1-29-1986

Federal Tax Reform Act of 1985: Impacts on Local Government

Senate Committee on Local Government

CALIFORNIA LEGISLATURE

SENATE COMMITTEE ON LOCAL GOVERNMENT

MILTON MARKS, CHAIRMAN

FEDERAL TAX REFORM ACT OF 1985: IMPACTS ON LOCAL GOVERNMENT

- Summary Report -

Summary of the Testimony Received
at the Special Hearing of the
Senate Committee on Local Government

January 29, 1986
State Capitol
Sacramento, California

162-S

California Legislature

Senate Committee on Local Government

SENATOR MILTON MARKS
CHAIRMAN

PETER M. DETWILER
CONSULTANT

LESLIE A. MCFADDEN
CONSULTANT

KAYE PACKARD
SECRETARY

ADDRESS ALL COMMUNICATIONS TO
SENATE COMMITTEE ON
LOCAL GOVERNMENT
ROOM 2080
STATE CAPITOL
SACRAMENTO, CA 95814
PHONE: (916) 445-9748

FEDERAL TAX REFORM ACT OF 1985: IMPACTS ON LOCAL GOVERNMENT

- SUMMARY REPORT -

Summary of the Testimony Received
at the Special Hearing of the
Senate Committee on Local Government

January 29, 1986
State Capitol
Sacramento, California

THE TAX REFORM ACT OF 1985: IMPACT ON LOCAL GOVERNMENT

--- A Staff Summary ---

On Wednesday, January 29, 1986, the Senate Local Government Committee held a hearing on the federal Tax Reform Act of 1985. Senator Milton Marks chaired the hearing. Senator Ruben Ayala, Senator William Craven, Senator Newton Russell, and Senator Rose Ann Vuich participated in the hearing. Also present was Jo Kuney, Northern California Field Representative for U.S. Senator Alan Cranston. She presented a statement on behalf of Senator Cranston which is reprinted in this report.

The bond experts and local government representatives who testified at the all day hearing, described the specific difficulties local governments will face if the Tax Reform Act passes in its current form. Many offered recommended changes to the Act.

This staff summary reports who spoke, lists the highlights of the oral testimony, reprints the Committee's background staff report, and includes written testimony submitted by both the witnesses and other experts.

WITNESSES

1. Tim Masanz
   Senior Staff Director
   National Conference of State Legislatures

2. James W. Bruner
   Roger L. Davis
   Robert P. Feyer
   Dean Criddle
   Orrick, Herrington & Sutcliffe

3. George D. Friedlander
   First Vice President
   Smith Barney, Harris Upham & Co., Inc.

4. Theresa Molinari
   Executive Secretary
   California Debt Advisory Commission

5. Scott C. Sollers
   Partner
   Stone & Youngberg

6. Martin C. Coren
   Vice-President
   Katz, Hollis, Coren & Associates, Inc.

7. Pamela M. Hamilton
   Assistant Vice President
   San Diego Centre City Development Corporation

8. Terence J. McCarty
   First Vice President
   E.F. Hutton & Company Inc.

9. Robert Davidson
   Senior Vice President
   The Parsons Corporation

10. Gary Peterson
    Auditor-Controller
    County of Fresno

11. Edward R. Gerber
    Legislative Advocate
    City and County of San Francisco

12. Daniel J. Wall
    Legislative Representative
    County Supervisors Association of California

Written testimony from all the witnesses is reprinted in this report. In addition, the following individuals submitted materials which are also included in the report:

- Richard B. Dixon
  Los Angeles County Treasurer and Tax Collector

- David E. Hartley
  Public Securities Association

- Albin C. Koch
  Attorney, Morrison & Foerster

- Donald Lunsford
  Placer County Executive Officer

- Gilbert T. Ray
  Partner, O'Melveny & Myers

- William A. Wittee
  San Francisco Mayor's Office of
  Housing & Economic Development

FOUR MAJOR CONCERNS

During the hearing, Committee members voiced their particular concern over several features of H.R. 3838. Although the Committee did not adopt a formal statement of findings, these four issues attract their special attention:

- The January 1, 1986 effective date of H.R. 3838.
- The "early issuance" rule.
- The arbitrary nature of the bill's restrictions
- The profound effect on California's housing industry.

● **January 1 Effective Date**. Witnesses repeatedly told the Committee that the January 1, 1986, effective date has brought the tax-exempt municipal bond market in California to a standstill, even though this bill is not law. **Theresa Molinari** of the California Debt Advisory Commission highlighted this point by stating that only two tax-exempt financings have been completed in California since January 1. Members questioned why a proposed bill would have an effective date that precedes its enactment. Members also expressed serious concern over the possibility that a tax-exempt bond issued in 1986 could be made retroactively taxable to January 1 if the tax bill becomes law, unless the effective date is moved to the date of enactment or later.

● **Early Issuance Date**. Many of the Committee members objected to the bill's feature which makes tax-exempt bonds taxable if 5% of a bond's proceeds are not spent within 30 days after the date of issue and the remainder of the proceeds are not spent within three years. They noted that these restrictions ignore the time needed for state and local competitive bidding and contract preparation. They concluded that many local governments would be unable to comply with this rule.

● **Arbitrary Restrictions**. Members found no policy rationale for the new 10% tax-exempt threshold or for including certain bonds like tax allocation bonds under the new volume cap, but excluding others like airports and docks. They also noted that the distinction between "essential" and "nonessential" bonds would preclude tax-exempt financing for projects with a public purpose.

● **Housing Hurt**. Estimates by the California Debt Advisory Commission show that H.R. 3838 would require California to **reduce multi-family housing bonds by more than 90%.** The "total issuance cap" would limit multi-family bonds to $936 million, far below the $5.1 billion issued in 1985. Likewise, the bill would **reduce single-family housing bonds by nearly 70%.** The federal tax bill would seriously hurt California's public-private partnership to produce more affordable housing.

TESTIMONY AND RECOMMENDATIONS

The participants commended the Committee members for their interest in the consequences of the federal tax bill and urged them to maintain their interest throughout the federal legislative process.

Subsequent witnesses all agreed with representatives of **Orrick, Herrington & Sutcliffe** that the volume cap, early issuance rule, and arbitrage restrictions will significantly reduce both the amount and type of bonds that local governments can issue as well as substantially increase their borrowing costs.

George Friedlander of Smith Barney told the Committee how the volume cap, early issuance date, and new 10% tax-exempt threshold will prevent local governments from financing their shortfall in local infrastructure (i.e., public works) needs.

Pamela Hamilton, San Diego Centre City Development Corporation, and **Ed Gerber** from San Francisco gave the Committee information on specific projects that would be abandoned or delayed in their communities if the new restrictions in the federal tax bill are enacted.

Dan Wall, representing California counties, placed the topic in the context of the severe fiscal constraints already faced by urban, suburban, and rural counties. He noted that California counties could loose up to $180 million in federal funds as a result of the Gramm-Rudman deficit reduction bill. The combined effects of Gramm-Rudman and the tax reform bill would be devastating for counties whose discretionary revenues are already lower than their rate of growth for population and inflation.

Adding it all up. **Theresa Molinari** informed the Committee that in 1985, local governments in California issued **$22 billion** or 72% of the state's tax-exempt debt. Single-family and multi-family housing bonds accounted for the largest share of local long-term debt issued last year at **$6.4 billion.** The new uniform volume "cap" would limit the annual issuance of tax-exempt debt for exempt facility bonds and other qualified bonds (including housing and redevelopment bonds) to **$4.6 billion.** If the volume cap had been in effect last year, local tax-exempt bonds worth **$8 billion** could not have been issued.

Few options. If the bill is enacted, **Martin Coren** of Katz, Hollis, Coren told the Committee that local governments would have to rely on more costly taxable bonds or pay-as-you-go financing. **Bob Davidson** from Parsons Corporation stressed the importance of developing financing alternatives that involve cooperation with the private sector.

Public-private partnerships restricted. **Tim Masanz** explained how the new 10% threshold restricts public-private partnerships. He noted that many public power agencies would not be able to continue to sell their excess capacity to privately-owned utilities without loosing their tax-exempt status.

Costly new reporting requirement. **Gary Peterson,** Fresno County's Auditor-Controller discussed the financial burdens to California's counties from the new requirement that county auditors provide each propertyowner with an annual written notice of the amount paid in property taxes. He stated that this requirement applies to approximately **10.5 million parcels** in California. In Fresno County he estimated that mailing costs alone would cost $300,000. Placer County estimates the cost of postage, new forms, and data processing changes to be $100,000.

Volume cap too broad. Most of the recommendations focused on the new uniform volume cap. **Pamela Hamilton** urged the Committee to state that tax allocation bonds are traditional public purpose bonds and should not be included in the new cap. **Terence McCarty** of E.F. Hutton stated that including 501(c)(3) hospitals under the cap will deny the public access to adequate health care. **Ed Gerber** predicted that the volume cap will remove local government from decision-making about tax-exempt financing for housing and economic development. **Scott Sollers** from Stone & Youngberg pointed out that authority to issue single family bonds expires in 1987. He suggested that these bonds be exempted from the proposed new volume limit and applied to the limit for multifamily projects.

Bias against developing areas. **Martin Coren** noted that many of the new restrictions and definitions for "qualified redevelopment bonds" seem aimed at older eastern states and do not account for developing areas like in California. **Ed Gerber** pointed out that the new income limits for single family bonds favors states where bond issues primarily finance the purchase of existing homes, whereas in California 60% of the bond proceeds must be used to finance new units.

***

California Legislature

Senate Committee
on
Local Government

SENATOR MILTON MARKS
CHAIRMAN

PETER M. DETWILER
CONSULTANT

LESLIE A. MCFADDEN
CONSULTANT

KAYE PACKARD
SECRETARY

ADDRESS ALL COMMUNICATIONS TO
SENATE COMMITTEE ON
LOCAL GOVERNMENT
ROOM 2080
STATE CAPITOL
SACRAMENTO, CA 95814
PHONE: (916) 445-9748

FEDERAL TAX REFORM ACT OF 1985: IMPACT ON LOCAL GOVERNMENT

A Background Paper For The Special Hearing

by the

Senate Committee on Local Government

Wednesday, January 29, 1986
Room 112, State Capitol
Sacramento, California

THE TAX REFORM ACT OF 1985: THE IMPACT ON LOCAL GOVERNMENT

On December 17, 1985, the U.S. House of Representatives passed the most far-reaching overhaul of federal income tax codes in years -- the Tax Reform Act of 1985 (H.R. 3838, Rostenkowski, D-Ill.). Buried among the new limits on dozens of tax deductions and credits are significant changes to the rules affecting tax-exempt interest on state and local bonds.

Although President Reagan's proposal to eliminate state and local tax deductions is not part of the House bill, the proposed changes will dramatically affect the timing, cost, and future of many locally funded public projects. If local bonds loose their tax-exempt status, local borrowing costs will increase and project costs will also be driven up. Some may even become too expensive to finance. For California's local governments, these changes threaten $15.4 billion worth of tax-exempt bonds issued in 1985.

In light of these impacts, Senator Milton Marks called a special hearing for January 29, 1986 to investigate how the federal tax bill will hurt California's local governments. The testimony given at the hearing will then be forwarded to the U.S. Senate Finance Committee so its members and staff have an opportunity to examine the impacts to California's local governments. The Senate Finance Committee has scheduled its own hearings in early February.

According to the House Ways and Means Committee Report on the bill, the purpose of the tax-exempt bond changes is to reduce their volume because they have reached "unjustifiably high levels." A second major purpose is to restrict the use of tax-exempt financing for "private" purposes.

This paper highlights major changes found in the tax-exempt bond portions of the bill. **These changes apply to bonds and other governmental obligations issued <u>after December 31, 1985</u>.** This effective date may cause many local issuers to delay financing until the tax reform process is over.

According to the House Ways and Means Committee Report, these changes are collectively estimated to increase federal revenues by:

- $132 million in 1986;
- $395 million in 1987;
- $637 million in 1988;
- $831 million in 1989;
- and $1,100 million in 1990.

New Bond Categories. The bill creates three new bond categories:

(1) essential function bonds,
(2) nonessential function bonds that are eligible for tax-exempt financing if certain new tests are met, and
(3) nonessential function bonds that are ineligible for tax-exempt financing.

An essential function bond is defined as any governmental obligation that is not a nonessential function bond. A nonessential function bond is any local or state obligation where more than 10% or $10 million of the proceeds are used by a nongovernmental person, or more than 5% or $5 million of the proceeds are loaned to a nongovernmental person. The bill does not define a nongovernmental person.

New Tax-Exempt Threshold

Municipal bonds would no longer qualify for tax-exemption if more than 10% or $10 million, whichever is less, of the bond proceeds are used by nongovernmental persons in trade or business, or if 5% or $5 million is loaned to nongovernmental persons. Bonds that meet this threshold are called "nonessential function bonds." Current law permits up to 25% of bond proceeds to be used by nongovernmental persons but does not limit the amount.

The bill exempts the following facilities from the 10% rule: airports, docks and wharves, publicly owned mass-commuting facilities, facilities for furnishing water (except irrigation), sewage and solid waste disposal facilities, and multifamily residential rental projects if they meet new targeting rules discussed below. Bonds for these facilities are called exempt facility bonds. (All these bonds would also come under the new uniform volume limitation).

Multifamily Residential Rental Project Restrictions. These projects retain their tax-exempt status if either of the following two new "set-aside" requirements are met throughout the project period: either 25% or more of the units must be occupied by tenants whose incomes do not exceed 80% of the area median income, or 20% or more of the units must be reserved for tenants whose incomes do not exceed 70% of the area median income. These requirements replace the current 20% set-aside rule. Unlike current law, there are no special rules for projects in targeted areas. If a tenant's income increases more than 20% above the applicable percentage of area median income, the next available unit would be reserved for a low-income family. The bill also increases the period during which the property must be used for rental housing to the longer of 15 years or the maturity date of the outstanding bonds (instead of the current 10 year or 50% limit).

ISSUE: TO WHAT EXTENT WILL THIS NEW LOWER THRESHOLD MAKE PROJECTS THAT ARE NOW TAX-EXEMPT INELIGIBLE FOR TAX-EXEMPTION?

Tax-Exemption Eliminated For Certain Bonds

The federal tax bill eliminates tax-exempt financing for:

- sports facilities;
- convention or trade show facilities;
- air or water pollution control facilities;
- public parking facilities (except as part of an airport);
- facilities for local furnishing of electric energy or gas;
- qualified hydroelectric facilities;
- local district heating and cooling facilities; and
- industrial parks, unless the facility is available for

use by all members of the public on an equal basis. For example, bonds for a sports facility used by a professional sports team would be taxable.

According to the Public Securities Association, financing of these projects in the taxable market will increase local borrowing costs by 30 percent.

ISSUE: TO WHAT EXTENT WILL THIS CHANGE BOOST LOCAL BORROWING COSTS?

New Restrictions On Tax-Exempt Bonds

The federal tax bill continues tax-exemption for the following bonds, but makes them subject to new eligibility and targeting requirements as "qualified" bonds:

- exempt facility bonds (listed in the section on New Tax-Exempt Threshold);
- qualified mortgage bonds;
- qualified veterans' mortgage bonds;
- qualified small issue bonds;
- qualified nonprofit organization 501(c)(3) bonds;
- qualified student loan bonds; and
- qualified redevelopment bonds.

The bill also adds qualified redevelopment bonds to the list of permitted tax-exempt nonessential function bonds. If the new eligibility and targeting requirements can not be met, the bonds would loose their tax-exempt status. (All these bonds also fall under the new volume "cap").

Qualified Redevelopment Bonds. The federal tax bill does not restrict redevelopment bonds that finance traditional public purposes such as streets, sidewalks, and sewers. But the bill does limit the use of tax allocation bonds used to pay for land acquisition by eminent domain, relocation costs, land clearance and preparation, and rehabilitation. In addition, only activities in designated blighted areas may be financed with these bonds. Designated blighted areas must be at least a quarter square mile but cannot contain more than 10% of the local agency's total assessed value.

According to the League of California Cities, over 210 existing California redevelopment projects are smaller than one quarter square mile threshold. In addition, many California cities currently have more than 10% of their assessed valuation within a redevelopment project area. Whether these changes preclude such cities from issuing any tax allocation bonds is not clear.

ISSUES: SHOULD TAX ALLOCATION BONDS BE SUBJECT TO THESE NEW RESTRICTIONS? TO WHAT EXTENT WILL THESE CHANGES REDEFINE THE FUNCTION OF REDEVELOPMENT IN CALIFORNIA?

Qualified Mortgage Bonds. The bill imposes new income limitations on recipients of qualified mortgage bond financing. At least 50% of all mortgage loans must be made to borrowers whose family income does not exceed 90% of the area's median income. In addition, the bond proceeds must be used to finance residences for first-time homebuyers. Current law requires that only 90% of the mortgages meet this test. The bill also reduces maximum home purchase prices from the current 110% of the average area purchase price to 90%. Authority to issue qualified mortgage bonds "sunsets" on December 31, 1987 as under current law.

ISSUE: CAN THESE NEW RESTRICTIONS BE MET?

Small Issue Bonds. The bill continues tax-exemption for small issue industrial development bonds (e.g., generally $10 million or less) to acquire, construct, or improve land used in privately-owned and operated businesses. The bill also repeals the scheduled termination dates in 1986 and 1987 for these bonds.

ISSUE: SHOULD THE SUNSET DATES BE REPEALED?

New Debt Volume Limitations

The bill replaces the three current volume limits or "caps" for industrial development bonds (IDBs); mortgage bonds and veterans' mortgage bonds; and student loan bonds with a unified volume "cap" on all permitted nonessential function bonds. This new cap would be equal to the greater of $175 per resident or $200 million. For California the volume cap for 1986 equals $4.6 billion. This $175 per capita limitation continues until 1988 when the amount will be reduced to $125 per capita.

The volume cap applies specifically to:

- exempt facility bonds (other than certain airport, dock, and wharf facilities);
- qualified redevelopment bonds;
- qualified mortgage bonds;
- qualified veterans' mortgage bonds;
- qualified small-issue bonds;
- qualified non-profit organization 501(c)(3) bonds
- qualified student loan bonds. In addition, the volume cap applies for the first time to the nongovernmental portion of any essential function bond (e.g., a traditional general obligation bond for schools or roads) in excess of $1 million.

New Set-Aside Rules. Of this total ceiling, the bill fixes a new mandatory set-aside for allocations to nonprofit Section 501(c)(3) organizations equal to $25 per resident. This allocation may not be reduced by either the Legislature or Governor. The Bill also allocates $8 per capita for qualified redevelopment bonds, which the Legislature or a charter city may revise. The League of California Cities estimates that the initial "cap" for redevelopment bonds would be approximately $207 million. Last year, California redevelopment agencies issued about $650 million in tax allocation bonds.

Otherwise, the volume limitation would be administered in the same manner as the IDB volume caps under current law. Unless overridden by statute, at least 50% of each state's cap must be reserved for multifamily rental bonds, qualified mortgage bonds, or qualified veterans' mortgage bonds. Within that portion, one-third must be reserved for multifamily bonds and one-third must be reserved for combined mortgage bond and veterans' bond uses. The residual would be available for exempt facility bonds such as mass-commuting facilities, sewage and solid waste disposal facilities, and student loan bonds.

In California, the California Debt Limit Allocation Committee (CDLAC) oversees the allocation of industrial development bonds among cities, counties, and state agencies. The California Mortgage Bond Allocation Committee approves mortgage revenue bond allocations for qualified cities, counties, and state agencies. The impact of this new allocation system on these two Committees is unknown.

ISSUES: BY FORCING COMPETITION AMONG LOCAL AGENCIES TO FINANCE MORE PROJECTS WITH FEWER DOLLARS, TO WHAT EXTENT WILL THE NEW VOLUME CAP MEAN PUBLIC PROJECTS WILL NOT BE FUNDED? WILL THE NEW ALLOCATION PROCESS PREJUDICE THE PROCESS AGAINST LARGE-SCALE PROJECTS?

New Arbitrage And Refunding Restrictions

Interest on arbitrage bonds is taxable under current law. Arbitrage bonds are bonds for which more than a minor portion of the proceeds are invested in higher yielding securities. Local agencies can generate revenue by borrowing at lower tax-exempt rates and investing at higher taxable market rates. This revenue can be used to reduce the amount of outstanding debt. The bill extends to all tax-exempt bonds additional arbitrage restrictions similar to those presently applicable to IDBs and to mortgage bonds. All arbitrage profits earned on tax-exempt bonds must be rebated to the federal government, unless the bond proceeds are spent within six months from the date of issuance. The bill further prohibits advance refundings for any nonessential function bonds and places new restrictions on advance refundings for essential function bonds.

ISSUES: TO WHAT EXTENT WILL THESE RESTRICTIONS PREVENT LOCAL AGENCIES FROM TAKING ADVANTAGE OF FAVORABLE MARKET CONDITIONS TO MINIMIZE LOCAL BORROWING COSTS AND PRODUCE ADDITIONAL REVENUE?

New Reporting And Hearing Requirements

All local issuers will be required to file detailed financial reports with the Internal Revenue Service identical to those now required for IDB issuers. Local issuers will have to file these reports quarterly and at the time of each bond sale. The bill also extends the current public hearing requirement for IDBs to all nonessential bonds. Consequently, bonds could only be issued after the local issuer holds a public hearing and the bonds are approved by the legislative body or, alternatively, are approved by voter referendum.

ISSUE: HOW COSTLY ARE THESE ADDITIONAL REQUIREMENTS TO LOCAL GOVERNMENTS?

Summary: What Does It All Mean?

Many bond experts believe that the federal tax bill arbitrarily denies or limits the use of tax-exempt financing for a wide variety of projects that provide important public benefits. Los Angeles County estimates that the loss of tax-exempt financing could increase interest costs on a bond by 2.5%, which in turn will increase annual debt service costs by more than 35%. Other observers think the bill will severely curtail local governments' ability to repair and rebuild their local public works. If the financial burden on local governments increases, a tax shift to local taxpayers may result. These issues and others will be discussed in greater detail at the January 29 hearing.

Sources

Materials from the following reports contributed to the preparation of this background paper:

Kutak Rock & Campbell, Memorandum Regarding the Effects of H.R. 3838, The Tax Reform Act of 1985, On Tax-Exempt Financing, January 17, 1986.

League of California Cities, Legislative Bulletin, December 23, 1985.

Los Angeles County, Federal Income Tax Reform Proposals, December 1985 and January 1986..

Orrick, Herrington & Sutcliffe, Summary of Tax-Exempt Bond Provisions Contained in H.R. 3838 As Passed By the United States House of Representatives, (Draft) January 1986.

Public Securities Association, Washington Newsletter, November 6, 1985 and January 10, 1986.

Smith Barney, The House Tax Reform Bill: A Devastating Effect On State and Local Government Finance, January 14, 1986.

The Tax Reform Act of 1985, Report of the Committee on Ways and Means House of REpresentatives on H.R. 3838, December 7, 1985.

**** CREDITS ****

This background paper was prepared by Leslie McFadden of the Senate Local Government Committee staff with assistance from Kaye Packard, the Committee secretary.

Special thanks to Christine Minnehan, Federal Relations Coordinator, for her assistance in researching this topic.

NEWS . . . from SENATOR MILTON MARKS

ROOM 2070, STATE CAPITOL, SACRAMENTO, CALIFORNIA 95814 (916) 445-1412

MARKS QUESTIONS AIM OF FEDERAL TAX REFORM BILL

Senator Milton Marks (D-San Francisco & Marin) will hold a special hearing this week to examine how the federal tax reform bill will hurt California's local governments. The Senate Local Government Committee will meet this Wednesday, January 29 at 9:30 a.m. in Room 112 of the State Capitol.

"I want the U.S. Senate to know what havoc the tax reform bill will create for our local governments," said Marks. "They call it tax reform, but I think the hearing will show it really shifts the tax burden to local taxpayers," he added.

Marks said Jo Kuney, aide to U.S. Senator Alan Cranston, will make a statement and then join the Senate Local Government Committee in hearing testimony from bond experts and local government representatives.

Last month, the House of Representatives passed the Tax Reform Act of 1985, the most thorough re-write of federal tax law in decades. The U.S. Senate will begin hearings on the bill this week.

According to the Public Securities Association, the federal bill knocks out or restricts the tax-exempt status from one-third of the state and local bonds now issued. These changes will increase borrowing costs by **$16.8 billion** over the next four years. Local taxpayers will bear these high costs, while increasing federal revenues by just $3 billion.

The tax bill eliminates the tax-exemption on bonds for air and water pollution control, sports facilities, convention centers, and inudstrial parks. These projects would then have to be financed with taxable bonds, increasing local borrowing costs by 30%. Other restrictions ration the volume of housing, redevelopment, and sewage disposal bonds in California to no more than $4.4 billion a year. In 1985, California local governments spent close to $5 billion alone for affordable housing bonds.

CALIFORNIA

45 Polk Street
San Francisco, CA 94102
Phone: (415) 556-8440

United States Senate

WASHINGTON, DC 20510

January 29, 1986

Mr. Chairman and members of the Senate Committee on Local Government, I am very pleased to be able to have my staff member, Jo Kuney, sit in on your special hearing on federal tax reform.

I understand your concern about the new tax bill and its impact on local governments. I very much appreciate the need to retain tax exempt financing for use by local governments. And, the need to keep the full deduction for payment of state and local taxes.

The provisions in the Ways and Means tax reform bill affecting tax exempt financing are among the most controversial in the entire bill. Tax exempt financing has been an extremely important means used by local governments to accomplish much good for their communities.

I will work in the Senate for modifications of those provisions in the Finance Committee's tax bill pertaining to tax exempt financing that may be unfairly injurious to California cities and counties, particularly, tax allocation or tax increment bonds.

Because of the complexity of these issues, as the Committee acts with respect to tax financing, I will be consulting closely with California government officials well in advance of Senate action on the floor.

Again, thank you for allowing me to participate in this hearing. I am certain that the testimony which will be given today will prove invaluable to me as the debate on the issue of tax reform continues in the Senate.

National Conference of State Legislatures

444 North Capitol Street, N.W.
Suite 203
Washington, D.C. 20001
202/624-5400

President David E. Nething
Majority Leader
North Dakota Senate

Executive Director
Earl S. Mackey

STATEMENT

OF

TIM MASANZ

SENIOR STAFF DIRECTOR

FOR

FEDERAL TAXATION, TRADE AND ECONOMIC DEVELOPMENT

NATIONAL CONFERENCE OF STATE LEGISLATURES

WASHINGTON, D. C.

BEFORE THE

LOCAL GOVERNMENT COMMITTEE

CALIFORNIA STATE SENATE

SACRAMENTO, CALIFORNIA

JANUARY 29, 1986

Mr. Chairman, Members of the Committee, my name is Tim Masanz and I currently serve as Senior Staff Director for Federal Taxation, Trade and Economic Development for the National Conference of State Legislatures. For the past 7 1/2 years, I have analyzed federal revenue and spending decisions and indecision for NCSL, and lobbied the Congress and the Administration on behalf of the policy positions of NCSL.

I have been invited today to bring you up-to-date on federal efforts at tax reform, to briefly outline how tax reform could affect local governments including tax exempt financing, and to share with you my best guesses on what will happen to tax reform in 1986. For your information, I have attached copies of the current NCSL policy positions on federal tax reform and on tax exempt financing.

STEPS TOWARD TAX REFORM IN 1985

In his State-of-the Union Address in 1984, President Ronald Reagan announced that the Treasury Department had been asked to study ways to make the federal tax system simpler and more equitable. He asked that a proposal for reform be drafted and presented to him by the end of 1984. He asked that the proposal be "revenue neutral", i.e., that it not be a disguise for a tax increase. Thus while the tax burden might be shifted, the total tax burden was not to be changed by this proposal.

On November 30, 1984, the Treasury Department published and sent to the President its plan entitled: Tax Reform for Fairness, Simplicity and Economic

Growth. Hailed as a thorough rewrite of the federal tax code, it contained one volume outlining proposed changes in both the individual and corporate income taxes, a second volume of more complete descriptions of the proposed changes, and a third volume describing the Department's views on a so-called Value-Added Tax, or V.A.T. The first two volumes became known as Treasury I. It met the President's goals of revenue neutrality, lower tax rates, and the removal of the poor and near poor from those required to file tax returns.

Throughout the year public opinion polls, including one done annually by the U.S. Advisory Commission on Intergovernmental Relations, had found the federal income tax to be the most unpopular or unfair tax of those at any level of government. Numerous studies pointed out major corporations which had escaped the payment of any taxes in the early 1980s, and that actual effective tax rates varied inconsistently from taxpayer to taxpayer even if incomes were identical. There appeared to be significant support for tax reform.

Also in 1984 the Treasury department was engaged in a study on the long range fiscal relationship of the federal government and states and local governments. Consistently Treasury staff referred to the deductibility of state and local taxes and of interest on state and local debt as federal "subsidies" to other levels of government. No amount of discussion, debate or argument would deter them.

Within a few weeks of the study's release, a wide range of taxpayer groups were formed to oppose certain sections of tax reform proposal. In response to the proposal to repeal the deductibility of state and local taxes, state and local government groups pointed out that the deductibility was not an abuse needing to be fixed--nor was it even a voluntary deduction. They also pointed out that the proposed treatment of tax exempt bonds would force nearly 80% of the current volume of issues to be treated as taxable bonds. This was not reform of tax exempt financing, it was nearly a repeal of the provision. The general analysis of the proposal was that it hurt too many taxpayers.

The next iteration of tax reform was a plan endorsed by President Reagan, The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity. It was published and forwarded to the Congress May 29th, and consisted of an outline of proposed changes and brief descriptions of the major provisions totalling 460 pagees. It soon became known as Treasury II. With the President's endorsement, this proposal became the first focus of thorough analysis and political debate. The Congressional Budget Office (CBO) reviewed the proposal and found it to be a tax cut yielding over $25 billion in additional deficit over the first five years, cutting individual taxes by $147 billion and raising corporate taxes by $122 billion. Further, CBO stated that because of optimistic economic predictions, the plan hid the fact that even more revenue would be lost annually after the first five years.

Briefly, what the President had done was to distribute billions of dollars in revenues back to certain categories of taxpayers in an attempt to win more support for his proposal. Treasury II raised revenues to pay for these changes in the following ways:

1. Mathematics: Treasury I earned a net $12 billion versus Treasury II's

HOW THE TAX PLANS COMPARE

	CURRENT LAW (1986)	NOVEMBER 1984 TREASURY PROPOSAL FOR20 1986	PRESIDENT'S PROPOSAL FOR 1986	ROSTY I 1986	ROSTY II 1986
Muncipal Bonds					
"Governmental"	Tax-exempt	1% rule	1% rule	5% rule	10% or $10 million rule
"Nongovernmental"					
Multifamily rental housing bonds	Tax-exempt	Taxable	Taxable	Tax-exempt, capped targeted	Tax-exempt, capped targeted
Single family mortgage revenue bonds	Tax-exempt	Taxable	Taxable	Tax-exempt, capped expire 1987 targeted	Tax-exempt, capped expire 1987 targeted
Small issue idbs	Expire 1986 except for manufacturing	Taxable	Taxable	Taxable	Tax-exempt, capped
Tax increment financing bonds	Tax-exempt	Taxable	Taxable	Taxable	Partially exempted, capped
Airport, docks, wharves	Tax-exempt	Taxable	Taxable	Tax-exempt, capped	Tax-exempt
Water, sewer, solid waste	Tax-exempt	Taxable	Taxable	Tax-exempt, capped	Tax-exempt, capped
Pollution control bonds	Tax-exempt	Taxable	Taxable	Taxable	Taxable
Deductibility of Individual					
Property taxes	Yes	No	No	Yes/modified	Yes
Sales taxes	Yes	No	No	No	Yes
Income taxes	Yes	No	No	Yes/modified	Yes
Personal property taxes	Yes	No	No	No	Yes
Housing Rehabilitation Tax Credit	Yes	No	No	Yes/modified	Yes/modified
Historic Tax Credit	Yes	No	No	Yes/modified	Yes/modified
Targetted Jobs Tax Credit	Yes	No	No	No	Yes/modified
Energy Renewal Conservation Tax Credit	Yes	No	No	No	No
Individual Tax Rates	14 rate brackets from 11 to 50% indexed	3 rate brackets 15, 25, & 35%, indexed	3 rate brackets 15, 25, & 35% indexed	3 rate brackets 15, 15, & 35% indexed	4 rate brackets 15, 15, 35 & 38% indexed
Exemptions					
Self, Spouse	$1,080, indexed	$2,000, indexed	$2,000, indexed	$1,500 for each, indexed,	Non-itemizers $2,000, indexed; itemizers, $1,500 indexed
Dependents	$1,080, indexed	$2,000, indexed	$2,000, indexed	$1,500, indexed	Non-itemizers $2,000, indexed; itemizers, $1,500 indexed
Standard Deductions					
Single	$2,480, indexed	$2,800, indexed	$2,900, indexed	Indexed	$2,950, indexed
Joint	$3,670, indexed	$3,800, indexed	$4,000, indexed	Indexed	$4,800, indexed
Heads of Household	$2,480, indexed	$3,500, indexed	$3,600, indexed	$3,000, not indexed	$4,200, indexed
Earned income credit	Yes, ($540 maximum)	Yes, indexed	Yes, indexed	Yes, indexed	Yes, indexed
Fringe benefits					
Employee provided health insurance	Not taxed	Taxed above a cap, $300 for family	Taxed up to $120 for individual	Taxed	Not taxed
Itemized deduction					
Charitable contributions	Deductible by itemizers and non-itemizers	Deductible (above 2% of Adjusted Gross Income) for itemizers, but no deduction for non-itemizers or for unrealized gains on contributed property	Deductible for itemizers, but no deduction for non-itemizers	Deductible for itemizers, but no deduction for non-itemizers	Deductible, non-itemizers permitted deduction for contributions in excess of $100
Mortgage interest	Deductible	Deductible, for principal residences	Deductible, for principal residences	Deductible for principal residences	Deductible, for principal and second homes

net loss of $25 billion.

Yield: $37 billion

2. Proposed Retroactive Tax: Established an excess depreciation windfall profits tax covering 1980 to 1986:

   Yield: $57 billion

3. Continued the oil windfall profits tax until its scheduled sunset date. Treasury I would have sunset the tax upon enactment.

   Yield: $6 billion

4. Changed the transition rule determining which purchases and investments would be covered by the investment tax credit before its repeal.

   Yield: $19 billion

These changes allowed the President to distribute over $100 billion in tax breaks to certain taxpayers which he felt suffered too much in Treasury I. Litle if any of these changes favored states or local governments. A chart comparing major provisions of tax reform in various proposals is attached.

Chairman Daniel Rostenkowski of the House Ways and Means Committee began hearings on the plan a few weeks after it was published. Chairman Robert Packwood of the Senate Finance Committee commenced Senate hearings a few weeks later. The House held over two months of hearings; the Senate, seven weeks. NCSL and other state and local interest groups presented testimony or statements and met with committee staff on the issues of deductibility and tax exempt financing.

Regarding deductibility there was concern that without its repeal, there could be no way to fund tax reform. On the topic of bonds, there was concern about the steadily increasing volume and what it might mean for future federal revenues, and concern that certain private businesses or individuals had profited from what was intended as a public benefit. The most often repeated stories were the skyboxes at a Chicago stadium visited by the chairman, and luxury condominiums financed by multifamily housing bonds in the southwest.

The President was asked to provide the Congress with amendments to restore the revenue neutrality of Treasury II. It was September before the Treasury Department communicated the President's proposal which was essentially to end the popular 401(k) retirement plans. This made up more than half of the deficit in the original proposal.

To facilitate his committee's work on tax reform, Chairman Rostenkowski regularly met with his committee members individually or in groups, successfully urging them not to speak out on single issues within the broad topic of tax reform, promising that as much as possible he would take care of their concerns within the committee's meetings. Working closely with the staff of the Joint Committee on Taxation, his committee staff produced a new tax reform plan in September in time for the scheduled mark-up. This plan, known as Rosty I, made a serious attempt at revenue neutrality and once again redistributed the benefits of the tax cuts and the burdens of tax increases. It was presented in a series of short pamphlets on major revenue topics (such as capital gains, compliance, minimum tax, etc.) and a large spread sheet comparing present law, the President's proposal, and possible options.

The Ways and Means Committee embarked on a three month long mark-up session, ending just before Thanksgiving, and yielding a stack of press releases describing the decisions the committee had reached. During the final month, as the Chairman continued to push for tax reform despite widespread reports of its death, he appointed task forces to tackle the toughest outstanding problems. These included such issues as housing, small business and tax exempt bonds.

The final evening, the committee took up the expensive issues; deductibility, tax rates, effective dates and transition rules. The Chairman orchestrated an agreement by creatively financing all the provisions he had agreed to accept. He adjusted the dollar level of income at which the three new proposed tax rates would become effective, and added a fourth rate of 38 percent. The package would shift $138 billion of the federal tax burden now borne by individuals to corporations, compared to a shift of $123 billion in the President's plan.

Following the early morning November 23rd completion of mark-up, the committee staff continued its drafting literally around the clock and on December 7 issued its report on H.R. 3838 along with the language of a tax bill. The thin press releases and the Administration's sets of books of descriptions had finally been replaced by a legislative proposal. Unfortunately, many groups including states and localities were surprised by parts of the translation. For example, Members of Congress were surprised to find that only their pensions -- and those of legislative staff and state legislators and state legislative staff -- were protected from the new rules regarding the tax treatment of the first years of benefits. State and local elected officials were outraged that promised clarifications in the language regarding the treatment of service contracts and lease contracts in public programs funded by tax exempt bonds were nowhere to be found. Because of the massive size of the project, problems are still being discovered in the legislation. The bill totals 1379 pages; the section on state and local government debt is 160 pages; the committee report is another 1076 pages.

Final House passage was negotiated before the Christmas recess with a number of small amendments being adopted on the House floor. One of them was a sense of the House resolution that key legislative leaders and Treasury Secretary James Baker would review the bill and change the effective dates for certain provisions. A similar Senate Resolution was also adopted. (Both are attached to my statement.) The exercise has yet to be completed. The final version of this bill, known as Rosty II, has now been sent to the Senate.

STATE AND LOCAL GOVERNMENT CONCERNS IN H.R. 3838: FEDERAL TAX REFORM LEGISLATION

The U.S. House of Representatives has enacted a bill (H.R. 3838) to reform the federal tax code which contains many provisions affecting state and local governments. The following are issues of major concern to states and local governments which are likely to be addressed as the Senate begins its work on tax reform.

1. Effective Dates

   The House bill contains a January 1, 1986 effective date for most provisions. This is most troublesome for the sections relating to tax

HOUSE RESOLUTION 335 ON EFFECTIVE DATES

RESOLUTION to express the sense of the House of Representatives with respect to the effective date of certain provisions of tax reform.

Whereas the prospect for significant revision of the Tax Code has been pending for over a year and may continue for the greater part of next year;

Whereas because of the possibility of significant tax changes occurring with an effective date of January 1, 1986, many individuals and businesses have been unable to determine with certainty how to plan their investments in the near future and for the long term;

Whereas such uncertainty over the prospects of tax reform and its effective date may result in an adverse economic impact on the country as a whole;

Whereas it is necessary to minimize the economic impact of any delay or uncertainty which major tax reform may create; and

Whereas some provisions of current tax law will expire in 1986, creating the necessity for their extension in order to prevent an adverse effort on economic growth: Now, therefore, be it

Resolved, That it is the sense of the House of Representatives that the chairman and ranking member of the House Committee on Ways and Means are hereby instructed, in conjunction with the Secretary of the Treasury and the chairman and the ranking member of the Senate Committee on Finance, to make public not later than December 31, 1985, an agreed upon statement which would have the effect of postponing the effective date until January 1987, of those selected items of tax reform the delay of which would reduce the adverse economic effects which might otherwise be caused by the uncertainty as to the date of final enactment, while still recognizing the need for some retroactive dates for certain expiring provisions.

SENATE RESOLUTION 281 ON EFFECTIVE DATES

RESOLUTION

Prospective Effective Date for Tax Reform:

Whereas the Senate will require adequate time to consider tax reform legislation proposed by the President and the House of Representatives, and to prepare legislation which will maximize fairness and long-term economic growth and minimize short-term economic disruption; and

Whereas, it is likely that such action will not be completed before August 1986; and

Whereas, the tax legislation as prepared in the House of Representatives by the Committee on Ways and Means contains effective dates of January 1, 1986 and earlier; and

Whereas, it is unreasonable to expect taxpayers to comply with fundamental changes in the tax laws before they are enacted and they can be certain what those changes will be; and

Whereas, uncertainty as to the future of particular tax provisions is causing taxpayers either to delay decisions that they otherwise would make or to rush into transactions that, absent tax considerations, they would enter into at a more appropriate time;

THEREFORE, BE IT RESOLVED that it is the sense of the Senate that the effective date of any fundamental tax reform legislation should generally be January 1, 1987 while recognizing that appropriate transition rules may be necessary to avoid unintended adverse effects both on taxpayers and the United States Treasury and recognizing, further, that retroactive effective dates may be necessary to extend certain provisions which expire before January 1, 1987.

exempt financing (Section 703). Several states have already been faced with the reluctance of bond counsel to provide assurance that proposed general obligation bond issues would be tax exempt. Unless this effective date is made more realistic (either date of enactment or January 1, 1987), states will face serious difficulty in getting favorable opinions from bond counsel on most projects. The specific proposals affecting tax exempt bonds are described below.

2. Major New Reporting Requirement Imposed

A last-minute provision inserted into H.R. 3838 requires (1) state and local governments to file 1099 forms for payments of income and property (real and personal) taxes received during a year on a taxpayer-by-taxpayer basis and (2) furnish the taxpayer with a written statement showing payments received from the taxpayer. Effective January 1, 1987, the first return to individuals would be required at the end of January 1987, and to the IRS by the end of February 1988. Aimed at improving taxpayer compliance, this provision places significant financial burdens on state and local governments to assemble information, prepare tapes and pay postage on mailings (Section 145).

3. Deductibility of State and Local Taxes

H.R. 3838 retains the deductibility of all currently deductible state and local taxes. However, because of the lower tax rates and the fewer number of taxpayers who will itemize under the proposed law, one third of the current value of deductibility will be lost. The Senate Finance Committee has already discussed the possibility of limiting or ending this deductibility. The proposals to retain deductibility of income and property taxes while ending the deductibility of sales and personal property taxes would severely harm those states which have chosen to depend more heavily on the sales tax, and be an incentive to other states to look to revenue sources other than the sales tax and personal property tax. This topic will remain an issue throughout the development of a tax reform package.

4. New Definition of Tax-Exempt Bonds

H.R. 3838 rewrites many of the tax code provisions governing tax-exempt bonds and dramatically changes the definition of a "governmental" bond. Section 701 establishes two major categories of bonds: essential function bonds and nonessential function bonds. In general, nonessential function bonds are taxable, although the proposal permits certain nonessential function bonds to be issued on a tax-exempt basis. Essential function bonds are distinguishable from nonessential function bonds by either of the following "tests":

- If more than 10 percent or $10 million, whichever is less, of the bond proceeds are "used" by persons other than a governmental unit, directly or indirectly, the bond is categorized as a nonessential function bond.
- If more than 5 percent or $5 million, whichever is less, of the bond proceeds are loaned to persons other than a governmental unit, directly or indirectly, the bond is a nonessential function bond.

This wholesale change in the treatment of bonds will disrupt public financings and intrude upon the authority of state and local governments to issue traditional governmental bonds. It imposes new and severe restrictions on governmental bonds and increases public project costs. If the present law definitional approach is not retained, the Internal Revenue Service will need to prepare a new set of regulations, which often take years to complete, and it will be permitted to exercise discretion to further restrict state and local governments through the regulatory process.

The House tax reform bill includes the following facilities in the nonessential bond category: airports, docks and wharves, mass commuting facilities, water facilities, sewer facilities, solid waste facilities, and tax increment bonds (now called qualified redevelopment bonds and subject to new restrictions). The inclusion of these types of facilities when publicly owned and operated in the nonessential function bond category illustrates flaws in the redefinition of bonds in H.R. 3838.

Other nonessential function purposes authorized to be financed on a tax-exempt basis are: rental housing, single family mortgages (until December 31, 1987), small-issue industrial development bonds, student loans, and not-for-profit hospitals and universities (501(c)(4) bonds).

The following nonessential function purposes which are permitted under present law are prohibited tax-exempt financing under H.R. 3838 if they fail the governmental-purpose tests: convention and trade show facilities, sport facilities, parking facilities, hydroelectric facilities, pollution control facilities for industry, electric energy and gas furnishing systems, local district heating and cooling facilities, and industrial parks.

Finally, the new definition seriously restricts public-private partnerships in two distinct ways:

- The existence of long-term management contracts and long-term service contracts with the private sector to provide services such as laundry, food and laboratory services in a public hospital will jeopardize the tax-exempt status of a bond if the nongovernmental limit is exceeded.
- Bonds used to finance projects where the public sector and private sector are partners such as solid waste; wastewater treatment; and inner-city revitalization projects combining retail, entertainment and public facilities will be designated as nonessential functions and subject to a volume cap. Public power agencies will not be able to sell freely their excess capacity to privately owned utilities if they want to retain their tax-exempt status.

5. <u>Further Restrictions on Bonds Including General Obligation Bonds</u>

Partially as a result of the new definitions and partly the result of a tightening of all restrictions, numerous other changes will make tax exempt financing more difficult.

- New and more complex <u>arbitrage restrictions</u> will severely limit the investment of note and bond proceeds by (1) restricting the amount of bond proceeds that can be invested (2) limiting the amount of interest that can be earned on invested proceeds, (3) dramatically reducing the "temporary" periods during which investments are unlimited and (4) requiring state and local governments to rebate arbitrage earnings to the federal Treasury if the gross proceeds of the issue are not completely spent within six months after the date of issue.

- A new early issuance restriction will make tax-exempt bonds taxable if 5 percent of bond proceeds are not spent within 30 days after the date of issue and the remainder of the proceeds (except a reasonable bond reserve) are not spent within three years. Competitive bidding requirements alone make this provision unworkable in many states, and impossible in the states where issuers are required by law to have all funds on hand before going to bid. The three year time limit would rule out major capital projects, and the provision that the Treasury Department could issue individual rulings allowing longer time periods because of "undue hardship" only adds to the confusion and uncertainty.
- New restrictions on the refunding of bonds more than 30 days prior to the date the bonds are retired limit the flexibility issuers will have to reduce interest costs and restructure their debt in order to eliminate burdensome convenant provisions. For example, no bond issue may be refunded more than twice and the aggregate amount of successive refundings may not exceed 250 percent of the original bonds (except to reduce interest costs.)
- Individuals must report all tax-exempt interest on their income tax returns.
- All issuers must file a report on every bond and note issue with the IRS.

6. New Unified Volume Cap Affects Governmental Bonds

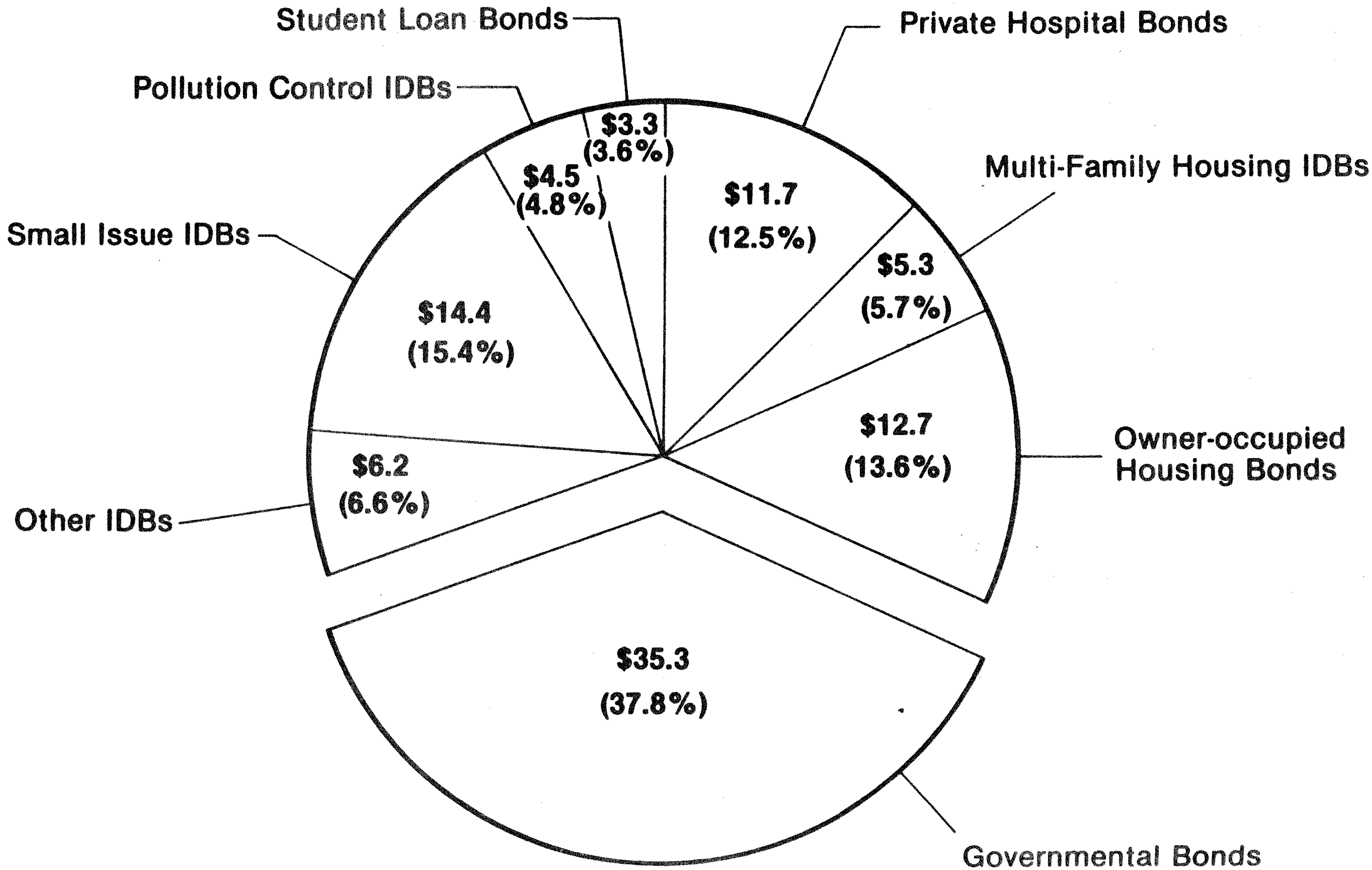
H.R. 3838 increases the types of bonds that are subject to the new unified state volume cap, restricts the ability of states and localities to allocate their approved allocation to specific uses and even subjects portions of essential governmental function bonds to the new unified state volume cap.

In general, all nonessential function bonds are subject to the annual $175 per capita limit beginning in 1988. Airports and docks and wharves are exempted from the cap except for cargo handling facilities at airports and storage facilities at ports. For essential function bonds, if nongovernmental use is involved, the issuer must obtain a volume cap allocation to the extent that the nongovernmental use exceeds $1 million. This means an allocation must be received for a portion of governmental bonds.

H.R. 3838 provides the same federal allocation formula as present law and continues to permit states to modify the formula by enacting legislation or having the governor issue an executive order on an interim basis. The federal law provides that at least $25 per capita (or not less than $30 million) must be reserved for not-for-profit organizations. This reserve cannot be modified by state law. Fifty percent of the remaining cap is set aside for housing under the federal allocation scheme, but state law may reduce this set aside. Additionally, any state that issued more than $25 million in tax increment bonds between July 18, 1984 and November 21, 1985 is permitted to allocate $8 per capita (or not less than $8 million) for tax-increment bonds. Half of this allocation is to be taken from the

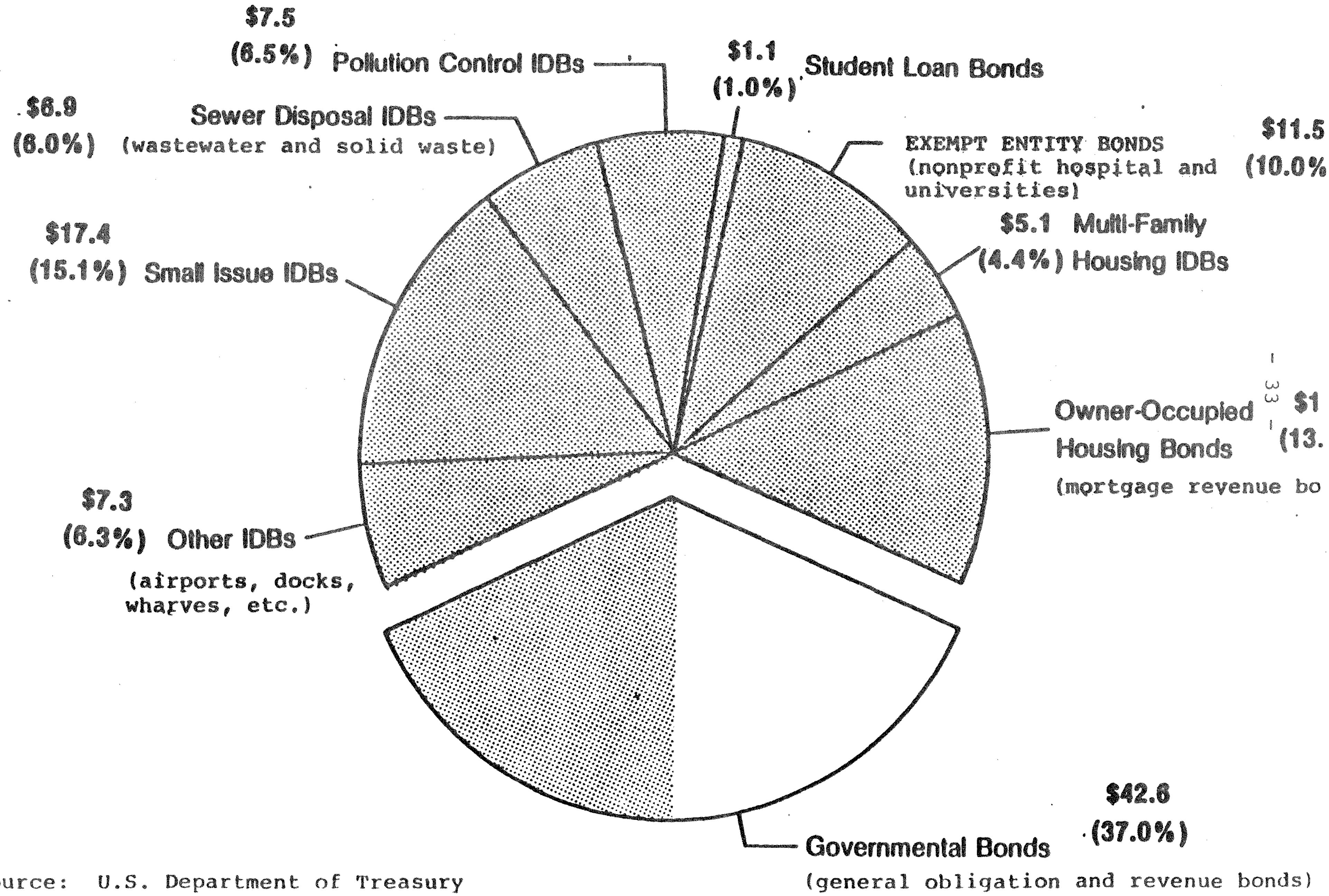
VOLUME OF LONG-TERM TAX-EXEMPT BONDS ISSUED IN 1983

(Amounts in $Billions)



Volume of Long-Term Tax-Exempt Bonds Issued In 1984

(Amounts in $Billions)



Source: U.S. Department of Treasury

housing set aside and half from the allocation that is generally available.

7. Provisions Reducing the Market for Tax Exempt Bonds

Three separate proposals will have a major impact on the bond market: the alternative minimum tax, the repeal of the interest deduction for banks and financial institutions, and certain provisions affecting property and casualty insurance companies.

A. Alternative Minimum Tax: the interest earned on municipal obligations will be subject to taxation because individuals and corporations subject to the alternative minimum tax will have interest earned on tax-exempt "nonessential function" bonds issued after December 31, 1985 taxed at a 25 percent rate in tax years beginning after December 31, 1985. These include many public purpose bonds. The bill contains specific language that property and casualty insurance companies will be required to pay an alternative minimum tax of 20 percent beginning in taxable years after December 31, 1987 which includes tax-exempt interest earned on all tax-exempt bonds acquired after November 14, 1985. Thus, even general obligation bonds will be affected.

NCSL does not oppose a minimum tax. However, such a provision will affect all bonds issued as their tax exemption becomes a matter requiring further research. Once the market is partially taxable, taxpayers might expect further changes. Treasury's insistence on inclusion of this bond interest as taxable ignores the data which Treasury has produced. These figures show that high income individuals and corporations do not avoid taxation because of municipal bonds. They rely on a plethora of preference items to shelter their income. A minimum tax on these other preference items is an appropriate means for making the tax system fairer.

B. Deduction for Bank Carrying Charges: The 80 percent interest deduction banks and financial institutions are permitted for interest costs they incur to carry or purchase tax-exempt obligations has been eliminated in most instances as of December 31, 1985. A three-year transitional exception beginning January 1, 1986 allows up to $10 million in bonds annually for small local issuers to be eligible for the 80 percent interest deduction as long as (1) the obligations purchased are not nonessential function bonds and (2) the bonds are acquired by a financial institution authorized to do business in the state of the issuer. These securities are often used by depositories as collateral securities to secure public deposits that are not insured.

C. Property and Casualty Insurance Companies: in addition to their separate treatment under the alternative minimum tax, these companies will be further discouraged from buying tax-exempt obligations as a result of another proposed tax code change. For tax years beginning after December 31, 1985, the deduction taken by property and casualty companies for loss reserves must be reduced by 10 percent of <u>all the tax-exempt interest earned</u> by the insurer. The percentage increases to 15 percent after December 31, 1987.

PROSPECTS FOR FEDERAL TAX REFORM IN 1986

The Senate Finance Committee last weekend held a 24 hour retreat in West Virginia on the subject of tax reform. As a result of votes taken, the Chairman, Senator Robert Packwood of Oregon, has been charged with drafting a proposal for the committee to consider. Neither the House bill nor the President's proposal were acceptable to the members. The chairman had hoped to begin mark-up in late February, but this new assignment may delay the start.

One of the votes showed a majority of the members favoring some reduction in the deductibility of state and local taxes. The Chairman's proposal will probably propose ending the deductibility of sales and personal property taxes. Besides the greater competition for tax dollars inherent in double taxation due to the loss of deductibility, Merrill Lynch testified before the House that restrictions in the deductibility of state and local taxes would result in higher bond ratings and thus greater interest costs for states and localities.

Regarding tax-exempt financing, there is sentiment on the committee for restrictions on bonds as treated in current law. Since the greatest concern expressed by committee members has been preserving an environment for economic growth and expansion after tax reform, the Senate Finance Committee will not be as harsh as the House in its treatment of bonds. Much of the money which is gained by the House proposal on bonds is generated by folding so many new uses under the volume cap. Thus the long list of intrusive and problematic regulations and requirements will not be of the same importance as in the House proposal. Thus even though they will be pressed to find money to pay for their proposed changes, the Senate Finance Committee is not likely to find these provisions necessary.

There continues to be concern about the ever increasing volume of bond issuances. The table on the next page shows the increases from 1975 to 1984. The 1985 volume of $160 billion represents a 40 percent increase on top of a 23 percent increase the year before. Pending federal tax reform does account for some of the higher 1985 volume, but the members will feel constrained to try to get greater control of this tax expenditure.

The first question is whether the Republican Senate can pass a tax reform bill in an election year. The next question is whether Gramm-Rudman will force the committee to focus on spending issues so much that it doesn't have time for tax reform. The third is whether Gramm-Rudman will force the tax reform bill to become a tax raising measure to soften the programmatic cuts needed to reach the new deficit targets. President Reagan recently addressed Republican congressional leaders and reiterated his opposition to new taxes such as a business transfer tax or an oil import fee.

There is little question but that there will be a lame duck session this year and that tax reform's only hope is to reach a compromise during the final days. The breadth of the bill's impact and the volatile nature of tax decisions on the economy guarantee the longest look, the latest decision and the maximum political safety.

I believe that the two tax writing committees will soon negotiate an agreement on the effective date for the bond provisions, reviving the market and

Table 1.—Volume of Long-Term Tax-Exempt Bonds by Type of Activity, Calendar Years 1975–1984

[In billions of dollars]

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Total issues, long-term tax exempt bonds [1] [2]	30.5	35.0	46.9	49.1	48.4	54.4	55.1	84.9	93.3	114.3
Nongovernmental tax-exempt bonds	8.9	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1	71.7
Housing bonds:	1.4	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0	20.0
Single family mortgage subsidy bonds	*	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0	12.8
Multi-family rental housing IDBs	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3	5.1
Veterans' general obligation bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7	2.1
Private exempt entity bonds [3]	1.8	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7	11.6
Student loan bonds	*	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3	1.1
Pollution control IDBs	2.1	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5	7.5
Small-issue IDBs	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6	17.4
Other IDBs [4]	2.3	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0	14.0
Other tax-exempt bonds [5]	21.6	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2	42.6

* $50 million or less.

[1] Total reported volume from *Bond Buyer Municipal State Book (1985)* adjusted for privately placed small-issue IDBs.

[2] This volume does not reflect amounts borrowed pursuant to installment sales agreements, financing leases, or other, non-bond, borrowing by State and local governments. *See*, II.A., above, for a discussion of the tax treatment of these types of debt.

[3] Private-exempt entity bonds are obligations issued for the benefit of section 501(c)(3) organizations such as private nonprofit hospitals and universities.

[4] Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

[5] Some of these may be nongovernmental bonds.

Note.—Totals may not add due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

protecting those states with shorter sessions. I also expect that the Senate treatment of bonds will be more favorable, both on the issue of public-private partnerships and the protection of public purpose financing. I further will suggest that several of the more onerous House provisions--the rapid spendout and the 10%-$10 million rule will be found unworkable and compromised by the House, but other important concerns such as advance refunding, arbitrage restrictions and the broader volume cap will not be as easily changed in conference.

The volume of bonds will not approach last year's total, and probably be back to the level of 1984. I expect that the Congress will not permit much growth from that figure, as efforts will be directed to making states decide the best use of bonds under a broader and broader volume cap. It is still possible that housing bonds can be brought out from under the state cap, but it will be difficult to avoid having a separate cap set for them.

Treasury's persistence will lead to greater reliance on government owned facilities to insure tax exempt financing. That means that privatization will become less viable possibly leading to more contracting and public management, and eventually the development of a more recognizable division between government with essential infrastructure projects, and public-private economic development projects. The repackaging of projects will stall this for a time, but this new problem will lead to another resourceful, creative approach, possibly use taxes, dedicated occasional lotteries, or major state financing efforts built around guaranteed loans or secondary market efforts.

I would be glad to try to answer any questions you might mave.

National Conference of State Legislatures

444 North Capitol Street, N.W.
Suite 203
Washington, D.C. 20001
202/624-5400

President David E. Nething
Majority Leader
North Dakota Senate

Executive Director
Earl S. Mackey

STATEMENT ON FEDERAL TAX POLICY
Adopted by the Committee on Federal Taxation, Trade and Economic Development
December 13, 1985

The National Conference of State Legislatures recommends and supports an overhaul of the federal tax code to create a simpler and more equitable system of taxation which respects state and local revenue systems.

When considering changes in the federal tax code, NCSL calls upon the federal government to avoid a negative impact upon state revenue systems and balanced federalism. The integrity of state revenue systems must be maintained as a healthy federal system requires fiscally sound state governments. In addition, balanced federalism can only be reached when all partners have the fiscal capacity to respond to their appropriate governmental responsibilities.

During the last several months the NCSL has carefully reviewed the pending tax simplification proposals. We believe they must continue to be scrutinized to determine the long-range effect upon state and local governments of the proposals to remove or reduce the investment tax credit and existing depreciation allowances, the proposals to remove or reduce the expensing of intangible drilling costs and the natural resources percentage depletion allowances, and tax credits or incentives involving energy conservation and renewable energy resources, and arbitrarily taxing life insurance cash values. We further believe that with respect to employee benefit plans, including both 401 (k) and 457 plans, that state and local employees should be on equal footing with employees in the private sector.

As state legislators dedicated to a balanced federalism, our concerns remain undiminished over the proposals to eliminate or modify the deductibility of state and local taxes, and the placing of constraints upon the issuance of tax-exempt bonds for public purposes. NCSL believes these concepts, if implemented, will adversely affect federalism and state and local revenue systems.

The federal government should continue to rely upon the income tax as its best source of revenue. A federal decision to initiate an entirely new tax such as a value-added tax or consumption tax would result in greater federal administrative costs and increased difficulty for state and local revenue decisions.

Since 1980 federal tax rates have declined substantially. However, state tax increases have consistently been needed because of a sluggish economy, additional responsibilities assumed by the states within our federal system, and because states are required to have balanced budgets. Operating surpluses of state governments are not a signal that the federal government should cut back on its responsibilities; rather they are the product of responsible state tax and budgetary policies. Changes in federal tax policy should not penalize states for having acted responsibly these past four years.

Since major federal tax changes affect state tax systems, consultation and cooperation between federal and state policymakers is essential. In no event should federal tax changes be retroactive, depriving states of duly deliberated and legislated revenues.

As genuine federal governmental partners, the states, and state legislatures as the policymaking branch of state government specifically, must participate in federal government tax simplification decisions.

National Conference of State Legislatures

Office of State Federal Relations

444 North Capitol Street, N.W. Suite 203 Washington, D.C. 20001 202/624-5400

President John T. Bragg Deputy Speaker House of Representatives State of Tennessee

Executive Director Earl S. Mackey

TAX-EXEMPT FINANCING
August 8, 1985

A fundamental principle of the federal system of government is the Constitutional doctrine of reciprocal immunity. Therefore, the federal government cannot tax the interest on obligations issued by states and local governments for their facilities and states and local governments cannot tax the interest on federal obligations. No federal tax should be imposed, either directly or indirectly, on the interest paid on state and local government obligations issued to provide services to the public.

Notwithstanding the Constitutional basis of the exemption from tax of interest on obligations issued to provide services to the public, it may be possible to restrict the issuance of bonds that are for the primary benefit of private users. The increased volume of tax-exempt finances has adversely affected the cost of borrowing for "public purposes." So, a workable definition of "public purpose" should be developed to preserve the tax-exempt market for governmental borrowing.

The National Conference of State Legislatures does not support restrictions that affect state and local governments' ability to finance the basic infrastructure of our states, counties, cities and special districts. If these facilities are not provided, industrial and commercial activities that rely on governmental services such as highways, streets, sewers, water systems and schools will not be able to operate efficiently or survive financially.

Recognizing the need to respond to the federal interest in restricting tax-exempt bonds for private users, the National Conference of State Legislatures supports a definition of "public purpose bonds" that provide unchallenged tax-exempt financing for:

- general obligation and revenue bonds that are used to finance such projects as schools, roads, bridges and government buildings;

- industrial development bonds that are used to provide public services such as airports, docks, wharves, and water and sewer facilities;

- bonds for facilities that provide public services that are financed on a public/private partnership basis such as resource recovery facilities; and

- bonds that primarily private users that are targeted to areas of economic distress or to specific purposes where it is in the public interest to continue such tax-exempt financing.

The National Conference of State Legislatures opposes changes in existing federal tax laws, regulations or interpretations which could diminish the value of tax-exempt bonds for governmental purposes. These bonds should be free of severely restrictive arbitrage limits such as the requirement to rebate investment earnings on bond proceeds to the U.S. Treasury, prohibitions against all advanced refundings, and burdensome reporting requirements. Additionally, the National Conference of State Legislatures believes arbitrary volume caps are not an appropriate way to restrict tax-exempt bonds.

The National Conference of State Legislatures urges the Administration and Congress to work with members of NCSL and to determine and implement proper restrictions on the uses of these bonds.

Orrick, Herrington & Sutcliffe

January 29, 1986

Municipal Financial Report

Special Supplement

SUMMARY OF TAX-EXEMPT BOND PROVISIONS CONTAINED IN H.R. 3838 AS PASSED BY THE UNITED STATES HOUSE OF REPRESENTATIVES

CONTENTS

I. House of Representatives Passes Tax Reform Bill of 1985 1

A. Effective Dates 2
B. Major Differences Between The Tax Reform Bill and Previous Committee Proposals 2

II. Summary of Tax Reform Provisions Relating to All Tax-Exempt Bonds 3

A. General 3
B. Arbitrage Rules 3
C. Early Issuance Rule 5
D. Information Reports 5
E. Advance Refundings 5
F. Interest Expense Disallowance 6
G. Property and Casualty Insurance Companies 6

III. Summary of Tax Reform Provisions Relating to Nonessential Function Bonds 6

A. "Essential Function Bonds" vs. "Nonessential Function Bonds" 6
B. Permitted Nonessential Function Bonds 7
C. Restrictions Generally Applicable to Permitted Nonessential Function Bonds 9
D. Nonessential Function Bonds Which Would Be Totally Prohibited 11
E. Alternative Minimum Tax 11

IV. Administrative Provisions 11

I. House of Representatives Passes Tax Reform Bill of 1985

On December 17, 1985, following substantial political efforts by President Reagan and the House Democratic leadership, the House of Representatives on a voice vote passed H.R. 3838, the Tax Reform Bill of 1985 (the "Bill"). The Bill would restructure substantial portions of the Internal Revenue Code and would, for the first time since 1954, recodify the entire tax law, to be known as the "Internal Revenue Code of 1985." The general effective date set forth in the Bill is January 1, 1986. The Senate Finance Committee is expected to start hearings on tax reform later this month, with mark-up of a bill expected to start in March.

The **Municipal Finance Report** is distributed quarterly without charge to public officials and finance professionals, and reports on current federal and State of California legislative and administrative developments affecting public finance. Inquiries about topics covered in the Report, or relating to any legislation on public finance, may be directed to *Rob Oglesby* or *James W. Bruner, Jr.* at 916-447-9200.

Orrick, Herrington & Sutcliffe

600 Montgomery Street
San Francisco, California 94111
(415) 392-1122

55 Almaden Boulevard
San Jose, California 95113
(408) 298-8800

555 Capitol Mall
Sacramento, California 95814
(916) 447-9200

1211 Avenue of The Americas
New York, New York 10036
(212) 704-9660

444 South Flower Street
Los Angeles, California 90017
(213) 624-2470

As discussed in our previous Municipal Finance Reports, the Bill would radically change federal income tax rules relating to tax-exempt financing. In particular, Section 103 of the Code would be restructured, Section 103A (relating to mortgage subsidy bonds) would be repealed, and a complicated web of rules would be added in new Code Sections 141 through 150.

As in the past, we are providing a summary of the provisions in the Bill relating to tax exempt financing for our clients and friends. Readers should carefully review these provisions and consider how the proposals would alter their plans and borrowing practices. *We urge readers to contact members of Orrick's Public Finance or Governmental Affairs Departments for interpretation or further information about the Bill and the progress of the tax reform process.*

A. EFFECTIVE DATES

Title VII of the Bill, relating to tax-exempt financing, generally would apply to bonds[1] and other governmental obligations issued on or after January 1, 1986. Both the House of Representatives and the Senate also passed non-binding resolutions, instructing members of the Ways and Means Committee, the Senate Finance Committee, and the Secretary of the Treasury to issue a statement by the end of 1985 postponing the effective dates relating to some provisions of the Bill until at least January 1, 1987. A confused colloquy on the House floor indicated that at least some Congressmen favored deferring some of the dates relating to tax-exempt financing. As of the date of this writing, the group designated by the House and Senate Resolutions has not met and no postponed effective dates have been announced. Accordingly, we currently are coping with the present law and threatened application (retroactive to the beginning of 1986) of provisions in the Bill. Additionally, the Senate (or the conference committee to follow) might add or substitute yet another set of rules but retain the January 1, 1986 effective date. As a result, there is substantial uncertainty in the tax-exempt market. The consensus of the financial market seems to be that, unless Congress makes a much clearer statement deferring the effective date, any bonds issued after December 31, 1985 must be able to comply with provisions of the Bill, as well as with present law.

B. MAJOR DIFFERENCES BETWEEN THE TAX REFORM BILL AND PREVIOUS COMMITTEE PROPOSALS

In large part, the Bill's provisions relating to tax-exempt financing reflect decisions made by the Ways and Means Committee on October 25, 1985 (reported in our November 4, 1985 *Municipal Finance Report* Special Supplement). Changes include substituting new terminology, adding a new type of permitted nongovernmental bond, and clarification of the new arbitrage rules.

1. ***"Nonessential Function Bonds."*** Until the Ways and Means Committee released its version of the Bill, all proposals had generally drawn a distinction between "nongovernmental bonds" and "governmental bonds." The Bill refers to what were previously called nongovernmental bonds as "nonessential function bonds." Although the Bill does not specifically use the term, the Ways and Means Committee Report refers to governmental bonds as "essential function bonds." The underlying definitions are not changed: a nonessential function bond is any obligation of a state or local government more than 10% (or $10 million) of the proceeds of which is used by nongovernmental persons or more than 5% (or $5 million) of the proceeds of which is loaned to nongovernmental persons. An essential function bond is any governmental obligation that is not a nonessential function bond. As discussed below, all tax-exempt bonds must meet new requirements, and nonessential function bonds are taxable unless they fall into certain categories and meet numerous special requirements.

2. ***"Qualified Redevelopment Bonds."*** Among the categories of permitted nonessential function bonds in the Bill is a new class of bonds called "qualified redevelopment bonds." As described more fully in Part III(B)(12) of this Report, these are tax increment bonds used for particular, limited purposes. The addition of this category of exempt nonessential function bonds indicates that the House generally intends to prohibit other types of tax increment or tax assessment financings where a significant portion of the proceeds are used directly or indirectly by nongovernmental persons.

---

[1] In this article, obligations of state and local governments will be referred to as "bonds." However, all tax reform proposals would apply equally to other governmental obligations such as notes, certificates of participation, leases or installment purchase contracts.

3. *Arbitrage Rules.* The Bill spells out in more detail the new arbitrage rules that would apply to all tax-exempt financings, including essential function bonds. As expected, the rebate and restricted investment rules generally would follow the industrial development bond ("IDB") arbitrage rules contained in H.R. 4170, the Tax Reform Act of 1984. Even though all arbitrage profits generally must be remitted to the United States government, detailed temporary period investment rules would increase the risk that bonds will become retroactively taxable years after they were issued (without increasing federal revenues, limiting the amount of tax-exempt bonds issued, or promoting tax simplicity). In addition, at least 5% of net bond proceeds would be required to be spent on the governmental purpose by 30 days after issuance of the bonds, and 100% of net proceeds would be required to be spent on the governmental purpose by three years after issuance of the bonds. These rules would make it extremely difficult (or impossible) for many issuers to issue mortgage subsidy bonds, student loan bonds, or other blind pool bonds. In many cases these new rules may conflict with state laws requiring that all financing be in place before a governmental unit may contract for acquisition or construction of a project, and would make complete financing impossible when construction of a project will take more than three years.

In summary, substantive changes from earlier proposals contained in the Bill continue the trend of making the issuance and monitoring of tax-exempt debt more difficult, more expensive, and fraught with risks even for traditional general obligation bond and revenue bond issuers, with little or no revenue enhancement to the United States. *We urge state and local government officials to explain to their Senate and House delegations the difficulties they will have in complying with the technical provisions of the Bill related to tax-exempt financing and the burden of such compliance relative to federal revenue enhancement.* For further information regarding what you can do, feel free to contact members of the Orrick, Herrington & Sutcliffe Public Finance or Governmental Affairs department.

II. Summary of Tax Reform Provisions Relating to All Tax-Exempt Bonds

A. GENERAL

The Bill contains provisions governing all tax-exempt obligations. Provisions relating to all types of tax-exempt bonds are summarized in this section. Provisions relating only to nonessential function bonds are summarized in Part III below. Issuers of traditional general obligation bonds, grant, revenue and tax anticipation notes, and traditional revenue bonds should review this section carefully. In addition, they should study the definition of nonessential function bonds, for many traditional forms of financing would be classified as nonessential function bonds under the Bill.

B. ARBITRAGE RULES

As under present law, the Bill would provide that no "arbitrage bond" may bear tax-exempt interest. The definition of arbitrage bond, however, would be substantially changed from current law.

1. *Rebate Requirement.* The Bill generally would require that all arbitrage profits from the investment of "gross proceeds" of a bond issue be paid to the United States government. The Bill would require that issuers or their delegates annually perform a series of calculations to determine arbitrage profits. At least once every five years the arbitrage profits (plus earnings on the profits) must be paid over to the United States government. "Gross proceeds" subject to this rebate rule include not only original and investment proceeds of the bonds, but also any moneys pledged to the bonds, replaced by the bonds, or expected to be used to pay debt service on the bonds. Thus, reserve fund earnings and earnings on moneys set aside to pay off the bonds generally must be taken into account. An exception to the rebate requirement would be available if all "gross proceeds" (other than debt service funds) are spent by six months after the date the bonds are issued. (Thus, this exception could not apply if a reserve fund were established for the bonds.) Additionally, if all earnings on the debt service funds are less than $100,000 in any

year, such earnings would not need to be taken into account for purposes of the rebate calculation. Failure to comply with the rebate rule at any time after the bonds are issued could result in taxability of interest on the bonds applied retroactively to the date the bonds were issued. (The separate rebate rules provided for single family housing bonds would be retained and extended to qualified veterans mortgage bonds as well.) The rebate requirement would not apply to earnings on tax-exempt investments or on obligations acquired to carry out the purpose for which the bonds were issued.

Similar rebate rules have been in place for a year now with respect to most industrial development bonds. The rules have resulted in larger bond issues (to make up for the amount required to be paid to the United States), more complicated bond documents, and ongoing administrative compliance costs for the borrowers.

2. ***Limitation on higher yielding investments.*** Notwithstanding the fact that any arbitrage profits must be rebated to the United States government, the Bill would limit the amount of "gross proceeds" that may be invested without regard to yield. Failure to comply with this rule could result in retroactive taxability of the bonds. Essentially, the investment rule provides that no more gross proceeds may be invested at a yield in excess of the yield on the bonds than an amount equal to 150% of the scheduled debt service during any year. Exceptions are provided for construction and acquisition funds during permissible temporary periods.

3. *Temporary periods.* The Bill would replace the general three-year temporary period rule with new, separate temporary periods for construction or acquisition projects. Any proceeds associated with the acquisition of tangible property would have a maximum temporary period of 30 days. The temporary period for proceeds used for construction would end on the earliest of (a) the date when the project is 90% complete or is abandoned, (b) the date when an amount (from whatever source) equal to all bond proceeds has been expended on the project, (c) three years from the beginning of construction, or (d) three years from the date the bonds are issued. For purposes of this rule, the Ways and Means Committee Report provides that whenever a project is delayed (other than brief delays occurring in the ordinary course of business) or abandoned, the project is deemed to be 90% completed and the related proceeds must be invested at a restricted yield until expended. As a result, the temporary period might end well before actual completion of construction because of a strike, an act of God, or other delays beyond the issuer's control. No other guidance is given issuers in determining when a project will be considered 90% complete.

Although no guidance is provided for distinguishing parts of a project that will be treated as "acquisition" and parts that will be treated as "construction," the Ways and Means Committee Report makes it clear that for projects involving both construction and acquisition elements, different temporary periods will apply to the different elements. For example, when proceeds are to be used to acquire a computer and build the building to house it, the moneys related to the acquisition would get only a 30-day temporary period, even though the computer may not actually be purchased until after the building is completed.

The temporary periods for tax and revenue anticipation borrowings, mortgage subsidy bonds, and student loan bonds apparently would remain the same as under current law. It is unclear whether the current law temporary periods for investment proceeds and proceeds held in a revolving fund would be permitted to the extent these proceeds will be used for the acquisition or construction of facilities.

As discussed above, investments during temporary periods generally would be subject to the rebate rule unless all gross proceeds are spent by six months after the date bonds are issued. Thus, the temporary period rules often will operate simply as technical rules giving the issuer greater investment flexibility during those time periods. However, an issuer taking advantage of such rules must be careful to monitor investments at the end of the temporary period, since failure to restrict yields at the end of a temporary period could result in retroactive taxability of interest on the bonds even though all profits are paid to the United States. If an issuer does not take advantage of a temporary period or upon expiration of the temporary period, the issuer may be forced to invest either in United States Treasury Securities—State and Local Government Series ("SLGS"), which lack flexible liquidity and may not be appropriate to yield restrict to a variable rate, or in tax-exempt obligations, which are not subject to the yield restriction or rebate rules.

4. *Minor portion.* Under present law, up to 15% of bond proceeds may be invested without regard to yield. This "minor portion rule," which often provides a margin for inadvertent error upon the expiration of a temporary period, would be repealed. However, provision for a reasonably required reserve fund of up to 15% would be continued.

5. *Yield.* Under the *State of Washington* case, costs of issuing bonds (including underwriters' spread) are taken into account in determining yield on the bonds. The *State of Washington* case would be reversed by the Bill. Because investment earnings exceeding the yield on the bonds generally must be rebated to the United States government, this will result in additional costs to the issuer, and in the issuance of larger bond issues to finance most projects. Accordingly, the allowable investment return which issuers may earn and retain under the rebate rules would actually be less than the issuer's true costs relating to the borrowing.

6. *Pension Bonds.* The yield on annuity contracts and any "investment-type property" (not including tangible property other than property held for purposes of investment), would have to be taken into account in determining allowable arbitrage profits. This generally would eliminate so-called "pension bonds." A special effective date makes this provision applicable to bonds issued after September 25, 1985.

7. *Student Loan Bonds.* The Secretary of the Treasury would be directed to issue regulations applying special arbitrage rules for qualified student loan bonds. The potential content of such regulations is relatively wide open.

C. EARLY ISSUANCE RULE

Under the Bill, bonds would be taxable unless (i) at least 5% of the net proceeds (after subtracting costs of issuance and any reserve funds) are spent within 30 days after the date of issue, and (ii) 100% of the net proceeds are spent within three years after the date of issue. The Bill would allow the Secretary of the Treasury to extend the three-year period if unforeseen circumstances prevent compliance, and undue hardship otherwise would result. The Ways and Means Committee Report suggests that the House intended similar relief to be available in connection with the requirement that 5% of net proceeds be spent within 30 days, but that is not clear in the Bill itself. It is unclear how these rules would apply in the case of refundings.

The three-year rule raises particular problems for issuers in states with laws requiring that all financing be in place before contracts for construction are bid, especially when the construction period is anticipated to be more than three years. It is also not clear how the three-year rule would apply in the case of a series of bonds issued for one project, a "draw-down" or "grid" bond, or in the case of cost underruns, where not all proceeds are needed for the project. The 30-day rule poses many potential problems for issuers who need their financing in place before they let their contracts be bid and for issuers who will use their bond proceeds to purchase mortgages, student loans, or other loans under blind pool bond programs.

D. INFORMATION REPORTS

All bonds would be made subject to information reporting requirements presently applicable only to "private activity bonds" and single family housing bonds.

E. ADVANCE REFUNDINGS

The Bill would eliminate tax-exempt advance refundings of nonessential function bonds. Current law already prohibits the tax-exempt advance refunding of IDBs and mortgage subsidy bonds by more than 180 days. The Bill would extend the prohibition to all nonessential function bonds, and would define advance refunding to mean the issuance of refunding bonds more than 30 days prior to the retirement of the refunded issue. This restriction would have significant financial impact on 501(c)(3) borrowers and many public power issuers who frequently benefitted from the use of the advance refunding technique.

Essential function bonds could be advance[2] refunded, subject to the following new limitations:

---

[2] The Bill says these restrictions would apply to all refundings of essential function bonds; based upon our reading of the legislative history, we believe the omission of the word "advance" in the Bill is a clear typographical error.

1. Each issue of bonds that is not a refunding issue could be advance refunded no more than twice.

2. A special limitation would apply to the amount of refunding bonds that may be issued if the present value of the savings realized does not exceed the costs of issuance. In such a case the amount of refunding bonds would be limited to to 250% of the amount of original bonds. Thus, refundings could still be made to eliminate burdensome covenants.

3. Refunded bonds would have to be called for redemption no later than the first date on which they can be called with a premium of three percent or less.

4. The "temporary period" for advance refundings would be reduced to no more than 30 days, effectively ending so-called two-year temporary period refundings. Significantly, issuance of advance refunding bonds also would cut off any remaining initial temporary period with respect to the original bonds.

5. To the extent that the prior governmental issue funded more than $1 million of nongovernmental activity, the nongovernmental portion of the advance refunding issue would be subject to the unified volume cap discussed in Part III.

F. INTEREST EXPENSE DISALLOWANCE

Under present law interest expenses on indebtedness incurred or continued to purchase or carry tax-exempt bonds is nondeductible. However, this rule generally has not been applied to financial institutions. Instead, up to 20% of such interest expense incurred by financial institutions has been treated as an item of tax preference.

The Bill would eliminate this item of tax preference and generally would disallow interest expense incurred by financial institutions allocable to tax-exempt obligations acquired after December 31, 1985. For this purpose, a financial institution's interest expense generally would be allocated in proportion to the adjusted basis of all its assets. An exception would be provided for certain designated essential function bonds and qualified 501(c)(3) bonds issued after December 31, 1985 but before January 1, 1989, and acquired by financial institutions authorized to do business in the state of the issuer. The exception would apply only to tax anticipation notes with a term not in excess of 12 months and to small bond issues (not exceeding $3 million) used to provide project financing, and would apply only to bonds issued by issuers that were in existence on October 23, 1985. An issuer may designate no more than $10 million of bonds issued each year for purposes of this exception. It is expected that this provision will severely reduce the market for tax-exempt bonds among banks and other financial institutions.

G. PROPERTY AND CASUALTY INSURANCE COMPANIES

Under the Bill property and casualty insurance companies would be required to reduce their deduction for "losses incurred" by 10% (15% for taxable years beginning after December 31, 1987) of the amount of any tax-exempt interest received or accrued in taxable years beginning after December 31, 1985 on bonds acquired *on or after November 15, 1985.* For taxable years beginning after December 31, 1987, the Bill also would impose an alternate income tax on property and casualty insurance companies, generally equal to 20% of "adjusted net gains from operations." In computing "adjusted net gains from operations," the amount of tax-exempt interest on bonds acquired by the company before November 15, 1985 would be allowed as a deduction.

III. Summary of Tax Reform Provisions Relating to Nonessential Function Bonds

A. "ESSENTIAL FUNCTION BONDS" VS. "NONESSENTIAL FUNCTION BONDS"

The Bill would impose new restrictions on "nonessential function bonds." These new rules, which are in addition to those applicable to all bonds described in Part II above, would limit the activities for which such bonds could be issued, and would restrict the volume of such bonds that could be issued in any state in any year.

The Bill would define as "nonessential function bonds" any bonds where

(a) more than 10% of the proceeds (or $10 million, if less) is *used* by nongovernmental persons in trade or business; or

(b) more than 5% of the proceeds (or $5 million) is *loaned* to nongovernmental persons.

(For purposes of these rules, the United States is treated as a nongovernmental person.) Thus, the Bill would modify current law by reducing the IDB "trade or business" test threshold from 25% to 10% (or $10 million), by eliminating the "security interest" test, and by expanding nonexempt users to include nonprofit organizations described in Section 501(c)(3) of the Internal Revenue Code. It also generally would incorporate the current law restrictions on "consumer loan bonds" (also known as "private loan bonds") into the definition of nonessential function bonds. Presumably, the meaning of the term "loan" under the Bill will reflect the meaning of such term under the "consumer loan bond" provisions of current law, and accordingly might include installment notes, financing leases, and certain long-term output contracts.

In determining whether bond proceeds are "used" by a nongovernmental person, the Bill generally would follow present law. Thus the use (by lease or otherwise) of property financed with bond proceeds would be treated as the use of bond proceeds. Similarly, indirect use of a financed facility through management contracts or output contracts, could all be treated as use of the bond proceeds (unless the contracts satisfy the requirements of Revenue Procedures 82-14 and 82-15). However, use of financed facilities by nongovernmental persons on the same basis as the use by or availability to all members of the general public would not be treated as forbidden "use" of the proceeds (*e.g.*, a public highway). The Ways and Means Committee Report indicates that assessment bonds or redevelopment bonds may be treated as essential function bonds despite the use of financed facilities by a limited number of developers during the initial development period, provided a governmental unit will ultimately own and operate the facilities and the developer proceeds with reasonable speed to transfer the development for sale and occupancy by the general public.

B. PERMITTED NONESSENTIAL FUNCTION BONDS

1. ***Multifamily Housing.*** The Bill would continue to allow tax-exempt financing for multifamily housing projects. However, at least 25% of the housing units would be required to be reserved for families whose income does not exceed 80% of the median income or at least 20% of the units would be required to be reserved for families whose income does not exceed 70% of the median income. The issuer would be required to elect which low-income rule would apply at the time bonds are issued. More generous depreciation rules would apply if at least 40% of the units are rented to families with incomes not in excess of 60% of the average median income. The Bill would eliminate any special income requirements for targeted areas. In all cases, income levels would be adjusted for family size, and the income limitation would be determined on a continuing basis. If a tenant's income increases more than 20% above the applicable percentage of area median income, the next available unit would be required to be held for a low-income family. The Bill would also increase the period during which the project must be used for rental housing and satisfy the low-income requirements to the longer of 15 years from the date 50% of the units are occupied or 100% of the term of the bonds (from the current 10 years or 50% of the term of the bonds).

Special depreciation rules, rehabilitation rules, and at-risk rules would apply to multifamily housing eligible for tax-exempt financing.

2. ***Airports.*** Because of their use by airlines, airport facilities may be considered used more than 10% by nongovernmental persons, and hence bonds financing airports may be nonessential function bonds. State and local governments could issue bonds to finance ground facilities directly related to the transportation by air of passengers and freight, including runways, air traffic control towers, radar installations, certain terminal facilities, public parking, facilities for crash and rescue operations, airport hangers, maintenance facilities, airline lounges, freight handling facilities, roadways, certain airport offices and land set aside for noise abatement or future airport use. Tax-exempt bonds could not be used to finance privately operated, leased, or managed airport hotels, food preparation facilities, restaurants, gift stores, or other commercial facilities located at an airport, unless the small issue exemption discussed below applied. Airport facilities financed with tax-exempt bonds would have to be owned by a governmental unit within the meaning of general federal tax principles. Allocation rules would apply to partially financeable facilities.

3. *Dock and Wharf Facilities.* Tax-exempt bonds could still be issued to finance governmentally owned dock and wharf facilities (including dredging) directly related to the transportation of passengers and cargo by water. Warehouses used to store goods for an extra charge or for more than 30 days could not be financed with tax-exempt bonds; however, warehouses used to store cargo immediately before or after transshipment could be financed.

4. *Sewage, Solid Waste Disposal and Water Furnishing Facilities.* Sewage treatment facilities, solid waste disposal facilities, and facilities for the furnishing of water would continue to be eligible for tax-exempt financing, even though such bonds may be nonessential function bonds. (If the bonds are essential function bonds, of course, the further restrictions discussed in this section would not apply.) The requirements of present law would all be retained, except that water bonds could not be issued to finance irrigation systems. In addition, tax exemption would only be permitted for those water furnishing facilities that are governmentally owned and are either operated by a governmental unit or for which the rates are governmentally established. Notably, a sewage or solid waste disposal facility could be owned or operated by a nongovernmental person.

5. *Mass Commuting Facilities.* Mass commuting facilities (but not vehicles) could be financed with tax-exempt bonds under the Bill even if they would be used more than 10% by nongovernmental persons, provided such facilities are owned for federal tax purposes by a governmental unit. Of course, most mass commuting facilities owned by a governmental unit will not violate the 5% loan test or the 10% use test, and accordingly, bonds to finance such facilities will generally be essential function bonds.

6. *Small Issue IDBs.* Small issue bonds would continue to be allowed, subject to the $1 million or $10 million limits and other requirements presently applicable to exempt small issue industrial development bonds. The present "sunset" on small issue IDBs would be repealed.

7. *Qualified Student Loan Bonds.* Certain tax-exempt bonds issued by governmental units or qualified scholarship funding corporations to provide for student loans would be allowed under the Bill, generally following current law. Supplemental student loan bonds currently issued by some states would also be allowed.

8. *Qualified Mortgage Bonds.* Interest on qualified mortgage bonds would continue to be tax-exempt. However, the Bill would tighten up targeting by requiring that all net bond proceeds (after subtracting costs of issuance and reasonably required reserve funds) be used to finance residences for first-time homebuyers, rather than 90% as under current law, and by reducing maximum home purchase prices to no more than 90% of the average area purchase price applicable to that residence, and 110% in targeted areas (instead of 110% and 120%, respectively, under current law). Additionally, federal income limitations would be imposed. Generally, at least 50% of all mortgage loans would be required to be made to borrowers whose family income does not exceed 90% of the greater of area or statewide median income, and no loans could be made to borrowers whose income exceeds 115% of the greater of area or statewide median income; in targeted areas, one-third of the loans could be made without regard to income, and the balance could be made to buyers having income not exceeding 140% of the greater of area or statewide median income. Issuer policy reports would no longer be required. As under present law, no tax-exempt mortgage bonds could be issued after December 31, 1987.

9. *Mortgage Credit Certificates.* The Bill would continue the authority to issue mortgage credit certificates as under present law, although the targeting requirements would be conformed to the revised targeting rules for qualified mortgage bonds.

10. *Qualified Veterans Mortgage Bonds.* The Bill would continue present law requirements for qualified veterans mortgage bonds, except that all bond proceeds other than amounts used to pay costs of issuance or to fund reasonably required reserve funds would be required to be used for qualifying mortgage loans to veterans.

11. *Qualified 501(c)(3) Bonds.* The Bill would continue to allow tax-exempt bonds to be issued to finance facilities used by 501(c)(3) organizations such as nonprofit schools and hospitals. However, new restrictions would apply to such bonds. Only activities directly related to the exempt purpose of the organization could be financed. Thus, for example, a hospital could not, as under current law, use up to 25% of bond proceeds to finance a doctor's office building. In addition, all property financed with the proceeds

of such bonds would have to be owned (for federal income tax purposes) by a 501(c)(3) organization or by a governmental unit. Finally, no 501(c)(3) organization together with any related organizations could be the beneficiary of more than $150 million of outstanding tax-exempt bonds for facilities located anywhere in the country (applying rules similar to the current law $40 million cap on small-issue IDBs). However, this $150 million cap would not apply to bonds issued to finance hospital facilities owned and operated by 501(c)(3) organizations. A governmental entity which is also a 501(c)(3) organization, such as many state universities, would be treated only as a governmental entity for purposes of the new rules.

12. ***Qualified Redevelopment Bonds.*** The Bill would allow tax-exempt nonessential function bonds to be issued for certain redevelopment purposes. The proceeds of these "qualified redevelopment bonds" could be used for (i) acquiring (through eminent domain or threat of eminent domain) real property in certain blighted areas, (ii) rehabilitating real property so acquired, (iii) clearing and preparing land in the blighted area followed by transfer of the land to nongovernmental persons at fair market value, and (iv) relocating the former occupants of the acquired real property. Qualified redevelopment bonds may only be issued pursuant to state laws relating to redevelopment of "blighted" areas and then only after a redevelopment plan has been adopted by a governmental body. Taxes or other charges against property or owners in the designated redevelopment area must be levied or assessed in a nondiscriminatory fashion. Tax increments relating to the blighted area must be pledged to repaying the qualified redevelopment bonds. There are further limitations on qualified redevelopment bonds. In all, it may well be that the rules for these bonds are so detailed and extensive that very little, if any, financing can actually occur under these provisions.

C. RESTRICTIONS GENERALLY APPLICABLE TO PERMITTED NONESSENTIAL FUNCTION BONDS

As described above, the Bill would continue to permit the issuance of nonessential function bonds for certain specified purposes. However, such bonds would have to meet important additional restrictions, described below. The volume limitation described in (1) is particularly onerous.

1. ***Volume Limitation.*** Under current law, there are separate sets of volume limitations imposed on mortgage subsidy bonds (MSBs) and IDBs other than multifamily housing bonds. There is no volume limit on bonds financing facilities for 501(c)(3) entities. The Bill would impose a unified volume cap on all permitted nonessential function bonds. In addition, the volume cap would apply to any nongovernmental use in excess of $1 million of bond proceeds for bonds that are otherwise essential function bonds.

The volume limitation would be applied on a calendar year and state-by-state basis, and would equal the greater of *$175 per resident* or *$200 million* per state. (The Ways and Means Committee Report states that U.S. possessions would not get the benefit of the $200 million minimum.) This would result in a volume limitation of approximately $4.5 billion for California, which in 1985 issued approximately $12 billion of bonds that would be classified as nonessential function bonds subject to the unified volume cap under the Bill. The per capita limitation would be reduced to $125 per resident after 1987 to reflect the present law sunset for mortgage subsidy bonds. At least $25 per resident would be reserved for 501(c)(3) organizations; this minimum set aside could not be altered by legislation or proclamation. States which issued[3] $25 million or more of tax increment bonds from July 18, 1984 through November 21, 1985 would have to reserve at least $8 per capita ($6, according to the Ways and Means Committee Report) or a minimum of $8 million for qualified redevelopment bonds. The state legislature could override this set aside.

Otherwise, the unified volume cap would be administered in much the same fashion as the private activity volume caps under present law: an initial allocation would be made by the Bill between the state and local governments, but that allocation could be overridden by state law or (during an interim period) by a governor's proclamation. Unless superseded by state statute, the federal law would allocate at least 50% of each

[3] The Bill would require that the *state* have issued the tax increment bonds for the set aside to come into effect. We believe the intent is to count the amount of tax increment bonds issued in the state, regardless of the issuer.

issuer's volume cap (aside from that set aside for 501(c)(3) bonds and qualified redevelopment bonds) to housing bonds. Within that portion, at least one-third would be set aside for multifamily housing and one-third for single family housing; this sub-allocation could be modified by a governor's proclamation. As with the current private activity volume cap, issuers could elect to carry forward unused bond authority for up to three years for specific, identified projects (other than projects to be financed by small issue bonds and qualified redevelopment bonds), for student loan bonds, or for mortgage subsidy bonds.

Bonds issued to finance airport facilities (other than freight-handling facilities) and port facilities (other than those storage facilities that would remain eligible for tax-exempt financing) would be exempt from the new volume cap.

2. ***100% Expenditure Rule.*** Under current law, at least 90% of the proceeds of an IDB must be used for the qualified facility, leaving a 10% "insubstantial portion" to fund a variety of project-related costs, including costs incurred before official action. The Bill would eliminate this rule and require 100% of the net proceeds (after costs of issuance and reasonably required reserves) of nonessential function bonds to be used for the qualified project. The Ways and Means Committee Report would additionally require that any excess be used to retire bonds within 30 days after construction was 90% completed. Bond proceeds could no longer be used to finance "functionally related and subordinate" facilities, although the scope of the repeal of this rule is unclear given the examples in the Ways and Means Committee Report.

3. *Miscellaneous IDB-type Rules.* The Bill would apply a number of present IDB rules to nonessential function bonds. Mortgage bonds and student loan bonds would be exempted from the rules in (a), (b), (c), and (d) below, and the rules already apply to IDBs. Accordingly, qualified 501(c)(3) bonds would be impacted the most by these rules. Under the Bill:

(a) Nonessential function bonds would not bear tax-exempt interest whenever they are held by a substantial user of the facilities financed by the bonds;

(b) The average maturity of the bond issue could not exceed 120% of the weighted average economic life of the financed facilities;

(c) Not more than 25% of the proceeds could be used to acquire land (however, a special exception would apply to some land acquisitions in relation to docks, wharves, airports, and mass commuting facilities);

(d) Existing or used facilities or equipment could not be acquired unless a rehabilitation test is met;

(e) Bonds would have to be approved by elected official(s) after a public hearing (which requirement may preclude blind pool financings); and

(f) No proceeds could be used to pay for an airplane, a skybox or other private luxury box, a health club facility, a facility used for gambling, or a store the principal business of which is the sale of alcoholic beverages for consumption off premises.

4. ***Change in Use.*** If the use of tax-exempt financed property changes from its qualified use, various tax effects would follow. First, the bonds may become taxable relating back to the date of issuance of the bonds. If the facility were an "exempt facility" required to be owned by a state or local governmental unit, any interest, rent or other user charges paid by any party using the property in a use not qualified for tax-exempt financing would not be deductible for federal tax purposes. If the facility were owned by a 501(c)(3) organization, the organization would realize unrelated business taxable income in an amount equal to the interest incurred on the bonds during the period of nonqualified use, and no offsetting deduction would be allowed. If the financed facility were privately owned or were a residence financed with mortgage subsidy bonds, any interest incurred with respect to the now nonqualifying bond-financed loan would be nondeductible during the period of nonqualified use.

5. ***Depreciation.*** Privately-owned facilities financed with nonessential function bonds and nongovernmental property financed within the allowable 5% or 10% limit for essential function bonds would be subject to straight-line depreciation over longer than normal depreciation periods. Generally, tangible personal property would be placed in the next higher depreciation class, and real property would be depreciated over 40 years. Special depreciation rules would apply to multifamily housing projects.

D. NONESSENTIAL FUNCTION BONDS WHICH WOULD BE TOTALLY PROHIBITED

Under the Bill, there would be no further tax-exempt financing for the following types of projects (except to the extent they meet the essential function bond test):

1. Sports facilities
2. Convention or trade show facilities
3. Public parking facilities (except as part of another qualified facility)
4. Facilities for local furnishing of electric energy or gas
5. Air or water pollution control facilities
6. Local district heating and cooling facilities
7. Industrial parks
8. Small hydroelectric generating facilities.

(As described under Section IV(2) below, certain individual projects described above may be financed if they meet the transition rules.)

E. ALTERNATIVE MINIMUM TAX

The Bill imposes an alternative minimum tax on both individuals and corporations. As the name implies, the alternative minimum tax would be imposed in lieu of the regular income tax if it results in a larger annual tax payment. Generally, the alternative minimum tax would be imposed at a flat 25% rate against the taxpayer's taxable income for the year, reduced by a $40,000 exemption ($30,000 for most single individuals, $20,000 for married individuals filing separate returns and certain trusts), but adjusted to reflect designated items of tax preference.

The Bill identifies as a new item of tax preference interest on tax-exempt *nonessential function bonds issued after December 31, 1985.* The tax preference amount would be reduced by the amount of any interest disallowed under Section 265 of the Code. An exception is provided for bonds issued on or after January 1, 1986 to refund bonds issued before that date. It is unclear whether this exception would apply to a series of refunding bonds issued on or after January 1, 1986 to refund bonds issued before that date.

IV. Administrative Provisions

1. ***General Effective Date.*** The Bill would generally apply to all bonds issued after December 31, 1985. The rules prohibiting "pension bonds" would apply to all bonds issued after September 25, 1985.

2. ***General Transition Rules.*** A general transition rule would apply to:

(a) the "essential function" bond test ((III)(A) above);
(b) projects denied further tax-exempt status ((III)(D) above);
(c) the requirement of governmental ownership for certain facilities ((III)(B)(2), (3), (4) and (5) above);
(d) new restrictions on bonds for 501(c)(3) organizations ((II)(B)(11) above); and
(e) the new volume limit ((III)(C)(1) above), provided in the case of facilities presently under a volume limit that a carryforward election was made by October 31, 1985 (December 31, 1985 in the case of certain solid waste disposal facilities).

(Note that even if an issue qualifies for a transition rule, it would still be subject to the new arbitrage and early issuance rules.)

The general transition rule would apply to bonds issued with respect to facilities approved by a governmental unit (*i.e.*, "official action") before September 26, 1985 if

(a) the facilities are newly placed in service by the taxpayer and the construction, reconstruction, or rehabilitation of the facilities commenced on or before September 26, 1985, and was completed after that date, or
(b) there was a binding contract entered into before September 26, 1985, to incur expenditures with respect to the facilities equal to more than 10% of the cost of the facilities approved for bond financing before September 26, 1985, and expenditures under the contract were incurred on or after that date, or
(c) the facilities are acquired after September 26, 1985 pursuant to a binding contract entered into before that date.

3. *Refunding Bonds.* The Bill would allow current refundings (including a series of refundings) after December 31, 1985 of bonds issued on or before that date and which would otherwise be prohibited or restricted as new issues, subject to the following limitations:

(i) the amount of the refunding bonds could not exceed the amount of the refunded bonds; and

(ii) refunding bonds must not have a maturity longer than the later of either (a) 120% of the economic life of assets originally financed, or (b) 17 years (32 years in the case of mortgage or veterans bonds) after the original date of issuance.

4. *Specific Transition Rules.* Many specific transition rules for various projects are also contained in the Bill. If you believe such a rule may apply to your project, please contact the Orrick Public Finance Department.

5. *Tax Return Reporting.* All tax-exempt interest received or accrued after 1985 would be required to be reported on the federal income tax return of the recipient.

To change a name on or add a name(s) to our mailing list, fill in this form and mail to:

ORRICK, HERRINGTON & SUTCLIFFE
600 Montgomery Street
San Francisco, California 94111
Attention: Jolene M. Overbeck

Change ☐ Add ☐

Name ______

Title ______

Firm/Agency ______

Street ______

City ______

State ______ Zip ______

Tax Reform - The Effect on Sewage Treatment, Resource Recovery, Arbitrage

By George D. Friedlander
First Vice President and Manager, Municipal Research Department
Smith Barney, Harris Upham & Co., Inc.

Testimony Before the California Legislature Committee on Local Government
January 29, 1986

I. The Overall Effect of HR3838 on State and Local Issuers

A. Increased cost of borrowing
B. Reduced access to tax-exempt financing; reduced flexibility
C. New risks for investors - retroactive loss of tax exemption
D. New levels of bureaucracy - reporting requirements, arbitrage and rebate requirements, volume caps, "early issuance," vague definition of "use."
E. Decreased local autonomy - volume cap requirements, definition of "nonessential purpose."
F. Sharply reduced availability of public/private partnerships
G. Conflicts with federal, state and local laws
H. Alternative minimum tax - increased costs for "nongovernmental issuers." Interest on these bonds would be included in an expanded alternatve minimum tax.
I. Complete elimination of arbitrage income
J. Requirement that some proceeds be invested in "SLG's"

II. Current Market Effect - The market has virtually ceased to function. Issuers are being impeded by "in fact" compliance and "early issuance" provisions, volume cap restrictions, and retroactive effective date. A wide range of institutional and retail investors are refusing to buy any 1986 bonds.

III. Key Provisions Affecting Sewage Treatment and Resource Recovery

A. Concept of private use. For a sewage treatment facility, if more than 1% of bond proceeds benefits a private user, the issuer needs a volume cap allocation for the private use. If more than the lesser of $10 million or 10% of proceeds benefits a private user, the entire project falls under the volume caps.

B. Volume caps. Not enough room, biased against large projects. All resource recovery projects, except those issued under transition rules, would be subject to the caps. California fares somewhat better than other states - 25.4% reduction from 1985 volume (PSA estimate - $5.18 billion-->$3.84 billion). After single family mortgage sunset, cap drops to $2.5 billion. No inflation adjustment.

C. "Early issuance." Issuer must spend 5% within 30 days, all of proceeds within 3 years, or bonds can be retroactively declared taxable. Many issuers cannot comply, for legal or operational reasons.

D. "In fact" compliance. An issuer must comply with all of the complex, technical and sometimes vaguely worded provisions of HR3838, or bonds could become taxable, retroactive to issuance date. This new risk is shutting down the new issue market. Most investors refuse to accept this risk without significant additional compensation.

E. $1-10 million rule. Requires a volume cap allocation for private use portion of essential function bonds.

F. 10%/$10 million rule. For an essential function bond, only the lesser of 10% or $10 million can benefit a private user, including a non-profit organization. Otherwise, bonds are taxable. Impairs privatization, long-term contractual arrangements, especially for essential function sewage treatment projects.

G. Facilities must be "directly related" to exempt purpose to qualify for tax-exempt financing.

H. For non-essential purpose, stringent limitations on land acquisition (25% of proceeds)

IV. Specific Problems for Resource Recovery

A. Volume cap allocations. $75 per capita available for all non-housing nongovernmental. Resource recovery costs approximately $300 per capita.

B. Electric generation equipment. Can't be financed with tax-exempt bonds. Ancillary facilities are borderline.

C. Loss of tax benefits. Elimination of investment tax credits, new depreciation schedules would reduce tax benefits from 25% of total cost to roughly 12-15%.

D. Some use of taxable debt will be required in virtually every case.

E. Net impact - increased cost, reduced credit quality, delays, reduced feasibility

V. Arbitrage Provisions

A. All arbitrage income would have to be rebated to the Federal government

B. Starting point for arbitrage calculations - interest cost minus cost of issuance. An issuer is forced to lose money on all invested proceeds.

C. Stringent temporary period. 3 years after commencement of construction or date of issuance, whichever is earlier; 30 days for land acquisition. After the end of the temporary period, all of proceeds must be invested in SLG's or tax-exempt bonds at a restricted yield.

D. Elimination of "minor portion," on which positive arbitrage may be earned

E. Severe restrictions on advance refunding for essential purpose bonds; complete prohibition for nonessential purpose bonds

VI. Conclusion

HR3838 has already had a painful effect on state and local issuers. That effect will get worse. The municipal bond provisions are seriously flawed. They should be scrapped and replaced by targeted regulations which meet specific goals of Congress. With respect to resource recovery, the cost paremeters already place many projects in jeopardy. HR3838 would make a serious situation much worse. (For further information, please refer to "The House Tax Reform Bill: A Devastating Effect on State and Local Government Finance," a Special Report dated 1/14/86.)

STATE OF CALIFORNIA
CALIFORNIA DEBT ADVISORY COMMISSION
915 CAPITOL MALL, ROOM 400
P.O. BOX 1919
SACRAMENTO, CALIFORNIA 95809
TELEPHONE: (916) 324-2585

THERESA MOLINARI

SENATE LOCAL GOVERNMENT COMMITTEE

<u>Federal Tax Reform Act of 1985:</u>

<u>Impact on Local Governments</u>

January 29, 1986

Good morning, Chair and members. My name is Theresa Molinari and I am Executive Secretary of the California Debt Advisory Commission. The Commission was created in 1981 by the California Legislature to serve as the State's clearinghouse on public debt issuance information. The Commission has nine members, is chaired by the State Treasurer, and includes four members of the Legislature.

I have been asked to provide testimony today on two subjects:

1. The issuance of tax-exempt debt in 1985 by local governments and
2. The potential effect of the "unified volume cap" in H.R. 3838--a.k.a. Federal tax reform--on local agencies.

1985 Local Debt Issuance

1985 was a banner year for public debt issuance. Interest rates declined; the State multifamily housing bond cap tripled; and Congress threatened "tax reform."

Faced with uncertainty about what the future would hold for both the supply and demand for municipal debt securities as well as conducive market conditions, local agencies issued nearly $22 billion in tax-exempt instruments in 1985. This represents a 59 percent increase in 1985 over 1984 issuance by local agencies. (NOTE: The 1985 debt issuance figures used thoughout this summary are as of January 27, 1986. The California Debt Advisory Commission estimates that an additional amount of 1985 issuance will be verified in the next two weeks.)

As Table 1 indicates, of the total 1985 local issuance, $18.2 billion was for long-term debt while $3.6 million was for interim financing. Total 1985 local government debt issuance ($21.9 billion) represents 72 percent of the total $30.2 billion issued Statewide. In comparison, local agencies issued 75 percent of the Statewide total in 1984.

Over 90 percent of the local long-term indebtedness in 1985 is comprised of certificates of participation, public enterprise and private obligor revenue bonds, and tax allocation bonds. General obligation bonds, special assessment bonds, and limited tax obligation bonds make up the remaining 10 percent of the local long-term debt.

TABLE 1

TOTAL CALIFORNIA PUBLIC DEBT ISSUANCE

1985

LOCAL		% OF TOTAL
Long-Term	$18,220,235,578	60.3
Interim	3,636,000,000	12.0
Total, Local	21,856,235,578	72.3
STATE		
Long-Term	5,240,000,000	17.3
Interim	2,373,000,000	7.8
Total, State	7,613,000,000	25.2
NONPROFIT STUDENT LOAN CORPORATIONS	760,000,000	2.5
TOTAL	$30,229,235,578	100.0

Source: California Debt Advisory Commission, January 27, 1986

Local agencies issued long-term securities to finance a variety of public purposes. "Typical" purposes included the construction of public buildings and the purchase of fire trucks and police cars as well as the provision of housing, commercial and industrial development, public infrastructure, local schools, public power facilities, health facilities, water supply, and sewage treatment. These projects are financed on a "pay as you use" rather than a "pay as you go" basis when public debt is issued. Debt financing makes possible the provision of certain critical local public services and projects which could not be financed exclusively on a "cash" basis.

In 1985, the single greatest "purpose" which was financed by local governments was housing. Housing accounts for $6.4 billion or 35 percent of the total 1985 long-term local debt issuance. Purposes for which more than $1 billion in local debt was issued in 1985 include:

1. Housing: $6.4 billion
   (Single-family: $1.5 billion, Multifamily: $4.9 billion)
2. Power Generation and Transmission: $2.9 billion
3. Redevelopment: $1.7 billion
4. Health Facilities: $1.3 billion
5. Various Capital Improvements: $1.3 billion
6. Public Buildings: $1.0 billion

Taken together, these six categories represent $14.6 billion or 80 percent of the total long-term local debt issuance in 1985.

Over 35 percent of the total local issuance was completed in November and December.

Potential Effect of the Unified Volume Cap

As the tremendous rush to market in November and December indicates, H.R. 3838 would fundamentally alter the issuance of tax-exempt debt.

Tax-exempt financings for certain specified projects would be prohibited (i.e., air and water pollution control) while issuances for other purposes would be severly limited due to the imposition of the unified volume cap (i.e., housing, nonprofit health and education facilities, and industrial development). Additionally, even "traditional governmental" public purpose debt would be subject to numerous new investment and expenditure restrictions.

Because of the January 1, 1986, effective date of the tax reform bill, this legislation--which is not now law--continues to leave its mark on the municipals market. Since January 1, 1986, only two tax-exempt financings have been completed in California. These issues total less than $60 million. In January 1985, 35 local financings representing nearly $300 million in par value had been completed.

Perhaps the most obvious and dramatic effect of the Federal tax reform bill would result from the imposition of a volume cap on certain "nonessential" bonds. Under the tax bill, all issuance of "nonessential" bonds above the limit set by the cap would be subject to Federal taxation. (NOTE: "Nonessential" and "essential" are used here without conceding their descriptive accuracy.)

The following are generally defined by the tax bill as tax-exempt "nonessential" bonds:

1. Exempt facilities including airports, docks and wharves, mass commuting facilities, water furnishing facilities (except for the purpose of irrigation), sewage disposal facilities, solid waste disposal facilities, and multifamily rental housing;
2. Qualified student loan bonds;
3. Qualified mortgage bonds including veterans' mortgage bonds;
4. Small-issue bonds;
5. Section 501(c)(3) organization bonds (predominantly for hospital/health care and education facilities);
6. Qualified redevelopment bonds.

Under H.R. 3838, this volume cap would limit the Statewide annual issuance of tax-exempt "nonessential" bonds by all issuers to $4.6 billion. The components of the State volume cap would be as follows:

1. Set-aside for 501(c)(3) Financings: $659 million ($25 per capita)
2. Set-aside for Housing: $1,872 million ($71 per capita)

3. Set-aside for Qualified Redevelopment: $211 million ($8 per capita)

4. Set-aside for Other "Nonessential" Bonds: $1,872 million ($71 per capita)

5. TOTAL CAP FOR CALIFORNIA: $4,614 million ($175 per capita)

Although it is extremely difficult to determine precisely the amount of 1985 debt issuance which would have been subject to the cap if it had been in place, it appears that California issued at least $10 billion more in "nonessential" bonds than H.R. 3838 would have allowed. This would have resulted in a needed 70 percent reduction in the issuance of tax-exempt debt for these purposes.

Due to the local housing bond volume, the impact on local government would have been more dramatic. Assuming that all but the "qualified redevelopment" allocation is split 50-50 between State and local issuers and that the redevelopment allocation is earmarked for local agencies, debt issuance by local governments for "nonessential" purposes in 1985 appears to have exceeded H.R. 3838's local issuance cap by over $8 billion. Of course, this amount would be reduced to the extent that tax allocation bonds do not qualify under the tax proposal.

The following summarizes local debt issuance in 1985 relative to the various volume cap components:

1. 501(c)(3)

   Local cap: $329.5 million

   Local issuance: $1,316 million

   Excess: $986.5 million

2. Housing

   Local cap: $936 million

   Local issuance: $6,420 million

   Excess: $5,484 million

3. Qualified Redevelopment

   Local cap: $211 million (Assumes modification of H.R. 3838's allocation.)

   Local issuance: $1,176 million

   Excess: $1,459 million (Assumes that all bonds qualify.)

4. Other "Nonessential"

   Local cap: $936 million

   Local issuance: $1,176 million

   Excess: $240 million

   (This category is relatively more difficult to estimate. The above figure is certainly on the conservative side.)

5. TOTAL "NONESSENTIAL"

   Local cap: $2,412.5 million

   Local issuance: $10, 582 million

   Excess: $8,169.5 million

Table 2 summarizes the reduction in total Statewide issuance and local issuance which could have been required by the volume cap in 1985. Moreover, it is reasonable to expect some additional reduction due to the elimination of financings for certain projects as well as various other restriciton.

TABLE 2

POTENTIAL EFFECT OF H.R. 3838 UNIFIED VOLUME CAP
ON 1985 CALIFORNIA DEBT ISSUANCE (1)

	1985 State Issuance(2)	1985 Local Issuance(2)	1985 Total Issuance(2)	Total Issuance Cap(2)	Total Reduction Required(%)(3)	Local Reduction Required(%)(3,4)
501(c)(3)	$1,437	$1,316	$2,752	$659	76.1	75.0
Tax Allocation Bonds	0	1,670	1,670	211(5)	87.4	87.4(6)
Housing	1,279	6,420	7,699	1,872	75.7	85.4
Single-Family	(1,125)	(1,476)	(2,601)	936	64.0	68.3
Multifamily	(154)	(4,944)	(5,098)	936	81.6	90.5
Other	1,359	1,176	2,535	1,872	26.2	20.4
Solid Waste	(512)	(289)	(802)	NA	NA	NA
Student Loans	(760)(7)	(0)	(760)	NA	NA	NA
Small-Issue	(86)	(887)	(973)	NA	NA	NA
TOTAL	$4,074	$10,582	$14,656	$4,614	68.5	77.2

Source: California Debt Advisory Commission, January 27, 1986

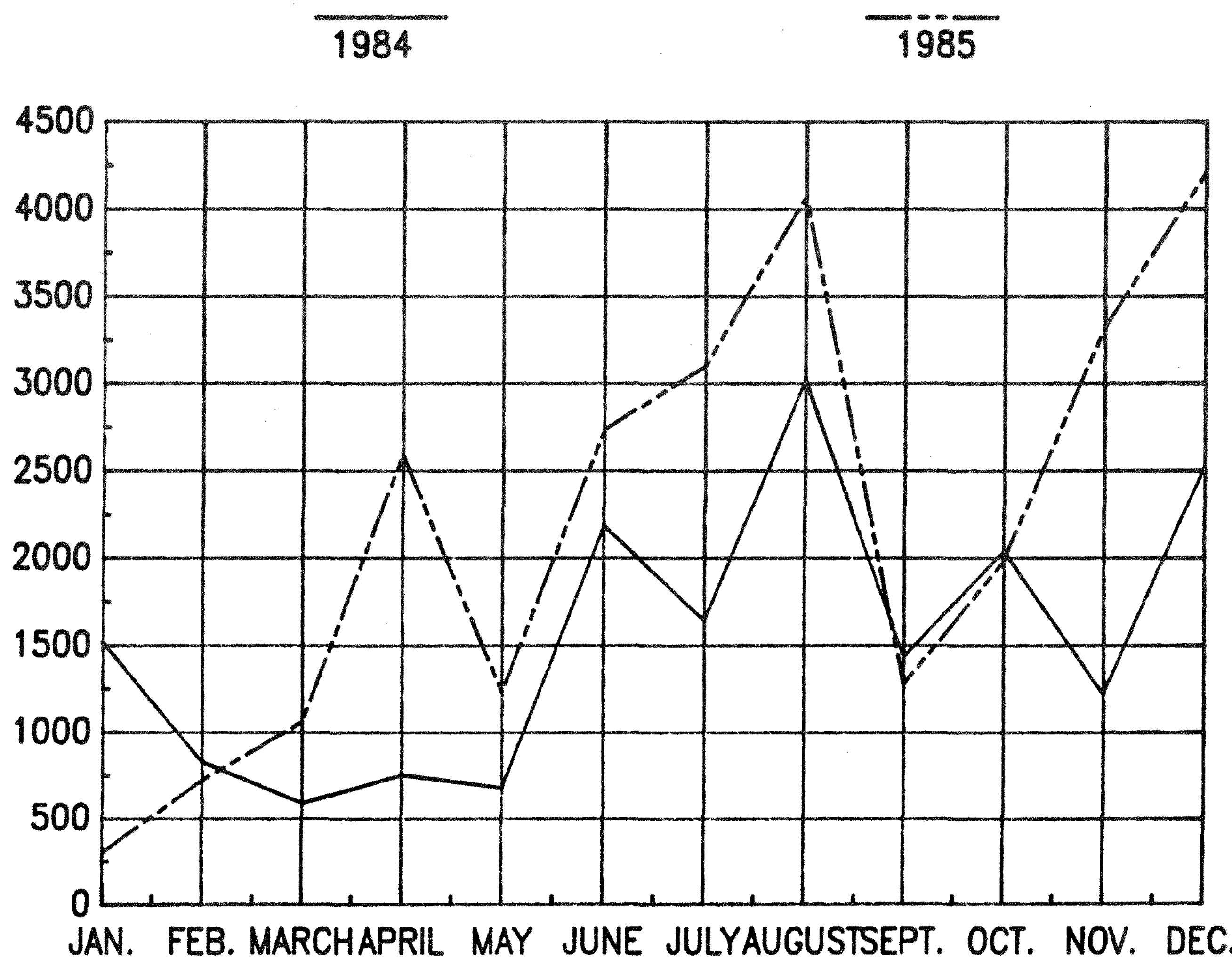
(1) Figures in this table are "best" estimates; actual issuance volume subject to cap is difficult to determine with precision.
(2) Figures in millions of dollars ($000,000).
(3) The percent decrease required in 1985 issuance to comply with estimated volume cap of H.R. 3838.
(4) Assumes that the volume cap for 501(c)(3), housing, and "other" is split equally between local and State agencies and that the total redevelopment cap is allocated to local issuers.
(5) Amount for "qualified redevelopment bonds." At least a portion of the tax allocation bond issuance may not constitute "qualified redevelopment bonds."
(6) Assumes that the entire "qualified redevelopment bond" cap is allocated to local agencies, for the purpose of this analysis.
(7) Student loan bonds are issued by nonprofit public benefit corporations. For the purpose of this analysis, these bonds are included in State issuance.

This concludes my prepared comments. I would be happy to answer any question.

####

CALIFORNIA STATE AND LOCAL TOTAL BOND ISSUANCE BY MONTH

(IN MILLIONS OF DOLLARS)



CALIFORNIA DEBT ADVISORY COMMISSION
JANUARY 10, 1986

Testimony of Scott C. Sollers

Mr. Chairman and Committee members, my name is Scott C. Sollers, Partner, Stone & Youngberg. We are a regional investment banking firm specializing in municipal finance for California public agencies. We have been involved in the structuring and sale of mortgage revenue bonds since 1979. I appreciate the opportunity to comment on the proposed changes to current tax exempt financing for housing as set forth in H.R. 3838 recently passed by the House of Representatives.

Currently, State and Federal law permits the sale of tax exempt securities to finance mortgages for certain owner-occupied single-family residences and for certain multifamily projects. Present authority to issue such securities is based on legislation that has been subject to considerable debate and amendment and provides for more affordable housing in this State. H.R. 3838 imposes severe restrictions on the amount and application of mortgage financing for both owner and non-owner occupied residences and limits the ability of local government to design and implement appropriate financing programs to provide affordable housing.

Volume Limit

Current federal law limits the amount of securities that may be issued in any state to finance owner-occupied single-family residences which are purchased by first-time homebuyers to the greater of $200M or a percentage of the average of the previous three year's conventional mortgage activity. According to Manny Val, Executive Secretary of the California Mortgage Bond Allocation Committee, the 1985 ceiling for California was $2.7 billion. Under applicable State law, this ceiling is further assigned to State and local agencies with 1/3 available to the State and the remainder to local agencies. Mr. Val indicates that in 1985, 80 local agencies issued $1.5 billion of single-family bonds while three State agencies issued approximately $1.4 billion of which $240 million were sold by California Veterans Administration and secured by a General Obligation of the State and therefore outside of the current statewide cap.

There is no current limit imposed by Federal law affecting the amount of tax-exempt securities for eligible multifamily projects. State law, however, limited the amount of multifamily bonds to $2.8 billion in 1985 and will reduce the cap to $1.5 billion in 1986.

H.R. 3838 would distinguish two classes of bonds based on use of proceeds and would restrict the volume of one such class. These classes include "essential" function bonds the proceeds from which are used by governmental entities, which include classic public improvements such as roads, sewer and water systems and other public buildings and for which there is no volume limit and "non-essential" function bonds, the proceeds of which are used by non-governmental entities, which include eligible industrial projects, hospitals, and housing, to name a few, and which are limited in volume per State to the greater of $200 million or $175 per capita.

For California, the total capacity of non-essential function bonds in 1986 would be approximately $4.4 billion. H.R. 3838 suggests that $75 of the $175 limit be available for housing. The State legislature could redirect this allocation. However, under the prescribed formula, the total capacity for both single and multifamily dwellings would be approximately $1.9 billion versus the $5.5 billion actually sold in California in 1985.

This $1.9 billion would require further allocation between single and multifamily financings and assignment between State and local issuers.

Assuming that 2/3 of the housing allocation is directed to single family programs and assuming that the current allocation formula between State and local agencies is sustained, the proposed new ceiling would provide approximately $1.2 billion for single family financing of which $800 million would be available to local agencies.

Current State law further divides that amount available to local agencies into two equal pools. The first pool called "Entitlement" is distributed to local agencies on a first come-first served basis in amounts of approximately $20 million per issuer, with the notion that this is the minimum size issue that can economically be marketed. The remaining pool, called "Supplemental" is distributed to all requesting issuers on a pro-rata basis. Currently, 86 local agencies have requested a total of $4.8 billion for single family financing in 1986. H.R. 3838 would accommodate less than 1/4 of the total number of requesting issuers and dollar volume.

The remainder, or approximately $700 million, would then be available for multifamily housing, or less than 1/2 of that amount permitted under State law.

It is true that other factors may limit the actual amount of bonds that may be sold in 1986 under existing rules to finance single family residences. Lower current conventional rates, the scarcity of earthquake insurance and increasingly onerous qualifying ratios imposed by mortgage insurers may result in fewer single-family mortgage revenue bonds to be sold in 1986 than actually authorized. Nevertheless, tax-exempt mortgage financing has provided the guarantee of cost-effective mortgage money over sustained periods which has insured continued construction activity, employment and affordable housing in periods of changing economic activity.

Under current federal law, the authority to issue single family bonds is due to expire at the end of 1987. It seems reasonable, then, to exempt single family bonds from the proposed volume cap and apply the total amount reserved for housing to multifamily projects, which would provide adequate capacity for the self-imposed Statewide ceiling.

Purchase Price Limits

Currently, the maximum purchase price of any eligible single family residence that may be bond financed is 110% of the locally determined average. According to Dr. Joseph Janczyk, President of Empire Economics, this purchase price ceiling for the State is approximately $128,000. H.R. 3838 would reduce the ceiling to 90% of average or, according to Dr. Janczyk, to approximately $105,000.

Income Ceilings

Additionally, H.R. 3838 imposes new income ceilings on qualified purchasers. Current State law limits the income of purchaser's using "Supplemental" allocations to 120% of median. The "Entitlement" portion is limited to persons whose incomes don't exceed 150% of median if the bonds are sold by a City or County and is unlimited with respect to income if the bonds are sold by a redevelopment agency.

With certain exceptions for "targeted areas", H.R. 3838 would limit the income of 1/2 of the funds available to finance homes to persons whose incomes don't exceed 90% of median and the balance to 115% of median.

According to Dr. Janczyk, an income of $44,700 is required to purchase a home costing $105,000, the approximate purchase price permitted under the proposed rules, assuming a 10% mortgage rate and 25% income to housing debt ratio. The median income ceiling permitted under H.R. 3838 would be approximately $30,000, far below the amount necessary to afford a qualifying residence.

Dr. Janczyk indicates that under current eligibility rules, approximately 2.7 million households in California would have adequate incomes to qualify for a home priced at or below $105,000. The proposed income ceiling would eliminate 75% of the households that would otherwise qualify to participate in these programs. Clearly, there exists a huge discrepancy between the cost of qualifying homes in California, the incomes necessary to qualify for a corresponding loan and the income ceilings permitted by proposed federal law.

Since development costs are affected by local factors, it would seem logical to set income restrictions that at least equal the amount of income necessary to qualify for an eligible residence.

Early Issuances

H.R. 3838 would require that 5% of the net proceeds of a bond issue be spent within 30 days following bond delivery. This requirement, intended to minimize potential arbitrage, is unreasonable for development type programs for housing. Since any net investment income must be rebated anyway, it seems reasonable to request some relief from the proposal in this area.

Owner-Occupancy

H.R. 3838 would disallow the deduction of interest payments on mortgages financing a single family residences with bonds if the owner fails to occupy the residence for more than one year. This rule would apply to mortgages funded after January 1, 1986 regardless of when the bonds were sold.

It seems unreasonable to retroactively apply potential penalties to homebuyers using bond proceeds from sales of bonds issued before the effective date of H.R. 3838.

Additional Multifamily Restrictions

Aside from the new volume restrictions on multifamily bonds, H.R. 3838 expands the rule that 20% of the units in a project be set aside for persons of low and moderate income (defined as incomes that don't exceed 80% of median) to 25% of the units or, at the project owner's option, retains the 20% set-aside requirement if the income ceiling is lowered to 70% of median. The income determination would require adjustment for family size. As you may know, current State law requires that 10% of the units be occupied by persons whose incomes don't exceed 50% of median.

The proposed federal rules would require that the set-aside requirement be maintained on a continuing basis requiring additional set-aside units if an originally qualifying tenant no longer meets the income ceiling and extends the set-aside requirement from essentially 10 years to 15 years.

The bill provides that the bonds could be declared taxable, retroactively to the date of issuance if the set aside period or rental use ceilings are not met. Additionally, the interest deduction on the mortgages to the owner would be disallowed during the period of non-compliance.

I would suggest that the loss of interest deductibility to the owner is sufficient penalty and that the loss of tax exemption in the event of non-compliance should be eliminated.

Yield Concession

H.R. 3838 further requires that the interest on all "non-essential" function bonds be included as preference for the computation of the alternative income tax. Such treatment negates the definition as "tax-exempt" and may require a yield concession that will only aggrevate the goal of providing affordable housing.

Clearly, bonds sold to finance housing should be excluded from such a category.

Summary

I hope the foregoing testimony highlights the provisions and impacts of H.R. 3838 on housing financing in the State. I urge this committee to adopt these recommendations and forward them to members of the Senate Finance Committee for consideration.

I thank you for your attention.

TESTIMONY BEFORE THE SENATE
LOCAL GOVERNMENT COMMITTEE
STATE OF CALIFORNIA
JANUARY 29, 1986

My name is Martin C. Coren. I am a principal in Katz, Hollis, Coren & Associates. We provide financial consulting services to redevelopment agencies, cities, counties, industrial development authorities and private companies. Since the inception of our firm in 1978, we have provided assistance to more than 90 redevelopment agencies and assisted in the issuance of more than $1 billion of Tax Allocation Bonds and more than $100 million of Industrial Development Bonds.

In discussing the impact of the proposed Tax Reform Act (HR3838), it is our view that if enacted in its present form it would have a fundamental and severe impact on redevelopment as it was conceived and is currently practiced in California.

Redevelopment was conceived in California as a process incorporating the private sector in the public purpose of eliminating blight, developing housing and creating jobs. This public purpose is achieved by creating a public/private partnership where by the redevelopment agency provides incentives and assistance to the private developer to channel development efforts to those areas determined by the local jurisdiction to be most appropriate. The redevelopment agency assistance involves such tools as

- the use of eminent domain to assemble development sites.
- the ability to acquire land and resell that land to a developer at a fair reuse value reflective of the nature of redevelopment or other constraints.
- the ability to construct, or cause to be constructed, public improvements and infrastructure necessary to development
- and to fund the agency's activities through the issuance of tax allocation bonds.

Historically, tax allocation bonds have been considered government purpose bonds because they do not meet the two-fold test of an Industrial Development Bond. That test consists of the following: 1) The proceeds of the bond issue are used for the benefit of a private trade or business, and 2) the bonds are repaid from the revenue of a private trade or business. Since Tax Allocation bonds are repaid from property tax revenues, they do not meet the second criterion of industrial development bondsand have always been considered government purpose bonds.

Because the Tax Act focuses <u>exclusively</u> on the use of bond proceeds it eliminates in many cases the capability local government to leverage private investment with public dollars. Specifically, the Tax Act ignores the fact that there can be a public benefit realized through the public/private partnership. This is evidenced by the tax allocation bond's dedication of tax revenues which would otherwise be used for other public purposes. Under the Act, any bond is taxable if more than ten percent of the proceeds (or $10 million) is used directly or indirectly in a trade or business, or five percent or $5 million is loaned directly or indirectly to a trade or business. This has the impact of disqualifying the majority of purposes for which tax allocation bonds are issued, and countermanding one of the main objectives of the California Community Redevelopment Law, that of assisting private enterprise to redevelop blighted areas.

The Act does make provision for what is termed a "qualified redevelopment bond" which could be issued under the State's volume cap for "nonessential function bonds", previously called private activity bonds. However, the restrictions on what may meet the requirements of a "qualified redevelopment bond" are such as to preclude the use of such bonds to all but a handful of redevelopment project areas in all of California. Particularly onerous is the requirement that the bonds may only be issued for projects located in a "designated blighted area". The definition of a designated blighted area is significantly different from blight as defined in California. Blight would be defined by the Tax Act as an area with:

- excessive vacant land on which structures were previously located
- abandoned or vacant buildings
- old buildings
- excessive vacancies
- substandard structures, and
- delinquency in payment of property taxes

While all of the forgoing are obviously characteristics of blight, they exclude many of the characteristics of blight contained in the California Community Redevelopment Law, such as:

- irregular subdivision of land
- inadequate public improvements
- mixed development or shifting uses

The Tax Act definition raises questions about the eligibility of existing project areas in California, that are blighted according to California and may not qualify under the Act. And, how will the eligibility of California project areas be determined?

The Act further limits a "designated blighted area" to an area that, when added to all other blighted areas in the jurisdiction, does not exceed ten percent of the total assessed value of the jurisdiction. This limit encompasses a great number of the redevelopment projects in California and appears to be particularly discriminatory against smaller cities. It is also counter to the direction the State Legislature has taken in recent years to reduce the size of project areas. Finally, financings would not be allowed in project areas that do not exceed a contiguous one-quarter of a square mile. This criterion alone would eliminate almost 200 of the 467 project areas existing in California as of 1985.

A further restriction would preclude the use of tax allocation bonds in project areas where the method or rate of property taxes or fees, differs from the method or rate of property taxes located outside such areas. This appears to impact areas where special assessments or development fees may be levied. And since the Act discusses the "rate" of property taxation, financings would conceivably be impacted by the existence of different tax rate areas.

The Tax Reform Act would also limit the use of the proceeds of a "qualified redevelopment bond" to

- acquisition of real property pursuant to the power of eminent domain, or the threat thereof
- preparation of land for redevelopment and sale to non-government persons for fair market value
- rehabilitation of real property, and
- relocation of occupants of acquired real property

These restrictions would impact a redevelopment agency's ability to package land for development, apparently precluding expenditure of tax allocation bond proceeds for market rate housing and replacement housing unless such housing is designed for low and moderate income persons in conformity with the Act. It would mandate the use of eminent domain powers with a subsequent increase in costs. This also appears to exclude those project areas in which the power of eminent domain has been forgone. It is uncertain whether the definition assigned to fair market value will allow the same latitude as currently permitted in California.

For agencies with project areas and projects that can meet all the specified tests, a portion of the State Ceiling for the issuance of "nonessential function bonds" would be required. And, like a small issue IDB, such a portion would not be eligible to be carried forward into future years.

The changes that would be occasioned by the proposed Tax Reform Act would significantly alter either the types of projects undertaken by redevelopment agency or the way projects are financed. Redevelopment agencies could focus more attention on publicly owned projects such as streets, sewers and city halls. Such public projects would have to be of benefit to the redevelopment project area, in accordance with the Community Redevelopment Law. Alternatively, redevelopment agencies could undertake activities with other methods of financing, such as "pay-as-you go" or taxable bonds. A difficulty with pay-as-you go is the necessity of a redevelopment agency incurring indebtedness in order to be allocated tax increment. Taxable bonds of course would cost more money due to the higher interest rates on such bonds.

In conclusion, the impact of the Tax Reform Act is to make it more difficult and more costly for redevelopment agencies to continue their role in the public/private partnership that has been successfully working toward the established public purposes of the Community Redevelopment Law.

Suite 601
Spreckels Building
121 Broadway
San Diego, California 92101-5074
619/236-7101

Centre City Development Corporation

TESTIMONY BEFORE THE SENATE
LOCAL GOVERNMENT COMMITTEE
STATE OF CALIFORNIA
JANUARY 29, 1986
BY
PAMELA M. HAMILTON, ASSISTANT VICE PRESIDENT
CENTRE CITY DEVELOPMENT CORPORATION

Honorable Chairman, Members and Staff of the Senate Local Government Committee, Witnesses, and Guests:

You have been provided with a good summary of House Bill 3838 by your staff and it is my understanding that other witnesses will be identifying those provisions of the bill which are most destructive of governmental tax-exempt financing as we know it today. My role at today's hearing is to place these provisions into a very specific context to illustrate the practical side-effects of the proposed legislation. My illustrative example will be the anticipated impacts of this legislation on San Diego's downtown redevelopment program (where four of the City's eight redevelopment projects are located).

The revitalization of downtown San Diego began in earnest in 1972 with the adoption of the Horton Plaza Redevelopment Project. In 1976 two additional redevelopment areas were adopted: Columbia and Marina. In 1982 the Gaslamp Quarter, a 16-block historic district on the National Register of Historic Places, was formally adopted as a Redevelopment Project area. These four Project areas represent an overall strategy for downtown revitalization: Horton Plaza was designed to return major retailing downtown. No major department store had had a downtown location in decades. The Marina area focused on the creation of a downtown residential neighborhood to create a 24-hour environment, Columbia emphasized the expansion of San Diego's small but viable traditional Central Business District toward the blighted area to the west and the Gaslamp Quarter's emphasis is the preservation of San Diego's past.

These four Project areas represent an aggressive compaign against structural deterioration and blight caused by the move to the suburbs and sordid uses which had moved into the downtown area after decades of sailors on the prowl. Legitimate businesses would not locate within these areas of our downtown and redevelopment was literally a reclamation project.

While our efforts were aggressive, the territory was conservatively selected. We carved out only the very worst portions of downtown - all together our four Project areas represent less than 375 acres within the 1200-acre Centre City area.

We have been proud that the funding for our local redevelopment efforts has come from primarily local resources. To date $122 million of public investment has been pledged to these efforts, $22 million from direct City loans, $21 million from federal grants, $34 million from developer payments and other Agency income and $44 million in tax increment-generated revenues.

Because we have only recently completed several major projects we are just now entering the period when tax increment revenues will be most critical. Early City loans and federal grants served as "seed monies" to create new development against which tax allocation bonds could be sold. Today more than half of these Project areas remain blighted and the City's and U.S. Government's abilities to assist with financing are over. We cannot complete implementation of these Redevelopment Plans without the continued reliance on tax increment funds.

The State of California has been supportive of the "boot strap" financing approach offered by the tax increment concept - this State pioneered this innovative financing tool in 1952. Those of us in the trenches appreciate this support and we now ask you to help preserve the integrity of the public purpose associated with the use of tax increment funds. If House Bill 3838 were to become law, effectively tax allocation bonds will become taxable instruments. The entire redevelopment process as shaped by the State of California's Health and Safety Code will no longer be recognized as a public purpose but will be categorized as "non-essential" activities. Even the nomenclature is an anathema to localities which have put years of effort to the revitalization of their downtowns and neighborhoods using, for the most part, local tax resources.

There are several specific issues I would like to address in House Bill 3838. I would like to use some actual projects to illustrate these concerns.

Market Street Square

In San Diego we represent the Redevelopment Agency as though we were private entrepreneurs representing our own interests. We structure our business transactions to yield the greatest financial return to the Agency - even if it means taking an up-side equity position in the project to recoup revenues from projects which can't bear up-front costs. For example, the Market Street Square project is 192 units of both market rate and low income housing units (an 80/20% mix). The project has received a Housing Development Grant from the U.S. Department of Housing and Urban Development. The low income units are locked in for 25 years. The land is leased by the Agency to the developer for 55 years and the land and improvements revert to the Redevelopment Agency at the end of the lease. Because front-end costs are difficult for the project the Agency will participate in the net cash flow from the project for the term of the lease. This is an innovative, award-winning project which we apparently will not be able to repeat in the future unless taxable bonds are used to acquire the land. House Bill 3838 would preclude this kind of project because:

1. The Marina Redevelopment Project area is only 125 acres (a 160-acre minimum Project area is required by the Bill to issue tax-exempt bonds).

2. The House intent appears to be that the receipt of revenue by the Agency after the lease of the property would be considered a "loan" to the developer and therefore not a tax-exempt bond. We could give the land away (presuming we could satisfy State and Federal law which requires the sale of property at fair market value). It is difficult to rationalize how the give away of the land would further the public purpose of the project. Our choice then: inequitably benefit the developer by receiving only the purchase price affordable at the front end (thereby preserving the tax exempt status of the tax allocation bonds), or sell taxable bonds to assemble the land so we can recoup revenues throughout the life of the project. With the land giveaway the developer benefits but the bonds are tax exempt (fewer bonds must be sold for initial project costs). With on-going Agency financial participation in the project, taxable bonds must be sold, meaning more tax increment is necessary to sell the bonds needed for the project. The

loser in either scenario is the local and state taxpayers whose best interests are clearly to minimize project costs by issuing the least debt possible while maximizing public agency revenues from private sources.

Park Row and Marina Park

These are 446 market rate condominium units constructed in the Marina residential area beginning in 1981. They are a part of our overall strategy for creating a socially and economically integrated residential neighborhood downtown. To date in Marina we have constructed 429 low and moderate income rental housing units and these 446 mid-range sales condominiums. Market Street Square, the Marina Palms Project (just breaking ground, now) and the planned construction this year of 250 units of low and moderate income units will shortly bring us to 719 low and moderate income rental units and 778 market rate rental and sales units. Our goal and the State law requirement is that within our Marina and Columbia Project areas, at Project completion, at least 15% of all housing will be for low and moderate income households.

Once these just-mentioned projects are occupied, newly constructed low and moderate income units will comprise 48% of these Project areas. The reason for this statistic is that we have been very vigilent to produce low and moderate income units wherever possible to "get ahead" of our 15% requirements. We were looking forward to creating additional market rate housing in the area in future years. Downtown now suffers from the perception of only low income housing opportunities and only new market rate projects will balance the community as intended. Tax-exempt bonds to acquire land for such market rate projects in the future would be precluded by HB 3838 because:

1. Marina at 125 acres and Columbia at 156.08 acres are below the 160-acre threshold for the sale of tax exempt bonds.

2. Solely market rate projects are prohibited by the Bill. While we have preferred to mix the occupancies of our rental housing projects, and therefore do not necessarily oppose the Bill's 20% lower income requirement for rentals, the restrictions on prices which could be charged for all sales housing are incredibly onerous and would preclude the balanced approach sought for the downtown area.

Horton Plaza

The key to downtown San Diego's revitalization is the Horton Plaza retail center completed in August, 1985 after more than ten years of negotiation and renegotiation. No State or Federal grant funds were used for this project, but tax allocation bonds were key to its financing plan. If developed today Horton Plaza would require taxable tax allocation bonds because:

1. The Horton Plaza Project area, at 41.5 acres, does not meet House Bill 3838's 160-acre minimum project size.

2. The Agency participates in the net cash flow of this project to recoup, over time, as much as possible of the $33 million public investment required to make the project feasible. Participation in such projects in the future may, as earlier described, be ruled out under HB 3838.

3. The kinds of activities which go on in Horton Plaza would make tax allocation bonds taxable if House Bill 3838 had been on the books in earlier years. For example, HB 3838 prohibits the use of tax exempt bonds to assemble land where retail food and beverage services or recreation or entertainment facilities are subsequently developed. Can you imagine trying to revitalize a downtown without permitting such uses? This is the heart of our region to which we are applying CPR. Not only are major resident and visitor attractions essential to bringing the downtown back, but neighborhood retail and restaurants are required to create a viable residential community.

Timing of Debt Instruments

Redevelopment is successful only when opportunities can be seized by the public agency as they arise. House Bill 3838 places tax allocation bonds under a State volume cap in competition with many other bonds and pitting localities' redevelopment programs in competition against one another. Clearly such a cap as now proposed is totally insufficient for the needs of California. Even the procedure required to deal with volume limitations would be onerous. Getting in line to finance local programs is counter-productive. Tax allocation bonds are repaid from local taxes. These are local monies most efficiently directed locally. To the extent funds must go through a statewide ranking or first come - first served system, local staffs will sit on their hands waiting for financial resources to implement programs.

What if Taxable Bonds?

There is a domino effect which is very difficult to assess if tax allocation bonds become taxable as a result of final passage of tax reform legislation.

For example, if there is indeed a market for taxable tax-secured bonds, our best guess is that, conservatively, interest rates will run 2% higher than tax-exempt issues. Using our Marina Redevelopment Project as an example, we ran the following conservative calculations:

Assume: 15 city blocks slated for development to complete the Project over the next 15 years.

Average cost per block:	$5.5 million
Total cost:	$82.5 million
Approximate bond requirements at par:	$100.0 million

Assume: Taxable rate 11% versus Tax Exempt rate of 9% on 20 year paper.

Interest paid using Tax Exempt:	$119,093,000
Interest paid on Taxable Bonds:	$151,151,200
Additional Interest Costs (or approximately a 27% increase):	$ 32,058,200

The effect of the additional $32.0 million in the above example is not only the diversion of tax increment which could have been used for hard project costs to financing costs, but the prolongation of the redevelopment process itself since more tax increment must be available before bonds can be sold at higher, taxable interest rates. This delay effect (not factored in the above example) would actually increase the $32 million difference over time. The tax increment diverted to increased financing costs and the resultant prolongation of the redevelopment process mean that local taxing jurisdictions are deprived of the more than $32 million in this example, since such tax increment would have reverted to such jurisdictions upon repayment of Redevelopment Agency debt.

Why Struggle to Keep the Tax Exempt Status of Tax Allocation Bonds?

The commitment cities have to their own economic well-being leads us involved in program implementation to believe that local programs will continue redevelopment by using taxable financing if that is our only recourse. As illustrated above, taxable financing will prolong the redevelopment process and create incredible job security for us in the profession. So, why am I here asking you to assist with Congress to fight what, at least in the House, became obvious as the inevitable?

It is a matter of principle and common sense. Redevelopment, when properly administered pursuant to the safeguards provided by California's Community Redevelopment Law, is clearly a public purpose. Local jurisdictions use their own local tax resources to provide an appropriate financing mechanism to implement the redevelopment process. Some of our cities and neighborhoods absolutely suffer from economic obsolesence and the private sector acting alone cannot and will not restore economic health to these areas without public leadership and financial participation where necessary. Not only does redevelopment deal with physical blight but with the basic needs of our citizens such as housing and jobs. For example, San Diego's Horton Plaza retail center not only provides a source of shopping and entertainment for our citizens and visitors, and needed tax revenues to our community and to the State, but it provides jobs - 2,000 entry level jobs to date. Twenty-five percent of these jobs were directly filled through the Private Industry Council in San Diego so that we know statistically that 72% of these 25% were minority, 70% came from families with incomes less than $10,000 and 57% came from neighborhoods with chronic poverty and unemployment.

The House did not understand that effective redevelopment requires a public-private partnership. We need the flexibility to structure the best business transactions possible for the public sector. Congress initially attempted to blanket all redevelopment activities with the definitions of nonessential function bonds - i.e., land-write downs were equated with a non-governmental person's use of bond proceeds in a trade or business, and the Agency's financial participation in a project after sale of the land was equated with a loan to a non-governmental person. The House-passed legislation at least seems to recognize the folly of this extreme, although only after a few stout souls threw themselves under the wheels. Unfortunately, rather than grapple effectively with the reality that tax allocation bonds - secured by taxes - were an entirely different animal than the industrial development bonds Congress was clearly out to curtail, the House threw a confused alternative at us - the "qualified redevelopment bond." The definition of such a bond provided by the House legislation contains nonsensical requirements. For example, although all of San Diego's redevelopment areas represent less than 3% of the City's total assessed valuation (thereby successfully falling below HB 3838's 10% maximum assessed valuation threshold), only one of the City's eight redevelopment areas is larger than HB 3838's required 160-acre minimum Project size. In addition, HB 3838 leaves so much to interpretation that agencies would be stalemated for years while bond counsels and the IRS sought to define which bonds might meet the qualified redevelopment bond test. The issue is further complicated by the differences nationally in the nuances of tax increment financing as authorized in varying states.

Assuming a Project could get by all of the technicalities of a qualified redevelopment bond, the House has thrown us into state volume caps for issuance. Most other types of bonds in the volume cap categories are repaid from other than tax revenues. It is clearly inappropriate to place in competition such diverse activities as veterans mortgages and student loans, airports and redevelopment of blighted areas. Why should clearly public purpose, tax-supported bonds, such as tax allocation bonds, be in any way subject to some sort of artificial restaint as the volume cap?

The biggest problem of all with the House-passed legislation is that it is not clear. If the Senate chooses to work over the confused House legislation it is likely the issues will become even less defined.

The solution? Simply stated, tax allocation bonds are clearly not nonessential function bonds. Bonds secured solely by increases in property taxes and used solely for redevelopment purposes should be clearly stated as traditional public purpose bonds.

Redevelopment has been recognized by Congress and state legislatures throughout the country as a valid and important public purpose for decades. Both federal and state courts have determined that redevelopment is a public purpose which justifies the use of eminent domain to acquire private property because the elimination of blight is a public purpose which is directly related to the health, safety and welfare of our nation. To push us to taxable financing would fly in the face of conventional logic.

I urge your aggressive support to redevelopment agencies in this State and nationally. Please urge the Senate and Congress to clearly state in the tax reform legislation that tax allocation bonds are traditional public purpose bonds and that such proceeds may be used by the public agency without artificial, counter-productive restraints posed by definitions such as "consumer loans," "nonessential function bonds" or "qualified redevelopment bonds."

SUMMARY OF REMARKS

TO THE

CALIFORNIA LEGISLATURE

SENATE COMMITTEE ON

LOCAL GOVERNMENT

BY

TERENCE J. MCCARTY

FIRST VICE PRESIDENT

E.F. HUTTON & COMPANY INC.

SAN FRANCISCO, CALIFORNIA

Subject: Potential Impact of Federal Tax Reform Act of 1985 (HR 3838) on Local Government

Topic: Health Care Facilities, Airports, Wharves and Docks

General: <u>Effective Date</u> - Retention of the January 1, 1986 effective date when final legislation is not in place serves no useful purpose, but in fact promotes confusion and uncertainty among issuers, counsel and purchasers and investors of municipal securities. Certainly a more reasonable approach would be to establish an effective date upon or after enactment so that its specific ramifications may be more clearly understood. The Congressional fear of another rush to market if the effective date is changed is probably unfounded since the pipeline was mostly empty by December 31, 1985.

Prohibition Against Early Issuance - The requirement that 5% of net proceeds must be spent within 30 days is an arbitrary restriction that does not take into consideration basic time requirements for construction bidding, contract finalization, sub-contractor selection and materials ordering. The result could be imprudent expenditures of funds without adequate controls and the sequential and more expensive sale of smaller issues to fund succeeding portions of a single project. The sequential sale of lease-secured obligations may not be possible because there is no assurance that the project will be completed until the final issue of securities funds the final contract.

Arbitrage Limitations - These limitations will increase financing costs because interest earnings in excess of interests costs during construction will no longer be available to the previous extent to reduce the original size of an issue. The increased interest requirements over the term of an issue will far exceed the arbitrage during construction that is foregone.

Computations and Reporting - An entirely new level of advisors, with their attendant fees, will be required to monitor and report on earnings yields, uses of proceeds, percentages of completion and uses of the completed facilities, to name a few.

Hospitals (501(c)(3))

Hospitals clearly serve an essential public purpose, and to include such facilities within a volume cap will deny the public access to adequate health care. Under the formula proposed in HR 3838, the limit for 501(c)(3) hospital financing will be far less than historical experience. It does not seem reasonable to treat a 501(c)(3) hospital as if it were a for-profit institution, which in fact HR 3838 does.

In addition, the general restrictions mentioned in the preceeding paragraphs will directly affect the costs of health care; this at a time when assistance from other sources is declining.

Airports, Wharves and Docks

These facilities are affected to a lesser extent than hospitals and other "qualified nonessential function bonds", but present a more ominous danger of losing their tax exempt status if certain use of proceeds provisions of HR 3838 are not strictly observed. The loss of tax exemption is retroactive to the date of issuance, which places the threat on the innocent investor. This uncertainty will create a two tier market, with securities issued after December 31, 1985 carrying higher interest rates than those issued prior to that date. It is axiomatic that increased costs are passed on to the ultimate consumer (i.e., the general public).

Conclusions

It is apparent that the HR 3838, as it pertains to municipal financing, will increase the costs of state and local government, health care, travel, and both airborne and waterborne goods. These costs will ultimately be imposed on the public at large. Moreover, essential public projects that do not meet the restrictive definitions of HR 3838 will be unreasonably delayed or even abandoned in the competition for allocations under the stringent volume caps.

My name is Bob Davidson. I am a Senior Vice President of The Parsons Corporation.

For those of you who may not be familiar with Parsons, it is one of the world's largest engineering/construction organizations. We are headquartered in Pasadena, California. Units of Parsons have been actively engaged in the planning, design and construction of local infrastructure projects for over 90 years. We are 100% employee owned. In fact, we are the largest U.S. company wholly owned by its employees. A large number of those employees live and work in California.

On behalf of Parsons and California Business for Infrastructure, I appreciate this opportunity to address the Committee and share Parsons experience and thinking about meeting California's enormous infrastructure needs. I would also very much like to express our appreciation to Senator Marks and the other members of this Committee for your support and authorship of Senate Bill 163 which takes important steps toward eliminating barriers to the privatization of wastewater treatment facilities for California cities and towns. Two of our privatization clients, San Luis Obispo County and the Santa Ana Watershed Protection Agency, are also appreciative of this committee's leadership in opening opportunities for privatization.

Recent federal legislation, and here I am talking about Gramm-Rudman-Hollings and proposed changes in the United States Tax Code, are clear indications that the federal government is reaching a very real limit on its ability to solve state and local problems.

Unless Congress can come up with a program to contain and eventually reduce the federal deficit, Gramm-Rudman-Hollings or some similar form of emergency legislation may be the only way that America can put its financial house in order. As for the specific impacts of Gramm-Rudman-Hollings, it is readily apparent that this legislation will focus a large share of federal budget cuts on revenue-sharing programs with state and local government and on programs that support infrastructure projects -- projects including waste-water grants, large western water programs, regional transportation programs, mass transit, airports -- and the list goes on. The point is that state and local governments are going to bear increased responsibility for their programs. As the role of the federal government shrinks, it is likely that local governments are going to turn to the state for aid. And the state, especially committees like yours, are going to be faced with raising revenues and expanding programs or looking at new ways for local governments to develop the means to solve their own problems.

At the same time that Gramm-Rudmann-Hollings is reducing the federal role, proposed changes in the United States Tax Code are going to make it more difficult to raise revenues at the state and local level. Elimination of deductions for state and local taxes will increase taxes for Californians. For our industry, the proposed changes will make it more difficult to attract private investment to local infrastructure projects.

We share the Committee's concern with current actions in Washington and agree that the administration, the Senate and the House need to know what their actions mean to us here in California.

Private enterprise knows what it means to live within a budget, to remain lean, to be competitive for services and prices. As we consider the impacts of a diminished federal presence, we believe that the private sector can play an important role in stretching the remaining public purse.

Through our pioneering efforts in the privatization of wastewater and water treatment facilities we have come to have a healthy respect for officials at the local government level. Working with these dedicated officials, we have found privatization at the local level works.

In Arizona, Alabama, Pennsylvania and California we have found that privatization of public services makes a great deal of sense.

- o The private sector can work faster and has the right incentives to get the job done.

- o The private sector has the flexibility to achieve increased labor efficiency. We can reward success.

- o The private sector has access to a wider range of financial resources and can structure financings that meet specific needs.

- o Under current law, the private sector can couple tax-exempt financing with tax benefits. This coupling is saving the citizens of Chandler, Arizona, over $1,000,000 per year on their new wastewater treatment plant.

- Private sector financings can preserve scarce bonding capacity for the highest priority public projects.

In the next few years the most important thing that the Governor and Assembly can do is create opportunities for local governments to solve local problems -- to remove barriers that inhibit local initiative -- barriers that restrict local bidding processes and result in inefficient facility and service delivery systems -- barriers that require inordinate delays and red tape for local government to obtain "approvals" from state agencies to solve local problems -- barriers that result in inefficient manpower utilization.

I'm talking about increasing the opportunity for local government and state agencies to consider privatization of services as an alternative. I stress the word alternative.

What can this Committee and the Assembly do to help?

- You have already taken steps with Senate Bill 163. As experience is gained in implementing this legislation, we will no doubt need to refine its provisions and streamline the implementation process.

- Work with appropriate state finance agencies to keep the flow of tax-exempt Industrial Development Bonds going, at least until final action in Washington on the tax bill. Let's not close doors before we have to.

- o Pursue discussions with local officials about their needs -- about ways to expand opportunities for private enterprise to compete at the local level for the provision of goods and services.

- o Resist the temptation to create new bureaucratic structures such as agencies, committees, task forces and the like. Expanding the state bureaucracy will only result in state imposed red tape and the bleeding off of precious dollars for state salaries and administration. Learn from experience of EPA clean water grants program. Sure, there were grants, but to get them, cities and towns had to stand in line, had to meet obscure and irrelevant federal guidelines and spend 30 to 40 percent more money than they should have had local government taken the initiative in the first place.

Certainly, there are going to be problems as California shoulders an increasing share of its responsibilities for infrastructure. But there will also be opportunities. We urge you to encourage local government to set local priorities and work with private enterprise to meet local needs.

Our experience with privatization has shown us that our clients are not "making do with less." By working smarter, involving private industry, our municipal clients are, in fact, creating savings that enable them to maintain and improve local services.

To summarize...Parsons and California Business for Infrastructure urge this

Committee to continue down the path you created in Senate Bill 163. Re-examine restrictive legislation and explore new horizons for innovation in the municipal procurement process, encourage competitive turnkey bidding for the financing, design, construction and operation of local infrastructure. We are confident that private enterprise can provide good alternatives.

Thank you.

State Association of County Auditors

FEDERAL TAX REFORM ACT

TESTIMONY FROM GARY PETERSON, FRESNO COUNTY AUDITOR-CONTROLLER

MR. CHAIRMAN, COMMITTEE MEMBERS, MY NAME IS GARY PETERSON, FRESNO COUNTY AUDITOR-CONTROLLER. I AM HERE TODAY REPRESENTING THE ASSOCIATION OF COUNTY AUDITORS AND WILL DISCUSS THE FEDERAL TAX REFORM ACT AS PASSED BY THE HOUSE OF REPRESENTATIVES.

LET ME STATE AT THE OUTSET THAT MY ASSOCIATION HAS NOT TAKEN A POSITION ON FEDERAL TAX REFORM. I AM HERE TODAY TO POINT OUT WHAT MAY BE A MASSIVE INCREASE IN WORKLOAD FOR COUNTY AUDITORS AND INCREASED ADMINISTRATIVE COSTS FOR COUNTIES. SPECIFICALLY, I REFER TO TITLE XIII, SECTION 145, OF THE ACT. THAT SECTION WOULD REQUIRE THAT LOCAL GOVERNMENT PROVIDE TO EACH PROPERTY TAXPAYER AN ANNUAL WRITTEN NOTICE OF THE AMOUNT PAID IN PROPERTY TAXES. I ASSUME THAT THAT NOTICE WOULD BE IN THE FORM OF AN IRS FORM 1099, MISCELLANEOUS. CURRENT LAW DOES NOT REQUIRE SUCH A NOTICE; IT IS UP TO THE INDIVIDUAL TAXPAYER TO REPORT THAT AMOUNT WHEN FILING FEDERAL INCOME TAX FORMS. NO BACK-UP DOCUMENT IS NECESSARY, SINCE COUNTY RECORDS ARE AVAILABLE SHOULD A PERSON FACE AN AUDIT.

THE IRS FORM 1099 IS CURRENTLY USED BY THE AUDITOR ONLY FOR REPORTING INCOME EARNED BY A PERSON WORKING UNDER A CONTRACT TO A COUNTY. TYPICALLY, A 1099 WOULD BE PROVIDED TO A SUB-CONTRACTOR WHO PERFORMED A SPECIFIC JOB OF LIMITED DURATION. I WOULD POINT OUT THAT THE FORM 1099 CURRENTLY IN USE WOULD NOT SUFFICE FOR REPORTING PROPERTY TAXES AND WOULD PROBABLY HAVE TO BE REVISED.

IN YOUR HANDOUT YOU WILL NOTICE A SAMPLE OF AN IRS FORM 1099. IT

CONTAINS THE RECIPIENT'S NAME, ADDRESS, AND CITY AND STATE. HOWEVER, IT ALSO REQUIRES THAT THE RECIPIENT'S IDENTIFICATION NUMBER BE PROVIDED. THAT NUMBER IS COMMONLY KNOWN AS THE SOCIAL SECURITY NUMBER.

THE CONCERNS OF THE ASSOCIATION OF COUNTY AUDITORS CAN BEST BE STATED BY OUTLINING THE PROBLEMS INHERENT IN IMPLEMENTING THIS PART OF THE FEDERAL TAX REFORM ACT.

1. CURRENT DATA PROCESSING SYSTEMS WOULD HAVE TO BE REVAMPED TO CAPTURE THIS INFORMATION FOR EACH OWNER BY PARCEL NUMBER WITHIN A COUNTY. THAT INFORMATION IS AVAILABLE, BUT NOT IN THE FORMAT NECESSARY TO COMPLETE THE IRS FORM 1099. THEREFORE, A REWRITE OF THE COMPUTER PROGRAM FOR AUDITORS WOULD BE NECESSARY.

2. ASSUMING THAT REPROGRAMMING IS ACCOMPLISHED, THE NEXT PROBLEM WOULD BE IN SECURING THE TAXPAYER IDENTIFICATION NUMBER. SINCE THAT DATA IS NOT NOW REQUIRED, IT WOULD BE NECESSARY TO CONTACT EACH PROPERTY TAXPAYER IN AN EFFORT TO OBTAIN THIS INFORMATION. IN ADDITION, MANY PARCELS HAVE MULTIPLE OWNERS. WOULD EACH OWNER HAVE TO BE CONTACTED? I DO NOT MEAN TO BE PESSIMISTIC, BUT I FEEL THAT 100% COMPLIANCE WOULD NEVER BE OBTAINED. LETTERS FROM TAXING AUTHORITIES SEEKING ADDITIONAL INFORMATION ARE NOT TOP PRIORITY TO A TAXPAYER. IT IS ANTICIPATED THAT THIS WOULD BE THE MOST DIFFICULT PART OF THE LAW WITH WHICH TO COMPLY.

3. ALTHOUGH I DO NOT SPEAK FOR ASSESSORS, IT APPEARS THAT THEY, TOO, WOULD BE AFFECTED. THEIR DATA SYSTEMS WOULD ALSO HAVE TO BE REVISED SO THAT IN THE FUTURE ALL PROPERTY TAXPAYERS WOULD HAVE TO PROVIDE A TAXPAYER IDENTIFICATION NUMBER.

ATTACHED TO THIS STATEMENT IS DATA RELATING TO THE LOCAL TAX ROLL. IT IS TAKEN FROM A DECEMBER 1984 REPORT, THE LATEST AVAILABLE, PROVIDED BY THE STATE BOARD OF EQUALIZATION AND COVERS FISCAL YEAR 1983-84. THAT REPORT SHOWS THAT THERE WAS IN THE STATE OF CALIFORNIA:

8,888,697 SECURED ROLL UNITS.

1,166,910 UNSECURED ROLL UNITS

THUS, AT THAT TIME, THERE WAS 10,555,607 TOTAL UNITS ON THE LOCAL TAX ROLLS. THAT NUMBER HAS OBVIOUSLY INCREASED SINCE THIS REPORT WAS PREPARED.

WHAT THIS MEANS TO LOCAL GOVERNMENT IS THAT THE COST OF IMPLEMENTING AND CONTINUING TO COMPLY WITH THE FEDERAL TAX REFORM ACT WILL COST A LARGE AMOUNT OF MONEY.

THERE IS NO WAY TO PREDICT THE INITIAL COST IN COMPUTER PROGRAMMING. HOWEVER, FROM MY EXPERIENCE I BELIEVE THAT IT WILL RUN IN THE MILLIONS.

THERE IS NO WAY TO PREDICT THE ON-GOING COST FOR ADDITIONAL STAFF TO ACCOMPLISH THIS WORKLOAD, BUT THAT, TOO, WILL BE EXPENSIVE.

THE ONLY ESTIMATE THAT I CAN GIVE AT THIS TIME IS FOR THE COST OF PREPARATION AND POSTAGE IN SECURING THE TAXPAYER IDENTIFICATION NUMBER AND THE FINAL MAILING OF THE IRS FORM 1099. I WOULD THINK THAT A MINIMUM OF $10 MILLION DOLLARS WOULD BE AN INITIAL EXPENSE. IN MY COUNTY OF FRESNO, FOR EXAMPLE, THERE WERE 277,844 SECURED AND UNSECURED UNITS ON THE ROLL IN FY 1983-84. THE COST OF MAILINGS COULD WELL APPROACH $300,000. THIS IS BASED ON AN ESTIMATE OF $1.00 FOR POSTAGE AND ADMINISTRATION: 1) INITIAL CONTACT TO THE TAXPAYER REQUESTING THE TAXPAYER IDENTIFICATION NUMBER, 2) FOLLOW-UP MAILINGS TO THOSE WHO DO NOT COMPLY, AND 3) FINAL MAILOUT OF THE IRS FORM 1099. IF THAT AMOUNT IS CLOSE TO ACCURATE, IT IS EASY TO SEE BY LOOKING AT THE ATTACHED CHART WHAT THE TOTAL COST OF JUST MAILINGS COULD BE, COUNTY BY COUNTY.

IN SUMMARY, THE ASSOCIATION OF COUNTY AUDITORS IS CONCERNED ABOUT THE FEDERAL TAX REFORM ACT INSOFAR AS THE NEW ADDITIONAL WORKLOAD AND INCREASED COST TO COUNTIES. I BELIEVE THAT IT IS NOT NECESSARY TO REQUIRE POSITIVE REPORTING TO THE TAXPAYER AND THAT THE ONUS SHOULD REMAIN ON THE PERSON FILING THE TAX FORMS TO ACCURATELY REPORT THE AMOUNT OF PROPERTY TAXES PAID. THE IRS HAS THE AUTHORITY TO SEEK TAX INFORMATION ON ANY INDIVIDUAL

TAXPAYER SIMPLY BY CHECKING WITH A COUNTY AUDITOR.

MY ASSOCIATION BELIEVES THAT THE INFORMATION CONTAINED IN MY STATEMENT SHOULD BE PROVIDED TO THE FEDERAL GOVERNMENT. THE NEGATIVE FISCAL IMPACT ON CALIFORNIA IS SIGNIFICANT AND SHOULD BE CONSIDERED BY THE CONGRESS AS IT CONTINUES TO CONSIDER THE FEDERAL TAX REFORM ACT.

THANK YOU MR. CHAIRMAN AND COMMITTEE MEMBERS. I WILL BE HAPPY TO ANSWER ANY QUESTIONS.

TABLE E

LOCAL ROLL VALUE & RELATED WORKLOAD INDICATORS

County	Full Market Value in (000's) (1)	Sales Tax Permits (2)	Secured Roll Units (3)	Unsecured Roll Units (4)	Total Roll Units (5)	1983-84 Supple-mental Assessments (6)	Single Family Transfers (7)	All Other Transfers (8)	Property Splits (9)	New Sub-division Lots (10)	Juris-dictions Issuing Permits (11)	Total Permits Received (12)	Total Permits Requiring Reappraisal (13)	Discovered New Const. w/o Permit (14)
Alameda	$ 33,925,218	35,434	353,131	54,580	407,711	10,633	19,496	6,636	787	2,760	19	24,900 E	21,654	N/A
Alpine	112,019	47	1,567	300	1,867	32	-	-	29	11	1	34	97	0
Amador	753,553	1,189	18,247	1,677	19,924	0	500 E	1,200 E	137	55	5	900 E	2,000 E	15 E
Butte	4,059,786	5,129	75,758	12,971	88,729	5,839	-	-	2,764	415	5	4,449	3,623	50 E
Calaveras	1,003,251	1,061	37,216	1,973	39,189	3,537	-	-	655	118	2	1,262	1,247 E	N/A
Colusa	968,091	480	10,399	1,416	11,815	-	-	-	-	107	3	691	612	105
Contra Costa	24,963,034	19,292	245,341	42,832	288,173	16,820	13,154	1,153	1,499	3,525	13	11,983	12,006	N/A
Del Norte	422,722	757	13,219	2,012	15,231	N/A	1,328	-	128	75	2	756	720	20
El Dorado	3,654,167	4,031	78,469	7,895	86,364	5,094	N/A	6,310	1,009	63	3	N/A	2,580	N/A
Fresno	15,664,819	15,185	212,804	15,080	227,884	14,758	13,414	14,920	4,074	2,029	16	24,217	10,945	N/A
Glenn	918,215	685	13,853	1,485	15,338	-	-	-	278	0	3	N/A	547	N/A
Humboldt	2,772,153	4,264	61,952	7,404	69,356	2,212	N/A (Total)	2,692	2,047	165	8	2,780	1,420	N/A
Imperial	2,250,968	2,697	73,580	4,650	78,230	3,260 E	N/A	N/A	330	408	5	2,241	1,900 E	N/A
Inyo	842,908	858	16,059	1,967	18,026	868	N/A	-	85	12	2	N/A	1,020	N/A
Kern	26,394,720	11,927	326,468	25,960	352,428	16,416 E	21,748	4,535	6,012 E	3,862	13	9,404	6,273 E	200 E
Kings	1,872,620	1,790	33,530	3,382	36,912	2,340	4,500 E	500 E	100	126	3	2,000 E	2,500 E	500 E
Lake	2,054,658	1,573	61,695	4,004	65,699	3,766	1,600 E	4,000 E	491	125	3	1,425 E	1,400 E	360 E
Lassen	597,659	861	27,637	1,603	29,240	1,700 E	690 E	1,025	150	65	2	897	725	600 E
Los Angeles	217,365,291	237,369	2,060,931	253,437	2,314,368	-	78,242	19,756	30,400	20,234	99	N/A	28,086	N/A
Madera	2,170,626	1,906	39,976	3,444	43,420	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Marin	10,014,418	9,614	86,994	18,192	105,186	-	5,500 E	1,400	1,292	669	12	6,202	2,500 E	900 E
Mariposa	411,035	511	10,574	3,077	13,651	-	-	-	239	61	1	N/A	N/A	N/A
Mendocino	2,051,763	3,009	64,163	4,366	68,529	4,147	2,300 E	2,400 E	1,113	400 E	5	1,400 E	2,600	200 E
Merced	3,686,284	3,092	48,674	6,223	54,897	-	N/A	4,781	123	259	7	N/A	3,437	N/A
Modoc	400,788	382	26,914	752	27,666	1,354	400 E	3,200 E	128	0	1	387	301 E	100 E
Mono	970,623	582	12,656	1,390	14,046	1,055 E	N/A	N/A	789	160	1	519	549	N/A
Monterey	8,654,742	8,435	92,177	16,834	109,011	7,950 E	4,484	2,058	560	1,016	13	4,993	3,075	N/A
Napa	3,216,116	3,384	.38,000	5,923	43,923	3,235	1,331	744	200	208	5	3,141	1,112	75 E
Nevada	2,311,430	2,877	52,436	5,629	58,065	5,308	1,602	2,434	140	68	2	1,863	2,038	25 E
Orange	74,370,365	74,719	590,137	155,840	745,977	40,223	29,777	20,793	1,948	2,580	27	51,505	21,137	N/A
Placer	5,482,803	4,817	84,278	9,597	93,875	8,500 E	5,121	3,794	2,509	852	6	9,081	6,018	N/A
Plumas	764,223	981	20,563	4,400	24,963	1,346	N/A	N/A	394	54	2	N/A	N/A	N/A
Riverside	22,840,439	22,548	422,944	23,823	446,767	33,000 E	35,686	4,374	1,933	14,296	20	28,022	21,544	N/A
Sacramento	22,238,112	23,300	300,508	51,091	351,599	29,433	20,577	9,627	6,579	4,002	5	24,389	10,243	N/A
San Benito	779,970	688	11,759	1,455	13,214	-	-	-	134	199	3	433	N/A	250 E
San Bernardino	23,253,776	29,977	560,252	28,177	588,439	50,917	36,268	7,429	4,051	2,949	18	35,000 E	14,886	300 E
San Diego	60,654,862	54,312	641,483	77,212	718,695	-	All Transfers	76,277	24,344	7,641	16	N/A	37,646	N/A
San Francisco	25,601,188	29,003	159,445	37,928	197,373	8,695	11,200	4,800	317	1,239	1	18,750	3,750	0
San Joaquin	9,377,757	8,884	124,102	20,343	144,445	0	7,130 E	2,200 E	1,328	1,211	7	5,815	9,500 E	1,500 E
San Luis Obispo	4,671,290	6,388	94,510	13,329	107,839	9,755	6,400 E	3,000 E	3,000	880	8	3,800 E	3,000 E	800 E
San Mateo	24,670,184	19,661	201,929	31,282	233,211	-	17,214	3,271	567	1,303	20	17,773	7,547	-
Santa Barbara	12,229,897	11,741	103,979	21,596	125,575	6,309	9,500	1,300	716	1,174	5	7,400	7,000	300
Santa Clara	47,006,658	41,296	377,843	58,910	436,753	20,997	32,221 E	8,343 E	2,352	3,460	16	25,132 E	28,361 E	150 E
Santa Cruz	5,912,504	7,233	85,125	10,239	95,364	5,344 E	-	-	1,201	794	5	3,365	7,072	163
Shasta	3,482,077	4,459	72,018	10,806	82,824	4,252	N/A	N/A	2,016	635	3	3,603	3,385	455
Sierra	165,132	141	4,980	2,086	7,066	283	N/A	172	7	15	1	166	144	30
Siskiyou	1,221,836	1,727	44,418	5,034	49,452	-	N/A	N/A	305	128	7	N/A	N/A	N/A
Solano	6,754,435	5,736	87,685	10,180	97,865	-	8,292 E	921 E	653	1,389	8	-	3,807 E	N/A
Sonoma	12,635,058	11,327	142,535	12,185	154,720	5,100	N/A	N/A	1,224	2,253	9	11,408	8,000 E	50 E
Stanislaus	7,752,174	8,070	98,523	12,881	111,404	6,302	5,819	3,646	406	594	10	7,769	5,384	1,500 E
Sutter	1,843,322	1,602	23,646	4,776	28,422	1,186	1,000 E	1,000 E	227	133 E	2	1,446 E	1,350 E	100 E
Tehama	1,080,972	1,293	39,284	2,174	41,458	2,776	All Transfers	3,342	276	-	3	-	1,070 E	10 E
Trinity	358,428	542	12,034	3,979	16,013	751 E	N/A	547	47 E	0	1	463	457	400 E
Tulare	5,679,031	7,001	102,886	8,792	111,678	-	3,136	2,010	2,000	1,773	9	N/A	5,626	N/A
Tuolumne	1,202,752	1,966	33,784	4,954	38,738	1,818	1,200 E	1,500 E	-	119	2	1,400 E	2,600 E	100 E
Ventura	18,186,772	15,804	195,859	21,444	217,303	-	13,272	1,898	349	1,667	10	9,423	15,170	300 E
Yolo	3,424,904	3,151	38,364	6,511	44,875	2,832	1,797	1,575	95	505	4	3,213	2,918	13
Yuba	1,052,749	1,440	19,404	5,428	24,832	N/A	1,194	865	60	244	3	2,489	974	30
TOTALS	$779,177,347	778,228	8,888,697	1,166,910	10,055,617	350,143 1/	417,093 1/	242,428 1/	114,597 1/	89,085 1/	485 1/	378,289 1/	343,556 1/	9,601 1/

(N/A = Not Available) (0 = nothing) (- = No response to this item) (E = Estimated)

1/ Totals are incomplete and represent summary of data furnished only.

AL-02-0316A

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code County of Fresno PO Box 1247 Fresno, Ca. 93715	1 Rents 2 Royalties	OMB No. 1545-0115 **1985** Statement for Recipients of	**Miscellaneous Income**
PAYER'S Federal identification number | RECIPIENT'S identification number	3 Prizes and awards	4 Federal income tax withheld	**Copy C For Payer**
RECIPIENT'S name (first, middle, last) John Quincy Taxpayer	5 Fishing boat proceeds	6 Medical and health care payments	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Form 1099 Series 1098, 5498, and 1096
Street address 1111 11th St.	7 Nonemployee compensation	8 Substitute payments in lieu of dividends or interest	
City, state, and ZIP code Fresno, Ca. 93715	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐		
Account number (optional)			

Form **1099-MISC** Department of the Treasury - Internal Revenue Service

[illegible]
CSBC Staff

I

99TH CONGRESS
1ST SESSION

H. R. 3838

To reform the internal revenue laws of the United States.

IN THE HOUSE OF REPRESENTATIVES

DECEMBER 3, 1985

Mr. ROSTENKOWSKI (for himself, Mr. PICKLE, Mr. RANGEL, Mr. STARK, Mr. JENKINS, Mr. GEPHARDT, Mr. DOWNEY of New York, Mr. HEFTEL of Hawaii, Mr. FOWLER, Mr. GUARINI, Mr. RUSSO, Mr. PEASE, Mr. MATSUI, Mr. ANTHONY, Mr. FLIPPO, Mr. DORGAN of North Dakota, Mrs. KENNELLY, Mr. DONNELLY, Mr. COYNE, Mr. GRADISON, and Mr. MCGRATH) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To reform the internal revenue laws of the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Tax Reform Act of 1985".

(b) TABLE OF CONTENTS.—

Sec. 1. Short title.
Sec. 2. Internal Revenue Code of 1985 enacted.
Sec. 3. Amendment of 1985 Code; coordination with section 15.

"(B) a parsonage allowance excludable from gross income under section 107."

SEC. 145. INFORMATION REPORTING OF INCOME TAXES AND REAL AND PERSONAL PROPERTY TAXES.

(a) IN GENERAL.—Subsection (a) of section 6050E (relating to State and local income tax refunds) is amended to read as follows:

"(a) REQUIREMENT OF REPORTING.—Every person who, with respect to any individual, during any calendar year—

"(1) makes payments of refunds of State or local income taxes (or allows credits or offsets with respect to such taxes) aggregating $10 or more, or

"(2) receives payments of State or local income taxes or real or personal property taxes aggregating $10 or more,

shall make a return according to forms or regulations prescribed by the Secretary setting forth the amount of such payments, credits, or offsets, and the name and address of the individual with respect to whom a payment described in paragraph (1), credit, or offset was made or from whom a payment described in paragraph (2) was received."

(b) TECHNICAL AMENDMENTS.—

(1) Subsection (b) of section 6050E (as amended by title XIII of this Act) is amended—

(A) by inserting "and of payments received from the individual" before the period at the end of paragraph (2), and

(B) by inserting "or, in the case of payments described in paragraph (2), will not claim itemized deductions under chapter 1 for the taxable year during which such payments are paid or incurred by the individual" before the period at the end of such subsection.

(2) Subsection (c) of section 6050E is amended to read as follows:

"(c) PERSON.—For purposes of this section, the term 'person' means—

"(1) the officer or employee—

"(A) having control of the payments of the refunds (or the allowance of the credits or offsets), or

"(B) receiving the payments described in subsection (a)(2), or

"(2) the person or persons appropriately designated for purposes of this section."

(c) CLERICAL AMENDMENTS.—

(1) The section heading for section 6050E is amended to read as follows:

"SEC. 6050E. CERTAIN STATE AND LOCAL TAX PAYMENTS AND REFUNDS."

(2) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking out the item relating to section 6050E and inserting in lieu thereof the following:

"Sec. 6050E. Certain State and local tax payments and refunds."

Subtitle F—Effective Dates

SEC. 151. EFFECTIVE DATES.

(a) GENERAL RULE.—Except as otherwise provided in this section, the amendments made by this title shall apply to taxable years beginning after December 31, 1985.

(b) UNEMPLOYMENT COMPENSATION.—The amendment made by section 122 shall apply to amounts received after December 31, 1986, in taxable years ending after such date.

(c) SCHOLARSHIP PROVISIONS.—The amendment made by section 123(a) shall apply to scholarships and fellowships granted after September 25, 1985, in taxable years ending after such date.

(d) REPEAL OF DEDUCTION FOR ADOPTION EXPENSES.—The amendments made by section 134 shall apply to expenses paid or incurred after December 31, 1986, in taxable years ending after such date; except that such amendments shall not apply to expenses paid or incurred during calendar year 1987 in connection with an adoption

County Supervisors
Association of California

Testimony Before the Senate Committee on Local Government

By

Daniel J. Wall, Legislative Representative

Mr. Chairman and Members, my name is Dan Wall and I am representing the County Supervisors Association of California.

I certainly agree with the previous witness, Mr. Gerber, that the federal tax reform package has serious and far reaching consequences for California's counties, and, I agree that we need your help.

Tax Status of Bonds

The tax status of bonds is far and away the most troubling portion of HR 3838. Because of the impact of Proposition 13 and because of relatively sluggish revenues in recent years, bonds have become a key element of state and local finance. HR 3838 will jeopardize the ability of all levels of government to utilize bond financing as tool for the funding of infrastructure and economic growth.

Some of the main problems with bond provisions are:

- The distinction between public, eligible projects and non-public, ineligible projects is arbitrary and nonsensical. For example, a county administration building which has a cafeteria or a snack bar would be classified as a non-public project and, therefore, ineligible for non-taxable bond financing.

- The County of Los Angeles, in its analysis, suggests that an unintended consequence of HR 3838 will be to "seriously restrict or eliminate the county's plans to contract with the private sector for services." Los Angeles is currently planning to use tax-exempt bond financing to construct pharmacy and food service facilities which would be staffed by private sector employees under contract with the county. This would not be possible under HR 3838.

- HR 3838 would add significantly to the cost of bond financing. The financing of the construction of the Van Nuys courthouse illustrates this point. It is estimated that HR 3838 would add 2 1/2% to the interest rate for the 17 year bonds used to finance the courthouse. This apparently small increase in the interest rate would yield a 36% increase in the total cost to retire those bonds.

- These proposed restrictions on bond financing come at a particularly bad time for counties since the June ballot will have a measure to restore general obligation bond authority to local government.

CSAC Founded 1895

Sacramento Office / 1100 K Street, #101 / Sacramento, CA 95814-3941 / 916/441·4011 ATSS 473-3727
Washington Office / 440 First St., N.W., Suite 503 / Washington, D.C. 20001 / 202-783-7575

Arbitrage

The provisions of HR 3838 which allow the federal government to expropriate all financial gain from the arbitrage of tax-exempt bond issuances makes no policy sense. This provision would preclude counties from practicing sound cash management. This makes as much sense as demanding that the federal government pay California the interest earned on federal welfare funds prior to the time they are remitted to California for disbursement.

Notification

The notification requirements in section 145 of the bill are frankly absurd. They would require counties to send notification of property and sales tax payments to the IRS and to individual taxpayers. Property tax collection systems would have to be totally revised to retain the taxpayer's name, address and social security number. In Placer County it is estimated that the cost of postage, new reporting forms and data processing changes would be about $100,000. This suggests that the cost prospects for our larger counties are staggering.

The prospect of similar notification requirements for the payment of sales tax is absolutely mindboggling. I cannot conceive of any system which could accumulate taxpayer identification information at each and every retail point of sale.

State and Local Tax Deductibility

Finally, CSAC remains opposed to the partial or full elimination of the deductibility of state and local taxes. While the impact of this provision may not be as tangible and immediate as those mentioned above, it will have a significant detrimental effect on economic activity in California. If the state, local and federal tax rates become completely additive, individuals who itemize their deductions will suffer a loss in disposable income. In turn, this will serve to reduce the level of personal consumption, savings and investment in California. As a consequence, the level of economic activity in each county, as well as in the entire state, will most likely decrease.

The concerns mentioned above must necessarily be viewed in the context of the fiscal conditions currently facing most of CSAC's member counties. As I reported to this committee at its interim hearing in Mariposa, counties are facing a fiscal crisis. This crisis is affecting all types of counties: urban and suburban as well as rural.

I would characterize the inability of rural counties to match revenues with expenditure needs as being caused primarily by the revenue side of the budgetary equation. Prices of agricultural products have either softened or dropped. This has led to a decrease in the assessed value of agricultural lands and the consequent property tax revenues. For example, the most recent property tax data from the Board of Equalization shows that Mono and Colusa counties have suffered a decrease in total assessed valuation. Five more counties have assessed value growth of less than 5%, and it is quite possible that these counties could find themselves in a negative growth situation in the near future.

Timber county revenues are also dropping. Much of the processing of timber after it has been harvested has moved out of California into Canada. Consequently, mills have been shut and employees have been laid off. The assessed value of the closed mills and the homes sold by laid off workers has decreased drastically.

Urban and suburban county budget problems probably derive more from the pressures of expenditure increases than from dampened revenues. Health and welfare costs due to increased caseloads, court and jail costs, and the cost of liability insurance have simply outstripped revenue growth. In fact the Legislative Analyst, after having visited a number of counties, indicated to the Assembly Committee on Local Government in November that: "... the growth rate of [county] discretionary revenue is lower than the rate at which inflation and population are increasing. In combination with the higher rates of growth in the cost of county matches, this appears to be causing significant reductions in service levels in some locally controlled programs."

Superimposed over all of this is the prospect of the federal Gramm-Rudman expenditure reductions. In his testimony before the Senate Committee on Budget and Fiscal Review earlier this week, Mr. Hamm, the Legislative Analyst, indicated that Californians could suffer up to $180 million in lost federal funds. The combined impact Gramm-Rudman and the already deteriorating fiscal health of counties cannot withstand the prospect of federal tax reform as contained in HR 3838. Mr. Chairman we ask your assistance in modifying federal tax reform to preserve the fiscal integrity of California's counties.

STATEMENT OF

RICHARD B. DIXON

TREASURER AND TAX COLLECTOR
OF LOS ANGELES COUNTY

SUBMITTED FOR
THE RECORD OF THE HEARING

BEFORE THE
LOCAL GOVERNMENT COMMITTEE
OF THE CALIFORNIA STATE SENATE

ON

JANUARY 29, 1986

I am testifying as Treasurer of the County of Los Angeles, Ex Officio Treasurer of various districts, including ninety-six school districts, and as a member of the California Debt Advisory Commission. This testimony concerns the impact of federal income tax reform as contained in HR 3838. There are three main areas of interest to State and local government: tax-exempt public finance, tax favored savings plans, and the deductibility of State and local taxes. I would like to address each of these areas in what I believe is their order of importance.

TAX EXEMPT PUBLIC FINANCE

HR 3838 contains four major provisions which would seriously impact our ability to finance local operations. These are: 1) retroactive effective dates, which cause uncertainty and corresponding rate increases; 2) arbitrage limits, which require a "rebate" of arbitrage earnings to the federal government; 3) the so-called "ten percent rule," which would hold any bond issue to consist of taxable "nongovernmental bonds" if the lesser of ten percent or $10 million of the proceeds were "used" directly or indirectly by any person other than a State or local government (use of a facility financed by the proceeds would be considered use of those proceeds); and 4) elimination of pension bonds, which are annuity contracts, purchased with bond proceeds, that fund all or part of an agency's unfunded pension liability.

These measures are intended to put an end to practices which some observers feel are abuses of the current system; but they are overly broad and will accomplish far more than closing loopholes. Adoption of these measures will have the unintended effect of making it difficult for local governments to finance many activities which are undoubtedly governmental, even in the strictest sense of the term, and will also prevent business-like efficient financial management.

1. Tax Reform Effective Date

HR 3838 contains an effective date of January 1, 1986 (September 26, 1985 for pension bonds). It is critical that the Senate quickly act to approve a prospective effective date, as announced in the congressional resolutions. Unless this occurs, there will be tremendous uncertainty in all sectors of the economy, until the date of enactment, as to how the economy is supposed to function.

Senate failure to clarify its intent to make public finance reform provisions prospective will not slow debt issuance, as projects and services must continue. What will occur is that uncertainty will cause increased rates, thereby enlarging issue size. This clearly works to the detriment of both the Treasury and State and local governments.

2. Arbitrage

HR 3838 will cost the County \$20-30 million per year without a net gain to the Federal government. It will not, therefore, contribute to a reduction of the Federal deficit.

Under existing law, the County temporarily reinvests the proceeds of a debt issue pending expenditure of the funds. Because the County borrows at tax-exempt rates and invests at taxable rates which yield revenue in excess of borrowing cost, the annual cash management borrowing program produces annual revenue to the County of \$20-30 million. Many school districts for whom I serve as Treasurer will also suffer proportional losses. A listing of their borrowing this year is contained in Exhibit A.

HR 3838 will require us to transmit this revenue to the Federal government. In addition, it imposes unfunded administrative cost mandates connected with identifying, reporting and paying the amount due the Federal government.

This will lead to an increased debt burden on local governments, a corresponding loss of valuable revenue currently available to such governments, an inevitable increased burden on taxpayers and users of tax-exempt financed projects, and, last but not least, a considerable loss of revenue for the Federal government.

The following simple hypothetical public purpose financing demonstrates the typical means by which arbitrage is generated and used.

A County wishes to build a jail. The cost of the project is $100 million, and the jail will take three years to build. Ordinarily, the County, on day one of the three year construction period, would issue $100 million in "jail bonds". Since this is a public purpose project, the issue would carry a tax-exempt interest rate. For our purposes, such a rate in today's market would be 7%. The $100 million, once received by the County from the sale of the bonds, would be invested in U.S. Treasury securities. Over the course of the three year construction period, the $100 million would be drawn down to pay off construction costs. At the end of the three years, all $100 million would be spent and the jail would be built and ready for operation. During the period of construction, those funds invested in the Treasuries which have not yet been disbursed would be earning interest at market rates (in today's market, roughly 9%). The difference between the "reinvestment" rate and the tax-exempt rate (i.e., 9%-7% or 2%) is arbitrage income. Because $2 million will be earned in arbitrage income, the County will only need to issue $98 million in jail bonds to generate the $100 million needed to build the jail. Accordingly, the County's jail bond issue will be sized at $98 million.

As this example demonstrates, the arbitrage earnings are used to "down-size" the bond issue in question. This makes for a lighter debt-burden on the issuer, and inures directly to the benefit of the taxpayers or users who ultimately bear the brunt of that issue.

A mandatory rebate to the Federal government of all arbitrage earned on all municipal issues is an extension of the law currently in effect with respect to arbitrage generated in connection with the issuance of Industrial Development Bonds ("IDBs). The implications of such an extension are profound.

To begin with, the unavailability of arbitrage income to the local governments will necessarily lead to increasing the size of municipal issues. In the above example, the County will have to issue an additional $2 million, placing additional debt pressures on the County, which must come up with more revenue to meet its debt service requirement. Thus, the County is financially worse off by the loss of arbitrage income.

In addition, however, the Federal government is worse off as well, to the extent that municipal issues have to be increased, that means that there are <u>more</u> investments in the marketplace generating tax free income.

On this last point, the Federal government has noted that whatever loss of revenue arises from increased debt in the marketplace will be more than offset by revenue in the form of arbitrage rebated to the Federal government pursuant to the new provision. This argument, thought logical, is simply not born out by the facts. A review of the date available form recent IDB issues shows that there will be no arbitrage to be rebated to the Federal government.

As derived from a wide sampling of major IDB issuers around the country, including such agencies as the New Jersey Economic Development Authority, the Massachusetts Industrial Finance Agency, and the Economic Development Corporation of Los Angeles County, the following picture has developed with respect to IDB issues and arbitrage income. That is, such borrowers, faced with having to reinvest bond proceeds at a higher rate, monitor the additional interest, and rebate it to the Federal government have forsaken higher rates in favor of reinvesting at rates equal to those on the bonds themselves. As a result, there has been no arbitrage generated and no rebate of such funds to the Federal government. This is precisely the same result that will be reached with respect to all municipal issues if the rebate provision is enacted as proposed. Accordingly, there will be no arbitrage revenue offsetting the loss of revenue arising from the issuance of more tax-exempt public purpose debt.

In addition, at present, a very high percentage of bond proceeds (up to 50% in The County of Los Angeles) are invested either in U.S. Treasury securities or in instruments that are collateralized with treasuries. If this rebate provision is enacted, the proceeds will be pulled away from the treasuries and into other lesser yielding investments having no connection to treasuries whatsoever. This redistribution of investments would result in a further major loss of revenue to the Federal government.

3. The Ten-Percent Rule

In attacking private exploitation of State and local governments' ability to borrow at favorable rates due to the tax-exempt status of interest payments on their obligations, HR 3838 provides that interest on State and local government bonds would be tax-exempt only if the bonds were "governmental" bonds. Bonds would be governmental bonds only if the lessor of ten percent or $10 million of the bond proceeds were used directly or indirectly by any person other than a State or local government, including the use of property financed with those proceeds. Thus, bonds would be classified according to who occupies or manages portions of a facility, rather than the purpose of the facility.

Opponents of so-called "private-purpose" bond issues argue that they distort the economy, cause relocation of business and jobs, and erode the federal income tax base. Supporters of these bonds claim that they are an efficient way to stimulate the economy, have a positive effect on our balance of payments problems by encouraging investments located in the United States rather than overseas, and in practice have little, if any, negative impact on Federal revenues.

The economic arguments on both sides are quite complex and will not be resolved by this testimony. Even if one were to ignore the favorable arguments and accept the anti-bond arguments, however, the ten-percent test would be the wrong way to address the problem. This is because it hits a far broader target than that at which it is aimed. It does not merely prevent the possibility of private concerns benefiting unfairly from favorable financing available to local governments; rather, it would do away with a whole range of financings, including those where the primary or sole purpose of the project is undeniably governmental, no matter how narrowly that term is construed.

For example, consider bonds issued to finance the construction of a new county office building. Presumably no one would argue that this is anything other than a governmental function. But even so, the bonds would lose their tax exempt status if more than ten percent of the floor space of that building were used by a nongovernmental entity. Such a situation is not hard to conceive. For instance, for the convenience of county employees, the building could contain a cafeteria. In addition, the county could contract for such services as security, housekeeping, etc., where such services could be more economically provided by the private section. With these private enterprises occupying space, it would be easy for the county to run afoul of the ten-percent test and the bonds would lose their tax-exempt status.

It simply does not make sense to apply any user-based restriction to such situations. Regardless of who runs the cafeteria, it is obviously in the government's interest to provide a convenient place for its employees to have lunch. Even if the cafeteria is operated by a private company, the evils at which the proposal is aimed (such as unfair competition and inefficient allocation of business locations between jurisdictions) simply are not present in this case; there is no public subsidization of a private interest.

The biggest problem with the ten-percent rule is that it will do away with the innovative, economically efficient and rapidly growing practice of "privatization." Privatization simply means that a governmental unit and a private firm work together in partnership to provide services for the community. Privatization is rapidly spreading because it is efficient and beneficial for both parties. For instance, sewage and solid waste disposal has become a highly complex process. It makes sense for local governments to contract with private firms, which have expertise in the subject, to design or operate complex disposal facilities. This allows the locality to have state-of-the-art facilities without having to undergo the costly, time consuming, and wastefully duplicative process of developing its own expertise in the field. In addition, the local government can shift the economic risks of the transaction (for instance, a plant that initially fails to meet performance specifications) to the private party. Finally, some of the most modern methods are actually proprietary, and not available except through the company which has developed the technology.

Similarly, many localities have found that the undeniably governmental function of operating criminal correction facilities is more efficiently carried out by private contractors. Indeed, the United States Department of Justice recently sponsored a seminar encouraging such privatization. Under HR 3838, however, such programs would be sharply curtailed, at least for new facilities, since whatever economies would otherwise result from privatization could be more than offset by increased borrowing costs resulting from loss of tax-exempt status.

The examples offered are just the tip of the iceberg. Indeed, Los Angeles County alone has saved more than $60 million over the last six years through effective use of privatization.

In focusing on who uses the facility, as opposed to what function the facility serves, the bill goes far beyond the intention of preventing private exploitation of State and local tax-exempt bonds. Regardless of the views on the propriety of funding shopping centers or industrial parks with bond issues, local government must be able to continue to use such financing for essential governmental services, and should be free to decide the most efficient means of providing such services without worrying about running afoul of the ten-percent rule.

4. Pension Bonds

Under HR 3838, Pension Bonds are eliminated. Elimination of tax-exempt pension bonds increases costs and leaves large, unfunded pension liabilities, America's "hidden deficit", unaddressed.

Los Angeles County alone has a $2.7 billion unfunded pension liability, the size of which dictates use of a prudent financing mechanism such as pension bonds. Other agencies share this problem, having in many instances far more serious unfunded liabilities.

Pension bonds offer a mechanism for retiring these critical "hidden deficits" which so commonly occur with defined benefit pension plans. This financing mechanism offers a practical way by which government can retire liabilities and transition to defined contribution plans such as 401(k) Savings Plans.

TAX-FAVORED SAVINGS PLANS

Except for certain grandfathered plans, HR 3838 prohibits the public sector from using 401(k) plans. These plans permit deferral of income tax and have proven to be a very popular method for employees to take responsibility for their own futures. While comprehensive statistics are not available, the October 29, 1984 issue of Pensions and Investment Age contains a survey showing that 322 of the Fortune 500 firms maintain Section 401(k) plans, with some 30 additional firms expecting to establish such a plan by 1985. A recent survey of some 228 companies, which was conducted by the Association of Private Pension and Welfare Plans, shows that over 80 percent of those firms maintain Section 401(k) plans, that almost 70 percent of their employees are eligible to participate in such plans, and that of those eligible employees, over 60 percent have elected to participate.

Pension and Investment Age also reports that state and local governments have established Section 401(k) plans under which more than 750,000 public sector employees are or soon will be eligible to join. For instance, Los Angeles County, the city of Dallas, and the states of Tennessee, Colorado, Mississippi, North Carolina, South Carolina, Utah, and Texas, have all either implemented or are implementing such plans, or have received determination letters form the Internal Revenue Service approving plans which will be implemented soon. It stands to reason that even more states and localities would implement such plans if they are not excluded for the public sector.

Under Section 401(k), the employee can designate a portion of his salary to be invested in a qualified profit sharing plan or stock bonus plan. Federal income tax on the amount thus invested is deferred until eventual withdrawal, as is tax on any amounts earned out of the funds contributed. The income is fully taxed, however, upon withdrawn from the plan. In addition, employers may (but are not required to) make matching contributions to the plan, as long as various nondiscrimination requirements are met.

The particularly appealing feature of the Section 401(k) plan is that it provides security; not just in the sense that amounts set aside for retirement provide a measure of security, but in the safeguards which the Code provides. Amounts in a Section 401(k) plan are placed in trust and are inviolate. Thus, they are not subject to claims of creditors, whether of the employee or the employer. This insures that the employee will get his money when he needs it. In these days of budget deficits and financial uncertainty for some public sector employers, such protection is not to be taken lightly.

In addition to security, Section 401(k) plans provide a number of benefits as compared to other types of retirement plans. Under Section 401(k), an employee is entitled to contribute up to 25 percent (with a cap of $30,000) of his or her salary per year, and the employer is permitted to make matching contributions as long as the combined total does not exceed those limits. In contrast, Individual Retirement Accounts and annuities only allow deferral of $2,000 per employee, and there is no matching feature. Section 401(k) plans are fully funded, "defined contribution" plans. Thus, they present a desirable alternative to the possibility of uncontrolled growth, and corresponding inability to pay benefits when due, which is associated with unfunded or underfunded public sector "defined benefit" plans.

Let me illustrate this crucial point using Los Angeles County as an example. Our defined benefit plan currently has assets of $4.9 billion, with over $2.7 billion in unfunded liabilities. Our 1985-1986 budget calls for $331.1 million in employer contributions. Roughly one-third of that employer contribution is to be applied this fiscal year pursuant to a 30-year amortization schedule to fund our unfunded liabilities, based on current mortality tables, with every likelihood that unfunded liabilities will grow as lifespans lengthen. Therefore, Los Angeles County alone is spending over $100 million per year to finance the unfunded liabilities its defined benefit plan has already assumed. A defined contribution plan, in contrast, would not present any unfunded liability to future taxpayers.

Given all of these undeniable advantages, it would appear that there would have to be compelling reasons for any scheme to limit or eliminate Section 401(k) coverage for public sector. The one reason offered in support of this proposal is that, since deferred compensation plans are available under Section 457, "extension" of Section 401(k) plans to public employees would be "unnecessarily duplicative."

Section 457 is in no way an acceptable substitute for a Section 401(k) arrangement, since a Section 457 plan is unfunded, and not protected by a trustee arrangement. Amounts set aside under Section 457 are available to general creditors of the governmental employer. The employee merely has an unsecured contractual claim for his or her account. As discussed previously, I feel that defined contribution plans are far more desirable than defined benefit plans from the employee's -- and taxpayer's -- perspective; but the security provided by the trustee requirement of Section 401(k) will be absolutely crucial to achieving employee and union acceptance of any transition from defined benefits to defined contributions. For these reasons, it is simply inaccurate to imply that availability of Section 457 would, in some way, make up for the loss of Section 401(k).

As shown above, relegating state and local government employees to Section 457 would result in a real decrease in their possibility for retirement security. But other ill effects also follow. As demonstrated, the proposal has offered no rational basis for distinctions between public and private sector employees in this area. Such discrimination will make it even harder for state and local governments to get or keep a high-quality work force. If the states increase other pension plans in order to counteract this effect, either local taxation will have to be increased to provide the necessary revenues, or already understaffed offices will have to be cut back even more. Dedicated, productive public servants could not be blamed for wondering whether they are indeed second-class citizens in the eyes of the Federal Government.

DEDUCTIBILITY OF STATE AND LOCAL TAXES

There has been a great deal of publicity surrounding the issue of the deductibility of state and local taxes. The administration proposal eliminated the deductibility of state and local sales, income, real estate, and property tax. HR 3838, however, retains full deductibility of state and local taxes.

I believe that the significance of the deductibility of state and local taxes in California has been overstated. Elimination of the deductibility of tax is predicted to:

-- increase public resistance to taxation.

-- attract growth and development to low-tax states at the expense of high-tax states.

Relatively speaking, California is not a high-tax state. As shown on Exhibit B, we rank 24th among states in regard to state and local taxes as a portion of personal income. Thus, proportionately we would not suffer like Alaska and New York, which ran number one and number three, respectively.

CONCLUSION

HR 3838 provisions concerning tax-exempt bonds and, to a lesser degree, tax-favored savings plans, seriously impact state and local government. While there may be abuses which must be curbed, these provisions extend far beyond any abuses, and will impact directly and catastrophically upon financing for the very type of fundamental governmental services which no one would argue should be curtailed.

In effect, the inadvertant results of these proposals seem to be that local governments are to be treated as just another special interest which must be disciplined. But, far from being a foe to be vanquished, State and local governments are valuable partners to the Federal government, with both striving for the same goal -- the general health and well being of our common constituency, the citizens of the United States.

This basic goal can best be met by each partner perfoming the functions for which it is best suited, utilizing those tools most particularly designed to effect those functions. Tax-exempt financing is a long established, efficient mechanism which enables us to meet our duties to our citizens and tax-favored savings plans provide a prudent alternative to defined benefit pension plans with their growing unfunded liabilities. They both should be retained.

1985-86 SCHOOL DISTRICTS TAX AND REVENUE ANTICIPATION NOTES AND BONDS

DESCRIPTION	AMOUNT	FACE RATE (BASIS)	ISSUE DATE	MATURITY DATE	BOND COUNSEL	UNDERWRITER	PAYING AGENT	REGISTERED/ BEARER	COMMENTS/ STATUS
lphur Springs ion School Dist. lection 1970, eries C *	$ 2,870,000	Various 6.5419% net (360)	6/1/85	Multi-year June 1 and December 1 of each year 1986-1990	O'Melveny & Myers	Bank of America, NT & SA; Dean Witter Reynolds, Inc.; Stone & Youngberg.	Treasurer (or other fiscal agencies of County)	Registered (Treasurer)	Rating: Moodys-A
whall School lection 1970, eries F Bonds *	$ 3,165,000	6.65648% Net 360	8/1/85	Multi-year 8-1 of each 1986-1992	O'Melveny & Myers	First Interstate et. al.	Treasurer (or (other fiscal agencies of Co.)	Registered/ (Treasurer)	Rating: Moodys-A-1
County 1985 TANs	600mm	4.90% (30/360)	7/2/85	6/30/86	O'Melveny & Myers	Merrill Lynch Capital Markets and Company	Security Pacific National Trust Comp. (New York)	Bearer	Rating: MIG-1 SP-1+
County TECP (TRANs)	250mm	Variable (Act/365)	7/1/85	6/30/86	O'Melveny & Myers	Merrill Lynch Capital Markets and Company	Bank America Trust Comp. of (New York)	Bearer	Rating: MIG-1 SP-1+
County 1985 TRANs	100mm	50% of Prime (Act/365)	7/2/85	6/30/86	O'Melveny & Myers	Merrill Lynch Capital Markets and Company	Security Pacific National Trust Comp. (New York)	Bearer	Rating: MIG-1 SP-1+
endale USD 85 TRANS	$ 9,250,000	4.50% (30/360)	7/1/85	6/30/86	Rutan & Tucker	Merrill Lynch Capital Markets	Mfrs. Hanover/ Treasurer	Bearer	Rating: MIG-1
Canada USD 85 TRANS	$ 1,365,000	4.75% (30/360)	7/1/85	6/30/86	Rutan & Tucker	SPNB	Mfrs. Hanover/ Treasurer	Bearer	Rating: MIG-2

Paid by Auditor-Controller

m/B-36

DESCRIPTION	AMOUNT	FACE RATE (BASIS)	ISSUE DATE	MATURITY DATE	BOND COUNSEL	UNDERWRITER	PAYING AGENT	REGISTERED/ BEARER	COMMENTS/ STATUS
Pasadena USD 1985 TRANS	$ 11,200,000	4.55% (30/360)	7/1/85	7/31/86	O'Melveny & Myers	Security Pacific Capital Markets Group	SPNB/Treasurer	Registered (SPNB)	Rating: MIG-1
Los Angeles USD 1985-86 TRANS	$115,000,000	4.70% (30/360 Series B)	7/2/85	7/1/86	O'Melveny & Myers	Bank America Captial Markets Group; Merrill Lynch Captial Markets; Security Pacific Capital	Bank America, Trust Co. of New York	Bearer	Rating: MIG-1
West Covina USD 1985 TRANS	$ 1,850,000	4.98% (30/360)	7/8/85	6/30/86	Brown, Wood, Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-1
Covina-Valley USD 1985 TRANS	$ 3,675,000	4.90% (30/360)	7/24/85	6/30/86	Brown, Wood, Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-1
Las Virgenes USD 1985 TRANS	$ 2,600,000	4.90% (30/360)	7/24/85	7/23/86	Brown, Wood Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-1
William S. Hart Union High School District 1985 TRANS	$ 3,200,000	4.85% (30/360)	7/24/85	6/30/86	Brown, Wood Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-1
Torrance USD 1985 TRANS	$ 4,750,000	5.4% (30/360)	7/31/85	7/30/86	Brown, Wood Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-2

mtm/B-37

DESCRIPTION	AMOUNT	FACE RATE (BASIS)	ISSUE DATE	MATURITY DATE	BOND COUNSEL	UNDERWRITER	PAYING AGENT	REGISTERED/ BEARER	COMMENTS/ STATUS
alnut Valley USD 985 TRANS	$ 1,300,000	5.8% (30/360)	8/30/85	8/29/86	Brown, Wood Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-1
ntelope Valley nion High School istrict 1985 RANS	$ 2,500,000	5.95% (30/360)	10/1/85	6/30/86	Brown, Wood Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-1
alos Verdes eninsula USD 985 TRANS	$ 3,690,000	5.75% (30/360)	10/17/85	6/30/86	Rutan & Tucker	Citicorp Investment Bank & Association	MFRS. Hanover/ Treasurer	Bearer	Rating: MIG-1
laremont USD 985 TRANS	$ 1,325,000	6.35% (30/360)	12/23/85	12/22/86	Brown, Wood, Ivey, Mitchell & Petty	Crocker National Bank	Treasurer	Bearer	Rating: MIG-2
.A. Community ollege District 985 TRANS	$ 21,700,000	6.10% (30/360)	12/31/85	12/30/86	Browm, Wood, Ivey, Mitchell & Petty	Ehrlich Bober & Company, Inc.	Citibank/ Treasurer	Bearer	Rating: MIG-1 Fiscal Agent: Citibank Letter of Credit: Mitsubishi Trust

EH:e
tm/B-37.F

EXHIBIT B

TOTAL STATE AND LOCAL TAX COLLECTIONS - 1983

Per $1,000 of Personal Income

1.	Alaska	$330.26	29.	Illinois	$104.09
2.	Wyoming	202.34	30.	Connecticut	103.77
3.	New York	153.49	31.	Georgia	103.23
4.	D.C.	144.62	32.	North Dakota	102.68
5.	Minnesota	132.21	33.	Ohio	102.60
6.	Wisconsin	131.83	34.	Oklahoma	102.56
7.	Hawaii	128.73	35.	Nevada	102.51
8.	Montana	125.53	36.	North Carolina	101.83
9.	Michigan	124.52	37.	Kentucky	100.69
10.	Vermont	121.77	38.	Mississippi	100.33
11.	Maine	120.99	39.	Virginia	99.70
12.	Rhode Island	120.32	40.	Idaho	99.27
13.	Oregon	119.48	41.	Colorado	97.75
14.	Massachusetts	117.56	42.	Kansas	96.64
15.	New Mexico	116.58	43.	South Dakota	95.81
16.	Washington	114.42	44.	Alabama	93.62
17.	Utah	113.03	45.	Texas	93.04
18.	West Virginia	111.80	46.	Arkansas	92.34
19.	New Jersey	111.74	47.	Missouri	91.90
20.	Maryland	111.31	48.	Tennessee	90.93
21.	Delaware	109.18	49.	Indiana	90.48
22.	Iowa	108.53	50.	Florida	90.39
23.	Arizona	108.37	51.	New Hampshire	89.35
24.	<u>CALIFORNIA</u>	<u>108.32</u>			
25.	Nebraska	108.08		U.S. Average	$110.67
26.	Pennsylvania	106.99			
27.	South Carolina	105.29			
28.	Louisiana	104.48			

Public Securities Association
40 Broad Street
New York, NY 10004-2373
(212) 809-7000

PSA

PROVISIONS ON MUNICIPAL BONDS IN TAX-REFORM PROPOSAL COULD INCREASE STATE AND LOCAL GOVERNMENT BORROWING COSTS BY $43 BILLION BY 1990

NEW YORK CITY--Local and state governments might have to pay an additional $43 billion in interest costs by 1990 if provisions on municipal bonds in the recently passed House of Representatives tax-reform bill becomes law.

The Public Securities Association (PSA) released today a preliminary cost analysis of the impact of these provisions on local and state governments based on 1985 bond volume.

Every state, and the governments therein, would be adversely affected. Increased borrowing costs could range from a high of more than $4 billion in California to $30 million in Idaho.

Provisions relating to municipal bonds were part of a tax reform bill passed by the House in late December. These provisions would prohibit local and state governments from issuing tax-exempt bonds for a wide variety of activities, such as pollution control; would sharply ration the amount of bonds that these governments could issue for an even larger area of public interest activities such as health care, housing, and job creation; would include the interest income earned by investors from these rationed bonds in the proposed alternative minimum tax;

(more)

and include a wide variety of other restrictions, regulations and requirements that would affect essentially every municipal bond issue.

"These provisions would have one inexorable result," said Heather Ruth, Executive Director of the Public Securities Association -- "they would sharply drive up the cost of borrowing by local and state governments regardless of the project, regardless of the purpose being served."

She pointed out that the House Ways & Means Committee estimated that the provisions on municipal bonds would raise less than $4 billion by 1990 to the Federal Treasury.

"In arriving at the projected $43 billion increase in borrowing costs for local and state governments, we used the same presumptions employed by House Ways and Means and the Treasury Department in forecasting revenue gains at the Federal level," Ms. Ruth noted.

"A first observation," she said, "is that no rational person can believe that the fate of reforming the Federal tax code rests on $4 billion in revenues. A second observation is equally obvious: it simply is not fair for state and local governments, and their taxpayers, to have to pay so high a price when it is absolutely unnecessary."

The PSA analysis of the 1985 municipal bond volume, compared to the House proposal that would limit the number of many bond issues, shows that three times as many bonds were issued last year for health care and private higher education than would be permitted under the House proposals.

(more)

Forty eight states and the District of Columbia (Mississippi and Wyoming are the exceptions) would have to curtail their support of non-profit hospitals, in most cases drastically.

Five states - California, Texas, Pennsylvania, Florida, and New York, issued more tax-exempt bonds last year to support non-profit hospitals and other private sector health care than would be permitted nationwide.

"Another observation is obvious from reviewing these numbers," Ms. Ruth said. "The cost of the health care delivery system in this country could increase while the quality of its delivery could decrease."

Not reflected in these cost estimates are provisions relating to arbitrage, advanced refunding, or, except for public power issues, the impact of the "10 percent" rule.

The PSA analysis is based on preliminary 1985 volume numbers which will increase as the reporting process works its course. Thus, the projected increased borrowing costs for local and state governments will probably rise.

#-#-#

Note:

Included with this release are two tables. One shows the increased borrowing costs, were the House proposal to become law, for each state by 1990. The second table shows the proposed rationing system compared to the preliminary 1985 bond volume on a state-by-state basis.

Public Securities Association
40 Broad Street
New York, NY 10004-2373
(212) 809-7000

PSA

FINANCIAL IMPACT OF HOUSE OF REPRESENTATIVES
PROPOSAL ON MUNICIPAL BONDS

Projected Increased Interest Costs Through 1990
Based on 1985 Municipal Bond Volume

U.S.	$43.7 Billion*		
California	$4188 MM	New Jersey	441
New York	2484	South Carolina	434.5
Texas	2245.5	Mississippi	318.9
Pennsylvania	2038.5	Kansas	280
Florida	1910.5	Nebraska	225
Arizona	1105	New Mexico	225
Illinois	1104.5	Alaska	190.5
Massachusettts	979.5	West Virginia	190.5
Georgia	971.2	Washington	178.5
Michigan	870	Arkansas	177.2
Minnesota	804	Oklahoma	174
Virginia	715.5	Nevada	147
Tennessee	702	Wisconsin	147
Ohio	700.5	Maine	139.8
Indiana	653.8	Iowa	131
North Carolina	652.5	Rhode Island	130.5
Connecticut	622.5	South Dakota	123
Maryland	604.5	Hawaii	120.
Oregon	584.3	Delaware	108
Louisiana	538.5	Montana	103.5
Kentucky	508.5	Wyoming	102
Utah	496.5	New Hampshire	97.5
Colorado	481.5	District of Columbia	87
Missouri	478.7	North Dakota	66
Alabama	454.5	Vermont	49.5
		Idaho	30

*Includes the sum of the individual states plus $13.5 billion through 1990 in higher interest charges because of the proposed loss of bank deductability.

These are preliminary figures subject to change as additional information becomes available.

Public Securities Association
40 Broad Street
New York, NY 10004-2373
(212) 809-7000

PSA

COMPARISON OF 1985 MUNICIPAL BOND VOLUME TO
PROPOSED STATE VOLUME CAPS[1]

State	Proposed $150.00/Capita[2] Volume Cap	1985 Volume[3]	Proposed $25.00/Capita[4] Volume Cap	1985 Volume
Alabama	$598.5MM	$675.8MM	$99.7MM	$598.4MM
Alaska	170	436.4	30	105.7
Arizona	457.9	1331.2	76.3	657
Arkansas	352.3	389.2	58.7	132.3
California	3843.3	5155.3	640.5	2395
Colorado	476.7	963.2	79.4	230.9
Connecticut	473.1	1312.3	78.8	261.6
District of Columbia	170	43.9	30	283
Delaware	170	203.7	30	130.2
Florida	1646.4	3568	274.4	1821.9
Georgia	875.5	1744.4	145.9	240.1
Hawaii	170	278.4	30	120.8
Idaho	170	60.7	30	110.4
Illinois	1726.6	1945.6	287.7	1060.4
Indiana	824.7	1329.2	137.4	443.6
Iowa	436.5	324.9	72.7	255.3
Kansas	365.7	435	60.9	166.6
Kentucky	558.4	936.3	93	280.1
Louisiana	669.3	1188.5	111.5	825.9
Maine	173.4	354.8	28.9	84.5

State	Proposed $150.00/Capita(2) Volume Cap	1985 Volume(3)	Proposed $25.00/Capita(4) Volume Cap	1985 Volume
Maryland	$652.3MM	$1548.2MM	$108.7MM	$ 243 MM
Massachusetts	869.7	1573.2	144.9	1249.8
Michigan	1361.2	1504.6	226.8	850.5
Minnesota	624.3	1589.9	104	514.1
Mississippi	389.7	609	64.9	50.3
Missouri	751.2	904.5	125.2	613.1
Montana	170	164.6	30	137.3
Nebraska	240.9	573.9	40.1	91.5
Nevada	170	357.3	30	69.5
New Hampshire	170	193.1	30	121.6
New Jersey	1127.2	1951.7	187.8	956.6
New Mexico	213.6	457.4	35.6	93.3
New York	2660	3350.5	443.3	2259.9
North Carolina	924.7	627.5	154.1	409.8
North Dakota	170	199.1	30	52.8
Ohio	1612.8	1148	268.8	956.4
Oklahoma	494.7	86	82.4	139
Oregon	401	1200.4	66.8	153.6
Pennsylvania	1785.1	2584.3	297.5	2451.3
Rhode Island	170	357.2	30	89.1
South Carolina	495	803.5	82.5	284
South Dakota	170	257.8	30	114.4
Tennessee	707.5	1351.5	117.9	669.1
Texas	2398	3254.8	399.7	2376.7
Utah	247.8	456.6	41.3	60
Vermont	170	187.3	30	46.7

State	Proposed $150.00/Capita(2) Volume Cap	1985 Volume(3)	Proposed $25.00/Capita(4) Volume Cap	1985 Volume
Virginia	$845.4MM	$1762.2MM	$140.9M	$414.7MM
Washington	645.3	525.9	107.5	323.4
West Virginia	292.8	252.7	48.8	360
Wisconsin	714.9	545	119	154.6
Wyoming	170	140.5	30	4.5
	35,973.7	56,059.9	8,256.3	26,306.9

Footnotes

1. These are preliminary 1985 volume numbers which are subject to change as additional information becomes available. The volume cap figures are based on estimated 1984 state populations. 1985 estimated population figures will not be available until later in 1986.

2. Projects included under this category include multi-family and single family housing, veteran housing, student loans, resource recovery facilities, sewage & waste disposal, redevelopment programs, and small issue industrial development bonds.

3. The volumes shown match only the activities listed in Footnote (2). Not shown are volume numbers for public power projects, which would be adversely affected by the House of Representatives' proposal, and airport and port facilities which are not under the volume cap restrictions, but which would, in part, lose tax-exempt status, and, in part, apply to the volume cap. Also not recorded are the 1985 volumes of projects that would lose tax-exempt status under the House proposals.

4. Projects included under this category include non-profit hospitals, private colleges and universities, and other non-profit organizations.

Addenda

- More than $38 billion of municipal bonds were issued in 1985 for the categories described than would be permitted under the House proposals.

- More than $11.7 billion of municipal bonds issued in 1985 would lose tax-exempt status by definition under the House proposals.

- More than $17 billion of municipal bonds were issued for public power projects, either as new issues or refundings, in 1985. A portion of these issues would be affected by the House proposals.

Addenda - continued

- More than $3.5 billion of municipal bonds were issued in 1985 for airport and port facilities. A portion of these issues would be affected by the House proposals.

- Forty eight states plus the District of Columbia issued more municipal bonds for health care, private higher education, and other non-profit purposes in 1985 than would be permitted under the House proposals.

- Forty states issued more municipal bonds for the other "non-governmental" purposes than would be permitted under the House proposals.

- Forty six states plus the District of Columbia issued more total "non-governmental" municipal bonds than would be permitted under the House proposals.

- In 1985, 14 states issued more municipal bonds for housing alone than their entire proposed state volume quota. Another 21 states issued more than half of the proposed volume quota for housing programs.

Washington Newsletter

PSA

Public Securities Association, 1110 Vermont Avenue, N.W., Suite 1075, Washington, D.C. 20005 • (202) 659-5850

January 10, 1986

A Brief Summary of the House of Representatives' Proposals Affecting Local and State Government Bonds

1. Local and state governments could no longer issue tax-exempt bonds for the following purposes:

   - Sports facilities;
   - Convention centers and trade show facilities;
   - Parking facilities except at airports;
   - Facilities for the local furnishing of gas and electricity by investor-owned utilities;
   - District heating or cooling facilities;
   - Air and water pollution control facilities;
   - Industrial parks.

2. Local and state governments could no longer issue tax-exempt bonds if more than 10 percent or $10 million, whichever is less, of the bond proceeds were to be used in a trade or business of any non-government entity. All other bonds are called "essential function" bonds, historically known as general obligation bonds and traditional revenue bonds.

   Note: This provision would adversely affect public power projects where up to 25 percent of proceeds can be used in such a way; i.e., the sale of electricity from a governmentally-owned power plant to an investor-owned utility.

It would also adversely affect a wide array of government activities that involve a public-private partnership such as operation of bus systems, maintenance and operation of public parks, zoos, libraries, and golf courses, sanitation systems, management and operation of jail and prison systems, repair and maintenance of street lighting systems, and many others.

This provision also means that the intended use of all or part of a municipal bond issue becomes the dominant factor in determining its tax-exempt status and not whether that issue is supported by the taxing powers of a government or the revenues to be raised by the project.

3. The Federal Government would permit tax-exempt bonds, as an exception to the "10% rule", to be issued for the following purposes but only under a severe and complex rationing system based solely on the population of a state. The "ration card" for these projects imposes a total volume ceiling of $175.00 per person broken down into two volume caps of $150.00 and $25.00 for each state. (A different formula would apply to states with low populations.) These bonds are called "non-essential function" bonds in the House proposal.

<u>The $150 Cap</u>:

- Multi-family rental housing;
- Single-family housing for first-time home buyers;
- Mass commuting facilities;
- Sewage and solid waste disposal systems;
- Facilities for the furnishing of water, except for irrigation programs;
- Small issue industrial development bonds, including agriculture bonds;
- Student loan bonds;
- Veteran's mortgage bonds;
- Veteran's land bonds;

Note: Unless overridden by the State Legislature, half of this cap would have to be issued for housing, and at least $6 per capita (a different formula applies for small population states) is required to be reserved for qualified redevelopment bonds. This applies only to states that issued more than $25 million in tax-increment financing bonds between July 18, 1984 and Dec. 31, 1985. Half would come from the housing portion of the cap and half from the non-housing portion.

In 1985, more bonds were issued for housing and industrial development alone nationwide than would be permitted, for <u>all</u> the projects listed above. This was true for 40 states.

<u>The $25 Cap</u>:

A different rationing allotment of $25.00 per person would be subscribed for tax-exempt bonds issued to support non-profit hospitals, private universities and colleges, and other non-profit organizations. No state could use this allotment for any other purpose, but additional bonds for this purpose could be issued under the $150 cap.

Nationwide in 1985, three times as many bonds were issued for these purposes than would be permitted. And 48 states issued more bonds for these purposes than would be permitted.

4. <u>Alternative minimum tax provisions</u>: The House proposal would also impose, for the first time, a Federal tax on certain tax-exempt bonds. Interest income earned on all the bonds listed in No. 3 above, plus bonds issued for airports and port facilities, would be subject to a proposed new alternative minimum tax for some investors.

5. Another rationing provision would force states to subtract from their state volume allotment a dollar amount over $1 million of any general obligation and traditional revenue bond that went to a private person or activity.

   Note: This provision could have a significant impact on the amount of "non-essential function" tax-exempt bonds a state could issue.

6. Tax-exempt bonds could be issued for airport and port work, as "non-essential function" bonds, and such work, at least in part, would be exempt from the state volume caps. However, tax-exempt financing could not be part of any work related to airport hotels, food preparation facilities, restaurants, gift stores and other commercial facilities located at an airport. Further, any portion of a tax-exempt bond issued to finance freight-handling facilities at an airport, or allowed storage facilities at a port, would have to be applied to the state volume cap.

7. <u>Advance refundings</u> would not be allowed on "non-essential function" bonds. Advance refundings on general obligation and traditional revenue bonds would be permitted with the following restrictions:

- Advance refundings would be included under the $150 volume cap.

- Each original issue of bonds could be advance refunded no more than two times, including refundings which occurred prior to the effective date of the bill.

- Unless the present value of interest savings exceeded the cost of issuance, the amount of refunding bonds could not exceed 250 percent of the amount of the refunded bonds.

- Refunded bonds would have to be called for redemption no later than the earlier of the dates they could be redeemed at par or at a premium of 3 percent or less.

8. <u>Arbitrage restrictions</u> would be tightened and would apply to all bonds, and would not allow an issuer to earn back its cost of issuance on invested bond proceeds.

9. <u>Information reporting requirements</u> similar to the present law rules would be extended to all tax-exempt bonds.

10. The proposals would <u>eliminate bank deductibility</u> for all interest on funds used to carry or purchase bonds acquired after January 1, 1986, with the following exception:

    - The present rule permitting deduction of 80% of such carrying costs would be permitted to continue for "essential function" bonds and short-term tax anticipation notes for a three-year period beginning January 1, 1986. Such bond issue may not exceed $3 million per project with a $10 million total limit per year per political subdivision, and is subject to certain other limitations.

COMMENTS OF MORRISON & FOERSTER

ON H.R. 3838

SENATE LOCAL GOVERNMENT COMMITTEE HEARING

JANUARY 29, 1986

We appreciate the opportunity to offer comments on the impact of certain of the tax-exempt bond provisions of H.R. 3838, 99th Cong., 1st. Sess. (1985) ("H.R. 3838" or "the Bill") on local governments in California. We will focus this paper on the impact of H.R. 3838 on the issuance of bonds to finance facilities to furnish water, which is one of this State's most important, and increasingly scarce, natural resources; the comments will also extend to the impact of the Bill on the issuance of tax increment bonds by California redevelopment agencies. In general, we are concerned that H.R. 3838 will make it more difficult, and in some cases, impossible, for local governments to finance water projects and to complete existing redevelopment projects on an economically sound basis. This would endanger, and possibly, foreclose, appropriate economic development of many regions and cities of the State.

H.R. 3838 would replace the present Internal Revenue Code with an entirely new statutory scheme identified as the

Internal Revenue Code of 1985.[1] The tax-exempt bond provisions of the New Code would be restructured and altered in content to provide that interest would no longer be generally tax-exempt on obligations of states and their political subdivisions. Under the New Code, interest on such bonds would be tax-exempt only if the bonds were either: (1) "essential function" bonds or (2) "non-essential function" bonds which are "qualified bonds." "Essential function" bonds are bonds that are not considered "non-essential function" bonds. These include bonds for traditional governmental functions such as construction of curbs, gutters, sewers and other infrastructure. "Non-essential function" bonds are bonds more than ten percent of the proceeds of which (or $10,000,000 for an issue in excess of $100,000,000) are to be "used" in a trade or business by, or more than 5 percent of the proceeds of which (or $5,000,000 for an issue in excess of $100,000,000) are to be "loaned" to, persons other than governmental units. Bonds whose proceeds are not to be so used or loaned are "essential function" bonds. In addition, a volume cap approximately equal in size to the present cap but applying to many more bonds is

---

1 The revised sections contained in the proposed New Code will be referred to in this statement as "New Code" sections from time to time as may be appropriate.

added under the New Code, and some of the restrictions formerly applicable only to small issue IDB's are applied to certain qualified bonds. The new rules would also inhibit advance refundings and apply the IDB arbitrage rules to all bonds as well as add certain additional restrictions.

The impact of the New Code on the ability of local governments to issue bonds to finance water projects and facilities (sometimes referred to herein as "water bonds") is critical because of the fundamental economic importance to California of having a plentiful water supply in all areas of the State. Tax increment bonds play a similar role in the revitalization of our cities.

As noted above, under the New Code, interest on water bonds would be tax-exempt only if the bonds were either: (1) "essential function" bonds or (2) "exempt facility" water bonds (a form of "qualified bonds") that comply with the volume cap and other applicable restrictions. The tax exemption of "exempt facility" bonds is only a partial one because interest on such bonds is viewed as a tax preference item which is subject to H.R. 3838's new alternative minimum tax. This feature of H.R. 3838 probably will result in higher borrowing costs to state and local governments for both water and tax increment bonds.

Although non-essential function bonds which qualify as exempt water facility bonds are also tax-exempt, such bonds will be subject to the new volume cap and other burdensome restrictions which do not apply to essential function bonds. In light of the small volume cap allocations of many local governments which will not increase appreciably under H.R. 3838, these restrictions may very well preclude some exempt water facility financings. Nor will tax increment bonds qualify as essential function bonds under the New Code if they are used to assemble land for redevelopment for ultimate private use. Therefore, they too will be subjected to many restrictive new rules and requirements, many of which cannot be met in existing California redevelopment project areas. A more detailed analysis of the issues and problems created by H.R. 3838 follows.

WATER BONDS

Present Law

Under present law, bonds issued for the construction of many water facilities are exempt as traditional governmental bonds. Notwithstanding, use of the proceeds for debt service or in a trade or business often requires such bonds to achieve exempt status as industrial development bonds (IDB's). Tax exemption is generally denied to state and local issues of IDB's unless they meet certain tests. A state or local government bond is an industrial development bond if (1) all or a major portion of the proceeds (more than 25 percent) of the issue are to be used in any trade or business not carried on by a state or local government or a tax-exempt organization; and (2) a major portion of the debt service payments is secured by an interest in, or derived from payments with respect to, property used in such a trade or business. However, certain industrial development bonds qualify for tax exemption, where the proceeds of the bonds are used to provide "exempt facilities."

Facilities for the furnishing of water are "exempt" if (i) such water is or will be made available to members of the general public, including electric utility, industrial, agricultural, or commercial users; and (ii) either the facilities are operated by a governmental unit or the rates for the furnishing of the water have been established or approved by a state or political subdivision thereof, by an agency of the United States, by a public service or utility commission or other similar body of any state or political subdivision thereof (IRC §103(b)(4)(G)).[2]

The provisions of IRC §104(b)(4)(G) were redefined in this regard in the Revenue Act of 1978 which amended the general public use test which had always been part of this

---

2 All IRC references are to the Internal Revenue Code of 1954 as amended.

provision.[3] This amendment became necessary because during the 1970's the Internal Revenue Service had interpreted the exemption for facilities for the furnishing of water as being inapplicable where a substantial amount of the capacity of of the facility was committed to use by a small number of industrial users. The IRS interpretation was premised on the public use requirement of present law and on the view that industrial users are non-exempt persons who may not be regarded as members of the "general public."[4]

These rulings also revealed the Service view that a governmental unit was not permitted to finance water facilities with tax-exempt bonds unless the system component so financed served the general public directly, notwithstanding that it may be part of an overall facility or system operated by the governmental unit to serve the general public in its service area. The 1978 legislation overruled the IRS on this point as well.

The legislative history of the Revenue Act of 1978 states that the exemption of bonds issued to provide facilities under the new provision was to be governed by the fol-

---

3 Revenue Act of 1978, Pub. L. No. 95-600, §333, 92 Stat. 2840, reprinted in 1978 U.S. Code Cong. & Ad. News ("U.S. Code").

4 See Rev. Rul. 76-494, 1976-2 C.B. 26, Rev. Rul. 78-21, 1978-1 C.B. 26.

lowing three tests. Such facilities: (i) must be for the furnishing of water; (ii) must be operated by a governmental unit or a regulated investor-owned public utility; and (iii) must make water available to members of the general public.[5]

In applying the first test, the legislative history distinguished between facilities for the furnishing of water and those for the use of water in a production process, as in the case of a "cooling pond" or a "hydroelectric dam."[6] (The latter facility could qualify if substantially all the water were used for other purposes as well as for the furnishing of hydroelectricity.[7]) The test of governmental or regulated utility operation would be deemed met if such an entity was responsible for repairs and maintenance with respect to the facility in question.[8] The requirement for general public use could be met notwithstanding that the users included electric utility, industrial, agricultural or other commercial users.[9] Meeting this test necessitated making the water

---

5 See H. Conf. Rep. No. 1800, 95th Cong., 2d Sess. ("Conference Report") 237-38, reprinted in U.S. Code at 7237-38.

6 See Sen. Rep. No. 1263, 95th Cong., 2d Sess. ("Senate Report") 142, reprinted in U.S. Code at 6905.

7 See Conference Report at 238, reprinted in U.S. Code at 7238. See IRC §103(d) which qualifies hydroelectric irrigation dams as meeting the tests of IRC §103(b)(4)(G). Apparently the New Code would repeal this provision.

8 See Senate Report at 142, reprinted in U.S. Code at 6905.

9 See Senate Report at 142-43, reprinted in U.S. Code at 6905-06.

available to all segments of the general public, including residential users and municipal water districts in the service area. Requirements contracts or "take or pay" fixed payment contracts with commercial or industrial users could be entered into, provided that a "substantial portion" (defined as 25 percent or more "if a considerable quantity in absolute terms") of the capacity of the facility is made available to other members of the general public. In applying the general public use test, it was said that a particular facility is to be viewed as an organic component of the system of which it is a part: if the system serves the general public, so does the particular facility.[10]

The legislative history of the Revenue Act of 1978 makes it clear that there is no requirement that a water facility serve the general public immediately after it is constructed if, (i) the facility is available to serve the general public; and (ii) the general public has an opportunity to take water from the pipeline.[11] Thus, a pipeline built to meet expected need in a sparsely populated region will be deemed to satisfy the general public use doctrine even though it may not do so immediately as long as it will serve the

---

10 Id.
11 Id.

general public that, attracted by a new source of water, moves into the region.[12]

If the system serves the general public as a whole, construction of a component part such as "an individual water line or canal, for transportation of water from the main system to a single industrial user" is financeable.[13] Finally, the legislative history provides that a water facility does not have to serve all segments of the general public to qualify as an exempt facility IDB financing.[14] It was deemed sufficient for residential and agricultural users to be served even if commercial and industrial were not.[15] Nor was there any requirement that the water be made available to "all residential users in the service area."[16]

Proposed Regulations §1.103-8(h)(3) require that, in meeting the general public use test under these rules, water must be made available to residential users and to municipal water districts within the service area. Use for recreational purposes only is not, sufficient to meet the general public use test.[17]

---

12 Id.
13 See Conference Report at 238, reprinted in U.S. Code at 7238.
14 Id.
15 Id.
16 Id.
17 See Prop. Reg. §1.103-8(h)(3)(i).

Problems Arising Under H.R. 3838

Listed hereafter are uncertainties and questions arising with respect to water bonds under H.R. 3838 and its accompanying House Committee Report.

1. Problem: "Essential Function Bonds" are bonds which are not within the ten percent use or five percent loan tests of New Code §141(a)(1). In applying the ten percent use test, however, "use as a member of the general public" is not to be taken into account. The Bill contains language which, on occasion, conflicts with that intent.

a. Issue: This reference is confusing with respect to water bonds previously exempt under existing IRC §104(b)(4)(G), since those bonds had to meet a well-defined public use test to be exempt from the small issue IDB rules of IRC §103(b)(6). Are those same "general public use" rules to be applied in determining whether a water bond constitutes an "essential function bond?"

Tentative Conclusion: Presumably, the intended answer to this question is "no," since the existing rules require only a 25 percent general use for IRC 103(b)(4)(G) to apply whereas New Code §141(a)(1) states that use of "10 percent" (or, if less $10,000,000) of the bond proceeds in any "trade or business" carried on by a non-governmental person will cause the bonds to constitute "non-essential function" bonds. Thus the general public use test of existing law appears incompatible with that of the proposed new statute. Nonetheless, it seems reasonably clear that the traditional municipal water district bond is intended to constitute an "essential function bond," absent special circumstances.

One special circumstance which probably might cause a water bond to become a "non-essential function bond" would be a "take or pay" contract for ten percent or more of the output of the water facility in question. In that case, exemption of such bond could be under New Code §142(a)(4) as an exempt facility bond for the "furnishing of water." California water districts typically do not furnish water under "take or pay" contracts and, therefore, most should be able to issue essential function bonds. If this conclusion is correct, the legislative history should confirm that most water bonds will constitute "essential function bonds" absent special circumstances.

b. Issue: Why doesn't the general public use test of New Code §141(a)(1) also modify the five percent (or if lesser, $5,000,000) loan prohibition of §141(a)(1)(A)?

Tentative Conclusion: The Bill's failure to do so appears to be the result of a drafting omission which should be corrected by substituting the words "paragraph (1)" for "subparagraph (B)" in the flush language at the end of §141(a)(1).

c. Issue: Section 141(a)(4) states that any activity by a "person other than a natural person" shall be treated as a "trade or business". Presumably, the purpose of this provision is to cause bonds issued by or on behalf of IRC §501(c)(3) organizations to become non-essential function bonds the exemption of which is to be governed by the "qualified bond" rules contained in New Code §144(a)(1).

Tentative Conclusion: If this analysis is correct, the language of New Code §141(a)(4) is overbroad and should be revised to apply only to activities carried on by a "non-governmental person" and not to to activities which amount to "use as a member of the general public." Otherwise, a public water district which sells its water only to other municipal water districts could be treated as able to issue only "non-essential function" bonds, a result which appears unintended, assuming the water district customers of the selling public district themselves furnish water to the general public. A cross-reference in New Code §141(a)(4) exempting use as a member of the general public is necessary in order to make it clear that New Code §141(a)(4) is not intended to override the general public use exception of New Code §141(a)(1). Otherwise any use by a non-governmental person could be aggregated with other such uses to cause the bonds to fail the ten percent use or five percent loan tests.

2. Problem: If a water bond meets the ten percent use or five percent loan test of New Code §141(a)(1), it must constitute an "exempt facility bond" as defined in §142(a)(4) and satisfy the volume cap rules and other applicable requirements of New Code §§145 and 146 to be exempt. Section 142(a)(4) of the Bill indicates that water bonds qualifying under its provisions must meet the following tests: (i) be issued to provide facilities for the furnishing of water; (ii) which make water "available to members of the general public (including electric utility, industrial, agricultural, or commercial users) but not for the purpose of irrigation"; and, (iii) the facilities must be operated by either a governmental unit or an investor-owned regulated utility. The language of New Code §142(a)(4) appears to have been lifted from the body of IRC §103(b)(4)(G) except that use "for the purpose of irrigation" has been prohibited.

Neither the Bill nor the accompanying House Committee Report contains any cogent explanation of the exclusion of irrigation from the permitted general public uses of the proceeds of exempt facility water bonds. Because this qualification represents an important policy change for many western states, including California, which will have a significant impact on farming and other activities in these states, it should not be made before Congress has been able to review the matter thoroughly. Possibly, the House's intent is to prohibit the use of exempt bond proceeds to construct facilities to transport water in special purpose districts to irrigation users (such as feeder pipes or canals) unless the bonds in question constitute qualified "small issue bonds." "Small issue bonds" under H.R. 3838 are derived from those under IRC §103(b)(6) of present law; these bonds involve a number of difficult technical issues, some of which may be avoided if the bonds constitute "exempt facility bonds." Thus, the prohibition of irrigation use in New Code §142(a)(4) creates several difficult technical questions, in addition to the significant policy issues relating to the need to finance irrigation in arid farm states such as California.

a. Issue: What is the relationship between the general public use test contained in the definition of "non-essential function bond" and that contained in New Code §142(a)(4). For example, is it intended that any direct or indirect irrigation use of water furnished through facilities constructed with bond proceeds will taint the qualification of water bonds as essential function bonds? Alternatively, is it intended that irrigation use constitutes a disqualifying use only if the use is under a direct contract and only if it constitutes use of ten percent or more of the bond proceeds?

Tentative Conclusion. Presumably, the latter is the intended technical solution. Under this approach, and in order to be consistent with the "general public use" rules of present IRC §103(b)(4)(G) (which permit trade or business use as long as 25 percent or more of the bond proceeds are used to construct facilities which make water available to the general public) under New Code §142(a)(4)(A) irrigation bonds would fail to constitute "exempt facility bonds" only if more than 75 percent of the bonds were used to construct irrigation facilities as long as a 25 percent general use were also present. Because of the similarity of the language of New Code §142(a)(4) to the language of present IRC §103(b)(4)(G), this interpretation of the proposed new statute seems appropriate.

If the irrigation exception of §142(a)(4) is to be retained, we recommend that language distinguishing non-public irrigation use from general public uses be added to the flush language of New Code §141(a)(1). As altered, that language could read as follows:

> "For purposes of paragraph (1), use as a member of the general public shall not be taken into account unless the use is directly for the purpose of irrigation."

The concept of direct use is intended to require privity between the irrigation user and the operator of the bond financed facilities for the furnishing of water and not to imply a requirement for a "take or pay" contract for the water in question. Otherwise, the bonds may be impacted unfavorably by uses of the water made by third persons as to whom the operator has no control or knowledge.

b. Issue: What is the relationship between an "agricultural" use which is said to be permissible and a "use for the purpose of irrigation" which is not permissible under New Code §142(a)(4)(A).

Tentative Conclusion. Presumably, reference to the term "agricultural" is an oversight which should be stricken from the Bill. If agricultural uses other than for irrigation are to be permitted, the legislative history should define what they are.

c. Issue: What is the definition of "irrigation" under New Code §142(a)(4)(A)?

Tentative Conclusion. Presumably, this term does not refer to residential, non-profit or governmental irrigation of lawns, parks and gardens but only to irrigation of farms and orchards and similar acreage used in the conduct of a trade or business.

d. Issue: What is the definition of "general public use" for purposes of new §142(a)(4)(A)?

Tentative Conclusion. The Committee Reports and other legislative history of the Bill should conform that definition to that contained in the proposed regulations. Thus, the following rules should be provided within that definition:

(i) The "general public" will include electric utility, industrial, commercial and residential users. Agricultural uses other than for irrigation may also be included if deemed appropriate. Recreational use for swimming boating or fishing is to be excluded.

(ii) To meet the "general public use" test, "a facility must make available to residential users . . . [and] municipal water districts within its service area or, any combination thereof, at least 25 percent of its capacity (which must be a considerable quantity in absolute terms). Except with respect to residential users and municipal water districts, a water facility is not required to make available water to all segments of the general public in order to qualify . . . ." Furthermore, "a water facility is not required to make its water available to the general public immediately after its construction in order to qualify . . .; it is sufficient that the facility is available to serve the general public. For example, if a pipeline is built to serve a sparsely inhabited region which lacks water, the pipeline meets the requirement . . . if it will serve the general public that the new source of water reasonably may be expected to cause to move into the region."

e. Issue: The House Committee Report indicates that "functionally-related and subordinate" facilities may no longer be financed with the proceeds of exempt facility bonds as is permitted under IRC §103(b)(4)(G). Therefore it becomes important to distinguish clearly between components of an exempt water system and facilities which are "functionally related and subordinate" to the water system.

Tentative Conclusion. Generally speaking, all facilities which are for the gathering, storage, purification, or transport of water for use by the general public should be included as components of a water system even though such components may serve only one commercial or industrial water customer as long as the water is furnished to that customer on the same basis on which it is furnished to the general public (e.g. no special contract or pricing). The provision of a volume discount to a customer will not violate this rule as long as such discount is available to all customers of the water district on the same basis.

3. Problem: A conflict exists between New Code §142(a)(4)(B) and New Code §142(b)(1). The latter states that a facility can qualify as an exempt facility only if it is owned by or on behalf of a governmental entity (with certain exceptions which are not relevant here). However, the former subparagraph provides specifically that a regulated investor-owned utility may own water facilities which may be financed with the proceeds of exempt facility bonds.

Tentative Conclusion. To eliminate this conflict, we suggest that the words "Except as provided in subparagraph (B) of paragraph 142(a)(4)" be added at the beginning of paragraph (1) of subsection 142(b).

4. Problem: New Code §149(c) raises certain timing problems for an issuer. It requires that all issuers spend at least five percent of the net proceeds of a bond issue within 30 days of the date of issue and all of the net proceeds (except for reserve funds) within three years. Failure to comply with these restrictions renders the interest on the bonds taxable retroactive to the date of issue.

Tentative Conclusions.

The first requirement could impair an issuer's ability to choose the most advantageous time to take a bond issue to market. Furthermore, it is not clear that a prudent issuer would secure contract bids, let alone, execute a binding contract to expend public funds, prior to the proceeds of an issue being available to be expended. Thus, as a practical matter, it may be impossible to issue bonds, pick a winning bid, execute a contract and spend five percent of the proceeds within 30 days.

The second requirement will substantially restrict and in some cases even preclude the financing of projects with a construction period of more than three years. This may necessitate additional transaction expenditures for the issuance of a later series of bonds which may not necessarily be treated as a separate issue. (*See*, *e.g.*, H.Rept. No. 426, 99th Cong., 1st Sess. 556 (1985). Furthermore, such a rule may not be a practical alternative because contractors may be unwilling to begin construction of a project without assurances that adequate funding for completion will be provided. In addition, the bond market may reject, or require a high interest rate for, an issue to finance a project whose successful completion will depend on a second bond issue at a future date. As a practical matter, these provisions appear to be unworkable in their current form.

TAX INCREMENT BONDS

What Are Tax Increment Bonds

Tax Increment Financing ("TIF") is a traditional method of municipal financing that many cities use to redevelop blighted areas. TIF essentially is used to improve a blighted area, *e.g*. a slum, by recapturing the increased tax revenues resulting from redevelopment that would not have occurred but for public involvement.

TIF begins with a public finding by a governmental unit that redevelopment is necessary in the public interest. California requires that redevelopment be limited to deteriorated areas, (*e.g.*, called a "blighted area"). The state standards for a blighted area are generally rigorous because competing users of local tax revenues (*e.g.*, the county or local school district) will assure that these scarce tax dollars are judiciously used. The California statute requires a public finding that "redevelopment of the project area would not be reasonably expected to be accomplished by private enterprise acting alone without the aid and assistance" of the redevelopment agency.

The city then generally determines a boundary to the redevelopment district and prepares a publicly approved plan. In California, a redevelopment agency is created as a separate governmental unit to prepare and carry out the plan. The plan must be approved by elected public officials and is usually subject to public hearings.

The essence of TIF is that the city and other taxing jurisdictions, e.g. a county or public school board, agree to forgo any taxes generated by the redevelopment activities. This works as follows: after the plan is approved, the city or redevelopment agency calculates the property taxes being generated in the redevelopment district. Any increase in taxes (i.e., the "tax increment") over the taxes generated in this "base year" is available exclusively for redevelopment purposes. Since various governmental units elect to forgo part of their tax revenues that would otherwise be used to pay for other traditional municipal services such as fire and police protection, it is certain that all TIF projects are subjected to close public scrutiny.

Once a plan has been approved, the city may use the "tax increment" in one of two ways: (1) on a pay-as-you-go basis, using tax increments each year as they are collected or (2) by issuing TIF bonds (called "tax allocation bonds" in California) in advance of the actual collection of the tax revenues so that a larger sum is available up front, thus accelerating the redevelopment process.

Under the pay-as-you-go method, the city is assured that it will not spend more for redevelopment than it collects. However, unless the city receives a federal grant for a project or otherwise has the financial resources for start-up costs, often the pay-as-you-go method will not spur private investment in a blighted area on a timely basis. After sufficient increment has been generated with "seed money," usually from public sources, TIF bonds secured by anticipated future increment may be issued. Cities often find that such financing is the only feasible way of actively creating redevelopment.

The use of TIF bond proceeds vary depending on the underlying causes for the urban decay of the redevelopment area. Part of most TIF bonds are used for infrastructure improvements (streets, sidewalks, sewers, public lighting, etc.) designed to assure the private sector that the local government has made a commitment to redevelop the blighted area.

Perhaps the most common use of TIF bond proceeds in California is to assemble land parcels through the power of eminent domain or the threat thereof. The land often comes with deteriorated and/or vacant buildings that are not reusable. Private developers have not purchased these parcels for many reasons. Perhaps developers were not willing to purchase land in an area until the local government evidenced an intent to redevelop the entire district. Perhaps it would not be economic for the redeveloper to both purchase and clear the land, i.e. the acquisition and demolition costs exceed the land's value. Or perhaps the developer could not acquire all of the parcels needed to assemble one large package.

Whatever the reason, the city or redevelopment agency may use the TIF bond proceeds to acquire the land, demolish the buildings and prepare the site for eventual resale to the private sector (sometimes a particular developer is identified when the land is acquired, other times one is not). It is important to note that the city or redevelopment agency may not use its eminent domain powers primarily to benefit a private developer because the public purpose doctrine under constitutional law requires that any taking of land serve a public purpose such as the redevelopment of a blighted area. For example, California courts have denied the use of eminent domain pursuant to two redevelopment plans because the city's intervention was not required to protect the public welfare (in one case, a city's plan to redevelop a golf course into a shopping center was invalidated because the golf course was not a truly blighted area, and in the other case, the court found that the targeted area was developing under private initiative).

Often the cleared land is worth less than the city's acquisition and clearing costs. Indeed, this could well be the reason why a private developer did not purchase the land on its own. In such case, the city will sell the cleared land below its cost but at fair value, as determined by the uses permitted by the redevelopment plan (e.g. a parcel on which only low income housing may be constructed will be valued according to such use instead of by reference to a high rise office building use). Typically, the TIF bonds are not secured by these sales proceeds or by the profits of the purchaser; they are backed only by the "tax increment" of redevelopment in the entire project area or by some other governmental obligation.

Other uses of TIF bond proceeds include construction of publicly owned buildings such as convention centers and parking facilities, grants to encourage low income housing (in California, 20% of all tax increment revenues must be used for low income housing), construction of replacement housing as required by state law (as in California), relocation of occupants from demolished buildings located in a project area and rehabilitation of certain existing structures in a project area. Office and commercial structures may not be constructed with TIF bond proceeds in California.

Present Law

1. Industrial Development Bonds.

Section 103(b) of the Internal Revenue Code ("Code" defines an industrial development bond ("IDB") as an obligation that satisfies both the "trade or business" use test and the "security interest" test.

As explained before, the trade or business test is met if 25 percent or more of a bond's proceeds are used in the trade or business of a "nonexempt person", *i.e.* an entity other than a governmental unit or a charity. Treasury regulations adopt an extensive definition of "use" to include, among other arrangements, a lease recognized as such under applicable tax law and a sale of property that a government unit acquired with the bonds proceeds or a loan of bond proceeds to finance the construction of a facility.

The security interest test is met if, either by the bond's terms or any "underlying arrangement," the payment of principal or interest is secured by property used in a trade or business or by payments in respect of property used in a trade or business (*e.g.*, a lease).

2. <u>TIF Bonds</u>.

In 1973, the IRS concluded in Revenue Ruling 73-481 that interest on a TIF bond, issued to acquire land in a redevelopment area and to sell it at below cost to a private developer, was not taxable under Code section 103(a)(1). Although the ruling did not expressly state why the bond was exempt under Code section 103(a) rather than Code section 103(b) (relating to IDBs), cities and bond counsel generally assumed that the holding was based on the security interest test.

Several years later, the IRS attempted to revoke the 1973 revenue ruling on the theory that the security test was satisfied. However, in 1977 the Treasury Department concluded that the security interest test was not in fact met in the revenue ruling, and the IRS accepted the Treasury Department's conclusion in 1979. Since then, the IRS has ruled that TIF bonds are not IDBs and therefore interest on TIF bonds is tax exempt as a public purpose bond.

3. <u>Tax Reform Act of 1984 (DEFRA)</u>.

The House Bill did not contain any provisions that would have affected the exempt status of TIF bonds. However, the Senate Finance Committee voiced concern about:

> the growing use of tax-exempt bonds to finance loans for personal expenses of higher education (including tuition, fees, books, and personal living expens-

> es) and the possible use of tax-exempt bonds to finance other personal loans.

To address this concern, the Senate Bill contained a "consumer loan bond" provision, the language of which went beyond the student loan issue. This provision would have taxed the interest on any consumer loan bond, defined as:

> an obligation [other than IDBs, "qualified" student loans, mortgage bonds or veterans' mortgage bonds] which is issued as part of an issue all or a significant of the proceeds of which are reasonably expected to be used directly or indirectly to make or finance loans . . . to persons who are not exempt persons. . . . [Emphasis added].

The Finance Committee report indicated that a "significant part" meant 5%. There was no discussion or analysis in the Senate Report that indicated a purpose other than to restrict the amount of bond proceeds that could be used to make loans to nonexempt persons. Although the definition of "person" in the present Internal Revenue Code is broad enough to include entities as well as individuals, it is fairly clear from the legislative history that the Consumer Loan Bond provision was intended to cover only individuals when it was first conceived.

The Conference Report merely stated that the conferees accepted the Senate version with certain modifications regarding student loan bonds. Code section 103(o) substantially codifies the Senate version of the consumer loan bond provision.

During and after the Senate's consideration of DEFRA, the National League of Cities and other organizations were told that the consumer loan bond provisions should not affect traditional municipal financing methods. There is no evidence the Senate Finance Committee intended these provisions to apply to TIF bonds unless the TIF bond proceeds were loaned to a private person as the term "loan" is ordinarily understood, i.e. including an installment sale disguised as a lease. It is inconceivable that the Senate intended these provisions to apply to the ordinary land write-down situation as described by Revenue Ruling 73-481.

Treatment Under H.R. 3838

Retroactivity

Section 1569(a) of H.R. 3838 would merely make a nomenclature change; Code section 103(o) would be retitled "Private Loan Bonds." Of course, this change in and by itself is not objectionable.

However, the description of this provision in the House Committee Report suggests that Code section 103(o) has a much broader scope than anyone thought when the Senate approved it in 1984. Specifically, the descriptive language suggests that typical uses of TIF bond proceeds (e.g., a land write-down) could render a TIF bond taxable as a private loan bond because such uses would be considered a trade or business use for purposes of the IDB rules. Clearly, Code section 103(o) was not intended to apply to TIF bonds unless the bond proceeds are used to make a loan as defined by traditional standards.

Because this analysis of the consumer/private loan bond provisions is categorized as a mere "clarification" of a "technical amendment," section 1569(a) of H.R. 3838 would be retroactive to the original enactment date of Code section 103(o), i.e. bonds issued after July 18, 1984. The House evidentally realized the impropriety of retroactively applying these provisions to the more than $1 billion of TIF bonds issued after DEFRA's effective date because section 1569(c)(5) of H.R. 3838 would exempt certain pre-1986 TIF bonds issued after DEFRA from its new interpretation of Code section 103(o).

However, there are several serious flaws in the House's approach to the retroactive issue. First, H.R. 3838 would grandfather only those TIF bonds that were used for a limited number of purposes. For example, TIF bonds that were used for construction of replacement housing as required by California law or for publicly owned parking facilities that were subject to long-term leases apparently would not be covered by the transitional rules.

Second, section 1569(c)(5) of H.R. 3838 contains severe technical flaws that render it useless. For example, section 1569(c)(5)(C) requires that the security of a grandfathered TIF bond be the tax increment attributable to the redevelopment resulting from a particular issue. No TIF bond would satisfy this condition because repayment of each such bond is secured by the total tax increment resulting from redevelopment in the entire project area.

Third, the special transitional rule for TIF bonds would apply only to bonds issued before 1986. If the final effective date for the tax-exempt bonds provisions of the tax reform bill is postponed, there would be a "window" period in which Code section 103(o) could apply to TIF bonds.

The following transitional rule for TIF bonds is suggested:

> The amendment made by section 626(a) of the Tax Reform Act of 1984 should not apply to any tax increment financing obligation issued before January 1, 1987 if substantially all of the proceeds of the obligation were or will be used to finance redevelopment activities authorized by state law in connection with a blighted area, as determined under such law.

Prospective Treatment

The fundamental flaw with the House Bill's treatment of TIF bonds is that its interpretation of its 5 percent loan and 10 percent use tests would render TIF bonds "nonessential function bonds," thereby subjecting TIF bonds to the same volume limitation cap as small issue IDBs and other bonds. This approach is incorrect for several reasons.

First, redevelopment of blighted urban areas has been recognized as a valid governmental purpose since Congress enacted the first urban renewal laws in the 1940s. These urban programs often provided the seed money for redevelopment project areas in California (which started TIF in 1952) and created the first incremental taxes upon which later redevelopment projects were based. Thus, TIF bonds have long been interrelated with public purpose federal redevelopment efforts.

Second, unlike IDBs, TIF bonds are governmental bonds that are backed by government, not private, revenues. In tax increment financing, the city or redevelopment agency is the responsible borrowing party and continues to remain responsible for the generation of the tax revenue to pay debt service on the obligations. In some states such as Minnesota, TIF bonds are further secured by the full faith and credit of the issuing governmental unit. In IDB financing, the city has no further responsibility after the closing of the bond transaction; the obligation is that of the private user. Congress need not worry that localities would use TIF bonds for activities now financed by IDBs because state law would not allow it (e.g., TIF bonds cannot be used to construct an industrial plant) and because local officials would not risk local tax revenues on a business venture.

Third, no benefit is passed through to a nonexempt person by a TIF bond because private developers pay fair value for any land assembled and cleared with TIF bond proceeds. I understand that the Treasury Department agrees that TIF bonds should be considered essential function bonds because of this absence of a pass-through benefit to a private person.

Fourth, there is no need to place TIF bonds under a volume limitation cap because their issuance is limited by scarce local tax revenues. Local officials zealously guard against any improper or unnecessary use of local taxes and this close scrutiny by our counterparts on the local levels acts as a self-enacting limitation on the volume of TIF bonds. The fairly steady volume of TIF bonds in California over the last several years disregarding the rush to market late last year caused by H.R. 3838) is proof that TIF bonds would not proliferate out of control (as IDBs and other types of bonds have) without further limitations in the Internal Revenue Code.

<u>Substantive and Technical Problems of TIF Bonds Under H.R. 3838</u>

The definition of "Qualified Redevelopment Bonds" presents many problems. First, the requirement in New Code §144(d)(3)(D) that a designated blighted area be no smaller than ¼ square mile (160 acres) would prevent approximately 210 of the 459 existing redevelopment project areas in California, including the project area in Watts, from being able to issue tax increment bonds after 1985. Land is often a scarce commodity in an urban context in California and redevelopment efforts are often concentrated in an area much smaller than ¼ square mile. In any event, this limitation is utterly unnecessary if TIF bonds are placed under a volume cap.

Second, New Code §144(d)(3)(C) would limit the area designated as a blighted area to 10 percent of the total assessed value of all real property located within the designating city. California has been issuing tax increment bonds since the early 1950's, and many California cities have designated areas that either were at least 10 percent of the city's assessed value at the time of designation or would fail the test at the present time. Tax increment bonds have been issued on the assumption that the redevelopment area could be fully redeveloped and the security for the bonds was premised on full redevelopment. It is unfair to retroactively restrict the area for which tax increment bonds can be issued and also unnecessary because Qualified Redevelopment Bonds would be subject to the volume limiting restrictions of state law, especially in light of the cap. Further, the combination of the 10 percent and ¼ square mile restrictions would mean that many smaller and medium sized cities could not issue any Qualified Redevelopment Bonds because ¼ square mile would necessarily represent more than 10 percent of the city's assessed value.

Third, proposed Code section 144(d)(4) would not allow a redevelopment agency to issue a tax increment bond if there were any special tax districts, market rate single-family housing and residential rental property, or retail food and beverage or entertainment facilities located in the redevelopment area, even if the housing or facility was not bond-financed. Further, the limitation on entertainment and other facilities would be stricter than those imposed on small issue bonds. These restrictions make no sense and would prevent cities or redevelopment agencies from attracting private capital (without any subsidy whatsoever) to invest in blighted areas or to enliven downtown areas with mixed-use property.

Fourth, the definition of Qualified Redevelopment Bonds in New Code §144(d)(1)(B) is technically deficient because it requires any increase in real property tax revenues resulting from use of the bond proceeds to be reserved exclusively for debt service on each separate bond issue. This language betrays a misunderstanding of the tax increment process because typically, tax increment bonds issued with respect to a particular redevelopment project area are secured by increased tax revenues throughout the entire project area, not just with those which result from redevelopment generated by a particular bond. Further, proposed New Code §144(d)(1)(B) would allow a city only to pledge the incremental real property taxes generated by redevelopment. Several states such as Colorado and Florida allow sales or other local taxes to secure TIF bonds. Sales taxes are revenues of a city as much as real property taxes, and cities in Colorado and Florida should be allowed the flexibility of selecting the type of tax revenue stream to use as security for TIF bonds.

Fifth, New Code section 145(i) contains many technical deficiencies that could vitiate the volume cap set-aside for Qualified Redevelopment Bonds established by H.R. 3838. For example, proposed Code section 145(i)(3) would require that an eligible State have issued $25,000,000 of tax increment bonds between July 18, 1984 and November 21, 1985 (December 31, 1985, according to the Ways & Means Committee Report). Since local governments, rather than States, issue tax increment bonds, the net effect of this statutory language would be to prevent cities in any state (including California, Minnesota and Iowa) from qualifying for the set-aside.

The last technical problem is that New Code §146(d)(1) would extend the existing property rule for small issue bonds IDBs to tax increment bonds. Such rule would prevent bond proceeds from being used to acquire previously used property. Because tax increment bonds are typically used to acquire land containing substandard structures, this provision apparently would prevent tax increment bond proceeds to be used to acquire land on containing existing buildings that the redevelopment agency intends to demolish.

COUNTY OF PLACER

BOARD MEMBERS

ROBERT P. MAHAN, District 1
ALEX FERREIRA, District 2
THERESA "Terry" COOK, District 3
MICHAEL R. LEE, District 4
ERIK HENRIKSON, District 5

OFFICE OF COUNTY EXECUTIVE

DONALD LUNSFORD, County Executive Officer

175 FULWEILER AVENUE, RM. 205 / AUBURN, CALIFORNIA 95603 / TELEPHONE (916) 823-4381

January 28, 1986

County Supervisors Association
of California
1100 K Street, Suite 101
Sacramento, CA 95814-3941

Attn.: Mr. Dan Wall, Legislative Representative

Subj.: Proposed Reporting Requirements in House Tax Reform Act

Dear Dan:

The last-minute reporting requirements proposed in the House Tax Reform Act would result in significant cost impacts to local governments. For Placer County, we would estimate that the forms, envelopes and postage costs to mail 1099's to all secured and unsecured property taxpayers would exceed $60,000 annually, at current rates. Since the county does not presently prepare 1099's for tax payments, additional costs also would have to be incurred for the initial data processing programming needed to implement such a requirement. We estimate that this development would cost at least $21,000.

The costs listed above do not include the annual costs for computer and operational support time to prepare the 1099's and possible tape input for the Internal Revenue Service, nor clerical and supervisory staff time for the actual 1099 mailings, handling of inquiries, returned mailed items, adjustments, etc.

At a time of diminishing federal resources, the imposition of these unnecessary costs will force the county to further reduce needed programs, yet will serve little useful purpose. Taxpayers are already provided with annual tax billings which may be easily verified by the Internal Revenue Service. Frankly, it appears that the reporting requirements proposed in the House Tax Reform Act are essentially punitive in nature, instituted perhaps because of the numerous protests lodged against the elimination or reduction of state and local tax deductions.

We urge that the proposed reporting requirements for tax payments be eliminated as an unnecessary and costly imposition on state and local governments. In addition, the following paragraphs contain our comments regarding other aspects of the Tax Reform Act that would affect Placer County.

CSAC, Dan Wall
House Tax Reform Proposals

January 28, 1986

EFFECTS OF HOUSE TAX REFORM PROPOSALS ON PLACER COUNTY

Arbitrage

The proposal to require rebating of all arbitrage earned in connection with a municipal issue is of great concern. We believe that good money management for local governments should be encouraged, not penalized. Placer County exercises good money management by borrowing on lagging reimbursements from the federal and state governments as well as on semi-annual property tax payments to finance monthly expenditure cash flow requirements.

The difference between the amount of interest paid on these short-term borrowings and the amount earned on investing the proceeds is arbitrage. If these earnings must be rebated to the federal government as proposed, then Placer County will be unlikely to continue short-term cash flow financing. The net effect will be no additional earnings to be applied to the federal deficit and less interest income to the county for governmental operations.

"Non-Governmental" Bonds

Likewise, the proposed percentage or dollar limitations on "non-governmental" bonds could further limit economic development or even the provision of residential services to new housing developments, even at the more liberal 5 percent or $5 million (whichever is less) rate offered by the Committee.

Furthermore, we believe that "non-governmental" bonds is an arbitrary classification that will penalize the more rural or growing counties that may have real need for tax-exempt financing. Reforms have already curbed any abuses from industrial development bonding; further restrictions seem unnecessary at best.

We suggest that locally elected officials, accountable directly to the residents of their areas, are most capable of determining those facilities and improvements that are needed for their communities. When those facilities and improvements serve the larger public interest, tax-exempt financing must be preserved as a means of securing them.

Tax Deductibility

Finally, continued deductibility of all state and local taxes is most important. Therefore, we urge that the Committee's proposal of allowing a deduction of $1,000 ($500 for unmarried taxpayers) or the portion in excess of 5% of adjusted gross income for these taxes be further liberalized and that sales and personal property taxes also continue to be fully deductible.

As you are aware, property and sales taxes paid do not always correlate with higher incomes, particularly for older citizens. Additionally, losses in federal aid to state and local governments have increased the importance of tax revenues for carrying out programs at the state and local level. For these reasons we urge that full deductibility of state and local taxes be maintained as part of the Federal Tax Code, as it has been since the code was written in 1913. Most important for Placer County, of course, is the continued full deductibility of local property tax payments.

EFFECTS OF GRAMM-RUDMAN

Finally, the effects of Gramm-Rudman, as best we can determine, would be to reduce the non-exempt federal program revenues by not less than 4.3% in this 1985-86 Fiscal Year. This could amount to more than $320,000 for Placer County, assuming that welfare and food stamp administrative costs and Title XX Social Services would not be exempt, and including 4.3% reductions in the current year's Revenue Sharing entitlement for the county. If Gramm-Rudman sequestration cuts are implemented in the 1986-87 Fiscal Year, it is possible that county revenue reductions could exceed $1.2 million plus the $1.6 million loss in Revenue Sharing already projected. Cuts of this magnitude will severely restrict vital program operations and needed support services.

Please do not hesitate to contact my office at (916) 823-4381 if we may provide any additional information regarding the effect of the original Treasury proposals or the House Ways and Means Committee's alternatives on Placer County.

Very truly yours,

COUNTY OF PLACER

Donald Lunsford

Donald Lunsford
County Executive Officer

DL:GC:bd

cc: Senator Milton Marks, Member of Senate Local Government Committee

TESTIMONY BEFORE THE CALIFORNIA STATE SENATE COMMITTEE ON LOCAL GOVERNMENT (SENATOR MILTON MARKS, CHAIRMAN)

BY

GILBERT T. RAY

OF

O'MELVENY & MYERS

LOS ANGELES, CALIFORNIA

JANUARY 29, 1986

MR. CHAIRMAN AND MEMBERS OF THE PANEL, THANK YOU FOR THIS OPPORTUNITY TO SPEAK TO YOU. I AM A PARTNER IN THE LAW FIRM OF O'MELVENY & MYERS, AND I WILL DISCUSS TODAY THE IMPACT ON CALIFORNIA WATER AGENCIES OF THE TAX BILL RECENTLY PASSED BY THE HOUSE OF REPRESENTATIVES.

HR 3838 IN ITS PRESENT FORM WOULD SUBSTANTIALLY ALTER THE STRUCTURE OF FINANCING FOR CAPITAL PROJECTS BY CALIFORNIA WATER AGENCIES. IT WOULD IMPAIR OR OBSTRUCT THE FINANCING OF CERTAIN FACILITIES AND INCREASE THE NET COST FOR ALL WATER PROJECTS. MY PRESENTATION WILL ADDRESS JUST A FEW PROVISIONS OF THE BILL WHICH POSE A SERIOUS PROBLEM FOR PUBLIC-ENTITY ISSUERS; THESE PROVISIONS WERE CLEARLY <u>NOT</u> DESIGNED WITH THE FINANCING NEEDS OF CALIFORNIA PUBLIC WATER DISTRICTS IN MIND.

BEFORE DISCUSSING THE BILL ITSELF, LET ME POINT OUT THAT MY USE IN THIS PRESENTATION OF THE TERMS "WATER DISTRICT" OR "WATER AGENCY" INCLUDES ALL OF THE MYRIAD TYPES OF ENTITIES THAT ARE CREATED UNDER THE VARIOUS CALIFORNIA WATER

ACTS. FOREMOST AMONG THESE IS THE CALIFORNIA MUNICIPAL WATER DISTRICT ACT, BUT MY DISCUSSION WILL APPLY TO ANY WATER SUPPLIER CREATED PURSUANT TO ONE OF THE SIX MAJOR ORGANIC LAWS OR ANY OF THE MINOR, SPECIALIZED ACTS. THESE ARE THE PUBLIC-PURPOSE WATER DISTRICTS WHICH ACCOUNTED FOR OVER $700 MILLION IN TAX EXEMPT FINANCING FOR CALIFORNIA WATER INFRASTRUCTURE FACILITIES JUST LAST YEAR.

EARLY ISSUANCE RESTRICTIONS

UNDER HR 3838, ALL TAX EXEMPT BONDS WOULD BE SUBJECT TO RESTRICTIONS ON EARLY ISSUANCE. UNDER THE BILL, AT LEAST 5% OF THE NET PROCEEDS OF BONDS MUST BE SPENT WITHIN 30 DAYS OF THE DATE OF ISSUE TO CARRY OUT THE INTENDED GOVERNMENTAL PURPOSE, AND ALL NET PROCEEDS MUST BE SPENT WITHIN THREE YEARS. BOTH RESTRICTIONS ARE NEW AND CONFLICT DIRECTLY WITH THE TYPICAL STRUCTURE OF LARGE WATER BOND FINANCING.

CALIFORNIA WATER AGENCIES USE BOND FINANCING TO SUPPORT A VARIETY OF CONSTRUCTION PROJECTS. LARGE WATER DISTRICTS WHICH MAINTAIN EXTENSIVE DISTRIBUTION SYSTEMS, SUCH

AS THE METROPOLITAN WATER DISTRICT IN SOUTHERN CALIFORNIA, TYPICALLY HAVE ONGOING, CONTINUOUS CAPITAL EXPENDITURE REQUIREMENTS, A PORTION OF WHICH ARE FINANCED WITH BONDS. THESE BOND ISSUES TAKE ON A CONTINUOUS NATURE CONSISTENT WITH THE CONSTRUCTION PROJECTS BEING FINANCED. SOME MONTHS BEFORE CAPITAL FUNDS ARE DEPLETED, AND WHILE THE MARKET RATES APPEAR FAVORABLE, THE WATER DISTRICT WILL CUSTOMARILY REVIEW ITS CONSTRUCTION PLANS AND GO TO MARKET TO RAISE THE NECESSARY FUNDS.

BECAUSE THERE IS NOT NECESSARILY A SINGLE, IDENTIFIABLE PROJECT BEING FINANCED WITH ANY SPECIFIC BOND ISSUE, THE BILL'S REQUIREMENT THAT 5% OF BOND PROCEEDS BE SPENT WITHIN 30 DAYS MAY BE DIFFICULT OR IMPOSSIBLE TO APPLY WITHOUT CHANGING THE PATTERN OF BORROWING. THERE IS OFTEN NO WAY TO ACCELERATE CONSTRUCTION IN ORDER TO MEET THIS ARBITRARY REQUIREMENT. THE ONLY OBVIOUS ALTERNATIVE FOR THE ISSUER IS TO "CUT UP" LARGE BOND ISSUES INTO A NUMBER OF SMALLER ONES, SUBSTANTIALLY INCREASING THE TRANSACTION COSTS

FOR ITSELF AND, INDIRECTLY, THE PUBLIC. THE PROBLEM IS ONE OF MISDIRECTION IN THE BILL ITSELF: WHILE THE 5% REQUIREMENT MAY SERVE TO PREVENT EARLY ISSUANCE OF BONDS IN THE CONTEXT OF A SINGLE FINANCING FOR A SPECIFIC FACILITY, IT LIMITS THE FLEXIBILITY OF MULTIPLE-PROJECT ISSUERS SUCH AS THE METROPOLITAN WATER DISTRICT.

A DIFFERENT ECONOMIC CHARACTERISTIC OF WATER AGENCY FINANCING COULD CREATE A PROBLEM FOR WATER BOND ISSUERS IN MEETING THE NEW THREE-YEAR EXPENDITURE RULE IMPOSED BY THE BILL. SUCH ISSUERS OFTEN FUND CONSTRUCTION EVEN BEFORE COMMITTING TO ARCHITECTURAL AND OTHER CONSTRUCTION CONTRACTS, THUS LENGTHENING THE PERIOD BETWEEN ISSUE DATE AND COMPLETION OF CONSTRUCTION. AS THE BILL PRESENTLY STANDS, HOWEVER, <u>ANY</u> LEFTOVER BOND PROCEEDS AT THE END OF THE THREE YEAR PERIOD, WHETHER RESULTING FROM DELAY IN CONSTRUCTION OR UNDER-EXPENDITURE, COULD CAUSE THE BONDS TO BECOME RETROACTIVELY TAXABLE.

ARBITRAGE

UNDER CURRENT LAW, ALL MUNICIPAL OBLIGATIONS ARE SUBJECT TO SOME ARBITRAGE LIMITATIONS, AND MOST INDUSTRIAL DEVELOPMENT BONDS ARE, IN ADDITION, SUBJECT TO A GENERAL REQUIREMENT THAT ALL "EXCESS" YIELD BE REBATED TO THE FEDERAL GOVERNMENT. HR 3838 CARRIES OVER THIS REBATE REQUIREMENT TO "ESSENTIAL FUNCTION" BONDS SUCH AS THOSE ISSUED BY MOST CALIFORNIA WATER DISTRICTS. BECAUSE THE DIFFERENCE BETWEEN THE YIELD ON THE TEMPORARY INVESTMENT OF SUCH BOND PROCEEDS AND THE YIELD ON THE BONDS THEMSELVES HAS BEEN CUSTOMARILY FACTORED INTO THEIR BOND FINANCING ANALYSIS, THE LOSS OF THIS DIFFERENCE WILL RAISE THE TRANSACTION COSTS TO WATER BOND ISSUERS AND TO THE PUBLIC SERVED BY SUCH ISSUERS. FURTHERMORE, THE BILL AGAIN INTRODUCES NEW RESTRICTIONS APPARENTLY DIRECTED TO SINGLE-PROJECT FINANCINGS BUT INAPPROPRIATELY APPLIED TO MULTIPLE-PROJECT ISSUERS AS WELL.

FOR EXAMPLE, THE 3-YEAR TEMPORARY PERIOD WHICH REMAINS AS AN EXCEPTION FROM THE YIELD RESTRICTION

REQUIREMENT (THOUGH NOT FROM THE REBATE REQUIREMENT) COMMENCES WITH THE EARLIER OF THE ISSUE DATE OR THE COMMENCEMENT OF CONSTRUCTION, IGNORING THE FACT THAT WATER FACILITY CONSTRUCTION HISTORICALLY HAS A LONGER TRACK THAN OTHER TYPES OF CONSTRUCTION. AS NOTED BEFORE, MANY OF THESE PUBLIC-PURPOSE ENTITIES FUND ONGOING CONSTRUCTION CONTRACTS WITH PERIODIC BORROWINGS. AN AUTOMATIC 3-YEAR CLOCK COMMENCING WITH THE COMMENCEMENT OF THE "PROJECT" (HOWEVER THAT MAY BE DETERMINED) THUS WORKS TO THEIR DISADVANTAGE.

THE NEW BILL ALSO TERMINATES THE TEMPORARY PERIOD WHEN AN AMOUNT EQUAL TO BOND PROCEEDS HAS BEEN SPENT ON THE PROJECT, WHETHER FROM BOND PROCEEDS OR FROM OTHER SOURCES. CALIFORNIA WATER BOND ISSUERS TYPICALLY FINANCE CONSTRUCTION WITH A MIXTURE OF BOND PROCEEDS AND OTHER MONIES. THIS PROVISION ALSO WORKS AGAINST THEM IN THIS REGARD, BY IGNORING THE ECONOMIC SUBSTANCE OF THIS MIXED-FINANCING STRUCTURE AND EFFECTIVELY REQUIRING 100% ALLOCATION OF BOND PROCEEDS FIRST

AND EXCLUSIVELY IN ORDER TO ACCELERATE THE END OF THE TEMPORARY PERIOD EXCEPTION.

BANK NON-DEDUCTIBILITY

OF GREAT CONCERN TO ALL CALIFORNIA WATER BOND ISSUERS IS THE PROVISION OF THE NEW TAX LEGISLATION WHICH REPEALS THE EXISTING DEDUCTION ALLOWED TO BANK-HOLDERS OF MUNICIPAL OBLIGATIONS OF A PORTION OF THEIR INTEREST COSTS INCURRED IN CARRYING SUCH OBLIGATIONS. THE MERE SPECTER OF THIS REPEAL HAS ALREADY HAD A DAMAGING EFFECT IN THE MUNICIPAL BOND MARKET GENERALLY, WITH BANKS NOW BIDDING TAXABLE RATES FOR SHORT-TERM MUNICIPAL OBLIGATIONS. THIS CHANGE IN THE TAX LAW AFFECTS ESSENTIAL FUNCTION AS WELL AS NONESSENTIAL FUNCTION BOND ISSUERS, AND CALIFORNIA WATER BOND ISSUERS HAVE HISTORICALLY PLACED A SIGNIFICANT AMOUNT OF THEIR BONDS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS.

NONESSENTIAL FUNCTION BONDS

MOST OBLIGATIONS CURRENTLY ISSUED BY CALIFORNIA WATER AGENCIES, INCLUDING BONDS, NOTES AND OTHER SECURITIES,

CONSTITUTE GOVERNMENTAL OBLIGATIONS AND ARE NOT SUBJECT TO THE RESTRICTIONS APPLICABLE TO "INDUSTRIAL DEVELOPMENT BONDS." HR 3838 REPLACES THE CONCEPT OF INDUSTRIAL DEVELOPMENT BONDS AND SUBSTITUTES THE CLASSIFICATION OF NONESSENTIAL FUNCTION BONDS. UNDER THE NEW CLASSIFICATIONS, SECURITIES ISSUED BY WATER DISTRICTS WILL GENERALLY BE DEEMED "ESSENTIAL FUNCTION BONDS." THIS MEANS THAT THE PROCEEDS OF SUCH BONDS WILL BE LESS RESTRICTED AS TO THEIR USE THAN NONESSENTIAL FUNCTION BONDS; THE BOND ISSUES WILL NOT BE SUBJECT TO A STATEWIDE VOLUME CAP APPLICABLE TO NONESSENTIAL FUNCTION BONDS; AND THERE WILL BE NO LIMITATIONS ON BOND MATURITY, LAND ACQUISITION, OR OTHER RESTRICTIONS GENERALLY APPLICABLE TO NONESSENTIAL FUNCTION BONDS.

NEVERTHELESS, BONDS ISSUED BY GOVERNMENTAL WATER AGENCIES MAY BE DEEMED "NONESSENTIAL FUNCTION BONDS" IF 10% OF THE PROCEEDS OR $10 MILLION (WHICHEVER IS LESS) ARE USED IN THE TRADE OR BUSINESS OF ANY NONGOVERNMENTAL ENTITIES. IN ADDITION, AN ISSUER MUST OBTAIN ALLOCATION FROM THE STATEWIDE

BOND VOLUME CAP FOR ANY PROCEEDS OVER $1 MILLION THAT ARE USED IN THE TRADE OR BUSINESS OF ONE OR MORE NONGOVERNMENTAL ENTITIES, EVEN IF THE BONDS ARE NOT NONESSENTIAL FUNCTION BONDS. CONTRARY TO CURRENT LAW, BONDS MAY BE DEEMED NONESSENTIAL FUNCTION BONDS (AND SUBJECTED TO THE RESTRICTIONS IMPOSED THEREON) EVEN IF NO PART OF THE OBLIGATION IS SECURED BY AN INTEREST IN PROPERTY USED IN A TRADE OR BUSINESS. THUS, A TRADITIONAL GENERAL OBLIGATION ISSUED BY A WATER DISTRICT COULD FALL WITHIN THE NONESSENTIAL FUNCTION CLASSIFICATION THROUGH THE ARGUABLE "USE" OF $1 MILLION OF BOND PROCEEDS BY A NONGOVERNMENTAL ENTITY, EVEN IF NO PORTION OF THE DEBT SERVICE ON SUCH BONDS IS PAYABLE FROM THAT ENTITY.

TO CITE A REAL-WORLD EXAMPLE, A WATER DISTRICT MIGHT USE A PORTION OF BOND PROCEEDS TO CONSTRUCT A POWER GENERATOR TO BE USED IN GENERATING ELECTRICITY FOR SALE TO A PRIVATE DISTRIBUTOR SUCH AS THE SOUTHERN CALIFORNIA EDISON COMPANY. ANY SUCH ARRANGEMENT INVOLVING MORE THAN $1 MILLION IN BOND PROCEEDS COULD PRESENT SERIOUS PROBLEMS FOR THAT

WATER DISTRICT WITH RESPECT TO THE ENTIRE BOND ISSUE, REGARDLESS OF THE PUBLIC BENEFITS THAT MAY ACCRUE FROM SUCH ARRANGEMENT.

WATER AGENCY BONDS THAT ARE DEEMED TO BE "NONESSENTIAL FUNCTION BONDS" WILL BE SUBJECT TO THE EARLY ISSUANCE AND ARBITRAGE RESTRICTIONS DISCUSSED PREVIOUSLY, WHICH ARE APPLICABLE TO ALL MUNICIPAL BONDS. IN ADDITION, HOWEVER, SEVERAL MAJOR LIMITATIONS APPLY EXCLUSIVELY TO NONESSENTIAL FUNCTION BONDS. THE AVERAGE MATURITY OF SUCH BONDS MAY NOT EXCEED 120% OF THE AVERAGE REASONABLY EXPECTED ECONOMIC LIFE OF THE FACILITIES FINANCED. NO MORE THAN 25% OF NET PROCEEDS MAY BE USED FOR LAND ACQUISITION. THERE ARE RESTRICTIONS ON ACQUISITION OF EXISTING PROPERTY; A REQUIREMENT THAT A PUBLIC HEARING BE HELD; AND A PROHIBITION OF ADVANCE REFUNDINGS. CONTRARY TO CURRENT RULES APPLICABLE TO IDB'S, THE PROCEEDS OF SUCH BONDS MAY NOT BE USED TO FINANCE FUNCTIONALLY RELATED AND SUBORDINATE FACILITIES, EVEN THOUGH SUCH FACILITIES ARE FUNCTIONALLY RELATED TO THE ELIGIBLE FACILITIES.

BEYOND THESE MANY RESTRICTIONS, HOWEVER, TWO SIGNIFICANT CHANGES TO THE RULES REGARDING NONESSENTIAL FUNCTION BONDS AFFECT CALIFORNIA ISSUERS IN PARTICULAR. FIRST, SUCH BONDS MAY NOT BE ISSUED TO FINANCE IRRIGATION PROJECTS. HR 3838 SPECIFICALLY PROHIBITS FINANCING FOR FACILITIES BUILT TO FURNISH WATER FOR IRRIGATION PURPOSES. THE IMPACT OF THIS CHANGE WILL PRESUMABLY BE GREATEST AND MOST ADVERSE IN THE WESTERN STATES, SUCH AS CALIFORNIA, WHICH DEPEND HEAVILY ON IRRIGATION TO SUPPORT THEIR AGRICULTURAL ECONOMIES.

SECOND, ALL NONESSENTIAL FUNCTION BONDS WILL NOW COMPETE FOR RATIONING UNDER A UNIFIED STATEWIDE VOLUME CAP. NONPROFIT SCHOOLS, HOSPITALS, HOUSING PROJECTS, AIRPORTS AND OTHER INFRASTRUCTURE FACILITIES, INCLUDING WATER PROJECTS, WILL ALL HAVE TO STAKE THEIR CLAIMS AGAINST A RIGID FORMULA BASED SOLELY ON POPULATION. THIS FORMULA, AS PRESENTLY DRAFTED, CONSIDERS NEITHER DYNAMIC FACTORS, SUCH AS ANTICIPATED FUTURE GROWTH, NOR UNIQUE FACTORS, SUCH AS CALIFORNIA'S CONTINUING WATER NEEDS.

IN SUMMARY, HR 3838, AS PRESENTLY DRAFTED, WOULD CHANGE THE LANDSCAPE FOR CALIFORNIA WATER AGENCY FINANCING. THE EARLY ISSUANCE RESTRICTIONS AND ARBITRAGE RULES, IN PARTICULAR, WOULD HAVE A SERIOUS ADVERSE IMPACT. IN ADDITION, THERE WOULD BE AN INCREASED DANGER THAT CERTAIN WATER BOND ISSUES -- HISTORICALLY TREATED AS ESSENTIAL FUNCTION, GOVERNMENTAL OBLIGATIONS -- COULD BE DEEMED NONESSENTIAL FUNCTION BONDS.

I THANK YOU AGAIN FOR THE OPPORTUNITY TO DISCUSS THESE PROBLEMS IN THIS FORUM.

STATEMENT OF WILLIAM A. WITTE
EXECUTIVE DIRECTOR
SAN FRANCISCO MAYOR'S OFFICE OF HOUSING & ECONOMIC DEVELOPMENT

on

FEDERAL TAX REFORM ACT OF 1985:

IMPACT ON LOCAL GOVERNMENT

SENATE COMMITTEE ON LOCAL GOVERMENT
SACRAMENTO, CALIFORNIA
JANUARY 29, 1986

As Director of the Mayor's Office of Housing and Economic Development under Mayor Dianne Feinstein, I am responsible for the administration of all housing and economic development programs for the City and County of San Francisco. These include the sale of tax-exempt mortgage revenue bonds for single- and multi-family housing, and of small issue industrial development bonds.

I will confine my remarks to the effects of the Federal Tax Reform Act of 1985, as passed by the U.S. House of Representatives, on housing and development activities in San Francisco. As I believe my remarks will demonstrate, this legislation is both an extreme and inequitable attack on the ability of not just San Francisco, but of local governments throughout California, to finance affordable housing and to retain and create jobs.

NEW DEBT VOLUME LIMITATIONS

Far and away the single most devastating provision of the House bill is its $175 per capita limit or "cap" on all permitted nonessential ("private-purpose") function bonds. In theory, this unified volume cap will allow states to make policy priorities in allocating bond issuing authority among competing uses.

In practice, the bill's volume cap will effectively mean the end of local government involvement in tax-exempt financing for housing and economic development in California.

Let me explain why:

Under the proposed volume cap, California would be entitled to sell $4.4 billion in tax-exempt bonds in 1986. Exempt facility bonds, redevelopment or tax allocation bonds, mortgage revenue bonds, veterans' mortgage bonds, student loan bonds, non-profit organization bonds, and small-issue IDBs, among others, all will fall under this cap. In 1985, over $5 billion in mortgage revenue bonds alone were sold in the state of California.

In San Francisco, with perhaps the most acute housing crunch in the state, if not the Country, over $300 million in housing bonds were sold by the City and its Redevelopment Agency. This was the culmination of an intense 5-year effort by Mayor Feinstein to increase the housing supply in a City with a rental vacancy rate below 0.5%, and where the average cost of a home last year was $165,000. Indeed, of the 5,000 new housing units built in San Francisco during the previous five years, over 80% were financed with tax-exempt bonds.

I can foresee no plausible way in which a rational allocation scheme can be devised to accommodate even a fraction of the housing needs of the state under this volume cap. City would be pitted against city, and I can almost guarantee a fight among local governments, redevelopment agencies, and the

California Housing Finance Agency, for the few dollars of bonding authority available. More importantly, it would be almost impossible for developers to plan projects, given the uncertainty in obtaining financing. These are decisions that no state legislature should be forced to make.

In San Francisco, the effects of this uncertainty have been immediate. At risk are the following housing proposals, each of which combines a number of public purpose objectives:

1) Polytechnic High School site: Last year, the City contributed $2.5 million from its general fund to prepay a long-term lease from the School District for the site of this long-vacant, surplus high school in the Haight-Ashbury neighborhood. Bids are due next week from developers to build up to 180 units of housing, 30% of which must serve low- and another 30% moderate-income households.

2) Gartland site: The nonprofit Mission Housing Development Corp. plans to build up to 50 units of affordable family housing on this site in the Mission district, a long-time eyesore purchased with Community Development Block Grant funds.

3) Rincon Plaza: The City has been working for almost two years with a developer to build 290 apartments on a site near the foot of the Bay Bridge in the newly rezoned Rincon Hill neighborhood. An area of old warehouses and lots South of Market Street, it has just been rezoned from nonresidential to residential use, to protect it from office development.

4) Van Ness Plaza: Similarly, the City is rezoning its Van Ness Avenue corridor to promote residential development. If tax-exempt financing is available, a developer will build the first apartment development, of 202 units, under this plan.

SINGLE-FAMILY MORTGAGE BONDS/TAX ALLOCATION BONDS

The volume cap problem is so compelling in California to local governments that other problems pale by comparison. Two other problems, however, are of particular concern in California:

1. Income limits for single-family bonds: The House bill imposes for the first time at the federal level income limits for first-time homebuyers in single-family bond issues. It would require that half of the buyers in an issue have incomes below 115% of the area median, and the other half have incomes below 90% of the median.

   This Committee has taken the lead in setting state income limits (a maximum of 150% of area median) for single-family bond issues that are appropriate for California's high costs and desire to promote new construction. The House bill would render most programs in the state unworkable. In this regard, San Francisco's situation is instructive: In order to serve as many lower-income buyers as possible, San Francisco has set aside a number of surplus public and redevelopment sites for affordable housing. The land is donated at no cost to a developer who, in turn must aside 30% of the units for low-income (80% of area median) buyers, and 30% for moderate-income (120% of area median). The program has been a tremendous success, but is economically feasible only because the developer can sell a portion of the homes to families with incomes up to the state maximum of 150% of median. The provision in the House bill would thus have the ironic effect of making it impossible for San Francisco to target a portion of its bond proceeds to lower-income people. In addition, it would favor states in which bond issues are used largely to finance the purchase of less costly existing homes; in California, where 60% of the bond proceeds must be used to finance new units, the proposed income limits will prove largely unworkable.

2. Tax Allocation Bonds: I believe other witnesses will address in more detail the problems presented by the House bill for Redevelopment Agencies planning to finance land clearance and improvements, housing, and other activities through the sale of tax allocation bonds. I can confirm that the proposed restrictions in the House bill would severely hamper San Francisco's redevelopment efforts, particularly in the pioneering Yerba Buena and South Beach redevelopment areas.

It is clear that the House tax reform bill will impact California severely, particularly through its ill-conceived and inequitable volume cap. I would urge the Committee to ask Senators Cranston and Wilson either to push for the removal of housing from the volume cap, or at least to see that a "hold-harmless" provision is included in the bill, to protect high-bond-volume/high-growth states like California from an immediate jolt to their economies. As it now stands, the bill would have the effect of "exporting" investment capital and jobs from California to other states.

I would also point out to the Committee that this bill, in combination with the impact of the Gramm-Rudman cuts in Washington, acts as a "double-whammy" to local governments. Tax-exempt bond financing is the only mechanism left to us to help provide affordable housing, and yet the House bill would effectively eliminate that in California.

In closing, I would like to thank Senator Marks and this Committee not only for conducting this hearing, but for your role over the years in promoting legislation to enable local governments to finance affordable housing and other local development activities. We need you help now more than ever.