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STATEMENT OF
MIKEL M. ROLLYSON
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the use of tax-exempt industrial development bonds ("IDBs") to provide private business with capital for the acquisition or construction of multifamily residential rental projects. After a brief description of current law governing the issuance of IDBs for the purpose of financing such projects, I will discuss our concerns about the growth in the use of IDBs for this purpose, and the reasons we believe Congress should reevaluate the tax-exempt status of these bonds. Finally, we will suggest that Congress carefully consider the President's proposal to repeal the tax-exemption for such bonds.

In addition, we are taking this opportunity to provide you with preliminary tabulations of the data available on private activity bond volume in 1984. These tabulations are set forth in the Appendix.

Description of Current Law

State and local government obligations are classified as IDBs if the bond proceeds are to be used in a trade or business of a person other than a government or a tax-exempt entity and if the payment of principal or interest on the bonds is derived from or secured by money or property used in a trade or business. Interest on IDBs as a general rule is taxable, but interest on two categories of IDBs is tax exempt: (1) IDBs that qualify as exempt small issues, and (2) IDBs issued to finance certain exempt activities.

A qualifying residential rental project is an exempt activity. Interest on an IDB is therefore exempt from Federal income taxation if substantially all the proceeds of the IDB are used to provide a qualifying residential rental project. A residential rental project qualifies for tax-exempt financing only if 20 percent or more of the units in the project are occupied by individuals of low or moderate income. This set-aside requirement is reduced to 15 percent if the project is located in a targeted area--that is, an area that is either (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or (2) an area of chronic economic distress as determined under the criteria established for mortgage subsidy bonds.

The term "low or moderate income" is determined by the Secretary of the Treasury in a manner consistent with Section 8 of the United States Housing Act of 1937. Treasury regulations provide that occupants of a dwelling unit generally are considered individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development ("HUD"). HUD determines median incomes for areas based upon families of four and then adjusts these incomes for smaller and larger families.

Uncertainty regarding how median income is to be determined has undermined the Congressional intent that these projects be targeted to benefit low or moderate income persons. Treasury regulations do not make clear that median income is to be determined by reference to the HUD adjustments for family size. Indeed, many issuers have concluded that it is not necessary to make such adjustments. Under such an interpretation of the regulations, an apartment is considered rented to a qualified person even if rented at a market rate to a single person whose income does not exceed 80 percent of the median income for a family of four. We will issue revisions to these regulations shortly to clarify that this adjustment must be made. The revised regulations will be prospective only.

Whether occupants satisfy the low or moderate income test for purposes of the 20 percent (or 15 percent) set-aside requirement is determined at the time they first occupy a unit in a project. If the occupants satisfy the low or moderate income test at that time, they will continue to qualify as long as they continue to reside in the project, without regard to their income levels in subsequent periods. When a qualifying occupant leaves the project, the unoccupied unit will continue to be a qualifying unit at least until it is reoccupied; at that time the status of the unit is determined by the income level of the new occupants.

The 20 percent (or 15 percent) set-aside requirement must be met continuously during at least a 10-year period that begins when 10 percent of the units are occupied (or the IDBs are issued). The 10-year period is extended in several circumstances, for instance, the continuation beyond that time of any Section 8 assistance. The project also must provide residential rental housing (but without any set-aside requirement) for the longer of the period described above or the term of the IDBs.

In general, for these purposes a project is a building or part thereof that contains units having complete living facilities, together with related facilities such as parking lots, trash disposal equipment, and swimming pools. Projects with units that are to be used on a transient basis do not qualify, however.

IDBs issued to finance residential rental projects permit the developers of those projects to receive additional Federal tax benefits that are denied to the developers of other tax-exempt financed facilities. These additional benefits are the ability to retain arbitrage profits rather than rebate them to the Federal government, the ability to benefit from a Federal guarantee, and an exception from the general rule that tax-exempt bond financed property is not eligible for accelerated cost recovery deductions, but rather must be depreciated on the straight-line method over the ACRS life of the property. In addition, these bonds are not subject to the state-by-state volume cap applicable to most other IDBs.

Growth of IDBs for Multifamily

Rental Housing

The original purpose of the Federal income tax exemption for interest earned on obligations of state and local governments was to allow those governments to finance their governmental needs at a reduced interest cost. Since 1979, however, over one-half of all long-term tax-exempt bonds issued have been to provide proceeds for the direct benefit of private businesses, certain tax-exempt organizations, or individuals, rather than to provide proceeds for use by state and local governments and their political subdivisions. I will refer to these tax-exempt bonds, in which the governmental issuer is only a conduit for private borrowing, as "nongovernmental bonds."

Chart 1 of the appendix shows the volume of long-term tax-exempt nongovernmental bonds issued in the years 1975 through 1984. Nongovernmental bonds issued in 1975 totalled only $9 billion, accounting for 29 percent of the long-term tax-exempt bond market. In 1984, reported nongovernmental bonds totalled $72.5 billion and accounted for 63 percent of the long-term tax-exempt bonds issued in that year. Thus, the volume of nongovernmental bonds issued in 1984 was more than eight times the volume of those bonds issued in 1975--only nine years earlier.

The volume of different types of nongovernmental tax-exempt bonds issued in recent years is shown in Table 1 of the appendix. A part of the growth in volume of nongovernmental bonds of course has been in IDBs issued for multifamily residential rental projects. The table shows that multifamily residential rental IDBs grew from $0.9 billion in 1975 to $5.1 billion in 1984--representing growth by a factor of 5.67.

The growth of IDBs for multifamily residential rental projects can be attributed to three principal factors. First, as interest rates rose in the late 1970s, developers searched for lower cost financing tools, and they tapped tax-exempt financing as a method of reducing their interest costs. Even with today's lower interest rates, however, tax-exempt bonds continue to offer a clear cost advantage to developers.

Second, more State and local governments began issuing IDBs for multifamily residential rental projects as they observed their neighboring jurisdictions doing so. This competition between jurisdictions eventually forced all states to begin offering such financing. States and other governmental units have little to lose from these offerings because tax-exempt financing for private developers involves no liability on the part of the issuer and no cost to the issuer.

Finally, part of the increase in the issuance of IDBs for multifamily residential rental projects may be attributable to reductions in direct expenditures by the Federal government. Table 1 of the appendix shows that the largest growth in IDBs for multifamily residential rental projects occurred in 1982. Although this was a period of falling interest rates accompanied by a general increase in housing construction, part of the growth in IDBs issued for multifamily residential rental projects during this period probably was due to the substantial cutback in 1981 in the Section 8 subsidy program for new construction and rehabilitation of low income housing. To the extent tax-exempt financing serves as a substitute for such direct subsidies, it is in direct contravention of Federal budget policies that gave rise to elimination of the Section 8 new construction program.

Reasons the Tax Exemption of IDBs Issued to Finance Multifamily Residential Rental Projects Should be Reevaluated

There are a number of reasons why Congress should reevaluate the tax exemption of IDBs used to finance multifamily residential rental projects. My discussion today will not repeat all the reasons stated in the President's Tax Proposals for repealing the tax exemption of all nongovernmental bonds, but rather will focus on reasons that are distinct to multifamily residential rental IDBs.

1. Revenue Loss.

The tax exemption of IDBs used to finance multifamily residential rental projects should be reexamined because it results in substantial present and future revenue losses by attracting capital away from alternative investments, the return on which would be taxable. The revenue loss from such IDBs issued in 1983 alone will be $180 million in the 1985 fiscal year and will total $2.6 billion over the entire period these bonds are outstanding. While this revenue loss is not overwhelming on its own, these bonds represent only one of many types of nongovernmental bonds, all of which together produce an aggregate revenue loss that is very large indeed. Furthermore, the potential revenue loss from IDBs to finance multifamily residential rental projects is unlimited, since these bonds are exempt from the state-by-state volume cap adopted in the Tax Reform Act of 1984 for most other IDBs. If this lost revenue is to be made up, income tax rates applicable to nonexempt income must be maintained at higher levels than they otherwise would be during the period while the bonds are outstanding.

2. Inefficiency.

The tax exemption of IDBs for multifamily residential rental projects should be reexamined because the subsidy such bonds provide to low and moderate income housing is extremely inefficient. This inefficiency occurs for three principal reasons. First, the interest cost savings to the developer of the project typically are far less than the revenue loss to the Federal government resulting from the lender's not being taxed on the interest received from the bonds. Studies show that for every $2 of interest cost savings to the party who uses tax-exempt bond proceeds, the Federal government usually foregoes more than $3 of tax revenues. In other words, at least one-third of the benefit of tax-exempt financing generally is captured by financial intermediaries and high-bracket investors who hold the tax-exempt bonds.

Second, IDBs issued to finance multifamily residential rental projects are inefficient because the subsidy represents a production incentive provided to the developer of the project rather than a subsidy provided directly to the tenants. Such a production incentive cannot be expected to be passed on to tenants in the form of lower rents except through the operation of general market forces that tend to push rents lower as the supply of rental units increase. In less than perfect rental markets, only a fraction of the subsidy is passed on to tenants through this means, with the remainder being retained by the developer. Moreover, to the extent the subsidy is passed on to tenants, it inures to the benefit of all tenants in the affected rental markets and not just to low or moderate income tenants of the project. Congress has recognized the relative inefficiency of production subsidies in its repeal of authorization for Section 8 new construction, a program under which payments were made directly to the developer, and its subsequent adoption of the HUD housing voucher program.

Third, the subsidy made available through these bonds is inefficient because it is not highly targeted. As a result, the portion of the subsidy passed on to tenants through lower rents is not directed entirely to the moderate or low income tenants in the project because the entire project--not just the 20 percent portion occupied by low or moderate income persons--receives subsidized financing. Congress has eliminated this inefficiency in related areas. For example, the costs incurred in rehabilitating residential rental units can be recovered under section 167(k) over a five-year period, but this recovery method is available only for those units occupied by low or moderate income persons, and not for other units.

3. "Double Dipping."

The third reason that the availability of tax exemption of IDBs used to finance residential rental projects should be reevaluated is that such projects are permitted this subsidy in addition to other Federal tax benefits denied to other tax-exempt financed facilities. These additional benefits are the ability to retain arbitrage profits, the ability to benefit from Federal guarantees, and an exception from the restrictions on the use of ACRS deductions applicable to other tax-exempt financed property. Congress has recognized that such "double dipping" may result in over-subsidization of many projects that would be undertaken with less subsidy, causing additional inefficiencies and distortions in the allocation of capital. Accordingly, the Internal Revenue Code prevents such "double dipping" for other types of tax-exempt bonds.

4. Difficulty of Administration.

A final reason to reevaluate tax exemption of bonds issued to provide low or moderate income residential rental projects is the difficulty and expense of administering the law in this area. The Internal Revenue Service relies primarily on voluntary compliance with the tax laws governing the issuance of tax-exempt bonds, as it does with most other areas of the tax laws. Indeed, the Internal Revenue Service has been aided in its administration in this area by reputable bond counsel and underwriters who historically have carefully adhered to statutory requirements and administrative pronouncements in connection with issuance of tax-exempt bonds, and in some cases have gone beyond such explicit requirements. For example, many bond counsel require the developers of multifamily residential rental projects to certify on a monthly or quarterly basis to the issuer that the 20 percent (or 15 percent) set-aside requirement has been satisfied and to provide the issuer with copies of the income certifications of any new low or moderate income tenants. The recent growth in the volume of nongovernmental bonds appears, however, to have been accompanied by somewhat more aggressive positions on the part of issuers and bond counsel. Unfortunately the Internal Revenue Service lacks the resources to audit a meaningful percentage of the vast numbers of bonds issued each year. In addition, there may understandably be a reluctance to terminate the tax exemption of a particular bond issue because the consequences fall upon the innocent bondholders, not those responsible for the failure to meet the statutory requirements for exemption. Notwithstanding these limiting factors, the Internal Revenue Service formalized a program in 1979 for examining selected tax-exempt bond issues and has had numerous bond issues under examination since that time. This program has led to a number of closing agreements with respect to issues that were found to violate the statutory requirements for exemption, resulting in collection of $40 million in revenues.

For the reasons described above, we believe tax-exemption for IDBs used to provide low and moderate income residential rental projects should be reevaluated. In this regard, we suggest that Congress carefully consider the President's Tax Proposals, which propose a fundamental change in this area of the law.

The President's Tax Reform Proposal

In general, the President's proposal would deny tax exemption to any obligation issued by a state or local government where more than one percent of the proceeds were used directly or indirectly by any person other than a governmental unit. In essence, this proposal would prevent the issuance of tax-exempt bonds to finance any facility other than facilities to be owned and operated by the state or local governmental unit. Thus, roads, parks, and government office buildings could continue to be financed by tax-exempt bonds, but bonds could no longer be issued on a tax-exempt basis to finance facilities intended for private use, such as multifamily residential rental projects.

The proposal would have a beneficial effect on state and local governments issuing bonds for governmental purposes by increasing the value of the Federal subsidy provided to governmental activities financed with tax-exempt bonds. This would come about as the result of the reduction in the supply of new tax-exempt bonds under the proposals, as well as cutbacks in alternative tax shelters and a greater demand by property and casualty insurance companies for tax-exempt bonds under the proposals. This benefit is expected to occur despite the decrease in demand for tax-exempt bonds caused by lower marginal tax rates and changes in the ability of banks to deduct the costs of borrowings to carry tax-exempt bonds, which are also part of the President's proposals. On balance, these factors will tend to increase the spread between long-term tax-exempt and long-term taxable interest rates and correspondingly the value of the subsidy.

The proposal would, of course, increase financing costs for developers of multifamily residential rental projects currently receiving tax-exempt financing. Such increase, however, would simply remove a tax-created distortion in the market's allocation of capital among all nongovernmental persons.

If Congress determines that Federal assistance is desirable to provide rental housing for low or moderate income tenants, it could of course provide direct Federal assistance to them. If this were done, a larger share of the Federal subsidy would inure to the low or moderate income tenants because direct assistance would bypass the bondholders and developers who now reap a substantial portion of the subsidy provided through tax-exempt financing. Moreover, the amount of a direct subsidy could be determined directly by Congress rather than relying on the tax-exempt bond market. In addition, the subsidy could be limited to the period in which it is needed, rather than being extended for the entire life of a tax-exempt bond. The HUD housing voucher program is an example of a promising direct subsidy program that provides low-income families with supplemental funds to purchase housing in the private housing market.

Conclusion

For the reasons discussed above, the Treasury Department strongly favors the elimination of tax-exemption for IDBs for multifamily residential rental projects.

This concludes my prepared remarks. I would be happy to respond to your questions.

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APPENDIX

Private Activity Tax-Exempt Bond Volume in 1984

Preliminary data for private activity tax-exempt bonds issued during calendar year 1984 show the volume of long-term private activity bonds totalled $72.5 billion, compared to $57.1 billion in 1983. Private activity tax-exempt bonds accounted for 63 percent of the estimated volume of long-term tax-exempt bond issues in 1984.

Table 2 shows the total face amount of long-term tax-exempt IDBs, student loan bonds, and bonds for private non-profit organizations issued in 1984 and compiled from the required information reporting form. 1/ The volume (face amount) of long-term bonds subject to the reporting requirement was $56.8 billion to which $15.7 billion of mortgage subsidy and qualified veterans' housing bonds must be added, 2/ for a total private activity bond volume of $72.5 billion.

The total volume of all long-term tax-exempt bonds issued in 1984 is estimated to be $115.1 billion. The published total of $101.8 billion reported by the *Bond Buyer* is adjusted for the large volume of privately-placed small issue IDBs. The $13.2 billion difference between the volume of small issue and industrial park IDBs reported to the IRS and the volume of "industrial aid" bonds reported by the *Bond Buyer* is added to the *Bond Buyer's* total. Private placements of other tax exempt bonds would mean that the estimated total volume of tax-exempt bond issues is understated.

Table 3 shows the face amount and new issue volume of the different reported private activity bonds. The bonds are separated into short-term obligations with maturities of one year or less and long-term obligations. The new issue volume equals the amount of funds received (purchase price) in excess of any proceeds used to retire outstanding obligations. Data from other sources generally report the face amount of bonds. The state volume limitation on student loans and certain IDBs restricts the new issue volume. New issues represent the increase in outstanding private activity tax-exempt obligations (not including non-refunding retirements).

The five largest categories of private activity tax-exempt bonds issued in 1984 are small issue IDBs, bonds issued for private, non-profit hospital and education facilities (section 501(c)(3) organizations), pollution control IDBs, sewage and waste disposal IDBs, and multifamily rental housing IDBs. Thirty-one percent of the reported new issue total, or $16.7 billion, was issued for private businesses under the small issue

IDB exemption. Bonds for section 501(c)(3) organizations totalled $0.1 billion, pollution control IDBs and sewage disposal IDBs totalled $7.6 billion and $6.6 billion, and multifamily rental housing IDB new issues totalled $5.0 billion.

Table 4 shows the percentage change in new issue volume of reported private activity bonds between 1983 and 1984. New issue volume grew by 37 percent in a single year. The main growth occurred in the issuance of IDBs. The largest absolute and percentage changes occurred in the issuance of pollution control IDBs and sewage and waste disposal IDBs. Some of the increase is attributable to bonds that would otherwise have been issued in 1985, but were issued in 1984 to avoid the proposed restrictions on arbitrage and full year effect of the state volume limitation in 1985 enacted in the 1984 Tax Act.

Table 5 shows the total reported new issue volume by type of bond for each state. The volume is reported for all private activity tax-exempt bonds subject to the information reporting requirement, including multifamily rental housing IDBs, private exempt entity bonds, and certain airport and dock and convention IDBs which are excluded from the state volume limitation. No data is available identifying the bonds issued in 1984 which were subject to the 1984 volume limitation. Although the volume limitation was in effect in 1984, it did not apply to obligations issued in 1984 for projects for which inducement resolutions were adopted before June 19, 1984 and for certain other grandfathered obligations.

[1] Issuers of tax-exempt IDBs and tax-exempt bonds for student loans and for private, non-profit organizations are required to report selected information about the bonds to the IRS. Issuers must file IRS Form 8038 within 45 days of the end of the calendar quarter in which the obligation is issued. The reporting requirement, effective January 1, 1983, provided the first comprehensive data on private activity tax-exempt bonds. Comparable data for periods before 1983 are not available.

[2] The 1984 Tax Act extended the information reporting requirement to mortgage subsidy bonds and qualified veterans' housing bonds.