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UNITED STATES GOVERNMENT

Memorandum

Department of the Treasury
Washington, D.C. 20220

TO : Robert H. Mundheim
General Counsel

DATE: MAR 24 1978

FROM : Daniel I. Halperin
Tax Legislative Counsel

SUBJECT: Guarantee of New York City Debt

This memorandum is to advise you of two serious tax problems in the proposed New York City Financial Assistance Act.

First, it is contemplated that guaranteed bonds will be taxable when issued, but may become tax-exempt if the guarantee lapses. This would be a sharp departure from the existing statutory pattern. It would be inconsistent with the premise that the guarantee is a substitute for (and not an addition to) tax-exemption. If a bondholder has a guarantee while the City's ability to repay is in doubt, and a tax-exemption once the City's financial strength is reestablished, then the bondholder has the best of both worlds. He has considerably more than a simple guarantee or tax-exemption. More important, bonds that are taxable when issued but that become tax-exempt would create serious tax avoidance problems. Based on a preliminary analysis, we have identified substantial opportunities for tax avoidance when such bonds are issued at a premium or a discount. For example, assume that a guaranteed bond is issued at a discount on January 1, 1980, becomes tax-exempt when the guarantee lapses on January 1, 1990, and matures on January 1, 1995. Under present law, the entire discount would be taken into account as the tax-exempt equivalent of interest on January 1, 1995. Thus, the bondholder would pay no tax on the discount attributable to the period while the guarantee is in effect even though the bond would be taxable during that period. In an extreme case, when a bond is sold at a large discount, the bondholder would, in effect, receive mostly tax-exempt interest on a guaranteed bond. Similar problems would arise if a bond were sold at a significant premium. Moreover, bonds that are taxable when issued but that become tax-exempt are a sufficiently radical departure from current practice that other problems, not yet identified, are likely to arise. Thus, a prudent tax policy requires that guaranteed bonds must be taxable at all times.

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The alternative is to undertake extensive and intricate revisions of the Internal Revenue Code with no assurance of success.

Second, guaranteed industrial revenue bonds or arbitrage bonds could be issued under the proposed New York City Financial Assistance Act. There is some unfortunate precedent where tax-exempt arbitrage bonds were issued under a Housing and Urban Development statute. The Act should specifically provide that industrial development bonds and arbitrage bonds are not eligible to be guaranteed.

Attached are two drafts of revisions to the proposed New York City Financial Assistance Act. The first draft provides that all interest on guaranteed bonds is taxable. It would also be desirable for the Committee Reports to state explicitly that interest on guaranteed bond is taxable even after the guarantee lapses. The second draft provides that industrial development bonds and arbitrage bonds are not eligible to be guaranteed. Please let me know if you have any difficulty with the substance of these revisions.

Attachments

cc: John Fouhey