MAR 31 1965

Dear Mike:

Thank you for your letter of March 22, 1965, forwarding the letter of Mr. Oscar E. Cutting, City Manager for the City of Bozeman, Montana. Mr. Cutting may be writing to you as a consequence of testimony which I recently gave before the House Banking and Currency Committee concerned with the growing practice of financing industrial plants through issuance of tax-exempt municipal bonds.

Municipal industrial development bonds are being used to finance the construction of industrial facilities which are then leased to private industry at rentals sufficient to meet interest and principal payments on the bonds. The lower interest costs attributable to the tax exemption of interest on State and local bonds are thus passed on to the private lessees in the form of lower rental payments. Although municipal industrial financing accounts for only a small proportion of the total State and local bonds outstanding, this practice is becoming widespread, and the propriety of using the tax exemption privilege for this purpose is being questioned by a number of groups, including many State and local officials.

In connection with the enactment of the Internal Revenue Code of 1954, the House of Representatives approved a provision which disallowed the deduction to private business for rental payments made to State and local governments on real property used for manufacturing which had been acquired or improved by the issuance of revenue bonds. In a favorable report on that legislation, the House Ways and Means Committee referred to the growing abuse of the tax-exempt privilege through the diversion to private business of the benefits of Federal tax exemption. That provision was not, however, enacted.

Bills are now pending in the 89th Congress which deny a deduction for any amounts (including rental, interest and taxes) paid by the lessee for use of facilities constructed with the proceeds of State and local revenue bonds.

The Advisory Commission on Intergovernmental Relations, composed of representatives of Federal, state and local governments, made an extensive study of this problem, and in a report published in June 1963 concluded that “the industrial development bond tends to impair tax equities, competitive business relationships, and conventional financing institutions out of proportion to its contribution to economic development and employment. It is, therefore, a device which the Commission does not endorse or recommend.” I was a member of the

Advisory Commission and concurred in that finding. The Commission recommended denial of the rental deduction, although limited to those situations in which the lessee purchased the bonds.

In my testimony before the House Banking and Currency Committee, I stated my great sympathy with municipalities and States in less developed areas which have adopted such a device as a means of attracting industry. While I believe it necessary to help those areas, such help should be provided through measures such as the Administration's program for development of the Appalachian region and an improved area redevelopment program, rather than through the use of tax-exempt industrial bonds. With the exception of this single special type of situation, I have not recommended any change in the continuance of the present tax exemption for State and municipal bonds.

I hope that the foregoing will be of assistance to you with respect to the paragraph of Mr. Cutting's letter dealing with the immunity of municipal bonds from Federal taxation.

I am returning Mr. Cutting's letter herewith.

With best wishes,

Sincerely,

Douglas Dillon

The Honorable
Mike Mansfield
United States Senate
Washington, D. C.

Enclosure