



# Private Activity Bonds: An Introduction

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## Summary

The federal tax code classifies state and local bonds as either governmental bonds or private activity bonds. Governmental bonds are for projects that benefit the general public, and private activity bonds are for projects that primarily benefit private entities.

The federal tax code allows state and local governments to use tax-exempt bonds to finance certain projects that would be considered private activities. The private activities that can be financed with tax-exempt bonds are called “qualified private activities.” Congress uses an annual state volume cap to limit the amount of tax-exempt bond financing generally and restricts the types of qualified private activities that would qualify for tax-exempt financing to selected projects defined in the tax code.

Although this report does not include a comprehensive economic analysis of tax-exempt private activity bonds, it does provide some background on the reasons for the federal limitation on tax-exempt bonds for private activities. In addition, this report explains the rules governing qualified private activity bonds, describes the federal limitations on private activity bonds, lists the qualified private activities, and reports each state’s private activity bond volume cap.

Since private activity bonds were defined in 1968, the number of eligible private activities has been gradually increased from 12 activities to 21. The state volume capacity limit has increased from \$150 million and \$50 per capita in 1986 to the greater of \$262.095 million or \$85 per capita in 2008. Because of the \$262.095 million floor, most small states (21 states and the District of Columbia) are allowed to issue relatively more private activity bonds (based on the level of state personal income) than larger states (29 states). Also, more recent additions to the list of qualified activities have been exempt from a state-by-state cap and subject to a national aggregate cap.

For more on tax-exempt bonds generally, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Steven Maguire. This report will be updated as legislative events warrant.

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## Overview and Issues for Congress

State and local governments issue debt for most large public capital projects such as new schools, public buildings, and roads. On occasion, state and local governments will issue debt for projects whose purpose is less public in nature, such as privately owned and operated multifamily residential housing. Nevertheless, these projects are often afforded the same tax privilege as debt issued for strictly government owned and operated projects. Congress limits the use of tax-exempt bonds for private activities because of concern about the overuse of tax-exempt, private activity bonds. The tax-exempt bonds issued for qualified private activities are limited by the type of activity financed and the volume of debt used for such activities.

### Overview

The federal tax code classifies state and local government bonds as either governmental bonds or private activity bonds. Generally, the interest on state and local governmental bonds is exempt from taxation whereas the interest on private activity bonds is not tax-exempt.<sup>1</sup> However, the federal tax code allows state and local governments to use tax-exempt bonds to finance certain projects that would otherwise be classified as private activities.<sup>2</sup> The private activities that can be financed with tax-exempt bonds are called “qualified private activities.”<sup>3</sup>

The current tax exemption for qualified private activities has evolved over time. Two events, however, critically shaped the current treatment of private activity bonds. First, in 1968, Congress passed the Revenue and Expenditure Control Act of 1968 (P.L. 90-364) which established the basis for the current definition of private activity bonds. After persistent challenges to the right of the federal government to restrict state and local government debt following the 1968 Act, the Supreme Court agreed to hear a case in 1988 that changed the nature of the federal tax treatment of state and local government debt. In that case, the state of South Carolina challenged the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248). The 1982 Act required that state and local government tax-exempt debt must be registered.<sup>4</sup> The registration requirement was viewed by the states, South Carolina in particular, as an unconstitutional intrusion on the ability of states to issue debt. The Supreme Court held that the registration requirement for non-federal government, though federally tax-exempt, debt was constitutional. In somewhat of a surprise to observers at the time, the Court went beyond the registration ruling and also held the following:

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<sup>1</sup> The tax-exemption is provided for in 26 U.S.C. 103.

<sup>2</sup> The Internal Revenue Service (IRS) uses a two part test to classify an activity as a private activity. This test will be explained in more detail later in the report. Generally, activities are classified as “private” because private individuals and businesses benefit directly from debt issued by the state or local government.

<sup>3</sup> 26 U.S.C. 141 describes requirements for qualified private activity bonds.

<sup>4</sup> Before this act was passed, state and local government usually issued bearer bonds that paid principal and interest to whomever presented the bond to the issuer (or the issuer’s agent, usually a bank). In contrast, a registered bond includes the owner’s name on the bond and a change in ownership must be registered with the issuer (or the issuer’s agent). For a full discussion of the impact of the South Carolina vs. Baker case on tax-exempt bonds, see Bruce Davie and Dennis Zimmerman, “Tax-Exempt Bonds After the South Carolina Decision,” *Tax Notes*, vol. 39, no. 13, June 27, 1988, p. 1573.

The owners of state [and local] bonds have no constitutional entitlement not to pay taxes on income they earn from the bonds, and states have no constitutional entitlement to issue bonds paying lower interest rates than other issuers.<sup>5</sup>

The ruling confirmed that Congress can restrict issuance of state and local tax-exempt debt and could even rescind the tax-exemption altogether.<sup>6</sup> Nevertheless, outright repeal of the tax-exemption is unlikely. Instead, Congress has limited legislative action to modification of the existing rules and definitions governing tax-exempt bonds for private activities. Generally, Congress limits the amount of tax-exempt debt that can be used for private-activities and restricts the type of private activities that can be financed with tax-exempt bonds. Congress can, and does, encourage selected private activities by exempting the activity from the volume cap or by allowing tax-exempt financing for the private activity.

### **Issues for Congress**

As noted above, Congress uses two primary means to restrain the use state and local debt for private activities: an annual state volume limit (or separate national aggregate limit) and restrictions on the type of qualified private activities. The private activity bond volume limit, which originated in the Deficit Reduction Act of 1984 (P.L. 98-369), was implemented because “Congress was extremely concerned with the volume of tax-exempt bonds used to finance private activities.”<sup>7</sup> The limit and the list of qualified activities were both modified again under the Tax Reform Act of 1986 (TRA 1986, P.L. 99-514). At the time of the TRA 1986 modifications, the Joint Committee on Taxation identified the following specific concerns about tax-exempt bonds issued for private activities:<sup>8</sup>

- the bonds represent “an inefficient allocation of capital”;
- the bonds “increase the cost of financing traditional governmental activities”;
- the bonds allow “higher-income persons to avoid taxes by means of tax-exempt investments”; and
- the bonds contribute to “mounting [federal] revenue losses.”

The inefficient allocation of capital arises from the economic fact that additional investment in tax-favored private activities will necessarily come from investment in other public projects. For example, if bonds issued for mass commuting facilities did not receive special tax treatment, the bond funds could be used for other government projects such as schools or other public infrastructure.

The greater volume of tax-exempt private activity bonds then leads to the second Joint Committee on Taxation concern, higher cost of financing traditional government activities. Investors have limited resources, thus, when the supply of tax-exempt bond investments increases, issuers must

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<sup>5</sup> *State of South Carolina vs. J.A. Baker, Secretary of the Treasury*: Supreme Court of the United States, April 20, 1988. 485 U.S. 505.

<sup>6</sup> *Ibid.*

<sup>7</sup> U.S. Congress, Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98<sup>th</sup> Cong., 2<sup>nd</sup> sess. (Washington: GPO, 1984), p. 930.

<sup>8</sup> U.S. Congress, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100<sup>th</sup> Cong., 1<sup>st</sup> sess. (Washington: GPO, 1987), p. 1151.

raise interest rates to lure them into investing in existing government activities. In economic terms, issuers raising interest rates to attract investors is analogous to a retailer lowering prices to attract customers.

The final two points are less important from an economic efficiency perspective but do cause some to question the efficacy of using tax-exempt bonds to deliver a federal subsidy. Tax-exempt interest is worth more to taxpayers in higher brackets, thus, the tax benefit flows to higher income taxpayers, which leads to a less progressive income tax regime.

The revenue loss generated by tax-exempt bonds also expands the deficit (or shrinks the surplus). A persistent budget deficit ultimately leads to generally higher interest rates as the government competes with private entities for scarce investment dollars. Higher interest rates further increase the cost of all debt financed state and local government projects.

Supporters of tax-exempt bonds for private activities counter that the benefit from tax-exempt bonds exceeds both the explicit (the revenue loss) and implicit (the inefficient allocation of capital) costs of the tax-exemption.

The debate surrounding use of tax-exempt bonds will continue well beyond the current Congress. Proponents and opponents of tax-exempt bonds generally, and private activity bonds specifically, both explore methods of modifying the rules for private activity bonds to advance their respective positions. Because the rules and definitions for private activity bonds are complex, uncertainty about the potential effects of the proposed modifications to those rules is common. This report will not attempt to either justify or criticize the existence of or use of tax-exempt private activity bonds.<sup>9</sup> Instead, the report provides a brief review of bond fundamentals and a more detailed examination of the rules and definitions surrounding private activity bonds to help clarify the impact of the of those modifications.

## **Fundamentals of Private Activity Bonds**

### **Interest Rates on Tax-Exempt vs. Taxable Bonds**

Tax-exempt bonds for governmental purposes and for qualified private activities are special because, unlike corporate bonds or U.S. Treasury bonds, the bond buyer does not have to include the interest income from the bond in federal gross taxable income.<sup>10</sup> The bond buyer is willing to accept a lower interest rate because the interest income is not subject to federal income taxes. The lower interest rate arising from the tax-exempt status subsidizes state and local investment in capital projects. For example, if the taxable bond interest rate is 7.00%, the after-tax return for a taxpayer in the 35% income tax bracket who buys a taxable bond is 4.55%. Thus, a tax-exempt bond that offers a 4.55% interest rate would be just as attractive to the investor as the taxable bond, all else equal. For more on tax-exempt bonds generally, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Steven Maguire.

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<sup>9</sup> For a comprehensive economic assessment of private activity bonds, see Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds: Controlling Public Subsidy of Private Activity* (Washington, D.C.: The Urban Institute Press, 1991).

<sup>10</sup> The discussion here does not address the effect of state taxes on the tax-exempt debt of other states. For example, taxpayers in Virginia must pay Virginia income taxes on the tax-exempt (exempt from federal income taxes) debt of other states. However, Virginia taxpayers do not have to pay income taxes on interest earned on Virginia bonds.

### Interest Rate Spread

In 2007, the average high-grade corporate bond rate was 5.52% and the average high-grade municipal (tax-exempt) bond rate was 4.42% (see **Table 1**).<sup>11</sup> The actual interest rate spread, the difference between the two interest rates, is smaller empirically than the earlier example because many tax-exempt bond buyers are below the 35% marginal tax bracket. Individuals in income tax brackets below 35% would require a higher tax-exempt bond interest rate because lower tax rates mean less tax savings from tax-exempt bonds.<sup>12</sup> The lower tax bracket taxpayers bid up the tax-exempt bond interest rate closer to the taxable bond interest rate.

**Table 1** reports the interest rate of corporate bonds and tax-exempt municipal bonds of like maturity for 1980 through 2007. Bonds issued by state and local governments are usually called “municipal bonds” by the investment community. Generally, the two rates move in tandem, with the taxable corporate bond interest rate always higher than the tax-exempt municipal bond interest rate.

**Table 1. Yield on Tax-Exempt and Corporate Bonds of Equivalent Risk, the Yield Spread, and the Yield Ratio: 1980 to 2007**

Year	High Grade Tax-Exempt Yield (%)	AAA Corporate Yield(%)	Yield Spread (%)	Yield Ratio (tax-exempt/ corporate)
1980	8.51	11.94	3.43	0.71
1981	11.23	14.17	2.94	0.79
1982	11.57	13.79	2.22	0.84
1983	9.47	12.04	2.57	0.79
1984	10.15	12.71	2.56	0.80
1985	9.18	11.37	2.19	0.81
1986	7.38	9.02	1.64	0.82
1987	7.73	9.38	1.65	0.82
1988	7.76	9.71	1.95	0.80
1989	7.24	9.26	2.02	0.78
1990	7.25	9.32	2.07	0.78
1991	6.89	8.77	1.88	0.79
1992	6.41	8.14	1.73	0.79
1993	5.63	7.22	1.59	0.78
1994	6.19	7.96	1.77	0.78

<sup>11</sup> Interest rate averages are composites of a variety of bond issues and provide a good benchmark for market interest rates for municipal bonds.

<sup>12</sup> For example, someone in the 10% income tax bracket would find tax-exempt bonds attractive only if the interest rate were 6.37%. Or, looking at the problem from a different perspective, the marginal tax rate below which tax-exempt bonds are not attractive is 16.58%. Thus, taxpayers in marginal tax brackets below this rate would not find tax-exempt bonds attractive investments because the market interest rate on municipal bonds would be too low. Taxpayers in the 15% marginal tax bracket would receive a higher after-tax return though buying taxable bonds and paying taxes on the interest income at the 15% rate.

Year	High Grade Tax-Exempt Yield (%)	AAA Corporate Yield(%)	Yield Spread (%)	Yield Ratio (tax-exempt/ corporate)
1995	5.95	7.59	1.64	0.78
1996	5.75	7.37	1.62	0.78
1997	5.55	7.26	1.71	0.76
1998	5.12	6.53	1.41	0.78
1999	5.43	7.04	1.61	0.77
2000	5.77	7.62	1.85	0.76
2001	5.19	7.08	1.89	0.73
2002	5.05	6.49	1.44	0.78
2003	4.73	5.67	0.94	0.83
2004	4.63	5.63	1.00	0.82
2005	4.29	5.24	0.95	0.82
2006	4.42	5.59	1.17	0.79
2007	4.42	5.52	1.10	0.80

**Source:** Council of Economic Advisors, *Economic Report of the President*, February 2008, Table B-73.

### *Tax-Exempt Bonds and the AMT*

Unlike tax-exempt government purpose bonds, the interest income from tax-exempt private activity bonds is included in the alternative minimum tax (AMT) base. The AMT is a tax that is levied in parallel with the income tax and is intended to ensure that taxpayers with many deductions and exemptions pay a minimum percentage of their gross income in taxes. Because private activity bonds are included in the AMT the bonds usually carry a slightly higher interest rate (approximately 50 basis points<sup>13</sup> higher) than do tax-exempt government-purpose bonds, all else equal.<sup>14</sup> However, the private activity bond rate is still lower than the taxable bond rate. For more on the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

Repealing the AMT or exempting some bonds issued for qualified private activities from the AMT would increase investor demand for those bonds. The increased attractiveness of those bonds would eventually lead to lower interest costs for the issuer of private activity bonds.

### **Technical Definition of Private Activity Bonds**

A private activity bond is one that primarily benefits or is used by a private entity. The tax code defines *private business (or private entity) use* as “...use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For purposes of the preceding sentence, use as a member of the general public shall not be taken into account.”<sup>15</sup> Two conditions

<sup>13</sup> 50 basis points is equivalent to one-half of a percentage point or 0.50%.

<sup>14</sup> Jacob Fine, “AMT Spreads on the Rise,” *The Bond Buyer*, July 26, 2000, p. 1.

<sup>15</sup> 26 U.S.C. 141(b)(6)(A)



or tests are used to assess the status of a bond issue with regard to the private entity test. Satisfying both conditions would mean the bonds are taxable private activity bonds. Bonds are *private activity bonds* and **not** tax-exempt if both of the following conditions are met:<sup>16</sup>

- [use test] more than 10% of the proceeds of the issue are to be used for any *private business use*,... [and]
- [security test] if the payment on the principal of, or the interest on, more than 10% of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly secured by any interest in (1) property used or to be used for a private business use, or (2) payments in respect to such property. Or [if the payment is] to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

If a bond issue passes both tests, the bonds are taxable and would carry a higher interest rate. Nevertheless, bond issues that pass both tests can still qualify for tax-exempt financing if they are identified in the tax code as *qualified* private activities. Thus, when those in the bond community refer to tax-exempt private activity bonds, the more technically correct reference is tax-exempt, *qualified* private activity bonds.

## What Are the Qualified Private Activities?

A number of qualified private activities are granted special status in the tax code (see **Table 2**). These activities are called “qualified private activities” because they qualify for tax-exempt financing even though they would likely “pass” the two part private activity test which would otherwise disallow tax-exempt financing. The list of qualified private activities has gradually expanded to 21 activities from the 12 that were originally defined by the Revenue and Expenditure Control Act of 1968. The Tax Reform Act of 1986 kept most of the activities listed in the 1968 Act and reorganized the private activity bond section of the federal tax code.

### *The Revenue and Expenditure Control Act of 1968*

The 1968 Act legislated that the interest payments on industrial development bonds (IDBs, the original private activity bonds) were to be included in taxable income. This was a shift from the previous Internal Revenue Service (IRS) position, which held that the interest on these bonds was not taxable income. The motivation behind the change offered in the 1968 Act was based “...on the theory that industrial development bonds described in the proposed [IRS] regulations were not ‘obligations of a State or any political subdivision’ within the meaning of section 103 since the primary obligor was a not a State or political subdivision.”<sup>17</sup> The 1968 Act also (1) established the basis for the current private use and private security tests; (2) created exceptions to the taxability provision for small issuers; (3) and specified a group of private activities that would qualify for tax-exempt bond financing.

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<sup>16</sup> 26 U.S.C. 141(b)

<sup>17</sup> U.S. Congress, Conference Committees, 1968, Revenue and Expenditure Control Act of 1968, conference report to accompany H.R. 15414, House Report No. 1533, 90<sup>th</sup> Cong., 2<sup>nd</sup> sess. (Washington: GPO, 1968), p. 32.

### ***The Tax Reform Act of 1986***

The 1986 Act, which rewrote the Internal Revenue Code of 1954, renewed most of the previously defined private activities identified in the 1968 Act. Notably, TRA 1986 added one private activity, qualified hazardous waste facilities, and limited the exemption for some previously acceptable private activities, including construction of sports facilities and privately owned (as opposed to government owned) airports, docks, wharves, and mass-commuting facilities. In **Table 2**, the activities that must be government owned to qualify for tax-exempt financing are identified in italics. Before and after enactment of TRA 1986, there were several other additions to the list of qualified private activities. The date of introduction for each qualified private activity is included in the last column of **Table 2**.

### ***Empowerment Zones and New York Liberty Zones***

In addition to private activities listed in **Table 2**, there are special zones where tax-exempt private activity bonds can be issued for qualified economic development projects in that zone. The Empowerment Zone / Enterprise Community (EZ) program has been implemented in rounds and each round is subject to different debt rules. Round I EZ bonds are subject to the state volume cap and each zone can have only \$3 million of EZ bonds outstanding.<sup>18</sup> There are also limits on the amount of Round I EZ bonds any one borrower can have outstanding. An EZ borrower can have an aggregate of \$20 million outstanding for all EZ projects throughout the country.

Round II EZs (and all EZs established after December 31, 2001) are subject to designation “lifetime” caps depending on the urban vs. rural designation and population for urban EZs. For the lifetime of the EZ designation, rural EZs can issue up to \$60 million; urban EZs with population less than 100,000 can issue up to \$130 million; and urban EZs with population greater than 100,000 can issue up to \$230 million. In contrast to Round I EZs, there are no limits on the amount any one entity can borrow for Round II EZs.<sup>19</sup>

The New York Liberty Zone (NYLZ) was established in the wake of the September 11, 2001 terrorist attacks upon New York City.<sup>20</sup> The tax benefits created to foster economic revitalization within the NYLZ included a “Liberty Bond” program. The program allows New York State (in conjunction and coordination with New York City) to issue up to \$8 billion of tax-exempt, private activity bonds for qualified facilities in the NYLZ. Qualified facilities follow the exempt facility rules within section 142 of the IRC. The original deadline to issue the bonds was January 1, 2005, but was recently extended to January 1, 2010, by P.L. 108-311.

### ***The Safe, Accountable, Flexible, Efficient, Transportation Equity Act of 2005***

This legislation created a new type of tax-exempt private activity bond for the construction of rail to highway (or highway to rail) transfer facilities. The national limit is \$15 billion and the bonds

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<sup>18</sup> A special EZ for the District of Columbia allows up to \$15 million of outstanding EZ bond debt.

<sup>19</sup> See the following publication for more details on the EZ programs: U.S. Department of Housing and Urban Development, *Tax Incentive Guide for Businesses in the Renewal Communities, Empowerment Zones, and Enterprise Communities: FY2003*. The report is available at the Department of Housing and Urban Development website: <http://www.hud.gov/offices/cpd/economicdevelopment/library/taxguide2003.pdf>.

<sup>20</sup> Section 301 of the *Job Creation and Worker Assistance Act of 2002*, P.L. 107-147, created the various NYLZ tax benefits (26 U.S.C. 1400L). The tax-exempt bond component can be found in 26 U.S.C. 1400L(d).

are not subject to state volume caps for private activity bonds. The Secretary of Transportation allocates the bond authority on a project-by-project basis.

### ***Gulf Opportunity Zone Act of 2005***

The hurricanes that struck the gulf region in late summer 2005 prompted Congress to create a tax-advantaged economic development zone intended to encourage investment and rebuilding in the gulf region. The Gulf Opportunity Zone (GOZ) is comprised of the counties where the Federal Emergency Management Agency (FEMA) declared the inhabitants to be eligible for individual and public assistance. Based on proportion of state personal income, the Katrina-affected portion of the GOZ represents approximately 73% of Louisiana's economy, 69% of Mississippi's, and 18% of Alabama's.<sup>21</sup>

Specifically, the "Gulf Opportunity Zone Act of 2005" (P.L. 109-35, GOZA 2005) contains two provisions that would expand the amount of private activity bonds outstanding and language to relax the eligibility rules for mortgage revenue bonds. The most significant is the provision to increase the volume cap (see **Table 3**) for private activity bonds issued for Hurricane Katrina recovery in Alabama, Louisiana, and Mississippi (identified as the Gulf Opportunity Zone, or "GO Zone"). GOZA 2005 would add \$2,500 per person in the federally declared Katrina disaster areas in which the residents qualify for individual and public assistance. The increased volume capacity would add approximately \$2.2 billion for Alabama, \$7.8 billion for Louisiana, and \$4.8 billion for Mississippi in aggregate over the next five years. The legislation defines "qualified project costs" that can be financed with the bond proceeds as (1) the cost of any qualified residential rental project (26 sec. 142(d)) and (2) the cost of acquisition, construction, reconstruction, and renovation of (i) non residential real property (including fixed improvements associated with such property) and (ii) public utility property (26 sec. 168(i)(10)) in the GOZ. The additional capacity would have to be issued before January 1, 2011. The provision is estimated to cost \$1.556 billion over the 2006-2015 budget window.<sup>22</sup>

The second provision allows for advance refunding of certain tax-exempt bonds. Under GOZA 2005, governmental bonds issued by Alabama, Louisiana, and Mississippi may be advance refunded an additional time and exempt facility private activity bonds for airports, docks, and wharves once. Private activity bonds are otherwise not eligible for advance refunding. Following is a brief description of advance refunding and how the GOZA 2005 provision confers a significant tax benefit to the gulf states.

Refunding is the practice of issuing new bonds to buy back outstanding bonds to potentially lower interest costs. *Advance* refunding is the practice of allowing the new bonds to be outstanding for longer than 90 days. Advance refunding, thus, allows for the existence of two sets of federally tax-exempt bond issues to be outstanding at the same time for a single project. GOZA 2005 allows the states of Alabama, Louisiana, and Mississippi to advance refund \$1.125 billion, \$4.5 billion, and \$2.25 billion, respectively. This provision was estimated to cost \$741 million

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<sup>21</sup> See CRS Report RL33154, *The Impact of Hurricane Katrina on the State Budgets of Alabama, Louisiana, and Mississippi*, by Steven Maguire.

<sup>22</sup> The 10-year revenue loss estimates for GOZA 2005 are from the Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4440, the 'Gulf Opportunity Tax Relief Act of 2005,'* as passed by the House of Representatives and the Senate on Dec. 16, 2005, JCX-89-05, Dec. 20, 2005.

over the 2006-2015 budget window.<sup>23</sup> For more on advance refunding, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Steven Maguire.

## IRS Review of Tax-Exempt Status

The IRS often reviews the tax-exempt status of outstanding bonds issued for *qualified* private activities. If the bonds that were originally issued as tax-exempt are found to no longer qualify (meaning that they pass both the security and use tests) the interest on the bonds becomes taxable. Technically, bond holders are the recipient of the tax benefit and are responsible for remitting forgone taxes to the Treasury when a tax-exempt bond fails to qualify. A *retroactive* taxability finding means all previous tax benefits to the bond holder would have to be returned to the Treasury. A *prospective* taxability finding means all future interest payments would be taxable to the bond holder. However, in most cases, the IRS will settle the apparent violation by requiring that the issuer, not the bond holders, pay a monetary penalty and that the issuer change the circumstances that led to the non-compliance finding.<sup>24</sup>

## What Is the Private Activity Volume Cap?<sup>25</sup>

The federal government has limited the amount of private activity bonds that states can issue to a subset of the 21 activities listed in **Table 2** and to EZ bonds. The third column of **Table 2** identifies the 13 activities (of the 21) that are subject to an annual state volume cap. The annual cap was increased from the greater of \$50 per capita or \$150 million in 2000, to the greater of \$85 per capita or \$262.095 million in 2008 (and is now adjusted for inflation). For small states, the \$262.095 million minimum provides a more generous volume cap than the per capita allocation. **Table 3** lists the volume cap amount in 2007 and 2008 for all states and territories and compares the 2008 cap to state personal income in 2007.

Of the 13 activities subject to an annual volume cap, two are treated differently than the others, and two others are subject to a separate cap. First, states are required to count only 25% of the bonds issued for high-speed intercity rail facilities (26 U.S.C. 142(I)) against the annual cap. If the facility is government owned and operated, no cap allocation is required. Second, bonds issued for solid waste disposal facilities (26 U.S.C. 142(a)(6)) are not subject to the cap if the facility is government owned and operated. Qualified public educational facilities (26 U.S.C. 142(k)), are subject to a separate annual cap which is the greater of \$10 per capita or \$5 million. The two newest activities, bonds for green buildings (26 U.S.C. 142(l)) and highway-freight transfer facilities (26 U.S.C. 142(m)), are subject to a separate cap. Green buildings are subject to a \$2 billion lifetime (not annual) cap and transfer facilities are subject to annual national caps ranging from \$130 million for 2005 rising to \$2 billion from 2011 through 2015 (for a total of \$15 billion).<sup>26</sup>

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<sup>23</sup> JCT, Dec. 20, 2005.

<sup>24</sup> See the following IRS website for more information on tax-exempt bond rulings and findings: <http://www.irs.gov/compliance/index.html>.

<sup>25</sup> 26 U.S.C. 146.

<sup>26</sup> For more on the transfer facility private activity bond program, see U.S. Department of Transportation, "Applications for Authority for Tax-Exempt Financing of Highway Projects and Rail-Truck Transfer Facilities," 71 *Federal Register* 642, Jan. 5, 2006.

The total 2008 private-activity bond volume cap for all states and the District of Columbia is over \$28 billion. California is allowed to issue over one-tenth of total new volume in 2008 or \$3.1 billion (see **Table 3**). However, as measured against total California personal income, the new volume cap is considerably less than the national average. For every \$100 of 2007 personal income in California, approximately \$0.20 of private activity debt can be issued in 2008 whereas the U.S. average is \$0.39.<sup>27</sup> In contrast, North Dakota could issue up to \$1.18 of private activity debt for every \$100 of personal income (see the last column of **Table 3**). The less populous states are more likely to not use the entire annual cap amount for this reason.<sup>28</sup>

**Table 2. Qualified Private Activities**

Internal Revenue Code Section	Type of Private Activity ( <i>Italicized activities must be owned by the issuing government to qualify</i> )	Subject to Volume Cap	Year Established
<b>Sec. 142</b>	<b>Exempt facility bonds</b>		
Sec. 142(c)	<i>Airports</i>	No	1968
Sec. 142(c)	<i>Docks and wharves</i>	No	1968
Sec. 142(c)	<i>Mass commuting facilities</i>	Yes	1981
Sec. 142(e)	Water furnishing facilities	Yes	1968
Sec. 142(a)(5)	Sewage facilities	Yes	1968
Sec. 142(a)(6)	Solid waste disposal facilities	Yes/No <sup>a</sup>	1968
Sec. 142(d)	Qualified residential rental projects	Yes	1968
Sec. 142(f)	Local electric energy or gas furnishing facility	Yes	1968
Sec. 142(g)	Local district heating and cooling facilities	Yes	1982
Sec. 142(h)	Qualified hazardous waste facilities	Yes	1986
Sec. 142(l)	High-speed intercity rail facilities	Yes <sup>b</sup>	1988
Sec. 142(j)	<i>Environmental enhancements of hydroelectric generating facilities</i>	No	1992
Sec. 142(k)	Qualified public educational facilities	No <sup>c</sup>	2001
Sec. 142(l)	Qualified green building and sustainable design projects	No <sup>c</sup>	2005
Sec. 142(m)	Qualified highway and surface freight transfer facilities	No <sup>c</sup>	2005
<b>Sec. 143</b>	<b>Mortgage revenue bonds</b>		
Sec. 143(a)	Qualified mortgage bond	Yes	1968
Sec. 143(b)	Qualified veterans' mortgage bond	No	1968
<b>Sec. 144(a)</b>	<b>Qualified small issue bond</b>	Yes	1968
<b>Sec. 144(b)</b>	<b>Qualified student loan bond</b>	Yes	1976

<sup>27</sup> The states were each given equal weight for the average calculation. The values in the last column of **Table 3** were summed then divided by 51.

<sup>28</sup> For more on state use of the volume cap, see CRS Report RL34159, *Private Activity Bonds: An Analysis of State Use, 2001 to 2006*, by Steven Maguire and Heather Durkin Negley.

Internal Revenue Code Section	Type of Private Activity (Italicized activities must be owned by the issuing government to qualify)	Subject to Volume Cap	Year Established
<b>Sec. 144(c)</b>	<b>Qualified redevelopment bond</b>	Yes	1968
<b>Sec. 145</b>	<b>Qualified 501(c)(3) bond</b>	No	1968

a. Exempt from the cap if governmentally owned. Subject to the cap if privately owned.

b. 25% of the bond issue is included in the cap. If the facility is owned by a governmental unit, no cap allocation is required. In addition, if the facility is not governmentally owned, to qualify for tax-exempt status, the owner must elect not to claim any depreciation deductions or investment tax credits with respect to the property financed with the bonds.

c. Educational facility bonds are subject to a separate cap: the greater of \$10 per capita or \$5 million. Green building bonds are subject to a national aggregate amount of \$2 billion through the expiration of the program, scheduled for October 1, 2009. Highway bonds are subject to the following annual issuance limits: \$130 million in 2005; \$750 million each year for 2006 through 2009; \$1.87 billion in 2010; and \$2 billion each year for 2011 through 2015, zero thereafter.

**Table 3. Annual State Private Activity Bond Volume Cap, 2007 and 2008**

State	2007 Volume Cap (\$ millions)	2008 Volume Cap (\$ millions)	2007 Personal Income (\$ millions)	2008 Cap per \$100 of 2007 Personal Income
Alabama <sup>a</sup>	390.9	393.4	149,959	\$0.26
Alaska	256.2	262.1	27,580	\$0.95
Arizona	524.1	538.8	209,361	\$0.26
Arkansas	256.2	262.1	85,214	\$0.31
California	3,099.0	3,107.0	1,519,547	\$0.20
Colorado	404.0	413.2	199,525	\$0.21
Connecticut	297.9	297.7	189,535	\$0.16
Delaware	256.2	262.1	35,116	\$0.75
District of Columbia	256.2	262.1	35,940	\$0.73
Florida	1,538.0	1,551.0	701,647	\$0.22
Georgia	795.9	811.3	319,339	\$0.25
Hawaii	256.2	262.1	50,359	\$0.52
Idaho	256.2	262.1	46,776	\$0.56
Illinois	1,091.0	1,092.0	518,245	\$0.21
Indiana	536.6	539.4	213,302	\$0.25
Iowa	256.2	262.1	104,651	\$0.25
Kansas	256.2	262.1	102,069	\$0.26
Kentucky	357.5	360.5	131,956	\$0.27
Louisiana <sup>a</sup>	364.5	364.9	149,214	\$0.24
Maine	256.2	262.1	44,418	\$0.59
Maryland	477.3	477.6	258,561	\$0.18
Massachusetts	547.2	548.2	316,568	\$0.17

State	2007 Volume Cap (\$ millions)	2008 Volume Cap (\$ millions)	2007 Personal Income (\$ millions)	2008 Cap per \$100 of 2007 Personal Income
Michigan	858.1	856.1	353,376	\$0.24
Minnesota	439.2	441.8	213,282	\$0.21
Mississippi <sup>a</sup>	256.2	262.1	84,193	\$0.31
Missouri	496.6	499.7	202,153	\$0.25
Montana	256.2	262.1	31,090	\$0.84
Nebraska	256.2	262.1	64,721	\$0.41
Nevada	256.2	262.1	103,847	\$0.25
New Hampshire	256.2	262.1	54,622	\$0.48
New Jersey	741.6	738.3	427,297	\$0.17
New Mexico	256.2	262.1	62,002	\$0.42
New York	1,641.0	1,640.0	914,432	\$0.18
North Carolina	752.8	770.2	304,781	\$0.25
North Dakota	256.2	262.1	22,291	\$1.18
Ohio	975.6	974.7	399,897	\$0.24
Oklahoma	304.2	307.5	123,541	\$0.25
Oregon	314.6	318.5	130,353	\$0.24
Pennsylvania	1,057.0	1,057.0	482,245	\$0.22
Rhode Island	256.2	262.1	41,745	\$0.63
South Carolina	367.3	374.7	136,696	\$0.27
South Dakota	256.2	262.1	26,996	\$0.97
Tennessee	513.3	523.3	204,896	\$0.26
Texas	1,998.0	2,032.0	888,926	\$0.23
Utah	256.2	262.1	82,506	\$0.32
Vermont	256.2	262.1	22,782	\$1.15
Virginia	649.6	655.5	318,873	\$0.21
Washington	543.6	549.8	261,415	\$0.21
West Virginia	256.2	262.1	53,522	\$0.49
Wisconsin	472.3	476.1	201,921	\$0.24
Wyoming	256.2	262.1	22,600	\$1.16
<b>U.S. Total</b>	<b>28,186.2</b>	<b>28,476.3</b>	<b>11,645,883</b>	<b>\$0.39</b>

**Sources:** Personal income data are from the Bureau of Census, State Annual Personal Income, available at <http://www.bea.gov/bea/regional/spi/>. Bond volume cap information for 2007 and 2008 is from the *Bond Buyer*, SourceMedia Inc., 2008.

- a. Under the Gulf Opportunity Zone Act of 2005, P.L. 109-135, Alabama, Louisiana, and Mississippi, can issue before Jan. 1, 2011, in aggregate, an additional (CRS estimated) \$2.17 billion, \$7.88 billion, and \$4.92 billion, respectively.

This disparity arises from the two part volume capacity calculation which provides for a minimum of \$262.095 million, regardless of state population. In addition, states that have total

personal income below the national average would also have a relatively high debt allowance as measured against personal income. The last column of **Table 3** provides a comparative measure of the state-by-state volume capacity based on 2007 personal income.

### Allocation by Type of Activity

Each state independently determines the allocation of its volume capacity. **Table 4** identifies the total cap distribution for private activities in 2004, 2005, and 2006. The category names used by the *Bond Buyer* newspaper, the source of the data, differ from the more detailed names for the private activities used in the tax code and listed in **Table 2**. Nevertheless, the *Bond Buyer* data roughly reflect the cap allocation preferences of the states and their subdivisions. Note that 46.5% of the available volume capacity for 2006 was not used and carried forward to 2007 (\$22,638 million).

From 2005 to 2006, the amount of capacity dedicated to mortgage revenue bonds (MRBs) increased significantly. In 2005, \$6.5 billion was used for MRBs and in 2006 the amount climbed to \$10.1 billion, a 55% annual increase. In 2006, MRBs accounted for more than one-fifth of bond volume capacity.<sup>29</sup>

Unused volume capacity can be carried forward for up to three years, as long as the state identifies the project for which the cap space is dedicated. Bond capacity that has not been used after three years is then abandoned. Abandoned bond capacity was less than 2% of total available capacity in 2004 and 2005, but rose to 2.9% in 2006.

**Table 4. Private Activity Bond Volume by Type of Activity in 2004, 2005, and 2006**

Private Activity	Issued in (\$ millions)		
	2004	2005	2006
Total Volume Capacity Available	43,088	49,142	48,675
New Volume Capacity	25,741	26,079	26,438
Carryover from previous years	17,347	23,063	23,277
Carry forward to next year	22,950	26,337	22,638
Single-family Mortgage Revenue	5,204	6,507	10,093
Multi-family Housing	5,007	5,562	6,252
Student Loans	4,723	5,124	4,018
Exempt Facilities	1,646	1,915	2,605
Industrial Development	797	1,000	1,195
Abandon Capacity	839	910	1,417
Housing not Classified	186	822	562

<sup>29</sup> For more on MRBs, see CRS Report RS22841, *Mortgage Revenue Bonds: Analysis of Sections 3021 and 3022 of the Housing and Economic Recovery Act of 2008*, by Mark P. Keightley and Erika Lunder.



Private Activity	Issued in (\$ millions)		
	2004	2005	2006
Mortgage Credit Certificates	417	493	510
Other Activities	1,320	485	284
	Portion of Available Capacity		
Total Volume Capacity Available	100.0%	100.0%	100.0%
New Volume Capacity	59.7%	53.1%	54.3%
Carryover from previous years	40.3%	46.9%	47.8%
Carry forward to next year	53.3%	53.6%	46.5%
Single-family Mortgage Revenue	12.1%	13.2%	20.7%
Multi-family Housing	11.6%	11.3%	12.8%
Student Loans	11.0%	10.4%	8.3%
Exempt Facilities	3.8%	3.9%	5.4%
Industrial Development	1.9%	2.0%	2.5%
Abandon Capacity	1.9%	1.9%	2.9%
Housing not Classified	0.4%	1.7%	1.2%
Mortgage Credit Certificates	1.0%	1.0%	1.0%
Other Activities	3.1%	1.0%	0.6%

**Source:** "State Allocations and Use of Private Activity Bonds in 2004," *The Bond Buyer*, May 2, 2005; "State Allocations and Use of Private Activity Bonds in 2005," *The Bond Buyer*, May 1, 2006; and "State Allocations of Private Activity Bonds in 2006," *The Bond Buyer*, June 27, 2007.

## Other Restrictions on Private Activity Bonds

The use of private activity bonds is also limited by other technical restrictions. In general, loosening the restrictions would allow issuers to reduce administrative and compliance costs. However, the relaxed restrictions would exacerbate the concerns (i.e., the economically inefficient allocation of capital) surrounding tax-exempt bonds that were discussed earlier in the report. Following is a list of the more technical rules along with the section in the tax code where the rule appears.

- The maturity of the bonds cannot be greater than 120% of the economic life of the asset purchased with the bonds (26 U.S.C. 147(b));
- less than 25% of the bond proceeds can be used to acquire land (except for qualified first-time farmers) (26 U.S.C. 147(c));
- proceeds of the bond issue cannot be used to purchase existing property unless greater than 15% of the cost of acquiring the property is spent on rehabilitating the property (26 U.S.C. 147(d));
- public approval of bonds, either through public hearing and notice or voter referendum, is required for private activity bonds (26 U.S.C. 147(f)); and
- issuance costs cannot be any greater than 2% of the bond proceeds (3.5% for mortgage bond issues of less than \$20 million) (26 U.S.C. 147(g)).
- private activity bonds cannot be advance refunded.<sup>30</sup>

## Conclusion and Further Reading

The history, tax laws, financial properties, and economic effects of tax-exempt bonds are all exceedingly complex and continually evolving. This report is intended to clarify part of the tax-exempt bond labyrinth. Nevertheless, the reader may wish to explore tax-exempt bonds in more depth or from a more general, less technical perspective. The following reading list should equip the reader with a good foundation for pursuit of either objective.

Bruce Davie and Dennis Zimmerman, "Tax-Exempt Bonds After the South Carolina Decision," *Tax Notes*, vol. 39, no. 13, June 27, 1988, p. 1573.

Peter Fortune, "Tax-Exempt Bonds Really Do Subsidize Municipal Capital!," *National Tax Journal*, vol. 51, no. 1, March 1998, p. 43.

Roger H. Gordon and Gilbert E. Metcalf, "Do Tax-Exempt Bonds Really Subsidize Municipal Capital?," *National Tax Journal*, vol. 44, no. 4, part 1, December 1991, p. 71.

George J. Marlin and Joe Mysak, *The Guidebook to Municipal Bonds: The History, The Industry, The Mechanics* (New York: The American Banker/Bond Buyer, 1991).

David J. Ott and Allan H. Meltzer, *Federal Tax Treatment of State and Local Securities* (Washington, D.C.: The Brookings Institution, 1963).

Judy Wesalo Temel, *The Fundamentals of Municipal Bonds, 5<sup>th</sup> Edition* (New York: John Wiley and Sons, 2001).

Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds: Controlling Public Subsidy of Private Activity* (Washington, D.C.: The Urban Institute Press, 1991).

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<sup>30</sup> Current refunding is the practice of issuing bonds to replace existing bonds. Issuers typically do this to "lock-in" lower interest rates or more favorable borrowing terms. Current refunding is allowed as long as the "old" bonds are redeemed within 90 days of the issuance of the refunding bonds. Advance refunding is the practice of issuing new bonds to replace existing bonds, but not immediately (within 90 days) retiring the old bonds. Thus, two sets of tax-exempt bonds are outstanding for the same project.

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