seems to have a sound policy basis since it is precisely in the context of smaller issues (no matter how large the issuer) that sale to a local financial institution may be necessary in order to avoid the disproportionately high costs of a public marketing. Moreover, it could be argued that it would be unfair to discriminate against larger issuers in this regard since it is just as uneconomical for a large issuer to publicly market a small issue as it is for a small issuer.

If the literal language of subsection 803(e) truly reflects the legislative intent of the House of Representatives, it should be redrafted to eliminate the "reasonable anticipation" test of subparagraph 802(e) (3) (C) (ii) since it would, in such case, be redundant as a practical matter and only add confusion.

However, despite the literal provisions of subsection 802(e) and the soundly-based policy there for reflected in the above-quoted language of the Committee Report, it would appear that the exception was probably only intended to benefit small issuers (i.e., those that reasonably anticipate issuing no more than $10 million of tax-exempt obligations that would otherwise qualify for the exception without regard to the designation requirement). Thus, the Committee Report expresses concern about the effect of the 100 percent disallowance on "smaller localities which depend upon local financial

[7] H.R. REP. NO. 426, 99th Cong., 1st Sess. (1985).

[8] Committee Report at 589.

institutions to buy tax-exempt bonds for bona fide governmental projects.”[9]

Despite the conflicting policy considerations, it would appear that the more restrictive approach is preferable. If the more restrictive approach is to be taken, the provisions of subparagraph 802(e)(3)(C)(ii) should be redrafted so as to disallow qualification for the exemption through a simple failure to designate otherwise qualifying obligations. In addition, however, it should be made clear that only those types of obligations which are otherwise qualified count against the $10 million limitation.

Qualified 501(c)(3) Bonds

Under paragraph 802(e)(3) a qualified 50l(c)(3) bond may be eligible for treatment as a qualified tax-exempt obligation. Subsection 144(b)[10] of the Code as added by Section 701 of H.R. 3838 generally defines a qualified 501(c)(3) bond as a bond issued to benefit a section 50l(c)(3) organization. By their terms, the $10 million limits of subparagraphs 802(e)(3)(C) and 802(e)(3)(F) apply at the level of the issuer. However, it is common for eligible issuers to undertake tax-exempt financings for the benefit of many section 501(c)(3) organizations. In a number of jurisdictions, for example, a single authority is given the exclusive power to issue tax-exempt obligations for the benefit of hospitals or universities that are section 501(c)(3) organizations. Since section 50l(c)(3) organizations typically reduce the burdens of government, they generally have the same access to tax-exempt financing as governmental entities

[9] Id

[10] The cross reference in paragraph 802(e)(3) to “section

have under existing law for essential governmental functions. If this broad policy is to be continued with respect to the exception provided by subsection 802(e), subparagraphs 802(e)(3)(C) and 802(e)(3)(F) should further provide that, in the case of a qualified 501(c)(3) bond, the $10 million limitations would apply only with respect to the section 5Ol(c) (3) organization (which for this purpose might be aggregated with other section 50l(c)(3) organizations under common management or control). Also, an issuer's designation of a conduit 50l(c) (3) obligation would not count against such issuer's own $10 million limit.

Qualified Project Bonds

Included within the definition of qualified tax-exempt obligations are qualified project bonds. The term qualified project bond is defined in subparagraph 802(e)(3)(E) to mean “any obligation issued to provide project financing and part of an issue not exceeding $3,000,000. In determining the amount of an issue for the purpose of the preceding sentence, all issues with a common purpose shall be aggregated.” However, neither H.R. 3838 nor the Committee Report gives a definition or instructive example of what constitutes a “common purpose”.

In the first instance, this limitation would appear to be unnecessary since there is no apparent reason why one issuer which finances several small projects should be eligible for the exception while a similarly situated issuer which chooses to use its entire $10 million limitation for a single project should not.

143” should be corrected.

Thus, while it might be argued that bonds issued to finance projects costing no more than $3 million result in disproportionately higher underwriting costs than single issues for $10 million projects, this rationale is seriously undercut by subparagraph 802(e)(3)(D), which makes the exception available for up to $10 million of certain tax anticipation notes without regard to the amount of proceeds to be applied to a single purpose.

If, however, the $3 million per project limitation is to be retained, a definition (or at least a “safe harbor” interpretation) should be included in H.R. 3838 or in its legislative history so as to avoid widespread confusion in monitoring compliance with the requirement. This is especially important since many of the obligations which are intended to be the beneficiaries of the exception are often issued for roads and sidewalks, water and sewer system improvements and other similar purposes where it is exceedingly difficult to define the “project”. The difficulty of this task is amply demonstrated by the six-year period that has transpired since the Internal Revenue Service first undertook to formulate a definition of the term “facility” for purposes of section 103(b) of the Code in regulations which have not yet been promulgated.

One approach might be that if an issuer specifically and exclusively delineated the purpose of an issue of up to $3 million in its authorizing resolution and no other obligations were previously issued during the same calendar year for that specific purpose or any other purpose which was the subject of a common construction contract, the issue would be treated as not having a “common purpose” with any later issue, at least in situations where the later issue was issued in a subsequent calendar year.

Moreover, future undesignated obligations issued for what might be deemed a “common purpose” should not retroactively invalidate an earlier designation in cases where it was originally expected that the cost of the “project” would not exceed $3 million. Any other interpretation would leave an issuer faced with unexpected cost overruns in the unfortunate position of not being able to issue additional obligations to complete a “project” financed with an earlier “qualified” issue without invalidating the prior designation and thereby possibly subjecting itself to a claim for damages from the bank which purchased the earlier issue.

Another problem with the definition of qualified project bond arises from the widespread practice of financing construction of a project with short-term bond anticipation notes which may be “rolled over” one or more times during the construction period and ultimately “taken out” with long-term bonds. In such instances, the exception provided by subsection 802(e) should be available as long as the total cost of the project financed with designated obligations does not exceed $3 million. The literal language of the provision, however, would appear to indicate that the face amount of the bond anticipation notes and the bonds might be aggregated in determining compliance with the limitation even though no more than $3 million of project costs were financed. In this type of situation, there would appear to be no valid reason for treating an issuer which took advantage of this typical cost-saving municipal financing practice more harshly than another issuer which funded construction costs solely with long-term bonds. This anomaly could be rectified by providing that an issuer need only aggregate issues with a common ultimate purpose to the extent that those issues are, at the time of designation, then outstanding and are not to be retired with the proceeds of the refunding issue.

Qualified Tax Anticipation Notes

The term "qualified tax anticipation note" is, for purposes of paragraph 802(e)(3), defined to mean any "tax anticipation note which has a term not in excess of 12 months." (emphasis added) The inclusion of qualified tax anticipation notes within the definition of qualified tax-exempt obligations indicates a policy decision on the part of the drafters of H.R. 3838 to allow certain cash flow borrowings to be sold under present laws governing the deductibility of interest. A possible additional reason for this more favorable treatment is that an issuer is often forced to borrow money from a local bank at times when a successful public marketing might be impossible due to the issuer's cash flow difficulties. This exception is too narrowly drawn, however, and is inconsistent I with present statutory and regulatory provisions which, for the most part, treat tax anticipation notes, revenue anticipation notes and grant anticipation notes in the same manner. As is apparently recognized by these provisions, there is no reason why less favorable treatment should be given where cash flow borrowing needs arise due to the timing of non-tax receipts.

Cash flow borrowings are permitted under the laws of most states in order to avoid problems resulting from the untimely receipt of both tax and non-tax revenues, such as federal revenue sharing funds, state moneys, or anticipated grants. In light of this fact, section 103(a) of the Code and the similar provisions of H.R. 3838 both permit tax-exempt cash flow borrowings in anticipation of both types of revenues. Subparagraph 802(e)(3)(D) should permit tax, revenue, and grant anticipation note borrowings to qualify for the exception provided by subsection 802(e) to the same extent that those borrowings are granted tax-exempt status under present law and the provisions of H.R. 3838.

Similarly, the 12-month limitation contained in the definition of qualified tax anticipation note is not consistent with present law. Current Treasury Regulations provide a temporary period during which proceeds of any type of cash flow borrowing can be invested at an unrestricted yield if, among other things, the obligations have a maturity of no longer than 13 months. In addition, temporary periods of up to 24 months are available for tax anticipation borrowings and up to 30 months for grant anticipation borrowings.[11] These temporary periods remain unchanged by H.R. 3838.[12] Thus, existing law and H.R. 3838 give similar favorable treatment to all three types of cash flow borrowings and there seems to be no policy reason for changing this practice by limiting the exception under subsection 802(e) only to tax anticipation notes with a term not in excess of 12 months.

Secondary Market Purchases

According to the Committee Report, the exception provided by subsection 802(e) is intended to enable

[11] Treas. Reg. § 1.103-14(c).

[12] See Committee Report at 554.

smaller financings to be undertaken without incurring the disproportionately high costs of a public marketing. In addition, the exception would permit an issuer to avoid having to market obligations through underwriters or others who may be unwilling to extend credit to the issuer, on terms otherwise available from local banks, due to uncertainty about the issuer's creditworthiness or other circumstances. The exception would, however, literally permit an issuer to designate an issue as a qualified tax-exempt obligation even in cases where the issue was, in fact, sold to an underwriter. The designation would, apparently, thereafter be effective to permit a financial institution within the state of the issuer to purchase the qualified tax-exempt obligation in a secondary market transaction and still take advantage of the permitted deduction for interest expense without the issuer having realized the cost savings that the exception was designed to provide. If this result is not intended, consideration should be given to amending the provision by limiting it to obligations acquired directly from the issuer.

Limitations as to Financial Institutions

The exception provided by Section 802(e) to the 100 percent disallowance rule applies to any “person authorized by State law to do business as a financial institution in the State of the issuer”. Presumably, Section 802(e) incorporates the definition of “financial institution” contained in amended section 265 of the Code, which includes any entity which accepts deposits from the public in the ordinary course of its trade or business and is subject to federal or state supervision as a financial institution. In this regard, the Committee

Report contains language with respect to both the substantive rule and the Section 802(e) exception indicating that the 100 percent disallowance rule may apply to a broader category of entities than the banks and thrift institutions (entities described in sections 585 or 593 of the Code) to which the current law 20 percent disallowance rule applies.[13] If this is the case, the scope of the definition ought to be made clear in this regard.

Furthermore, neither H.R. 3838 nor the Committee Report gives any guidance regarding the scope of the federal or state authorization that is necessary in order for the financial institution to be eligible for the exception. If the exception is only intended to be available to financial institutions which accept deposits from the public and make loans in the state of the issuer in the ordinary course of their business, it should so state. However, a broader meaning of “doing business in the State of the issuer” may have been intended. For example, qualified tax-exempt obligations might be purchased by a financial institution which was only authorized to exercise trust powers in the state of the issuer. Absent further clarification, “doing business as a financial institution” could be interpreted to include other business activities as well. The scope of this provision should be clarified.

Effective Dates

By its terms Section 802(e) applies to bonds issued after December 31, 1985 and before January 1, 1989 that are not “nonessential function bonds”. On March 14,

[13] Committee Report at 590.

1986, the Secretary of the Treasury and the Chairmen and ranking members of the House Ways and Means Committee and the Senate Finance Committee issued a Joint Statement on the Effective Dates of Pending Tax Reform Legislation. The Joint Statement would generally postpone until September 1, 1986 (or the date of enactment of tax reform legislation, if earlier) the application of certain of the tax-exempt bond provisions and restrictions of H.R. 3838, including the definition of “nonessential function bonds”. A technical uncertainty arises because section 802(e) relies, in part, on the term “nonessential function bond” for a period beginning after December 31, 1985 while, under the Joint Statement, the definition of “nonessential function bond” has a postponed effective date. Assuming that section 802(e) will continue to have an effective date of January 1, 1986, it should be made clear that, for purposes of section 802(e), H.R. 3838's definition of “nonessential function bond” will apply with respect to obligations issued after December 31, 1985.