United States Government Accountability Office

GAO

Report to the Committee on Finance, U.S. Senate

February 2008

TAX POLICY

Tax-Exempt Status of Certain Bonds Merits Reconsideration, and Apparent Noncompliance with Issuance Cost Limitations Should Be Addressed

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GAO-08-364

Highlights

Highlights of GAO-08-364, a report to the Committee on Finance, U.S. Senate

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TAX POLICY

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Why GAO Did This Study

The outstanding amount of state and local government tax-exempt bonds has increased over the years. Congress is interested in whether the bonds are used for appropriate purposes since the federal government forgoes billions in tax revenues annually by excluding the bonds' interest from investors' federal gross income. Questions also exist over the bonds' borrowing costs as they can divert funds from the funded projects.

This report (1) describes recent trends in tax exempt bonds, (2) provides information on the types of facilities financed with tax-exempt bonds, and (3) discusses borrowing costs considering the methods of selling bonds and compares issuance costs paid from bond proceeds for governmental and qualified private activity bonds. In addition to interviewing relevant officials, we analyzed IRS's Statistics of Income (SOI) data and data from Thomson Financial to address these objectives.

What GAO Recommends

Congress should consider whether facilities, including hotels and golf courses, that are privately used should be financed with tax-exempt governmental bonds. GAO also recommends that IRS clarify how bond issuers report issuance costs and develop methods to detect and address apparent noncompliance with limits on using bond proceeds for issuance costs.

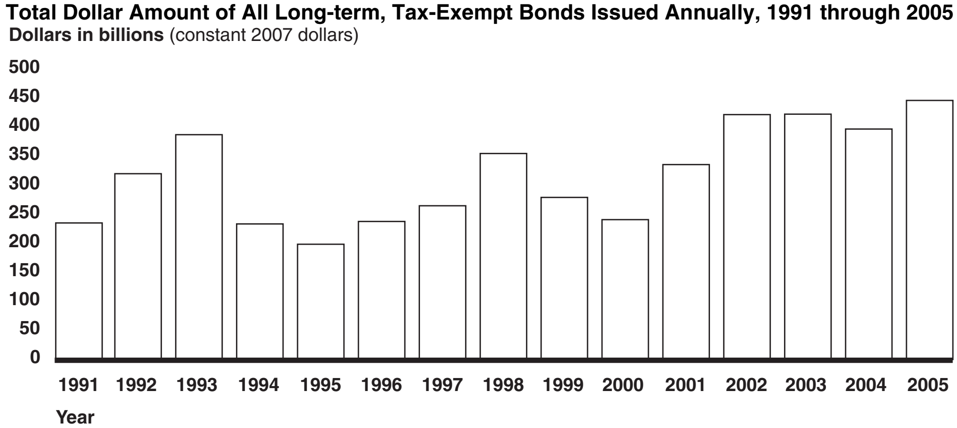
In response, the Acting IRS Commissioner agreed with our recommendations and outlined the actions IRS would take.

To view the full product, including the scope and methodology, click on GAO-08-364. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

In recent years, the volume of tax-exempt bonds issued annually for both governmental and private activity bonds has reached historically high levels. Generally, the volume of new money bond issues has been greater than bonds issued for refunding purposes. The volume of tax-exempt bonds issued, particularly bonds issued for refunding, tends to be highest when interest rates decline. Because the interest earned by investors who purchase tax bonds is generally excluded from federal income taxes, the federal revenue losses amount to billions of dollars annually.

Total Dollar Amount of All Long-term, Tax-Exempt Bonds Issued Annually, 1991 through 2005



Source: GAO analysis of IRS's Statistics of Income Division data.

Note: Amounts include governmental and qualified private activity bonds for new money and refunding bonds. Calendar year 2005 is the most recent available IRS data.

Tax-exempt governmental and private activity bonds are used to finance a wide range of projects and activities, with bonds issued for "educational purposes" generally being the largest category of governmental bonds annually. Nonprofit organizations are the largest issuers of qualified private activity bonds. Previous legislation prohibited using qualified private activity bonds for certain facilities, including professional sports stadiums, hotels, and private golf courses. However, many of these types of facilities are still being financed with tax-exempt governmental bonds. Congress has held hearings on this issue primarily focusing on sports stadiums.

Although the evidence is not definitive, studies have generally shown that interest costs are lower for bonds sold when competition between underwriters exists compared to when bond sales are negotiated with underwriters after controlling for other factors. About half of all issuers of qualified private activity bonds reported paying issuance costs from bond proceeds from 2002 to 2005. IRS's guidance does not indicate what to report when no issuance costs are paid from bond proceeds. Of those reporting issuance costs, some private activity bond issuers reported paying issuance costs from bond proceeds that exceed statutory limits.

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Abbreviations

AMT	alternative minimum tax
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
MSRB	Municipal Securities Rulemaking Board
SOI	Statistics of Income Division
Treasury	Department of the Treasury

United States Government Accountability Office
Washington, DC 20548

February 15, 2008

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

The outstanding volume of state and local government tax-exempt bond debt grew significantly from about $1.4 trillion in 2000 to over $2.1 trillion in 2006 in constant 2007 dollars. Because the tax exemption allows taxpayers to generally exclude the bond interest from their federal gross income, the federal government forgoes tax revenue. According to our analysis of the Department of the Treasury's (Treasury) estimates, forgone federal tax revenues were about $32.0 billion in 2000 and were projected to be about $37.0 billion in 2007.[1] Congressional interest in the use of tax-exempt bonds has heightened because of the large dollar amounts of bonds outstanding coupled with the large amounts of forgone federal tax revenues.

State and local governments have broad discretion in using tax-exempt bonds to finance public infrastructure and other projects. Although state and local governments (and certain nonprofit entities) can use tax-exempt bond financing to subsidize activities of private entities, Congress previously placed limitations on the use of such financing for specific private activities and, in general, has limited the annual volume on such bonds.[2] For example, Congress allows the use of tax-exempt bonds for privately owned facilities such as airports, docks, and wharves subject to annual state-by-state volume caps. In addition, there are special rules for providing tax-exempt bond financing for private uses within certain

[1]Summing the individual tax preference estimates, as is done to obtain these totals, is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions. Despite the limitations in summing separate revenue loss estimates, these are the best available data with which to measure the value of tax expenditures. Other researchers also have summed tax expenditure estimates to help gain perspective on the use of this policy tool and examine trends in the aggregate growth of tax expenditure estimates over time.

[2]Pub. L. No. 99-514 (1986).

geographic areas (e.g., enterprise and empowerment zones, the New York Liberty Zone, and the Gulf Opportunity Zone) to provide incentives for economic development.

Because issuing bonds can be a complex process requiring specialized services in planning and selling the bonds, congressional interest has also focused on the borrowing costs, including interest costs and issuance costs, that bond issuers pay when bonds are issued. Concerns have focused on the methods of selling the bonds because this might affect the interest costs paid by municipal governments and ultimately the amount of federal forgone revenues. Further, issuance costs can divert bond proceeds from the facilities and activities for which the bonds were intended to be used.

To support Congress's efforts to review the types of facilities and activities that are financed with tax-exempt bonds and understand the factors affecting the costs of issuing the bonds, you requested this study. Our objectives were to

- describe recent trends in the dollar volume of tax-exempt bonds;
- provide information on the types of facilities and activities that are financed with tax-exempt bonds, in particular, information on hotels and municipal golf courses that were recently financed with tax-exempt bonds; and
- provide information on borrowing costs that bond issuers pay by summarizing relevant research on whether bond interest costs vary by the method of sale, considering characteristics of the bond and bond issuer and providing information on how bond issuance costs vary between governmental and private activity bonds, including the extent to which private activity bond issuers exceed the statutory limit for issuance costs as a percentage of bond proceeds.

To address our objectives, we obtained information from several sources that are recognized as being reliable sources for data on tax-exempt bonds. To describe recent trends in the dollar amounts and numbers of tax-exempt bonds, we used data from the Internal Revenue Service's (IRS) Statistics of Income Division (SOI), which collects data from the information returns issuers of tax-exempt bonds are required to file with IRS. We also used data contained in the *Bond Buyer Yearbook*, a publication that summarizes information on bond issuances that is widely used as a reference by bond industry experts. To provide information on the facilities and activities financed using tax-exempt bonds, we relied on data from SOI, the *Bond Buyer Yearbook*, and a limited random sample of official statements for tax-exempt bonds. Official statements are used to market the bonds and contain descriptive information on the facilities and activities financed using the bonds. Because we could not find a comprehensive source of information on hotels and municipal golf courses financed with tax-exempt bonds, we provide some limited data from the best available sources we could identify. To provide information on borrowing costs associated with tax-exempt bonds, we summarized relevant recent research on whether interest costs vary considering the method of sale and analyzed SOI data on issuance cost as reported to IRS by bond issuers. For information pertaining to our work in general, we interviewed officials in IRS's Tax-Exempt Bond Office in its Government Entities and Tax-Exempt Division and Treasury's Office of Tax Policy and other experts in taxation and government finance in the Government Finance Officers' Association, the Securities Industry and Financial Markets Association, and the Congressional Research Service.

We determined that the data we used in this report were sufficiently reliable for our purposes. Appendix I provides a detailed description of our methodology, sources, and limitations. We conducted our work from December 2006 through January 2008 in accordance with generally accepted government auditing standards.

Results in Brief

Since 2002, the dollar amount of long-term tax-exempt bonds issued annually has reached historically high levels. Governmental bonds, which are generally issued for traditional public purposes, account for the majority of the bonds issued each year. However, the dollar volume of qualified private activity bonds, which provide tax-exempt financing for facilities and activities that are private in nature and meet certain legal requirements, has also been noticeably higher in recent years. More than half of the bonds issued are new money issues, that is, bonds for new facilities and activities. Because the interest income that investors earn from tax-exempt bonds is generally not included in their federal gross income, the cost to the federal government is significant and growing. Based on estimates by Treasury and the Joint Committee on Taxation (JCT), the federal government forgoes tens of billions of dollars of revenue annually.

The majority of governmental bonds are used for purposes related to education, transportation, and public facilities and activities, whereas qualified private activity bonds are mostly used by 501(c)(3)[3] nonprofit organizations and entities, such as governmental authorities specifically established to support private activities, such as airports, docks, wharves, and other facilities often intended to generate economic development. In the 1980s, Congress passed laws that limited the dollar amount of private activity bonds that could be issued in a given year as well as specifying certain facilities as not being eligible for tax-exempt private activity bond financing, including sports stadiums, hotels, and private golf courses. However, tax-exempt governmental bonds can still be used to finance some of these types of facilities and projects for which tax-exempt private activity bonds can no longer be used. Based on limited information, we found 18 newly constructed hotels that were financed in whole or in part with governmental bonds issued from 2002 through 2006. Also, based on limited information, we found that six municipal golf courses that opened in 2005 were financed by governmental bonds. Recent congressional hearings have raised questions about using governmental bonds for purposes that are private in nature, such as professional sports stadiums, but similar attention has not been focused on other types of facilities that are essentially private in nature.

Although the results varied, recent studies generally showed that the competitive method of selling municipal bonds has lower interest costs, after controlling for other factors, than using the negotiated method of sale. However, several recently issued studies also show that there is not a statistically significant difference in interest costs for bonds sold on a competitive versus negotiated basis. Bond issuance costs vary by size and type of bond for both governmental and private activity bonds. Smaller bonds tend to report higher issuance costs as a percentage of bond proceeds than larger bonds. Some qualified private activity bonds issued from 2002 through 2005 reported issuance costs paid from bond proceeds that exceed statutory limits, an apparent violation of applicable federal laws. For example, from 2002 to 2005, between 17 and 39 qualified private activity bonds annually—about 1 to 2 percent of qualified private activity bonds that reported issuance costs paid from bond proceeds—reported issuance costs that exceeded applicable statutory limits. IRS officials said that these apparent violations merited investigation, but given the large lost revenue implications of certain other forms of noncompliance, IRS would have to address low-cost options for addressing violations of

[3] Section 501(c)(3) of the Internal Revenue Code defines the conditions for nonprofit, or charitable organizations to maintain tax-exempt status.

issuance cost restrictions. Over half of the issuers of qualified private activity bonds issued from 2002 through 2005 reported issuance costs paid from bond proceeds, but for nearly half of issued bonds the issuers left the line on issuance costs blank when reporting to IRS. IRS cannot be sure it is able to detect nonreporting and address apparent violations with the statutory limit on using bond proceeds for issuance costs, in part because its instructions to issuers do not clearly indicate what to report to IRS when no bond proceeds are used for issuance costs.

As Congress considers whether tax-exempt governmental bonds should be used for professional sports stadiums that are generally privately used, it should also consider whether other facilities, including hotels and golf courses, that are privately used should continue to be financed with tax-exempt governmental bonds. Additionally, to help IRS better monitor whether issuers of qualified private activity bonds are complying with the statutory limit on using bond proceeds for issuance costs, we recommend that the Commissioner of Internal Revenue (1) clarify IRS's forms and instructions for reporting issuance costs paid from bond proceeds so that bond issuers are required to clearly designate on the form instances where bond proceeds were not used to pay issuance costs and (2) develop cost-effective methods to address apparent noncompliance with the statutory limits in a manner that would not preclude IRS from examining the bonds for more substantive compliance issues in the future.

The Acting Commissioner of Internal Revenue provided comments on a draft of this report in a February 7, 2008, letter. She said that IRS agrees with our recommendations and indicated specific actions it plans to take to address them. The Treasury Assistant Secretary for Tax Policy also provided comments on a draft of this report in a February 8, 2008, letter. Treasury's comments focused on use of tax-exempt governmental bonds to finance stadiums and other projects with significant private business use. Treasury said that this is arguably a structural weakness in the targeting of the federal tax expenditure for tax-exempt bonds under the existing legal framework and noted options to address this structural weakness. Written comments from IRS are reprinted in appendix VI and written comments from Treasury are reprinted in appendix VII.

Background

Tax-exempt bonds are valid debt obligations of state and local governments. Under Section 103 of the Internal Revenue Code (I.R.C.), the interest earned on most bonds issued by state and local governments is tax-exempt. This means that the interest paid to bondholders is generally not included in their gross income for federal income tax purposes.[4] The tax exemption lowers the bond issuer's borrowing costs and may provide equivalent or higher after-tax yields to investors than alternative investments that are not tax-exempt. Tax-exempt bond financing can apply to different types of debt financing arrangements, including notes, loans, commercial paper, certificates of participation, and tax-increment financing.[5] The tax-exempt status remains throughout the life of the bonds provided that all applicable laws are satisfied. IRS's Tax-Exempt Bond Office in its Tax Exempt and Government Entities division is responsible for administering tax laws pertaining to tax-exempt bonds.

Tax-exempt bonds can be characterized as new money and refunding issues. New money issues refer to bonds used to finance a new project. A refunding issue refers to any bond issue used to pay debt service on and retire an outstanding issue. Typically, refunding is done for reasons such as to reduce the interest rate and ease restrictions on the original bond contract. Refunding issues are either current or advanced based on the timing between the issuance of the new bonds and the maturity date of the outstanding bonds. Current refunding occurs when new bonds are issued within 90 days of the final payment on the prior issue and advance refunding occurs if the new bonds are issued more than 90 days before final payment on the prior issue.

For federal tax purposes municipal bonds are classified as either governmental bonds or private activity bonds. In general, governmental bonds are tax-exempt and are used to build public capital facilities and serve the general public interest. The I.R.C. does not specifically define governmental bonds; rather, all municipal bonds that do not meet the criteria to be classified as private activity bonds are governmental bonds.

[4]States may also allow tax-exempt bond interest to be excluded from state income taxes.

[5]Notes, commercial paper, certificates of participation, and tax-increment financing are all different types of financing arrangements typically used in connection with tax-exempt bonds. Notes have short-term maturities and are issued to address mismatches in timing of expenditures and offsetting revenues. Commercial paper is an unsecured obligation also used to finance short-term credit needs. Certificates of participation are financing arrangements in which an individual buys a share of the lease revenues of an agreement made by a municipal or governmental entity, rather than the bond being secured by those revenues. Tax-increment financing is a way of pledging some of the increased taxes that result when property is redeveloped to pay the costs of associated public investment.

Municipal bonds are classified as private activity bonds, which provide financing to private businesses, if they pass both the private payment and the private business use test. These tests specify that if more than 10 percent of the bond proceeds are used for private business purposes and more than 10 percent of the bond proceeds are secured by payments from property used for private business use, then the bond is a private activity bond. A bond that is classified as a private activity bond can be taxable or tax-exempt. Congress has specified certain private activities (see tables 4 and 5) that can be financed with tax-exempt bonds. Private activity bonds that receive tax-exempt status are called qualified private activity bonds. Private activities that are not "qualified" are taxable.

Generally, qualified private activity bonds are subject to a number of restrictions that do not apply to governmental bonds, including a 2 percent limit on using proceeds of the bond sale to pay issuance costs,[6] annual state-by-state limitations on the volume of bonds that can be issued, and the disallowance for advanced refunding. In addition, the interest income from qualified private activity bonds is an addition to income for purposes of calculating the alternative minimum tax (AMT) whereas the interest on governmental bonds is not.[7] However, some exceptions to these restrictions exist for qualified 501(c)(3) private activity bonds[8] issued by or on behalf of nonprofit entities. Qualified 501(c)(3) bonds do not count toward annual state-by-state volume limits; the interest income on these bonds issued after August 7, 1986, is not subject to AMT rules; and unlike other qualified private activity bonds, qualified 501(c)(3) bonds can be advance refunded.

Tax-exempt bonds can be structured as general obligation or revenue bonds. General obligation bonds, also known as full faith and credit obligations, are secured by revenues obtained from the issuer's general taxing powers, including sales taxes, property taxes, and income taxes.

[6]Qualified private activity bonds for small mortgage revenue bonds and veterans' mortgage revenue bonds are subject to a 3.5 percent limit on bond proceeds for issuance costs.

[7]AMT is a separate federal tax system that applies to both individual and corporate taxpayers. It parallels the income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.

[8]Section 501(c)(3) bonds are issued by charitable organizations that qualify for exemption under I.R.C. § 501(c)(3). Such organizations must be organized and operated exclusively for educational, religious, or charitable purposes, and no part of the organizations' net earnings may inure to or be for the benefit of any shareholders or individuals.

Most general obligation bonds are used to build public infrastructure, such as school buildings, jails, police stations, and city halls, and are classified as governmental bonds for tax purposes. In contrast, revenue bonds are issued to finance specific projects or enterprises and investors get paid from the revenues generated by the financed projects. Revenue bonds can be either governmental bonds or private activity bonds for tax purposes.

In addition to issuing tax-exempt bonds directly, state and local governments may establish other entities to issue bonds "on behalf of" such governmental units, or any political subdivision thereof.[9] For example, a specifically constituted nonprofit corporation acting on behalf of governmental units might own, operate, and issue debt to finance a local airport. In addition to issuing bonds for government operations and services, qualified governmental units are permitted to issue qualified private activity bonds to provide tax-exempt financing for certain private activities. In these cases, the qualified governmental unit generally acts as a conduit, meaning that the qualified governmental unit issues the bonds, but the nongovernmental entity receiving the benefit of tax-exempt financing is required to provide the funds to repay the bonds.

Municipal governments incur costs to issue their bonds. Bond issuance costs include the underwriting spread, which is the difference between the price paid to the issuer by the underwriter and the price at which the bonds are reoffered to investors, and fees for bond counsel, financial advisors, public hearings, printing, and other costs. In addition, at the time bonds are issued, issuers may choose to purchase bond insurance or secure a line of credit to further ensure that principal and interest payments will be made on time. This additional security can improve the bond's credit rating and result in lower interest costs over time for bond issuers. Bond insurance or other types of credit designed to ensure the timely repayment of bonds may not count as issuance costs for the purposes of calculating the 2 percent limit with which qualified private activity bonds generally must comply.

[9]Although not states or subdivisions of states, Indian tribal governments are provided with a tax status similar to state and local governments for specified purposes under I.R.C. § 7871. Among the purposes for which a tribal government is treated similar to a state is the issuance of tax-exempt bonds. However, tribal bond issues are subject to limitations not imposed on state and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.

Bond issuers have two principal avenues for marketing their bonds in the primary market[10]—competitive bids and negotiated sales.[11] In competitive bids, underwriters who sell the bonds compete against each other to market the bonds for the issuer, while in negotiated sales, the issuer selects the underwriter and negotiates the terms of the bond sale. The majority of tax-exempt bonds are issued through negotiated sales. Guidance issued in 1996 and revised in 2007 by the Government Finance Officers' Association on the preferred method of sale emphasized that both methods offer advantages in different circumstances. Generally, competitive sales are favored in cases when the bond has a relatively high credit rating; the bond is secured by strong, long-standing revenue streams; and the structure of the bond does not include innovative financing methods that require explanation to the bond market. Negotiated sales may be preferred in cases where a bond with relatively complex features is to be issued during a time period with volatile interest rates, giving the underwriter and the issuer more flexibility in terms of the timing of the bond issue and the underwriter more time to search for investors better suited to more complex bonds. The revised guidance on the preferred method of sale puts more emphasis on the advantages for issuers to obtain financial advice that is independent from the underwriter.

In offering bonds for sale, various documents may be prepared, including a preliminary (announcing the prospective bond sale) and final (after the bonds have been issued) official statement. Official statements contain information describing the bond issue, including the dollar amount, maturity dates, financing arrangements, and information on the types of facilities and activities being financed. A copy of the final official statement is required to be sent to the Municipal Securities Rulemaking Board (MSRB), a congressionally chartered organization that regulates securities firms and banks involved in underwriting, trading, and selling municipal securities.

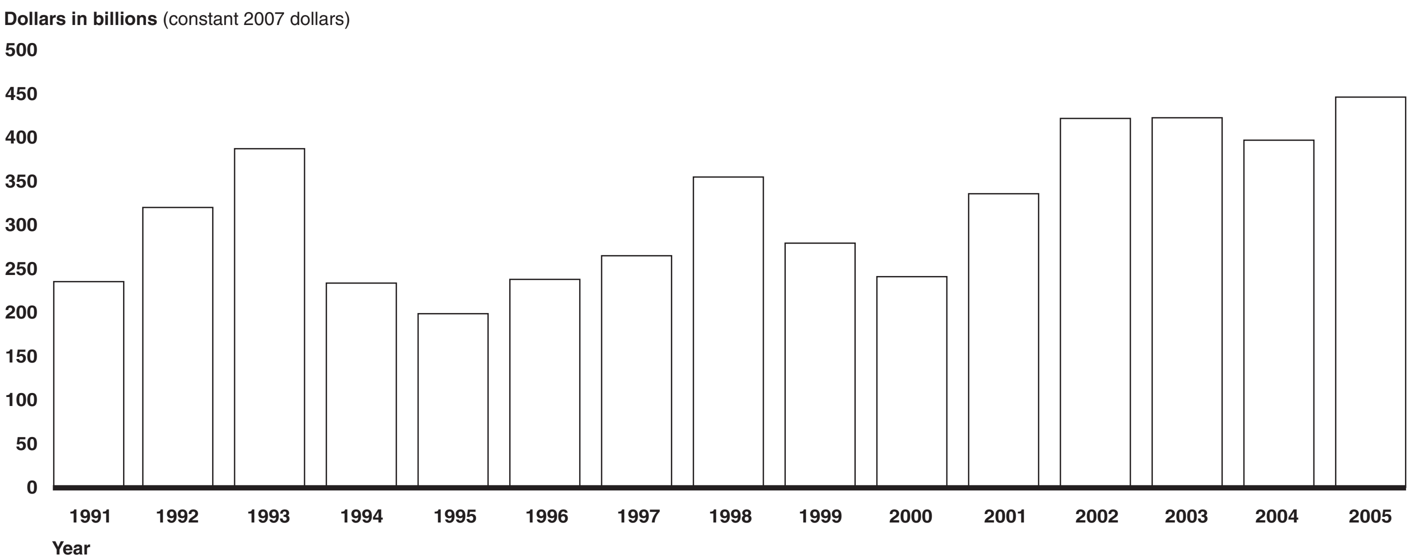
[10]A bond is being offered in the primary market during its original sale, where the bond proceeds go to the bond issuer. Bonds being offered in the secondary market are being traded among investors after the original sale has taken place.

[11]A third method, referred to as private placement, is less frequently used. Under the private placement method, the issuer sells bonds directly to investors.

In Recent Years, the Dollar Amount of Long-term Tax-Exempt Bonds Issued Annually Has Been at Historically High Levels, and the Tax Exemption Is One of the Largest Federal Tax Expenditures

Based on IRS data, the dollar amounts of long-term tax-exempt bonds issued have been at their highest levels in recent years. Since 2002, the dollar amount of long-term, tax-exempt bonds issued has exceeded $395 billion annually.[12] In only 2 earlier years from the period 1991 through 2001, did the annual amount of bonds issued exceed $350 billion. Furthermore, during this same period, municipal governments never issued more bonds than in recent years. Figure 1 shows the annual dollar amount of long-term, tax-exempt governmental and private activity bonds, including new money and refunding bonds, issued from 1991 through 2005.

Figure 1: Total Dollar Amounts of All Long-term Tax-Exempt Bonds Issued Annually from 1991 through 2005



Source: GAO analysis of IRS's Statistics of Income Division data.

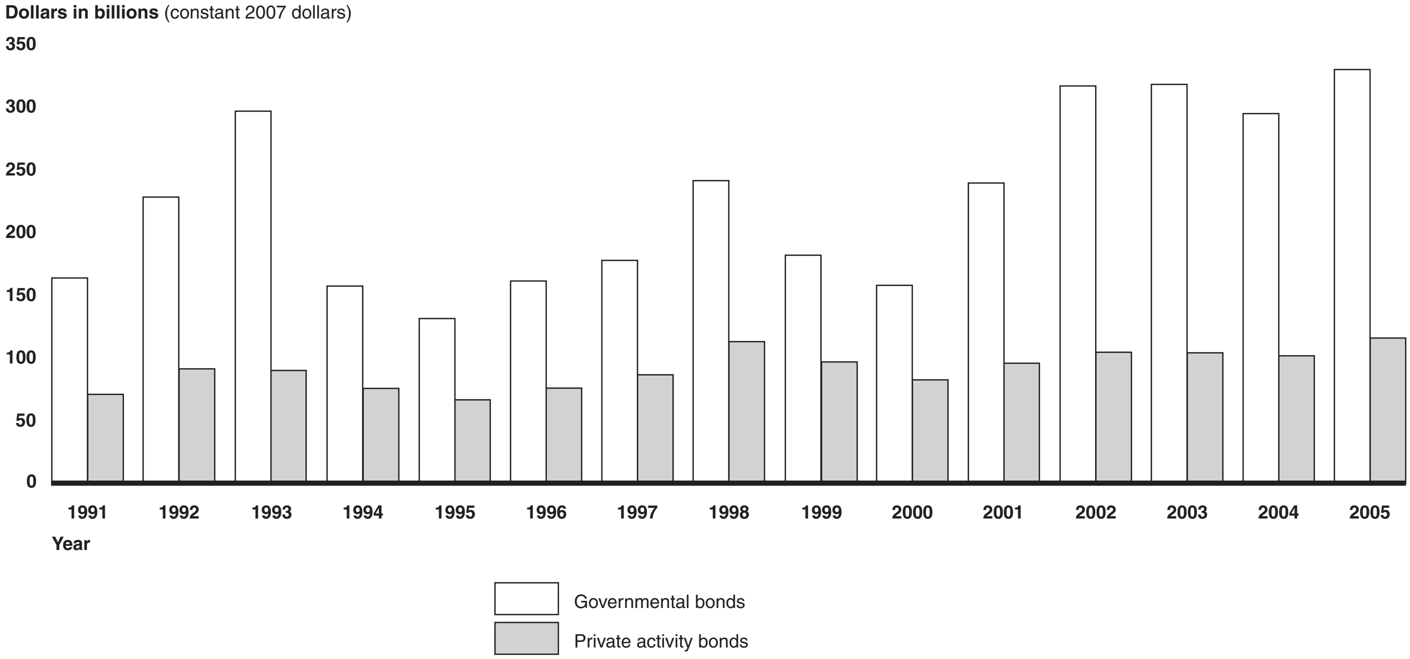
Note: Amounts presented each year include governmental and qualified private activity bonds for new money and refunding bonds. Calendar year 2005 is the most recent available IRS data.

[12]Numbers are presented in constant 2007 dollars.

The recent increases in the dollar amounts of governmental bonds issued have been a leading factor contributing to the high volume of tax-exempt bonds issued since 2002. Figure 2 compares the annual dollar amounts of governmental and qualified private activity bonds issued from 1991 through 2005. In recent years, that is, 2002 through 2005, at least $295 billion of governmental bonds have been issued annually, or on average about $314.8 billion per year. In comparison, in the earlier years of 1991 through 2001, the average amount of governmental bonds issued annually was about $194.3 billion, or about 62 percent less than the average annual amounts from 2002 through 2005 after adjusting for inflation.

Similar to governmental bonds, the amounts of private activity bonds issued annually has also been at peak levels since 2002. From 2002 through 2005, over $100 billion dollars in qualified private activity bonds were issued each year. About $116 billion of qualified private activity bonds were issued in 2005, more than in any other year since 1998. The average dollar amount of qualified private activity bonds issued annually from 2002 through 2005 was about $106.7 billion. In comparison, in the earlier years of 1991 through 2001, the average amount of qualified private activity bonds issued annually was about $86.1 billion, or about 24 percent less than the average annual amounts from 2002 through 2005 after adjusting for inflation. Thus, though not as large as the comparable increase for governmental bonds, there has been a noticeable increase in the amount of qualified private activity bonds issued recently.

Figure 2: Comparison of the Dollar Amounts of Long-term Governmental and Qualified Private Activity Bonds Issued from 1991 through 2005



Source: GAO analysis of IRS's Statistics of Income Division data.

While both governmental and qualified private activity bonds reached historically high levels recently, the amount of governmental bonds issued annually has fluctuated to a greater extent. For example, from 1992 to 2005, the dollar amounts of governmental bonds issued annually either increased or decreased by an average of about 25 percent per year. In contrast, qualified private activity bonds fluctuated to a lesser extent, by an average of about 13 percent per year. The wider fluctuation in governmental bonds could be in part because governmental bonds are not subject to as many restrictions, including annual state-by-state volume caps, as qualified private activity bonds. Even if the volume cap for private activity bonds is not reached for all states, the volume cap can place constraints on the volume of private activity bonds issued because some individual states may reach their limits and this would restrict them from issuing any additional qualified private activity bonds that year.[13]

[13]From 2001 through 2005, about half of the states, including the District of Columbia, used their full allocation of tax-exempt private activity bonds. In total, only about 2 percent of all qualified private activity bonds subject to annual volume caps were not used by the states during this period.

Another way to analyze the dollar amount of tax-exempt bonds is to compare new money bonds to refunding bonds. Although the amount of refundings substantially increased around 2002, new money bond issues were generally higher than refunding issues each year since 1991. Since 1991, the dollar amount of refundings has been greater than new money issues in only 3 years—1992, 1993, and 2005. From 2001 through 2005, the amount of new money tax-exempt bond issues has exceeded $200 billion annually (in constant dollars). This is greater than any year from 1991 through 2000. Table 1 shows the annual volume and percentage of long-term, tax-exempt bonds issued for new money and refunding purposes from 1991 through 2005.

Table 1: The Amounts of Long-term Tax-Exempt Bonds Issued for New Money and Refunding Purposes, 1991 to 2005

Dollars in millions (constant 2007 dollars)

Year	New money	Percentage of total	Refunding	Percentage of total
1991	$146,746	62.5	$ 88,188	37.5
1992	144,697	45.3	174,969	54.7
1993	128,582	33.2	258,222	66.8
1994	139,764	59.9	93,487	40.1
1995	125,931	63.5	72,360	36.5
1996	140,312	59.1	97,179	40.9
1997	152,271	57.6	112,233	42.4
1998	192,762	54.4	161,694	45.6
1999	184,067	66.0	94,831	34.0
2000	173,223	72.0	67,385	28.0
2001	203,402	60.7	131,955	39.3
2002	227,899	54.1	193,494	45.9
2003	225,440	53.4	196,723	46.6
2004	224,850	56.7	171,688	43.3
2005	218,491	49.0	227,287	51.0

Source: GAO analysis of IRS's Statistics of Income Division data.

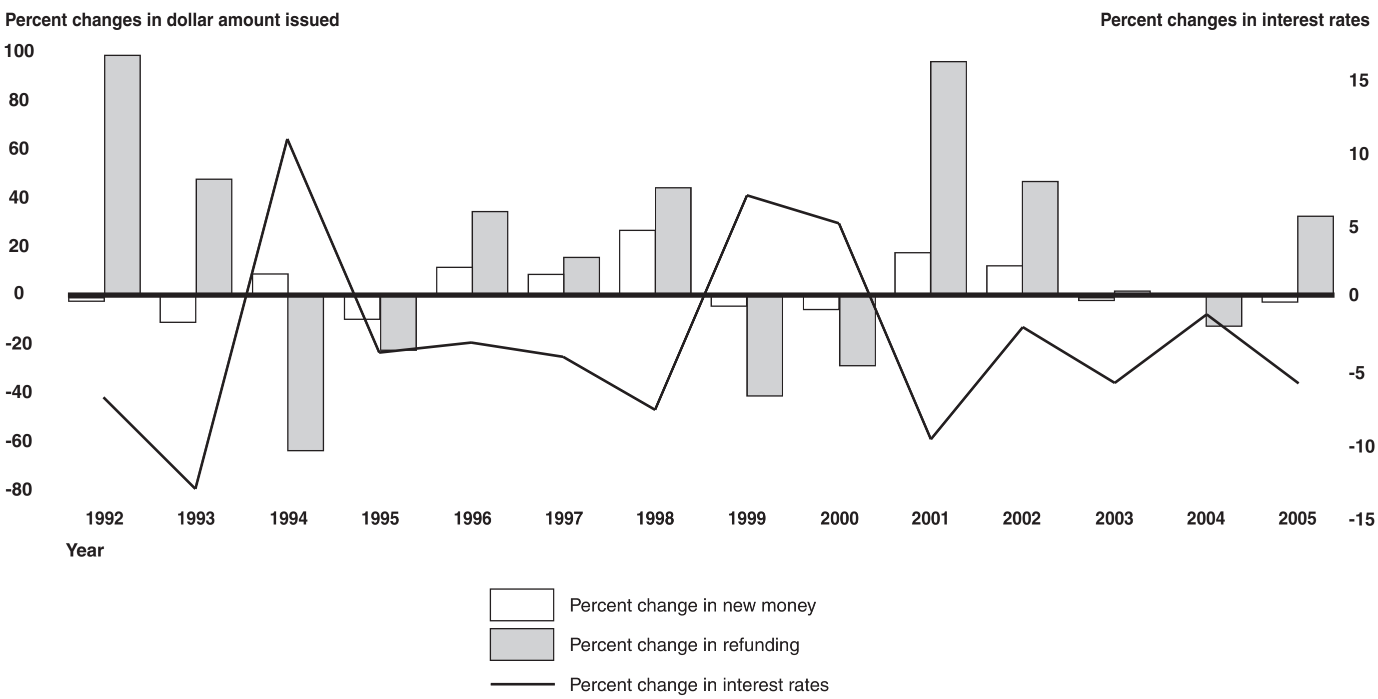
Note: Totals include both governmental and qualified private activity bonds.

Tax-exempt bond issuers tend to issue more debt when interest rates decline. Since 1991, years when interest rates were at their lowest levels generally have corresponded with the years in which the amounts of tax-exempt bonds issued, including bonds for refunding, were the highest. For example, since 2002, average interest rates on tax-exempt bonds[14] have fallen to their lowest levels since the early 1970s. During this same time period, the dollar amount of tax-exempt bonds issued has been at the highest level since 1993.

Figure 3 shows how changes in interest rates have corresponded with the amounts of new money and refunding bonds. As the figure illustrates, generally, increases in the dollar amounts of bonds that were refunded have accompanied declines in interest rates. This indicates that municipal governments tend to take advantage of interest rate declines to restructure existing bond debt to obtain more attractive financing terms, such as obtaining a lower interest rate to reduce borrowing costs. On the other hand, changes in the dollar amounts of new bond issues do not appear to correspond as closely to interest rate changes as the amounts of refundings. One explanation for this could be that municipal governments tend to issue new bonds based on current needs to finance operations and activities, and decisions regarding new financing are likely to be less sensitive to interest rates.

[14] We used the Bond Buyer 20-Bond Index, a set of general obligation bonds maturing in 20 years, to compare interest rates on tax-exempt bonds over time.

Figure 3: Percentage Change in New Money and Refunding Issues versus Changes in Interest Rates, 1992 through 2005



Source: GAO analysis of IRS's Statistics of Income Division data and Thomson Financial data in the *Bond Buyer Yearbook.*

The Estimated Revenue Loss from Outstanding Tax-Exempt Bonds Is One of the Largest Federal Tax Expenditures

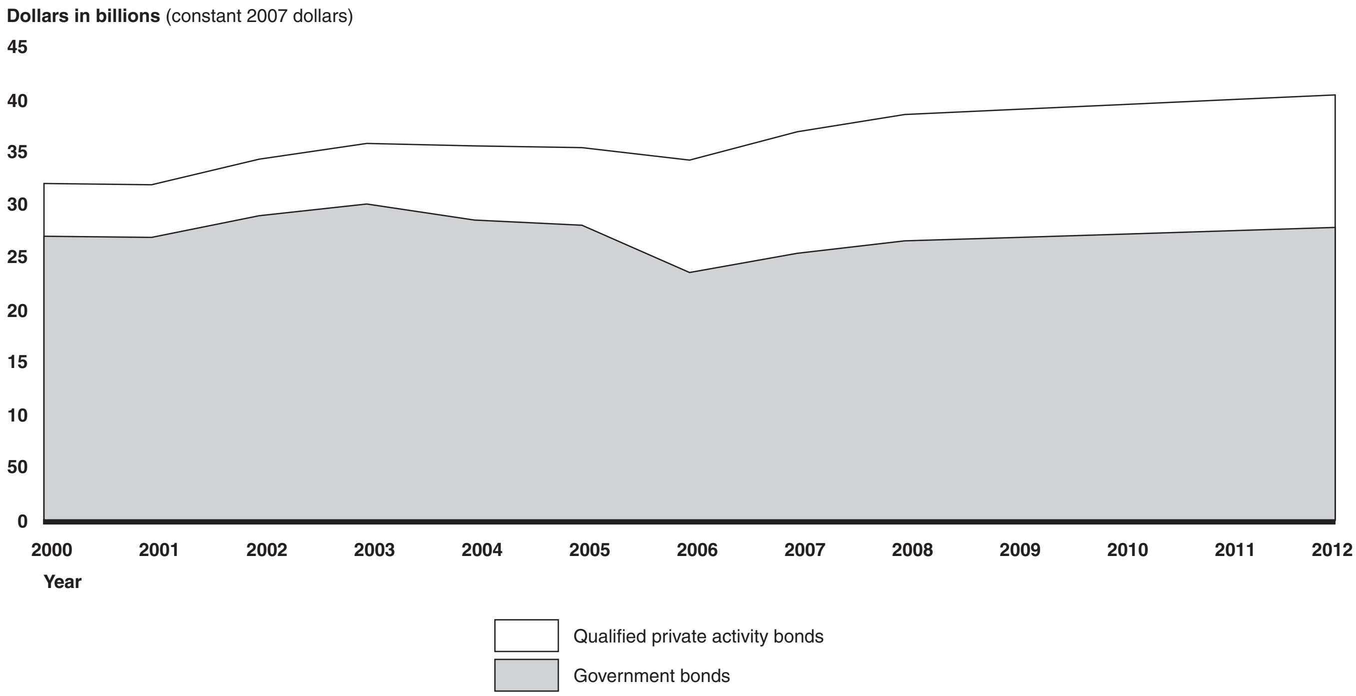
Because the interest earned by investors who purchase tax-exempt bonds is generally excluded from federal income taxes, the federal government incurs a revenue loss each year. Revenue loss estimates are based on the total dollar value of outstanding tax-exempt bonds and not on the dollar amounts of tax-exempt bonds issued in a given year. Both Treasury and JCT provide estimates of the revenue loss associated with tax-exempt bonds. Though calculated differently, both estimates show that the revenue loss is in the billions of dollars annually.

According to our analysis of Treasury's estimates, the revenue loss from excluding the interest earned on tax-exempt bonds from federal income tax is the ninth largest tax expenditure in the I.R.C. in 2007. Figure 4 shows our analysis of Treasury's revenue loss estimates from 2000 to 2012. The estimates indicate that the federal government could lose about

$37 billion in 2007—$25.4 billion from interest on governmental bonds and $11.6 billion from interest on qualified private activity bonds.[15] As figure 4 shows, the estimated revenue loss from governmental bonds has fluctuated from a high of $30.1 billion in 2003 to a low of $23.6 billion in 2006. According to our analysis of Treasury's estimates, the revenue loss is likely to be about $27.9 billion from governmental bonds and about $12.6 billion from qualified private activity bonds by 2012.

[15] Summing the individual tax preference estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions. Despite the limitations in summing separate revenue loss estimates, these are the best available data with which to measure the value of tax expenditures and make comparisons to other spending programs. Other researchers also have summed tax expenditure estimates to help gain perspective on the use of this policy tool and examine trends in the aggregate growth of tax expenditure estimates over time.

Figure 4: Estimated Revenue Loss from Excluding Interest Earned on Tax-Exempt Bonds from Federal Income Tax, 2000 through 2012



Source: GAO Analysis of Treasury Department Estimates Printed in the President's 2002, 2004, 2006, and 2008 Budgets, *Analytical Perspectives*.

Note: Summing the individual tax preference estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions. All data points presented are estimates, but data points for future years are also projections.

JCT estimates also suggest a similar pattern of higher estimated revenue losses attributable to excluding the interest earned on tax-exempt bonds from federal gross income in future years. For example, in 2007, JCT reported that the federal government would forgo about $27.8 billion due to tax-exempt governmental bonds and projected that the revenue losses would grow to about $31.9 billion in 2011. For qualified private activity bonds, our analysis of JCT estimates shows the revenue loss increasing from $8.6 billion in 2007 to about $10.1 billion in 2011, an 18 percent increase.[16]

Tax-Exempt Bonds Are Used to Finance a Wide Range of Facilities and Activities

Tax-exempt governmental and private activity bonds are used to finance a wide range of facilities and activities, primarily in support of the entity responsible for paying the bond debt service. Information describing the types of facilities and activities that are financed with tax-exempt bonds is available from several sources. In addition, tax-exempt governmental bonds can be used to finance some facilities and activities for which most tax-exempt private activity bonds cannot, including some facilities that Congress specifically prohibited from being financed with qualified private activity bonds.

To illustrate the wide range of purposes for which tax-exempt bonds are used, we reviewed the most recent information available on bonds in Thomson Financial's *Bond Buyer Yearbook* and IRS's SOI data. We also reviewed a limited sample of official statements to further illustrate the uses of tax-exempt bonds. Because most of the information is summarized by broad descriptive categories, it does not fully reveal the wide range of facilities and activities for which tax-exempt bonds can be used. Appendix II describes the primary sources for information on the facilities and activities financed with tax-exempt bonds.

Uses of Municipal Bonds Based on *Bond Buyer Yearbook* Data

The *Bond Buyer Yearbook* contains historical data and is a resource and reference tool for portfolio managers, underwriters, financial advisors, and other professionals seeking information on municipal bonds. As previously stated, the yearbook does not separate information on the uses of bonds based on whether the bonds are governmental, qualified private activity, or taxable bonds. Nonetheless, the *Bond Buyer Yearbook* still provides a general sense of the types of projects financed with tax-exempt bonds. Table 2 summarizes Thomson Financial 2006 data in the *2007 Bond Buyer Yearbook* by 10 major categories and 48 subcategories. The table also shows the proportion of bonds issued for each category and subcategory.

[16]JCT does not publish estimates for tax expenditures valued at less than $50 million per year. As a result, JCT does not include estimates for the revenue loss associated with all qualified private activity bonds.

Table 2: Summary of *Bond Buyer Yearbook* Data on Uses of Municipal Bonds Issued in Calendar Year 2006

Dollars in thousands (nominal 2006 dollars)

Category	Total amount	Percentage of total amount for all categories	Total issues	Percentage of total issues for all categories	Average size
Development	**$4,891,000**	**1.3**	**387**	**3.0**	**$12,638**
Industrial	2,279,900	0.6	224	1.8	10,178
Economic	2,367,300	0.6	152	1.2	15,574
Office buildings	243,800	0.1	11	0.1	22,164
Education	**106,545,800**	**27.4**	**4,197**	**33.0**	**25,386**
Primary	60,492,500	15.6	3,380	26.5	17,897
Higher	29,447,800	7.6	650	5.1	45,304
Student loans	16,051,200	4.1	82	0.6	195,746
Other	554,300	0.1	85	0.7	6,521
Electric power	**12,897,200**	**3.3**	**177**	**1.4**	**72,866**
Environmental facilities	**7,869,800**	**2.0**	**154**	**1.2**	**51,103**
Pollution control	6,206,800	1.6	95	0.7	65,335
Solid waste	1,663,000	0.4	59	0.5	28,186
Recycling	0	0.0	0	0.0	0
Health care	**40,102,200**	**10.3**	**827**	**6.5**	**48,491**
General acute	30,871,100	7.9	518	4.1	59,597
Single specialty	475,400	0.1	20	0.2	23,770
Children's	1,398,600	0.4	14	0.1	99,900
Equipment loans	58,400	0.0	3	0.0	19,467
General medical	1,384,400	0.4	19	0.1	72,863
Nursing homes	474,900	0.1	34	0.3	13,968
Assisted living	914,700	0.2	66	0.5	13,859
Continuing care	4,524,700	1.2	153	1.2	29,573
Housing	**30,532,700**	**7.9**	**955**	**7.5**	**31,971**
Single family	24,107,400	6.2	606	4.8	39,781
Multifamily	6,425,300	1.7	349	2.7	18,411
Public facilities	**14,650,700**	**3.8**	**661**	**5.2**	**22,164**
Libraries/museums	867,400	0.2	71	0.6	12,217
Government offices	2,968,200	0.8	121	1.0	24,531
Fire stations	366,700	0.1	93	0.7	3,943
Jails/prisons	1,418,900	0.4	62	0.5	22,885
Police stations	558,700	0.1	16	0.1	34,919
Convention centers	2,443,100	0.6	57	0.4	42,861

Dollars in thousands (nominal 2006 dollars)					
Category	**Total amount**	**Percentage of total amount for all categories**	**Total issues**	**Percentage of total issues for all categories**	**Average size**
Stadiums/arenas	3,996,300	1.0	31	0.2	128,913
Theaters	311,000	0.1	7	0.1	44,429
Parks/zoos/ beaches	824,800	0.2	132	1.0	6,248
Other recreation	895,600	0.2	71	0.6	12,614
Transportation	**42,344,000**	**10.9**	**519**	**4.1**	**81,588**
Airports	8,245,900	2.1	105	0.8	78,532
Seaports	3,008,500	0.8	48	0.4	62,677
Toll roads	14,576,500	3.8	222	1.7	65,660
Bridges	2,127,400	0.5	13	0.1	163,646
Tunnels	0	0.0	0	0.0	0
Parking facilities	510,600	0.1	49	0.4	10,420
Mass transit	13,875,000	3.6	81	0.6	171,296
Other	100	0.0	1	0.0	100
Utilities	**42,014,500**	**10.8**	**1,328**	**10.4**	**31,637**
Water/sewer	28,715,400	7.4	1,153	9.1	24,905
Gas works	10,741,700	2.8	27	0.2	397,841
Telephone	148,500	0.0	9	0.1	16,500
Sanitation	737,600	0.2	59	0.5	12,502
Flood control	620,000	0.2	24	0.2	25,833
Combined utilities	1,051,300	0.3	56	0.4	18,773
General purpose	**86,711,000**	**22.3**	**3,526**	**27.7**	**24,592**
General purpose	86,449,400	22.2	3,518	27.6	24,573
Veterans	203,800	0.1	1	0.0	203,800
Places of worship	47,900	0.0	5	0.0	9,580
Agriculture	9,900	0.0	2	0.0	4,950
Total	**$388,558,900**	**100.0**	**12,731**	**100.0**	**$30,521**

Source: GAO analysis of Thomson Financial data in the *2007 Bond Buyer Yearbook*.

As shown in table 2, the majority of municipal bonds issued in calendar year 2006, both in terms of dollar amounts and numbers of bonds, fell in the education and general purpose categories. Bonds categorized for education-related purposes accounted for over 27 percent of the total amount issued and about one-third of the number of bonds issued that year. Bonds in the general purpose category accounted for over 22 percent of the total dollar amount and more than one-quarter of the number of bonds issued during 2006. In addition, nearly one-fourth of the total number of bonds issued in calendar year 2006 was categorized only as general purpose in the subcategory of the general purpose category. For these bonds, it is not clear what activities or facilities were funded by the $86.5 billion of bonds.

Bonds placed into the transportation and electric power categories were the largest bonds, averaging $81.6 million and $72.9 million, respectively, per bond issue. The Long Island (New York) Power Authority issued the largest bond in the electric power category in 2006 for $950 million, which included about $100 million for capital improvements to things like power transmission lines, substations, and transformers, and about $850 million for refunding purposes. The largest transportation bond in 2006 was a $2.0 billion mass transit bond sale by the Hudson Yards Infrastructure Corporation, New York, for the extension of a subway line that is part of an effort to redevelop the Hudson Yards area of midtown Manhattan. Bonds categorized by the *Bond Buyer Yearbook* as development and public facilities, on average, were the smallest bonds, averaging $12.6 million and $22.2 million, respectively.

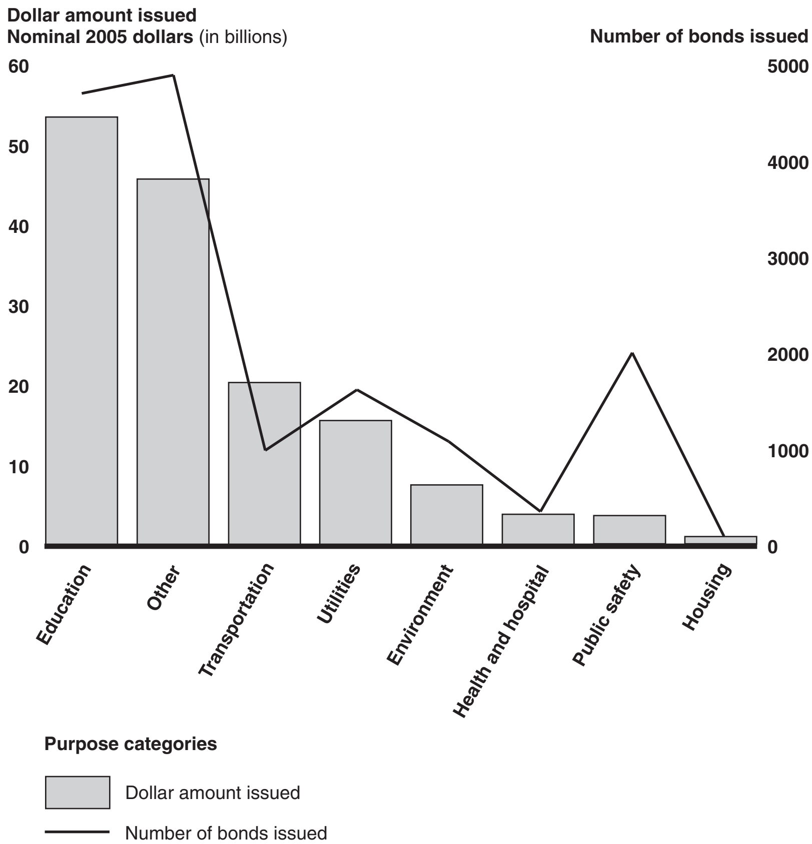
Appendix III shows information on the uses of municipal bonds from the *Bond Buyer Yearbook* for the 5-year period of 2002 through 2006 combined.

Uses of Governmental Bonds Based on IRS's SOI Data and a Limited Random Sample of Official Statements

To provide information on the facilities and activities financed with governmental bonds, we reviewed two data sources: (1) IRS's SOI tax-exempt bond publications and database for 2002 though 2005 and (2) a limited sample of official statements that MSRB received in 2006.

IRS's SOI categorizes information on governmental bonds into eight broad categories. Unlike the Thomson Financial data, the SOI data do not further categorize bonds into subcategories by purpose. For 2005, the education and the other categories were the two largest categories measured by dollar amount and total number of bonds issued. Governmental bonds issued for transportation and education had the largest average size per issue, $20.6 million and $11.4 million, respectively. Figure 5 summarizes the dollar amounts and numbers of new money, long-term governmental bonds issued in 2005 by the eight SOI purpose categories. (See app. IV for similar data for the 5-year period of 2001 through 2005.)

Figure 5: Dollar Amount and Number of New Money, Long-term Governmental Bonds Issued in 2005 by IRS SOI Purpose Categories



Source: GAO analysis of IRS's Statistics of Income data.

As shown in figure 5, based on IRS data, nearly $45.7 billion of the new money, long-term governmental bonds issued in 2005 are classified in the other category. This amounts to nearly one-third of all long-term new money tax-exempt governmental bonds issued in 2005. Bond issuers may provide additional information that describes their bond issues if they classify their bonds in the “other” category. Because IRS transcribes this information in its tax-exempt bond database, we conducted a limited analysis of it to obtain information on the types of activities and facilities that are included in the other category.[17]

Among other things, our analysis showed that bonds in the other category were issued for a wide range of purposes, reflecting the broad discretion that state and local governments have in determining what facilities and projects to finance with tax-exempt bonds. We found that bonds in the other category were issued to finance industrial parks, arenas, stadiums, parking facilities, sidewalks, golf courses, general government operations, public recreation facilities, land, vehicles, computer hardware, and various other purposes. While we found that the facilities and activities financed with some bonds were apparent in many cases, they were not as obvious in some other cases, such as when "various government operations" and similar descriptions were provided. However, our limited review does not provide a comprehensive list of the facilities and activities being financed with governmental bonds classified in IRS's other category.

While the Thomson Financial and SOI data provide aggregate data on the projects financed with tax-exempt bonds, the official statements for the bonds often provide more detailed information on the uses of the bonds. Because of this, we reviewed a limited random sample of official statements of governmental bonds to provide examples of the types of descriptive information they contain on the projects financed with the bonds. The sample was drawn from official statements MSRB received in calendar year 2006. In total, the sample consists of 40 bonds—5 bonds that we identified that would likely be classified into each of the eight SOI categories for governmental bonds.[18] The sample is not generalizable—meaning it cannot be used to generate estimates about all governmental bonds issued in 2006. Instead, it provides a limited number of specific examples of projects and activities that were financed with governmental bonds. Table 3 shows descriptions of the uses of bonds based on our

[17]Our limited analysis included searching for particular words in the description that we believed would describe activities associated with tax-exempt bonds. This included searching for words such as "pollution," "industrial park," and "stadium," in order to identify a few of the purposes for which bonds placed into the other category were used. The data we reviewed do not allow us to make generalizations about how governmental bonds in the other category are used or provide us with a comprehensive list of purposes for bonds in the other category.

[18]We classified the bonds into the eight SOI categories by reviewing the official statements. We classified bonds that included multiple uses as other. In SOI's data, bonds classified as other are regularly used for multiple purposes; however, a single bond issue for multiple purposes can be classified into more than one category.

analysis of official statements. (The methodology for our sample is discussed in app. I.)

Table 3: Summary of Facilities and Activities Financed with Tax-Exempt Bonds Issued in 2006 Based on a Limited Sample of 40 Official Statements

Bond category	Description of bond use
Education (5 bonds)	• Construction of university track and field stadium • Construction of schools • Construction of schools • Construction of schools • Shared computer, learning resources, and staff development services
Environment (5 bonds)[a]	• Sewer and water facilities • Sewer and water facilities • Sewer and water facilities • Sewer and water facilities • Sewer and water facilities and pollution control
Health and hospital (5 bonds)	• Construction of new hospital and demolition of old hospital • Construction of health care facilities • Construction of new hospital • Improvements to existing hospital • Improvements to existing hospital
Housing (5 bonds)	• Rehabilitate a housing development and office space for the issuing authority • Construction of a continuing care retirement facility • Finance single-family residences for low-income families • Construction of a multifamily housing unit • Finance owner-occupied single-family residences
Public safety (5 bonds)	• School fire prevention and safety purposes • Construction of courthouse and other public buildings, computer equipment, and county vehicles • Construction of jail facility • Construction of county justice system building • Construction of two fire stations, emergency medical vehicles, and equipment
Transportation (5 bonds)	• Street improvements • Street improvements • Marina and other port-related projects • Street improvements • Street improvements

Bond category	Description of bond use
Utilities (5 bonds)[a]	• Water system improvements • Water system improvements • Water system improvements • Water system improvements • Electric system improvements
Other (5 bonds)	• Furnishings and equipment • Streets, sewers, and other public improvements • Various public works projects, including water and sewer systems, electric systems, gas systems, airports, and other revenue-producing public works projects • Various capital improvement projects and equipment, including city trucks, police cars, water main extension, school renovations, and fire department equipment • Construction of two YMCA facilities

Source: GAO analysis of official statements received by MSRB in 2006.

Note: Some of the official statements we reviewed in each category were for bonds that had similar purposes. As a result, some of the entries in each category are identical.

[a]IRS Form 8038 instructs bond issuers to classify bonds for sewer facilities as environment. As a result, we classified bonds that indicated that they were for sewer and water facilities in the environment category. Bonds only used for water system improvements were classified in the utilities category.

As table 3 shows, in general, the official statements we reviewed were for bonds with purposes traditionally associated with financing for governmental bonds.

Uses of Private Activity Bonds Based on IRS's SOI Data

Table 4 provides summary information on the uses of tax-exempt private activity bonds issued in 2005 based on IRS's SOI data. As the table illustrates, in 2005, section 501(c)(3) bonds, including those issued for hospitals, accounted for over half of the dollar amount and number of new money, long-term private activity bonds. Section 501(c)(3) nonhospital bonds constituted the largest category of qualified private activity bonds in 2005 (29 percent). As a percentage of all private activity bonds, the section 501(c)(3) nonhospital bond category has been larger in recent years than in the early 1990s.

If only new money long-term private activity bonds are considered, section 501(c)(3) bonds for other than hospitals have risen from about 20 percent of private activity bonds in the early 1990s to nearly 30 percent yearly in 2003 through 2005. Since 1997, section 501(c)(3) nonhospital bonds have accounted for more than 27 percent of new long-term private activity bond amounts, with 4 peak years of 38 to 39 percent. Before 1997, section 501(c)(3) nonhospital bonds had never accounted for more than 24 percent of the total amount of new money private activity bonds issued annually. According to a Treasury official, one possible explanation for the increase in 501(c)(3) bonds as percentage of all qualified private activity bonds is that unlike other qualified private activity bonds, 501(c)(3) bonds are not subject to annual state volume caps.

Section 501(c)(3) bonds help finance construction of facilities and other property used by charitable, educational, religious, and similar organizations recognized as tax-exempt under section 501(c)(3) of the I.R.C. and can generally only be used for projects that support the charitable activities of the 501(c)(3) organization that is benefiting from the bonds.[19] Analysis of 2003 and 2004 SOI data for "Qualified 501(c)(3) Nonhospital" bonds indicated that about 83 percent of tax-exempt bond dollars in this category were used for the following purposes: transportation (10.3 percent), construction (5.6 percent), renting and leasing real estate (14.8 percent), education (15.4 percent), and health care (37.2 percent).[20]

[19]To qualify as a tax-exempt 501(c)(3) bond, the property financed with the bond issue must be owned by the 501(c)(3) organization or a governmental entity and it must not satisfy both the modified private business use and modified private payments test. This means that more than 5 percent of the net bond proceeds cannot be used for any private business use and more than 5 percent of the payment of principal and interest on the bond issue cannot be directly or indirectly secured by payments or property used or to be used for a private business use.

[20]We identified uses for nonhospital 501(c)(3) bonds by matching two-digit industry codes on the IRS Form 8038 with the corresponding dollar amounts for the bonds that were issued.

Table 4: Summary of Facilities and Activities Financed with New Money, Long-term Tax-Exempt Private Activity Bonds Issued in 2005

Nominal 2005 dollars in millions

Bond purpose	Amount issued	Percentage of total amount	Number issued	Percentage of number issued	Average size
Airport	$3,152	5.8	39	1.5	$80.8
Docks and wharves	156	0.3	6	0.2	26.0
Water	189	0.3	14	0.5	13.5
Sewage	194	0.4	12	0.5	16.2
Solid waste disposal	1,464	2.7	57	2.2	25.7
Qualified residential rental	6,459	11.8	478	18.5	13.5
Local electricity or gas furnishing facilities	142	0.3	3	0.1	47.3
Local district heating or cooling facilities	24	0.0	3	0.1	8.0
Hydroelectric environmental facilities[a]	—	—	—	—	—
Tax Reform Act of 1986 transition property	125	0.2	5	0.2	25.0
District of Columbia enterprise zone[a]	—	—	—	—	—
Qualified new empowerment zone	232	0.4	10	0.4	23.2
New York liberty zone[a]	—	—	—	—	—
Qualified mortgage	6,602	12.1	145	5.6	45.5
Qualified veterans mortgage[a]	—	—	—	—	—
Qualified small issue	701	1.3	422	16.3	1.7
Qualified student loan	4,699	8.6	36	1.4	130.5
Qualified redevelopment[a]	—	—	—	—	—
Qualified Section 501(c)(3) hospital	12,224	22.4	288	11.1	42.4
Qualified Section 501(c)(3) nonhospital	15,745	28.8	1,080	41.8	14.6
Nongovernmental output property[a]	—	—	—	—	—
Other purposes[b]	31	0.1	13	0.5	2.4
Total[c]	**$54,691**	**100.0**	**2,586**	**100.0**	**$21.1**

Source: GAO analysis of IRS's Statistics of Income Division data.

[a]Based on SOI data, these cells are blank to avoid disclosure of information about specific bonds. However, the data are included in the appropriate totals.

[b]For this table, other purposes refers to obligations for which a specific purpose either did not apply or was not clearly indicated on the Form 8038.

[c]A given bond issue can include more than one purpose. As a result, when added together, the number of issues for each individual purpose is greater than the total number of bonds issued. In addition, the amounts issued and number of bonds issued may not equal the total because the amounts in the individual cells are rounded.

Recently, Congress has enacted legislation creating new types of tax-exempt private activity bonds. Table 5 provides a summary of the new types of tax-exempt private activity bonds enacted since 2001.

Table 5: New Types of Private Activity Bonds Created since 2001

Type	Year authorized	Volume authorized (dollars in millions)	Purpose and examples of authorized uses
Public education[a]	2001	$15,000	For public-private partnerships between school districts and private developers. • Authorized uses include school buildings, athletic facilities, and property used in connection with the school facility.
New York Liberty Zone[b]	2002	$8,000	For economic development and rebuilding in designated areas of New York City after 9/11. • Authorized uses include financing the construction and rehabilitation of nonresidential and residential real property.
Green building[c]	2004	$2,000	For the development of energy-efficient buildings and their surrounding landscapes. • Authorized uses include commercial buildings meeting certain standards or including a brownfield site—sites being redeveloped that may contain pollutants or other contaminants.
Highway and surface freight transfer[d]	2005	$15,000	For financing for certain projects to transfer freight from trucks to rail cars or vice versa. • Authorized uses include international bridges or tunnels, cranes, loading docks, and computer-controlled equipment.
Gulf Opportunity Zone[e]	2005	$14,800	For assistance to support areas affected by hurricanes Katrina, Wilma and Rita. • Authorized uses include office buildings, hotels, retail stores, warehouses, manufacturing, medical, and other commercial facilities.

Sources: GAO analysis and Congressional Research Service.

[a]Pub. L. No. 107-16 (2001).

[b]Pub. L. No. 107-147 (2002) and Pub. L. No. 108-311 (2004).

[c]Pub. L. No. 108-357 (2004).

[d]Pub. L. No. 109-59 (2005).

[e]Pub. L. No. 109-135 (2005).

Governmental Bonds Can Be Used to Finance Certain Projects That Generally Cannot Be Financed with Qualified Private Activity Bonds

Over the last several decades, Congress has prohibited qualified private activity bonds from being used to finance certain projects. For example, the Tax Reform Act of 1986[21] prohibited the use of qualified private activity bonds to finance a number of specific facilities, including hotels adjacent to airports, professional sports stadiums, and private golf courses.[22] Although qualified private activity bonds can no longer be used to finance such facilities, these types of facilities can be financed with tax-exempt governmental bonds because, as previously discussed, they fail either the private payments or private business use test. In addition, governmental bonds could be issued by authorities that directly operate facilities, such as golf courses, that qualify as general public use. Under current law, state and local governments have broad discretion to make decisions on the types of projects and activities they finance with tax-exempt bonds. Further, while the 1986 act prohibited qualified private activity bonds from being used to finance certain projects such as hotels, Congress did not prohibit such projects from being financed with governmental bonds. According to legislative history surrounding the 1986 change, Congress directed Treasury to liberalize guidelines regarding the treatment of third-party use pursuant to management agreements.[23] The liberalization of the guidelines has permitted governmental entities to use third parties to operate facilities financed with tax-exempt governmental bonds under management agreements so that the third-party use of the bond-financed property is not treated as a private trade or business.

[21]The Tax Reform Act of 1986, Pub. L. No. 99-514 (1986) disallowed the use of private activity bonds for several types of facilities allowable under the previously existing laws. Some examples include (1) development associated with airports including hotels, retail facilities, office buildings, and industrial parks; (2) small issue bonds for nonmanufacturing facilities, another type of financing used for hotels; (3) redevelopment bonds for private or commercial golf courses, country clubs, massage parlors, hot tub and suntan facilities, racetracks and other gambling facilities, and liquor stores; and (4) exempt facility bonds for certain purposes, such as sports facilities, convention or trade show facilities, and parking facilities.

[22]Gulf Opportunity Zone private activity bonds, authorized in 2004 for rebuilding areas affected by hurricanes Katrina, Rita, and Wilma, and Liberty Zone private activity bonds, authorized in 2001 to help rebuild areas affected by the September 11, 2001, terrorist attacks in New York City, can be used to finance hotels.

[23]Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (Washington, D.C.: 1987), 1161.

Generally, the guidelines issued by Treasury in Revenue Procedure 97-13[24] provide that tax-exempt governmental bonds can be used to finance certain facilities provided ownership of the facility remains with the governmental entity issuing the bonds and that payments to the facility operator are not based on the facility's net profits. The facility operator may be compensated based on the gross operating revenues of the facility, a per unit fee, or a per person fee.

As you requested, we are providing information on newly constructed hotels and golf courses that were recently financed, at least in part, with some amount of tax-exempt bonds. Our information is limited because we could not identify any comprehensive lists of hotels and municipal golf courses that were financed with tax-exempt bonds. Neither the *Bond Buyer Yearbook* nor the SOI data had information on hotels and golf courses that were financed with tax-exempt bonds.[25] We considered recent years for our analysis because information on financing would more likely be available than information for facilities financed in earlier years. For hotels, we limited our analysis to hotels that were financed with tax-exempt bonds issued from 2002 through 2006, and for golf courses we limited our analysis to municipal courses that opened in 2005. We found 18 hotels and 6 golf courses that we could confirm had some tax-exempt bond financing in those years.

In general, the hotels were large, full-service hotels. Not all the hotels were yet rated by the American Automobile Association (AAA),[26] but those with AAA ratings were all three- or four-diamond hotels, meaning that at a minimum the hotels provided multifaceted, comprehensive services and, in the case of four-diamond hotels, were considered upscale with extensive amenities. In 14 of the 18 cases, the hotels contained conference facilities or were located near convention centers. According to the official statements, the hotels that were built in connection with convention centers were usually intended to enhance the competitive position of convention center facilities, making the convention center a more

[24]97-1 C.B. 632.

[25]We were able to identify limited information in the SOI data on golf-related facilities in our review of the other category for governmental bonds. However, we were not able to use these data to determine the number of golf courses financed with tax-exempt bonds.

[26]The AAA ratings service is a nationally recognized source of information on hotel ratings. The ratings range from one to five diamonds. The definitions of the ratings vary, ranging from basic to luxurious in terms of service and amenities.

appealing and convenient location to hold large meetings, and to contribute to economic development in the areas where they are being built. Table 6 summarizes information on the hotels we identified.

Table 6: New Hotels Financed with Tax-Exempt Governmental Bonds Issued from 2002 through 2006

Year bond issued	Hotel location	Issuer type	Amount[a]	Bond type[b]	General description[c]
2002	Bay City, MI	City-created nonprofit corporation	$15,455,000	Revenue	A 150-room, three-diamond Doubletree hotel and conference center in downtown area.
2002	Omaha, NE	City-created nonprofit corporation	$102,970,000	Revenue	A 450-room, four-diamond Hilton hotel adjacent to Omaha convention center and arena.
2002	Louisville, KY	Local government	$38,900,000	General obligation	A 616-room, four-diamond Marriott hotel next to convention center in downtown area.
2002	Washington, DC	Local government	$45,995,387	Tax increment financing	A 400-room, four-diamond Mandarin hotel and conference center.
2002	Hollywood, FL[d]	Local authority	$469,000,000	Revenue	A 250-room, four-diamond Hard Rock hotel and resort facility in Hollywood, FL, attached to a casino on the Seminole Indian Reservation.
2002	Tampa, FL[d]	Local authority	$469,000,000	Revenue	A 250-room, four-diamond Hard Rock hotel and resort facility in Tampa, FL, attached to a casino on the Seminole Indian Reservation.
2003	Vancouver, WA	Local authority	$65,855,000	Revenue	A 226-room, three-diamond Hilton hotel and conference center in downtown area.
2003	Denver, CO	City-created nonprofit corporation	$354,825,000	Revenue	A 1,100-room, four-diamond Hyatt Regency hotel next to convention center.
2004	Montebello, CA[e]	Local authority	$17,060,000	Revenue	A 121-room, three-diamond Hilton Garden Inn hotel next to country club and banquet facility.
2004	Schaumburg, IL	Local government	$239,320,000	General obligation	A 500-room, four-diamond Renaissance hotel next to convention center.
2005	Raleigh, NC	Local government	$216,940,000	Certificates of participation	A 400-room, three-diamond Marriott hotel adjacent to convention center.
2005	New Brunswick, NJ	Local authority	$30,000,000	Revenue	A 248-room, three-diamond Heldrich hotel, part of a mixed-use facility near Rutgers University.
2005	Shreveport, LA	Local authority	$40,000,000	Revenue	A 313-room Hilton hotel next to convention center complex.
2005	San Antonio, TX	City-created nonprofit corporation	$129,930,000	Revenue	A 1,000-room Hyatt hotel next to convention center.
2005	Erie, PA	Local authority	$45,390,000	Revenue	A 200-room waterfront Sheraton hotel next to convention center.

Year bond issued	Hotel location	Issuer type	Amount[a]	Bond type[b]	General description[c]
2005	Phoenix, AZ	City-created nonprofit corporation	$156,710,000	Revenue	A 1,000-room Sheraton hotel located downtown next to convention center.
2005	Lombard, IL	City-created nonprofit corporation	$161,250,000	Revenue	A 500-room conference center Westin hotel in the Chicago suburbs.
2006	Baltimore, MD	Local government	$300,940,000	Revenue	A 757-room Hilton hotel adjacent to convention center located downtown.

Source: GAO analysis of financial reports of municipalities and documents from Orrick, Herrington, and Sutcliffe LLP; HVS International; Akin Gump Strauss Hauer & Feld LLP; and Piper Jaffray and official statements from MSRB.

[a]The amount of bond proceeds for each bond is not necessarily equal to the total cost of the project. Some hotel financings have generated funds from multiple sources.

[b]Bonds received investment grade rankings from bond rating services.

[c]The number of diamonds is the AAA rating for the quality of the hotel. Not all hotels we identified have received AAA ratings.

[d]The Hard Rock Hotel Projects in Hollywood and Tampa, Florida, did not provide separate financing breakout per location. In addition, the number of hotel rooms financed was 250 of a total of 750 rooms at the locations.

[e]The bond issued in 2004 was a partial refunding for a bond previously issued in 2001 for construction of the hotel.

In general, the six golf courses we identified and confirmed as being constructed, at least in part, with tax-exempt governmental bond financing were considered among the better golfing facilities in their respective regions. For example, in 2006, *Golf Styles* magazine recognized the Lorton, Virginia, course as one of the “100 Must Play Courses of the Middle Atlantic.” Additionally, *Golf Digest* recognized the publicly financed course in Patterson, Louisiana, as one of the best new public courses in 2006. Table 7 provides information on the municipal golf courses we identified.

Table 7: Municipal Golf Courses Opened in 2005 and Financed with Tax-Exempt Governmental Bonds

Year bond issued	Golf course location	Issuer type	Amount[a]	Bond type[b]	General description
2003	Pleasanton, CA	City-created nonprofit corporation	$28,425,000	Certificates of participation	An 18-hole Callippe Preserve Golf Course rated as one of the top 10 in California and one of the best new public courses in 2006, and recognized for environmental excellence by the Audubon Cooperative Sanctuary System (green fees range between $36 and $52).
2003	Lorton, VA	Local authority	$15,530,000	Revenue	An 18-hole Laurel Hill Golf Club located on the grounds of the former Lorton Correctional Facility (green fees range between $74 and $89).
2003	Fargo, ND	Local government	$3,065,000	Certificates of participation	A 9-hole Osgood Golf Course with 3-hole developmental facility (green fees range between $13.50 and $15).
2002	La Quinta, CA	Local authority	$103,760,000[c]	Tax increment financing	An 18-hole Arnold Palmer Classic Silver Rock Resort golf course (green fees range between $145 and $160).
2002	Patterson, LA	Local authority	$3,000,000	General obligation	An 18-hole Atchafalaya at Idlewild Golf Course rated as one of the top 10 in Louisiana and rated as one of the best new public courses in 2006 (green fees range between $55 and $65).
2003	Norfolk, VA	Local government	$9,050,000	General obligation	A 9-hole executive Lamberts Point Golf Course constructed on a former landfill. Winner of the Affinity Award for best environmental project at the 2006 Golf Course News Builder Excellence Awards (green fees range between $18 and $20).

Source: GAO analysis of National Golf Foundation data and official statements from MSRB.

[a]The amount of bond proceeds for each bond is not necessarily equal to the total cost of the project. Some golf course financings are part of a larger project, and some are constructed using funds from multiple sources.

[b]All bonds received investment grade rankings from bond rating services.

[c]Amount denotes a total of three bonds issued to fund a project that includes the golf course, and the information we reviewed did not specifically disclose the amount of financing dedicated only to the golf course.

While tax-exempt governmental bonds are typically used to support traditional governmental functions with a public purpose, they are sometimes used for activities that are essentially private in nature, as illustrated by the hotels and golf courses we identified. Municipal governments have used their broad discretion to finance projects and activities, such as hotels, that are essentially private with tax-exempt governmental bonds on the grounds that the facilities and activities serve broader public purposes. Broader public purposes may include providing benefits to a community that extend beyond the purpose of the facility being financed by the bonds or providing certain services to those who would not otherwise be able to use them.

It is not clear whether facilities like these provide public benefits to federal taxpayers that extend beyond the purposes of the facilities. The state and local governments that issued the bonds to finance hotels and golf courses generally justified the projects on the grounds that they would generate economic development, including new jobs and businesses. However, in some cases, it is not clear whether the facilities generate public benefits that would be underprovided by the private market or whether the facilities generally make services available to those who would not otherwise be able to use them. For example, in 2005, about 85 percent of existing golf courses had been financed privately, offering a range of fees and services often similar to those offered by publicly financed courses. As a result, the use of tax-exempt governmental bonds for facilities and activities like hotels and golf courses, which are routinely financed with private funds, raises questions about how much public benefit is produced at the local level and what, if any, benefits federal taxpayers receive for subsidizing these and other kinds of facilities that are essentially private in nature.

The House Committee on Oversight and Government Reform's Subcommittee on Domestic Policy recently held hearings that focused primarily on whether tax-exempt governmental bonds should be used to finance professional sports stadiums that are privately used.[27] In 1986, Congress removed sports stadiums, along with other facilities, including certain hotels and golf courses, from the list of facilities eligible for tax-exempt private activity bond financing. Participants in congressional hearings leading up to the restrictions placed on tax-exempt private activity bonds in 1986 debated allowing stadiums and other facilities that were routinely financed with private funds from being financed with tax-exempt private activity bonds. However, stadiums and other facilities, including hotels and golf courses, continue to be financed with tax-exempt

[27]Hearing on Taxpayer Financed Stadiums, Convention Centers and Hotels, 110th Cong. (Mar. 29, 2007) and Professional Sports Stadiums: Do They Divest Public Funds From Critical Public Infrastructure, 110th Cong. (Oct. 10, 2007).

governmental bonds if they satisfy certain requirements for governmental bonds or safe harbors pertaining to private use. For example, according to Treasury's Assistant Secretary for Tax Policy, under current law, the requirements to use governmental bonds for stadiums can generally be met when state and local governments subsidize the projects with governmental revenues or governmental sources of funds, such as generally applicable taxes. He also stated that from a tax policy perspective, the ability to use governmental bonds to finance stadiums with significant private business use when the bonds are subsidized with state or local governmental payments possibly represents a weakness in the targeting of the federal subsidy for tax-exempt bonds under the existing legal framework. A similar situation may exist with the continued financing of hotels and golf courses using tax-exempt governmental bonds.

Borrowing Costs Vary Depending on Bond Characteristics, and Some Bonds Appear to Exceed the Statutory Limit on Issuance Costs Paid from Bond Proceeds

Borrowing costs paid by bond issuers include interest and issuance costs. Although study results varied, most studies that we reviewed indicate that bonds sold through competitive sales generally have lower interest costs than bonds sold through negotiated sales after taking other factors into account that might influence interest costs. Median issuance costs paid from bond proceeds as a percentage of bond proceeds vary by the size and type of tax-exempt bond. Slightly over half of the qualified private activity bonds issued from 2002 through 2005 had issuance costs paid from bond proceeds—with nearly half leaving the reporting line blank—and some of the bonds had issuance costs that exceeded statutory limits. For example, from 2002 to 2005, between 17 and 39 qualified private activity bonds annually—about 1 to 2 percent of qualified private activity bonds that reported issuance costs paid from bond proceeds—reported issuance costs that exceeded applicable statutory limits.

Although Study Results Varied, Most Studies Generally Found That Competitive Bond Sales Have Lower Interest Costs after Controlling for Other Factors

Researchers have attempted to determine whether the method of sale (i.e., competition between underwriters or negotiation with underwriters) has an effect on the interest costs that bond issuers pay investors. From the federal government's perspective, lower interest costs for municipal governments may be preferable because this might result in less forgone federal tax revenue and better target the subsidy to its intended beneficiaries. However, even if the competed method of sale generally yields lower interest costs to municipal governments, the negotiated method of sale may still be preferable in some instances.[28] We reviewed studies published from 1996 through 2007 that address whether there is a difference in interest costs for bonds sold on a competitive basis versus bonds sold on a negotiated basis.

The studies we reviewed generally used statistical analysis techniques[29] to identify the effect that the method of sale (i.e., competitive or negotiated) has on the interest cost paid by bond issuers. In addition to the method of sale, a number of other factors in the municipal bond market could affect interest costs, and the studies we reviewed attempt to control for these factors to isolate the effect that the method of sale has on interest costs. Other factors that could affect a bond issuer's borrowing costs include marketwide factors, such as the average level of tax-exempt interest rates and the recent volatility of these rates; issuer-specific factors, such as economic characteristics of the issuing jurisdiction and the amount of experience the issuer has in issuing bonds; and bond-specific factors, such as the number of years until the bond matures, the amount of the bond, the purpose of the bond, the funding source that backs the bond, the bond's credit rating, and whether the issuer purchased bond insurance or other credit enhancers.

In general, after controlling for other factors that may affect interest costs, research suggests that bonds issued on a competitive basis will likely have lower interest costs than bonds sold on a negotiated basis because bond

[28]For example, in cases where a bond with relatively complex features is to be issued during a time period with volatile interest rates, a negotiated sale might be preferred because in a negotiated sale the underwriter and the issuer have more flexibility in terms of the timing of the bond issue, and the underwriter has more time to search for investors better suited to more complex bonds.

[29]The studies we reviewed generally used multivariate regression analysis techniques to identify the effect that the method of sale has on interest costs. Multivariate regression analysis is a research technique commonly used by economists and other researchers to isolate the effect of one or more variables on the variable of primary interest.

issuers are likely to benefit from multiple underwriters bidding on the right to sell the bonds.[30] In addition, several of the studies suggested that as the number of competitive bids on a bond issue increase, the interest costs that state and local governments pay decline further. However, one of the studies we reviewed found no significant differences in interest costs for competitive and negotiated sales and one found some advantage for negotiated bonds.[31]

The studies included in our literature review had several limitations. Because of limited data availability, some key variables are not available to be included in the study. No study that we reviewed had data on the extent to which issuers that used a negotiated sale searched among several underwriters before making a selection. Also, none of the studies we reviewed included a comprehensive, recent review of competitive and negotiated bond sales for the entire municipal bond market. Most of the studies we identified were limited to certain states for certain time periods or focused on a particular market sector, such as bonds issued specifically for hospitals.

See appendix V for a list of the studies we reviewed addressing whether interest costs vary by method of bond sale.

[30]Of studies that reported the magnitude of the difference in interest costs for competitive and negotiated bonds, one found the difference to be 0.6 percentage points. However, most of these studies found the difference to be lower, generally ranging from 0.1 to 0.2 percentage points, and two of the studies raised questions about whether bonds issued through the competitive method of sale have significantly lower interest costs.

[31]Some debate exists about the appropriate statistical specification and whether potential selection bias issues need to be taken into account. In the case of comparing competitive and negotiated bond sales, potential selection bias may arise from the fact that most bond issuers can choose the method of sale that they believe will be most beneficial. Some studies have found either insignificant or relatively small advantages to competitive sales after taking these potential bias issues into account, but other studies have found the potential bias to have little effect on the results.

Some Qualified Private Activity Bond Issuers Reported Issuance Costs Exceeding Legal Limits, and Issuance Costs Vary Depending on Bond Characteristics

IRS requires qualified private activity bond issuers to report issuance costs paid from bond proceeds on the Form 8038, and for most types of private activity bonds, issuance costs that can be paid from bond proceeds are limited to 2 percent of bond proceeds.[32] From 2002 to 2005, bond issuers reported issuance costs paid from bond proceeds on slightly more than half of the filed Form 8038s. For example, bond issuers reported issuance costs paid from bond proceeds between 51 percent and 59 percent of the time annually for 2002 to 2005. Bond issuers for the remaining bonds left the line for issuance costs paid from bond proceeds blank. Issuers of smaller bonds, meaning those with bond proceeds of less than $1 million, reported issuance costs less frequently than issuers of larger bonds; however, issuers of large bonds, meaning those with proceeds over $100 million, also did not report issuance costs about 35 percent of the time.

According to the Director of IRS's Tax-Exempt Bond Office, IRS would need to contact the issuer to determine whether a tax-exempt bond information return that a bond issuer submitted to IRS reporting no issuance cost is a problem. He said that there may be legitimate reasons why issuance cost was not reported on the form, such as when issuance costs are paid from other sources or special funds. Currently, IRS does not have mechanisms in place to routinely determine whether unreported issuance cost is a compliance problem or a bond issuer's mistake. IRS's instructions for Form 8038 require bond issuers to enter the amount of proceeds that will be used to pay bond issuance costs, including underwriters' spread and fees for trustees and bond counsel. However, the instructions do not provide any guidance for instances when issuance costs are not paid from bond proceeds.

For qualified private activity bonds with reported issuance costs, the median issuance costs as a percentage of bond proceeds varied by the size and type of the bond. For all qualified private activity bonds that reported issuance costs paid from bond proceeds, the median issuance cost as a percentage of bond proceeds ranged from a low of 1.6 percent in 2005 to a high of 1.8 percent in 2002. For bonds under $10 million, the median issuance cost as a percentage of bond proceeds reached or came close to

[32]By law, bond issuers are required to file IRS Form 8038-G, Information Return for Tax-Exempt Government Obligations for Governmental Bonds, for bonds with an issue price of $100,000 or greater, or IRS Form 8038, Information Return for Tax-Exempt Private Activity Bonds. Generally, these forms are required to be filed by the 15th day of the second calendar month following the quarter in which the bonds were issued.

the 2 percent limit annually from 2002 to 2005. Larger bonds reported lower issuance costs as a percentage of bond proceeds, possibly indicating that issuance costs include fixed fees or other payments that are not based on the size of the bond. When considering bond purposes, the median issuance costs as a percentage of bond proceeds for qualified private activity bonds issued reached or came near the 2 percent statutory limit for numerous categories of bonds. Table 8 shows median issuance costs paid from bond proceeds as a percentage of bond proceeds for long-term qualified private activity bonds issued from 2002 to 2005.

Table 8: Median Issuance Costs Paid from Bond Proceeds as a Percentage of Bond Proceeds for Long-term Qualified Private Activity Bonds Issued from 2002 to 2005

	2002	2003	2004	2005
All	1.81	1.77	1.69	1.64
Purpose				
Airport	1.17	1.36	1.30	1.13
Docks	1.17	1.38	1.70	0.90
Water	1.64	2.00	1.89	1.89
Sewage	1.99	2.00	2.00	1.99
Solid waste	2.00	2.00	2.00	1.81
Rental	1.89	1.76	1.75	1.61
Mortgage revenue[a]	1.00	1.01	1.06	0.71
Small issue	2.00	2.00	2.00	2.00
Student loan	0.90	0.61	0.60	0.63
Hospital	1.28	1.26	1.15	1.08
501(c)(3)	1.89	1.87	1.81	1.85
Other	1.49	1.86	1.48	1.44
Size				
Under $1 million	2.00	2.00	2.00	1.94
$1 million – under $10 million	2.00	2.00	1.96	1.99
$10 million – under $50 million	1.66	1.63	1.63	1.55
$50 million – under $100 million	1.16	1.16	1.13	1.08
$100 million and over	0.90	0.87	0.83	0.72

Source: GAO analysis of IRS data.

Notes: In cases where the median issuance cost percentage is equal to 2, it means that at least half the bonds were at the statutory limit. It does not mean that half of the bonds exceeded the 2 percent limit—multiple bonds could be at the limit without exceeding it.

The size of the issue is measured in 2007 dollars. The percentages in the table are calculated from forms where issuance costs paid from bond proceeds were reported. Forms where issuers reported zero issuance costs paid from bond proceeds or left the line blank are excluded from these median calculations.

[a]Mortgage revenue and veterans' mortgage revenue bonds are combined into one category. These bonds are subject to 3.5 percent limits for issuance costs paid from bond proceeds.

Of the qualified private activity bonds with reported issuance costs, we identified 38 bonds in 2002, 39 bonds in 2003, 25 bonds in 2004, and 17 bonds in 2005 that reported issuance costs as a percentage of bond proceeds that exceeded statutory limits. This accounts for 1 to 2 percent of qualified private activity bonds issued annually.

According to the Director of IRS's Tax-Exempt Bond Office, IRS does not routinely check to determine if all issuers of qualified private activity bonds are complying with the statutory 2 percent limit on using proceeds for issuance costs. He said that if the limit is exceeded, it may be a potential compliance issue. During its examinations of tax-exempt bonds, IRS routinely assesses whether issuance costs exceed legal limits. The Director recognized the importance of bond issuers adhering to the statutory issuance cost limit; however, he also stated that because of resource constraints, IRS places more emphasis on tax-exempt bond compliance examinations and checks that have the most impact. He stated that in considering how best to address potential compliance issues regarding issuance costs, IRS would want to ensure that these inquiries are not automatically construed as audits. Once IRS initiates an audit, it is precluded from auditing the same return again in the same tax year even if more substantial compliance issues arise. The Director indicated that IRS has plans to conduct more special initiatives to monitor compliance with tax-exempt bond rules than it has in the past, such as starting to provide "soft notices" to certain bond issuers that could be used to identify potential issues related to compliance. Soft notices alert taxpayers to potential errors they made and encourage them to correct such errors. In a number of cases, IRS has found many taxpayers do take corrective actions. Because soft notices do not require taxpayers to send IRS any information from their books and records, they are not considered audits. Although it would need to be tested, the Director thought it might be cost-effective to begin using soft notices, when appropriate, to inform bond issuers that they reported issuance costs paid from bond proceeds that exceed statutory limitations.

Unlike qualified private activity bonds, issuance costs for governmental bonds are not subject to any limits; however, like qualified private activity bonds, they vary based on the type of bond and the size of the bond issue.

For all governmental bonds issued from 2002 through 2005 where bond issuers reported issuance costs on the Form 8038-G, median issuance costs paid from bond proceeds as a percentage of bond proceeds ranged from 1.51 percent in 2005 to 1.67 percent in 2003. For bonds with reported issuance costs, from 34 to 39 percent indicated that issuance costs exceeded 2 percent of bond proceeds, the statutory limit for most qualified private activity bonds. Governmental bonds issued for housing generally had the highest median issuance costs paid from bond proceeds as a percentage of bond proceeds while bonds issued for education and health and hospital purposes generally had the lowest median issuance costs paid from bond proceeds as a percentage of bond proceeds. Table 9 shows the median issuance costs paid from bond proceeds as a percentage of bond proceeds for long-term governmental bonds issued from 2002 to 2005 by bond purpose and size of bond.

Table 9: Median Issuance Costs as a Percentage of Bond Proceeds for Long-term Governmental Bonds Issued from 2002 to 2005

	2002	2003	2004	2005
All types	1.62	1.67	1.63	1.51
Purpose				
Education	1.36	1.45	1.36	1.27
Health and hospital	1.57	1.41	1.36	1.19
Transportation	1.61	1.60	1.47	1.39
Public safety	1.53	1.46	1.53	1.44
Environment	1.54	1.62	1.50	1.50
Housing	1.81	1.93	2.01	1.98
Utilities	1.82	1.89	1.76	1.71
Other	1.76	1.75	1.83	1.72
Size of issue				
Under $1 million	2.78	2.59	2.70	2.77
$1 million – under $10 million	1.83	1.86	1.80	1.73
$10 million – under $50 million	1.16	1.12	1.19	1.15
$50 million – under $100 million	0.80	0.83	0.82	0.82
$100 million and over	0.61	0.62	0.60	0.58

Source: GAO analysis of IRS data.

Note: The size of the issue is measured in 2007 dollars. The percentages in the table are calculated from forms where issuance costs paid from bond proceeds were reported. Forms where issuers reported zero issuance costs paid from bond proceeds or left the line blank are excluded from these median calculations.

Like qualified private activity bonds, smaller governmental bonds generally had higher median issuance costs as a percentage of bond proceeds. For example, for bonds under $1 million, the median issuance cost paid from bond proceeds as a percentage of bond proceeds exceeded 2.5 percent in all years for 2002 through 2005. Median issuance costs as a percentage of bond proceeds for governmental bonds issued for amounts greater than $100 million were about 0.6 percent from 2002 to 2005.

Conclusions

State and local governments have broad discretion in deciding which activities and facilities to finance using tax-exempt bonds. In particular, the broad discretion afforded to state and local governments allows them to use tax-exempt governmental bonds to finance facilities and activities that cannot be financed with private activity bonds. Recently, the dollar amount of tax-exempt governmental bonds reached peak levels as municipal governments issued bonds for a wide variety of purposes ranging from traditionally public facilities, such as schools, fire stations, and roads, to facilities that are essentially private in nature, such as sports stadiums.

Congressional policymakers have recently shown interest in whether certain facilities providing benefits that are essentially private in nature, such as stadiums, should be financed with tax-exempt governmental bonds. However, similar attention has not been given other types of facilities, like hotels and golf courses that also provide benefits that are essentially private in nature. As Congress continues to hold discussions on whether sports stadiums are appropriate uses of tax-exempt governmental bonds, it should also consider whether other facilities that are privately used, such as hotels, should continue to be financed with tax-exempt bonds. However, if Congress still views these and other facilities that are essentially private in nature as appropriate uses of tax-exempt governmental bonds, then legislative changes would not be necessary.

Issuers of qualified private activity bonds must adhere to the limits on using bond proceeds for issuance cost that are imposed by law. In part, this helps to ensure that the federal subsidy afforded to issuers of bonds for private uses is appropriately targeted to the purposes for which the bonds were issued. This is equally important to ensure that the bonds' tax-exempt status remains intact. In addition, it would be more beneficial to IRS if its forms and instructions included specific directions to bond issuers that did not use bond proceeds for issuance costs to indicate this on the form. Although this may require that IRS revise Form 8038, we believe that it would be beneficial for IRS to know positively whether issuers used bond proceeds for issuance costs and, if so, how much was used. This would better equip IRS to determine if there are any compliance issues that need to be addressed. We believe that if the Form 8038 is revised, the benefits to IRS would likely outweigh the costs.

Matter for Congressional Consideration

As Congress considers whether tax-exempt governmental bonds should be used for professional sports stadiums that are generally privately used, it should also consider whether other facilities, including hotels and golf courses, that are privately used should continue to be financed with tax-exempt governmental bonds.

Recommendations for Executive Action

To better ensure that IRS can routinely and cost effectively determine whether issuers of qualified private activity bonds are complying with the statutory limits on using bond proceeds for issuance costs, we recommend that the Commissioner of Internal Revenue take the following two actions:

- Clarify IRS's forms and instructions for reporting issuance cost paid from bond proceeds to require that bond issuers clearly designate on the form instances when bond proceeds were not used to pay issuance costs.
- Develop cost-effective methods to address apparent noncompliance with the statutory limits on using bond proceeds for issuance costs in such a manner that it would not preclude IRS from examining the bonds for more substantive compliance issues in the future.

Agency Comments

We provided a draft of this report to IRS and Treasury for comment. The Acting Commissioner of Internal Revenue provided comments on a draft of this report in a February 7, 2008, letter, which is reprinted in appendix VI. IRS said that it agreed with our recommendations. Regarding our recommendation that IRS clarify its forms and instructions for reporting issuance cost paid from bond proceeds to require that bond issuers clearly designate on the form instances where bond proceeds were not used to pay issuance costs, IRS said that it will clarify instructions for IRS Form 8038 to require that bond issuers clearly indicate when no bond proceeds were used to pay issuance costs. Concerning our recommendation that IRS develop cost-effective methods to address apparent noncompliance with the statutory limits, IRS said that it will develop a compliance project to address apparent noncompliance with the issuance cost requirements for the fiscal year 2009 tax-exempt bonds work plan that will likely incorporate sending soft-contact letters similar to ones previously used with success in other areas.

In a February 8, 2008, letter, Treasury's Assistant Secretary for Tax Policy commented that the use of tax-exempt governmental bonds to finance stadiums and other projects with significant private business use is arguably a structural weakness in the targeting of the federal tax expenditure for tax-exempt bonds under the existing legal framework. Treasury pointed out that while the existing framework might have a tax policy justification in giving municipal governments flexibility to use governmental bonds for a range of public-private partnerships, it may also be debatable in certain cases, such as for certain stadium financings. Treasury noted its recent testimony that outlined several options to address the possible structural weakness in the targeting of tax-exempt bond subsidy relative to tax-exempt governmental bonds for stadium financings. Treasury's comments are reprinted in appendix VII.

As arranged with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days after its date. At that time, we will send copies of this report to the Commissioner of Internal Revenue and the Secretary of the Treasury and other interested parties. We will also provide copies to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff members have any questions about this report, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made contributions to this report are listed in appendix VIII.

Michael Brostek
Director, Tax Issues
Strategic Issues

Appendix I: Objectives, Scope, and Methodology

The objectives of this report were to (1) describe recent trends in the dollar volume of tax-exempt bonds; (2) provide information on the types of facilities and activities that are financed with tax-exempt bonds, in particular, information on hotels and municipal golf courses that were recently financed with tax-exempt bonds; and (3) provide information on borrowing costs that bond issuers pay when issuing bonds by summarizing relevant research on whether bond interest costs vary by the method of sale, considering characteristics of the bond and bond issuer and provide information on how bond issuance costs vary between governmental and private activity bonds, including the extent to which private activity bond issuers exceed the statutory limit for issuance costs as a percentage of bond proceeds.

To provide information on trends in the volume of tax-exempt bonds, we relied primarily on data from the Internal Revenue Service's (IRS) Statistics of Income Division (SOI), which collects statistical data from information returns that tax-exempt bond issuers are required to file with IRS. We used SOI data from 1991 through 2005, the most recently available data, to provide information on the overall volume of tax-exempt bonds issued, the volume of governmental and private activity bonds issued, and the volume of new money versus refunding bonds issued. We also relied on the 20-Bond Index in the *2007 Bond Buyer Yearbook*, which presents average interest rates on a set of 20 investment grade general obligation bonds maturing in 20 years, to compare interest rate changes from 1992 through 2005 with the volume of new money and refunding tax-exempt bond issues. We used data from the *Technical Appendix of the President's Budget* for fiscal years 2002, 2004, 2006, and 2008 and data from the Joint Committee on Taxation's *2007 Estimates of Federal Tax Expenditures* to provide estimates of the amount of forgone revenue resulting from the exclusion of interest earned on tax-exempt bonds from federal income taxes.

To describe the types of activities and facilities that are being financed with tax-exempt bonds, we relied on data in the *2007 Bond Buyer Yearbook*, IRS's SOI data, and a limited random sample of official statements. We used *Bond Buyer Yearbook* information because it provided us with more information about the purposes of tax-exempt bonds than other private data sources we identified. Data in the *2007 Bond Buyer Yearbook* provide summary information on the uses of municipal bonds in 10 main categories and 48 subcategories. Information in the *Bond Buyer Yearbook* is obtained from Thomson Financial's municipal bond database, one of the most comprehensive data sources on tax-exempt bonds. One limitation of the *Bond Buyer Yearbook* is that it does not provide separate breakouts of the uses of governmental and private activity bonds and includes taxable bonds. Taxable municipal bonds generally account for less than 10 percent of all municipal bonds.

We used SOI data to provide information on the uses of governmental and private activity bonds. IRS's SOI collects data on the purposes of governmental and qualified private activity bonds as reported on Form 8038-G and Form 8038, respectively. The information is summarized into broad categories for governmental bonds and by allowable uses for qualified private activity bonds. IRS generates summary tables on tax-exempt bond uses that are posted on IRS's Web site and published in regularly issued bulletins. We used IRS's SOI tax-exempt bond data for 2002 through 2005 to analyze the other category for governmental bond purposes and the nonhospital 501(c)(3) category for qualified private activity bond purposes.

In some cases, information from the *Bond Buyer Yearbook* and information from the SOI database differ for similar types of bonds and for statistics about similar bond characteristics. Several possible reasons exist for the difference between summary information from SOI and the *Bond Buyer Yearbook*. For example, SOI relies on bond issuers to timely and accurately report bond information while Thomson Financial relies on automated reporting systems from the financial marketplace to develop reports in the *Bond Buyer Yearbook*. Even though the amounts differ in some instances for SOI and Bond Buyer data, our testing of these data allowed us to conclude that both sources were sufficiently reliable for providing information on tax-exempt bonds used in this report.

We reviewed a limited random sample of official statements to provide more detailed information about the specific uses of tax-exempt governmental bonds than can typically be found in other data sources, such as the *Bond Buyer Yearbook* and the SOI data. The sample was not designed to provide projectable data on the uses of tax-exempt bonds. We drew the sample using the Municipal Securities Rulemaking Board's (MSRB) database of official statements that it received in calendar year 2006. MSRB is a congressionally chartered organization that regulates securities firms and banks involved in underwriting, trading, and selling municipal securities, and based on its rules, bond issuers are required to send a copy of their final official statements to it. We reviewed the randomly ordered official statements until we identified five official statements that we determined would likely be included in each of the eight categories in the SOI data.

For providing information on hotels that were financed with tax-exempt bonds, we could not find a comprehensive, reliable source with information on the numbers of hotels financed with tax-exempt bonds. Thus, we provide some limited data from the best available sources we could find for hotels financed with tax-exempt bonds from 2002 through 2006. We used these recent years because information on financing for these hotels would more likely be available than information for hotels financed in earlier years. To identify the hotels, we used information from a previous GAO report;[1] HVS International, a global consulting services firm that focuses on hotel and hospitality services; and Bond Buyer daily publications that provide additional information on municipal bonds. From these sources we identified a number of hotels that may have been financed with tax-exempt bonds. However, we were only able to confirm that the 18 hotels identified in our report were financed, at least in part, with tax-exempt bonds by reviewing official statements and government financial reports and contacting local officials. The list of hotels we present likely is not a comprehensive list of all hotels financed with tax-exempt bonds.

For providing information on municipal golf courses that were financed with tax-exempt bonds, we could not find a comprehensive, reliable source with information on the number of municipal golf courses financed with tax-exempt bonds. Thus, similar to our review of hotels, we provide limited data from the best available sources we could find. We used the National Golf Foundation's database to identify municipal golf courses that opened in 2005. We identified nine municipal golf courses that opened in 2005. However, the National Golf Foundation's database did not have information on whether the golf courses were financed with tax-exempt bonds. To confirm whether these nine municipal golf courses were financed with tax-exempt bonds, we contacted city, county, and golf course officials. From these contacts, we determined that six of the nine municipal golf courses were financed with tax-exempt bonds, and we obtained the official statements for those municipal golf courses.

To provide information on borrowing costs, we conducted a literature review of previous studies that reviewed whether bond issuance costs vary by method of sale, including characteristics of the bond and bond issuers, and we analyzed IRS data on issuance costs. We reviewed studies

[1]GAO, *Federal Tax Policy: Information on Selected Capital Facilities Related to the Essential Government Function Test*, GAO-06-1082 (Washington, D.C.: Sept. 13, 2006).

published in peer-reviewed academic journals from 1996 through 2007. Because the studies we reviewed had several limitations, including that they were limited to certain states for certain time periods or focused only on certain market sectors, we initially attempted to conduct original research on this topic by obtaining a broad set of data on tax-exempt bonds and developing similar econometric analysis to the studies we reviewed that would have covered a wider range of bonds over a longer time period. However, we determined that the available data were not sufficiently reliable for our purposes. As a result, we confined our review of bond issuance costs to a summary of previous studies that attempt to address the same issue, but not on as wide of a scale as we had initially intended. We analyzed IRS's SOI data on tax-exempt bonds from 2002 to 2005 to identify how issuance costs vary between governmental and private activity bonds. We reviewed issuance costs as a percentage of total bond proceeds for the various categories of governmental and qualified private activity bonds and by bond size. We also used IRS data to identify the extent to which issuance costs for qualified private activity bonds exceed the statutorily required 2 percent limit and the extent to which bond issuers do not report issuance costs on the IRS Forms 8038 and 8038-G.

We interviewed officials in IRS's Tax-Exempt Bond Office in its Government Entities and Tax-Exempt Division and Treasury's Office of Tax Policy and other experts in taxation and government finance, such as representatives of the Government Finance Officers' Association, the Securities Industry and Financial Markets Association, and the Congressional Research Service, to gain an understanding about the volume and uses of tax-exempt bonds. We determined that the data we evaluate in this report were sufficiently reliable for our purposes. We performed our work from December 2006 through January 2008 in accordance with generally accepted government auditing standards.

Appendix II: Sources of Information on the Facilities and Activities Financed Using Tax-Exempt Bonds

Information on the types of facilities and activities that are financed with tax-exempt bonds is available from several sources, including the official statements prepared by underwriters to market the bonds, IRS, and private vendors, such as Thomson Financial.[1] Specific information on what tax-exempt bonds are used for varies by source. Overall, the official statement generally contains the most detailed descriptive information. However, because there are no standard guidelines on the format and content of official statements, the level of detailed information they contain on the facilities and activities financed with tax-exempt bonds varies. For example, an official statement for a bond issued in 2006 stated that the bond was to be used to construct and improve the water facility for a municipality. Another official statement for a bond issued the same year showed that the bonds were to be used for various capital improvements. While in the first instance, the official statement more clearly discloses what the bond is to be used for, it is not fully apparent from the other example what specific capital improvements were financed by the bond.[2]

The information IRS collects on tax-exempt bonds is transcribed from information returns bond issuers are required to send IRS. By law, bond issuers are required to file IRS Form 8038-G, Information Return for Tax-Exempt Government Obligations for Governmental Bonds for bonds with an issue price of $100,000 or greater, or IRS Form 8038, Information Return for Tax-Exempt Private Activity Bonds. In filling out the form, a bond issuer checks boxes that best describe the types of facilities and activities to be financed with the bonds. For governmental bonds, the form has eight broad categories, including education, transportation, public safety, and other. If the other category is checked, the bond issuer is also asked to write in information that describes the intended use of bond proceeds. While the information that IRS collects from the form is useful in presenting summary information on the facilities and activities financed with governmental bonds, it only presents a very broad picture of the facilities for which the bonds are used. For example, if the bond issuer checked education, it is only apparent that the bonds were intended for educational facilities and activities. However, the specific nature of the educational facilities and activities is unknown based on the type of data IRS collects. For instance, it would not be apparent whether the bonds

[1]Some of the other private vendors are Bloomberg and DCP Data.

[2]Routinely, state and local governments authorize a single bond issue for multiple facilities and activities because it is more cost-effective to do so than to issue separate bonds for each individual project.

were used to finance new educational facilities, such as public and charter schools; fund teachers' pension plans; construct a college athletic field; or pay for computer equipment used in a school. Likewise, issuers of private activity bonds are required to send IRS a similar form wherein they check boxes that broadly describe the facilities and activities financed with the bonds. IRS publishes descriptive statistics from these forms.

Another source of information on the facilities and activities financed by tax-exempt bonds that we used was the *Bond Buyer Yearbook*, a publication by Thomson Financial that summarizes information on municipal bonds on a yearly basis. Information in the *Bond Buyer Yearbook* is obtained from several sources and provides one of the most comprehensive sources of information describing the facilities and activities financed by municipal bonds.[3] The *Bond Buyer Yearbook* categorizes the facilities and activities financed by municipal bonds based on 10 broad categories and 48 subcategories. Even though the *Bond Buyer Yearbook* categorizes municipal bonds into many categories, the information only presents a general picture of the range of facilities and activities for which the bonds are used. For example, the *Bond Buyer Yearbook* development category has 3 subcategories—industrial, economic, and office buildings. From this summarized information, it is not apparent whether facilities such as hotels financed with tax-exempt governmental bonds are included as economic development.

It is also important to note that *Bond Buyer Yearbook* information on the uses of bonds does not distinguish between tax-exempt governmental, qualified private activity, and taxable municipal bonds. However, according to *Bond Buyer Yearbook* information, generally less than 10 percent of all municipal bonds issued annually are taxable. Despite that, the *Bond Buyer Yearbook* is a useful source for summarized information on the types of facilities and activities that are financed using municipal bonds, including tax-exempt bonds.

[3]The *Bond Buyer Yearbook* is published by Thomson Financial, one of several private vendors that collect information on municipal bonds. The Bond Buyer staff develops the information presented in the *Bond Buyer Yearbook* primarily from the Thomson Financial municipal bond database.

Appendix III: Summary of Thomson Financial *2007 Bond Buyer Yearbook* Data, Use of Proceeds, 2002-2006 Combined

Dollars in thousands (constant 2007 dollars)

Category	Total amount	Percentage of total amount	Total issues	Percentage of total issues	Average size
Development	**$39,608,241**	**1.9**	**2,166**	**3.1**	**$18,286**
Industrial	12,505,367	0.6	1,053	1.5	11,876
Economic	22,126,773	1.1	1,012	1.5	21,864
Office buildings	4,976,101	0.2	101	0.1	49,268
Education	**549,361,712**	**26.7**	**22,909**	**32.9**	**23,980**
Primary	320,522,558	15.6	18,595	26.7	17,237
Higher	140,826,687	6.9	3,579	5.1	39,348
Student loans	84,509,389	4.1	454	0.7	186,144
Other	3,503,078	0.2	281	0.4	12,466
Electric power	**81,192,942**	**3.9**	**976**	**1.4**	**83,189**
Environmental facilities	**38,725,608**	**1.9**	**947**	**1.4**	**40,893**
Pollution control	30,173,427	1.5	544	0.8	55,466
Solid waste	8,041,327	0.4	384	0.6	20,941
Recycling	510,854	0.0	19	0.0	26,887
Health care	**176,373,183**	**8.6**	**3,781**	**5.4**	**46,647**
General acute	128,167,687	6.2	2,137	3.1	59,976
Single specialty	7,027,622	0.3	121	0.2	58,080
Children’s	4,859,249	0.2	63	0.1	77,131
Equipment loans	576,403	0.0	34	0.0	16,953
General medicine	13,750,733	0.7	290	0.4	47,416
Nursing homes	2,034,315	0.1	190	0.3	10,707
Assisted living	3,414,538	0.2	275	0.4	12,417
Continuing care	16,542,636	0.8	670	1.0	24,691
Housing	**135,595,064**	**6.6**	**5,084**	**7.3**	**26,671**
Single family	86,004,557	4.2	2,307	3.3	37,280
Multifamily	49,590,507	2.4	2,777	4.0	17,858
Public facilities	**73,666,106**	**3.6**	**3,512**	**5.0**	**20,976**
Libraries/museums	7,337,590	0.4	450	0.6	16,306
Government offices	15,209,684	0.7	523	0.8	29,082
Fire stations	1,952,056	0.1	568	0.8	3,437
Jails/prisons	12,267,564	0.6	400	0.6	30,669
Police stations	1,475,514	0.1	79	0.1	18,677
Convention centers	14,106,238	0.7	243	0.3	58,050

Dollars in thousands (constant 2007 dollars)

Category	Total amount	Percentage of total amount	Total issues	Percentage of total issues	Average size
Stadiums/arenas	$7,942,644	0.4	123	0.2	$64,574
Theaters	1,019,123	0.0	33	0.0	30,883
Parks/zoos/beaches	6,791,057	0.3	719	1.0	9,445
Other recreation	5,564,636	0.3	373	0.5	14,919
Transportation	**224,211,008**	**10.9**	**2,624**	**3.8**	**85,446**
Airports	51,156,780	2.5	646	0.9	79,190
Seaports	8,186,168	0.4	179	0.3	45,733
Toll roads	80,102,761	3.9	1,073	1.5	74,653
Bridges	12,011,682	0.6	78	0.1	153,996
Tunnels	1,716,243	0.1	5	0.0	343,249
Parking facilities	3,984,134	0.2	244	0.3	16,328
Mass transit	64,805,175	3.2	364	0.5	178,036
Other	2,248,063	0.1	35	0.1	64,230
Utilities	**191,901,506**	**9.3**	**7,560**	**10.8**	**25,384**
Water/sewer	159,860,413	7.8	6,752	9.7	23,676
Gas works	14,037,362	0.7	71	0.1	197,709
Telephone	997,091	0.0	67	0.1	14,882
Sanitation	3,493,435	0.2	215	0.3	16,249
Flood control	2,537,538	0.1	142	0.2	17,870
Combined utilities	10,975,667	0.5	313	0.4	35,066
General purpose	**557,020,590**	**27.1**	**20,161**	**28.9**	**27,629**
General purpose	556,138,961	27.1	17,211	24.7	32,313
Veterans	407,330	0.0	1,001	1.4	407
Places of worship	160,640	0.0	931	1.3	173
Agriculture	313,544	0.0	1,018	1.5	308
Total	**$2,055,644,205**	**100.0**	**69,720**	**100.0**	**$29,484**

Source: GAO analysis of Thomson Financial data in the *2007 Bond Buyer Yearbook*.

Appendix IV: Amount and Number of New Money, Long-term Governmental Bonds Issued by IRS SOI Purpose Categories, 2001-2005 Combined

Dollars in millions (constant 2007 dollars)

Category	Total amount	Percentage of total amount	Total issues	Percentage of total issues	Average size
Education	$266,513	32.7	23,202	30.4	$11.5
Other	263,796	32.3	22,342	29.3	11.8
Transportation	100,671	12.3	4,887	6.4	20.6
Utilities	91,235	11.2	7,742	10.1	11.8
Environment	47,736	5.8	5,470	7.2	8.7
Health and hospital	18,363	2.3	1,832	2.4	10.0
Public safety	21,200	2.6	10,203	13.4	2.1
Housing	6,583	0.8	643	0.8	10.2
Total	**$816,099**	**100.0**	**76,321**	**100.0**	**$10.7**

Source: GAO analysis of IRS's Statistics of Income Division data.

Appendix V: List of Studies Reviewed on Interest Costs in Competitive and Negotiated Sales

Gershberg, Alec Ian, Michael Grossman, and Fred Goldman. "Competition and the Cost of Capital Revisited: Special Authorities and Underwriters in the Market for Tax-Exempt Hospital Bonds." *National Tax Journal*, vol. 54, no. 2 (2001): 255-280.

Kriz, Kenneth A. "Comparative Costs of Negotiated versus Competitive Bond Sales: New Evidence From State General Obligation Bonds." *The Quarterly Review of Economics and Finance*, vol. 43 (2003): 191-211.

Leonard, Paul A. "An Empirical Analysis of Competitive Bid and Negotiated Offerings of Municipal Bonds." *Municipal Finance Journal*, vol. 17, no. 1 (1996): 37-66.

Peng, Jun and Peter F. Brucato, Jr. "Another Look at the Effect of Method of Sale on the Interest Cost in the Municipal Bond Market—A Certification Model." *Public Budgeting and Finance*, vol. 23, no. 1 (2003): 73-95.

Robbins, Mark D. and Bill Simonsen. "Competition and Selection in Municipal Bond Sales: Evidence From Missouri." *Public Budgeting and Finance*, vol. 27, no. 2 (2007): 88-103.

Simonsen, Bill, Mark D. Robbins, and Lee Helgerson. "The Influence of Jurisdiction Size and Sale Type on Municipal Bond Interest Rates: An Empirical Analysis." *Public Administration Review*, vol. 61, no. 6 (2001): 709-717.

Simonsen, William and Mark. D. Robbins. "Does It Make Any Difference Anymore? Competitive versus Negotiated Municipal Bond Issuance." *Public Administration Review*, vol. 56, no. 1 (1996): 57-64.

Appendix VI: Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

February 7, 2008

Mr. Michael Brostek
Director, Tax Issues
Strategic Issues
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Brostek:

We appreciate the opportunity to review your draft report concerning tax-exempt bonds and the issue of compliance with limitations on issuance costs. The report fairly represents the growth, character and size of the tax-exempt bond market, and its impact on federal revenues. Although the choice made by the issuer of tax-exempt bonds between a competitive or a negotiated sale method does not present issues under the federal tax laws, it is clear that the choice of sales method can significantly affect the cost of issuing the bonds.

The Internal Revenue Service (IRS) is committed to ensuring compliance with the federal tax law applicable to tax-exempt bonds. Our Tax Exempt Bond function, within the Tax Exempt and Government Entities division, operates enforcement, educational, and voluntary compliance programs to ensure compliance with the applicable law and to assist the issuers of tax-exempt bonds in understanding their tax responsibilities.

These programs include an audit planning process that takes into account non-compliance with the federal tax law requirements related to issuance costs. They also include a program involving both general examination activity and compliance checks. For example, we recently sent charities a compliance questionnaire inquiring whether they were properly maintaining documentation reflecting the allocation of bond-financed proceeds to bond issuance costs. We also have developed and distributed two compliance guides that educate issuers and borrowers regarding issuance cost requirements (Publication 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable* Organizations, and Publication 4078, *Tax-Exempt Private Activity Bonds Compliance Guide*).

Thank you for your interest in this area. If you have questions concerning this response, please contact Steven T. Miller, Commissioner, Tax Exempt and Government Entities, at (202) 283-2500.

Sincerely,

Linda E. Stiff

Linda E. Stiff
Acting Commissioner of Internal Revenue

Enclosure

Enclosure

Recommendation One:

To better ensure that IRS can routinely and cost effectively determine whether issuers of qualified private activity bonds are complying with the statutory limits on using bond proceeds for issuance costs, we recommend that the Commissioner of Internal Revenue should clarify its forms and instructions for reporting issuance cost paid from bond proceeds to require that bond issuers clearly designate on the form instances when bond proceeds were not used to pay issuance costs.

Response:

The IRS agrees with this recommendation. We will clarify the instructions for IRS Form 8038, *Information Return for Tax Exempt Private Activity Bond Issues*, to require that bond issuers clearly indicate when no bond proceeds were used to pay issuance costs.

Recommendation Two:

To better ensure that IRS can routinely and cost effectively determine whether issuers of qualified private activity bonds are complying with the statutory limits on using bond proceeds for issuance costs, we recommend that the Commissioner of Internal Revenue develop cost-effective methods to address apparent noncompliance with the statutory limits on using bond proceeds for issuance costs in such a manner that would not preclude IRS from examining the bonds for more substantive compliance issues in the future.

Response:

The IRS agrees with this recommendation. For the FY 2009 Tax Exempt Bonds Work Plan, we will develop a compliance project that will address apparent non-compliance with the issuance cost requirements but will not preclude us from examining the bonds for other issues at a later date. This compliance project will most likely incorporate "soft-contact" letters of the sort we have used successfully in other areas in the past.

Appendix VII: Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

FEB 0 8 2008

Mr. Michael Brostek
Director, Tax Issues, Strategic Issues Team
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Brostek:

Thank you for providing the Treasury Department with an opportunity to review and comment on your draft report, entitled "Tax Policy: Tax-exempt Status of Certain Bonds Merits Reconsideration and IRS Should Address Apparent Noncompliance with Issuance Cost Limitations (GAO-08-364)." John Cross, Associate Tax Legislative Counsel, previously provided technical comments to your staff on the draft report.

I want to take the opportunity in this letter to underscore one main point referenced in your report that I made in recent testimony before the House Committee on Oversight and Government Reform's Domestic Policy Subcommittee on October 10, 2007. A copy of my testimony is attached. In particular, from a tax policy perspective, the ability to use tax-exempt governmental bonds to finance stadiums and other projects with significant private business use when the bonds are subsidized with State or local governmental payments, such as generally applicable taxes, arguably represents a structural weakness in the targeting of the Federal tax expenditure for tax-exempt bonds under the existing legal framework. That possible structural weakness exists because current law generally allows characterization of bonds as tax-exempt governmental bonds unless more than 10 percent of the bond proceeds are <u>both</u> used for private business use and are payable from private payments. Thus, governmental bonds, which are not subject to the state volume cap and other limitations of qualified private activity bonds, may finance a project with significant private business use so long as private payments are limited.

The tax policy justification for the existing framework is that it gives State and local governments appropriate flexibility to use governmental bonds to finance a range of projects in public-private partnerships with significant private business use when the projects are sufficiently important to warrant subsidizing them with State and local governmental funds. Here, political constraints against commitment of governmental funds ordinarily serve as a sufficient check against excess financing of such projects. This justification may be debatable in certain cases, such as in the case of certain stadium financings. My above-noted recent testimony outlined several options that could be considered to address the possible structural weakness in the targeting of the tax-exempt bond subsidy relative to tax-exempt governmental bonds for stadium financings.

At this time, the Administration does not take a position on any specific policy option with respect to possible legislative changes to the tax-exempt bond provisions relative to stadium financings or other governmental bond financings involving significant private business use. This topic raises difficult questions that require balancing the interests of State and local governments in having flexibility to finance projects they deem sufficiently important to subsidize with governmental funds and the Federal interest in ensuring effective targeting of the Federal tax expenditure for tax-exempt bonds. The Administration recognizes that review of this important Federal tax expenditure may be appropriate in considering ways more generally to simplify this area and to ensure effective targeting of this subsidy for public infrastructure.

Thank you again for the opportunity to comment on your draft report.

Sincerely,

Eric Solomon
Assistant Secretary (Tax Policy)

Attachment

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 2 P.M. EDT October 10, 2007
CONTACT Andrew DeSouza (202) 622-2960

TESTIMONY OF TREASURY ASSISTANT SECRETARY FOR TAX POLICY ERIC SOLOMON BEFORE THE HOUSE OVERSIGHT SUBCOMMITTEE ON DOMESTIC POLICY ON TAX EXEMPT BOND FINANCING

Washington, DC— Chairman Kucinich, Ranking Member Issa, and distinguished Members of the Subcommittee:

I appreciate the opportunity to appear before you today to discuss certain Federal tax issues regarding the use of tax-exempt bond financing The Administration recognizes that tax-exempt bond financing plays an important role as a source of lower-cost financing for State and local governments. As a nation, we are focusing on the critical need to support capital investment in public infrastructure. The Federal government provides an important Federal subsidy for tax-exempt bond financing through the Federal income tax exemption for interest paid on State or local bonds under Section 103 of the Internal Revenue Code (the "Code"), which enables State and local governments to finance public infrastructure projects and other public-purpose activities at lower costs.

The cost to the Federal government of tax-exempt bonds is significant and growing. Unlike direct appropriations, however, the cost of this Federal subsidy receives less attention because it is not tracked annually through the appropriations process. In addition, it also is important to recognize that the Federal subsidy for tax-exempt bonds is less efficient than that for direct appropriations because of the inefficiency of pricing in the tax-exempt bond market. In this regard, since some bond purchasers have higher marginal tax rates than those of the bond purchasers needed to clear the market, tax-exempt bonds cost the Federal government more in foregone revenue than they deliver to State and local governments in reduced interest expenses The steady growth in the volume of tax-exempt bonds reflects the importance of this incentive in addressing public infrastructure and other needs. At the same time, it is appropriate to review the tax-exempt bond program to ensure that it is properly targeted and that the Federal subsidy is justified in light of the lost Federal revenue and other costs imposed.

My testimony covers four main issues First, my testimony provides an overview of the legal framework for tax-exempt bonds. Second, it discusses the use of tax-exempt bonds to finance public infrastructure projects and stadium projects under the existing legal framework. Third, my testimony

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comments on certain tax policy and regulatory authority considerations. Finally, it provides certain statistical data on tax-exempt bonds for background

Overview of Legal Framework for Tax-Exempt Bonds

A. Introduction

In general, there are two basic types of tax-exempt bonds: Governmental Bonds and Private Activity Bonds. Bonds generally are classified as Governmental Bonds if the proceeds are used for State or local governmental use or the bonds are repaid from State or local governmental sources of funds. Bonds generally are classified as Private Activity Bonds if they meet the definition of a Private Activity Bond under the Code, based on specified levels of private business involvement. In general, the interest on Private Activity Bonds is taxable unless the bonds meet qualification requirements for financing certain projects and programs specifically identified in the Code

B. Governmental Bonds

State and local governments issue Governmental Bonds to finance a wide range of public infrastructure projects. The Code does not provide a specific definition of "Governmental Bonds." Instead, bonds are generally treated as Governmental Bonds if they avoid classification as Private Activity Bonds, as defined in the Code, by limiting private business use or private business sources of payment or security, and also by limiting private loans. Here, it is important to appreciate that bonds can qualify as Governmental Bonds if they are either used predominantly for State or local governmental use or payable predominantly from State or local governmental sources of funds, such as generally applicable taxes. Stated differently, under the current legal framework, Governmental Bonds can be used to finance a project that has significant private business use or that are payable from significant private business sources of payment, but not both.

In order for the interest on Governmental Bonds to be excluded from the bond holder's gross income for Federal tax purposes, a number of general eligibility requirements must be met. Requirements generally applicable to all tax-exempt bonds include arbitrage restrictions, bond registration and information reporting requirements, a general prohibition on Federal guarantees, advance refunding limitations, restrictions on unduly long spending periods, and pooled financing bond limitations.

C. Private Activity Bonds

1. In General

Under section 141 of the Code, bonds are classified as Private Activity Bonds if more than 10 percent of the bond proceeds are both:

(1) used for private business use (the "private business use limitation"); and

(2) payable or secured from payments derived from property used for private business use (the "private payments limitation").

Bonds also are treated as Private Activity Bonds if more than the lesser of $5 million or 5 percent of the bond proceeds are used to finance private loans, including business and consumer loans. The permitted private business thresholds are reduced from 10 percent to 5 percent for certain private business use that is "unrelated" to governmental use or that is "disproportionate" to governmental use financed in a bond

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issue. These tests are intended to identify arrangements that have the potential to transfer the benefits of tax-exempt financing to nongovernmental persons

2. Projects and Programs Eligible for Tax-Exempt Private Activity Bond Financing

Private Activity Bonds may be issued on a tax-exempt basis only if they meet the requirements for qualified Private Activity Bonds, including targeting requirements that limit such financing to specifically defined facilities and programs. Under present law, qualified Private Activity Bonds may be used to finance eligible projects and activities, including the following: (1) airports, (2) docks and wharves, (3) mass commuting facilities, (4) facilities for the furnishing of water, (5) sewage facilities, (6) solid waste disposal facilities, (7) qualified low-income residential rental multifamily housing projects, (8) facilities for the local furnishing of electric energy or gas, (9) local district heating or cooling facilities, (10) qualified hazardous waste facilities, (11) high-speed intercity rail facilities, (12) environmental enhancements of hydroelectric generating facilities, (13) qualified public educational facilities, (14) qualified green buildings and sustainable design projects, (15) qualified highway or surface freight transfer facilities, (16) qualified mortgage bonds or qualified veterans mortgage bonds for certain single-family housing facilities, (17) qualified small issue bonds for certain manufacturing facilities, (18) qualified student loan bonds, (19) qualified redevelopment bonds, (20) qualified 501(c)(3) bonds for the exempt charitable and educational activities of Section 501(c)(3) nonprofit organizations, (21) certain projects in the New York Liberty Zone, and (22) certain projects in the Gulf Opportunity Zone.

Qualified Private Activity Bonds are subject to the same general rules applicable to Governmental Bonds, including the arbitrage investment limitations, registration and information reporting requirements, the Federal guarantee prohibition, restrictions on unduly long spending periods, and pooled financing bond limitations. In addition, most qualified Private Activity Bonds are also subject to a number of additional rules and limitations. One notable additional rule limits the annual amount of these bonds that can be issued in each state (the "bond volume cap" limitation) under section 146 of the Code. Another notable additional rule prohibits advance refundings for most Private Activity Bonds under section 149(d)(2) (other than for qualified 501(c)(3) bonds). Further, unlike the tax exemption for interest on Governmental Bonds, the tax exemption for interest on most qualified Private Activity Bonds is generally treated as a preference item under the alternative minimum tax ("AMT"), meaning that the benefit of an exclusion from income for interest paid on these bonds can be taken away by the AMT.

The current legal framework for Private Activity Bonds was enacted as part of the Tax Reform Act of 1986. The basic purpose of the Private Activity Bond limitations was to limit the ability of State and local governments to act as conduit issuers in financing projects for the use and benefit of private businesses and other private borrowers except in prescribed circumstances. Prior to the Tax Reform Act of 1986, the predecessor legal framework had more liberal rules regarding the use of tax-exempt bonds for the benefit of private businesses (then called "industrial development bonds"), including a more liberal 25-percent limitation on permitted private business use and private payments (as compared to the present 10-percent private business and private payment limitations), and it did not include bond volume cap limitations on private activity bonds

Prior to the Tax Reform Act of 1986, stadiums were on the list of eligible facilities that could be financed with tax-exempt industrial development bonds. Stadiums were removed from the list of facilities eligible for tax-exempt Private Activity Bond financing in 1986, but stadiums remain eligible for Governmental Bond financing notwithstanding the substantial private business use of these facilities if they meet the requirements for Governmental Bonds. Under current law, these requirements can generally be met when State and local governments subsidize the projects with governmental revenues or generally applicable taxes.

3

3 The Private Business Use Limitation

In general, private business use of more than 10 percent of the proceeds of a bond issue violates the private business use limitation. Private business use generally arises when a private business has legal rights to use bond-financed property. Thus, private business use arises from ownership, leasing, certain management arrangements, certain research arrangements, certain utility output contract arrangements (e.g., certain electricity purchase contracts under which private utilities receive benefits and burdens of ownership of governmental electric generation facilities), and certain other arrangements that convey special legal entitlements to bond-financed property.

Various exceptions and safe harbors apply with respect to the private business use limitation, which allow limited private business use of property financed by Private Activity Bonds in prescribed circumstances. Exceptions to the private business use limitation include exceptions for use in the capacity as the general public, such as use by private businesses of public roads ("general public use"), certain very short-term use arrangements, certain de minimis incidental uses, certain uses as agents of State and local governments, and certain uses incidental to financing arrangements (e g , certain bondholder trustee arrangements). In addition, safe harbors against private business use apply to certain private management and research arrangements. Thus, for management contracts, in Rev. Proc. 97-13, 1997-1 C.B. 632, the IRS provided safe harbors that allow private businesses to enter into certain qualified management contracts with prescribed terms and compensation arrangements without giving rise to private business use to accommodate public-private partnerships for private management of public facilities. For research contracts, in Rev Proc. 2007-47, 2007-29 I.R.B. 108 (July 16, 2007), the IRS provided updated safe harbors that allow certain research contract arrangements with private businesses at tax-exempt bond financed research facilities without giving rise to private business use (e.g., certain Federally sponsored research).

4 The Private Payments Limitation

In general, private payments aggregating more than 10 percent of the debt service on a bond issue (on a present value basis) violates the private payments limitation. The private payments limitation considers direct and indirect payments with respect to property used by private businesses that represent sources of payment or security for the debt service on a bond issue. For example, if a private business pays rent for its use of the bond-financed property, the rent payments give rise to private payments. Various limited exceptions apply for purposes of the private payments limitation.

5 The Generally Applicable Taxes Exception to the Private Payments Limitation

A notable exception to the private payments limitation applies to payments from generally applicable taxes. In the legislative history to the Tax Reform Act of 1986, Congress indicated its intent to exclude revenues from generally applicable taxes from treatment as private payments for purposes of the private payments limitation. The Conference Report to the Tax Reform Act of 1986 included the following statement:

> *Revenues from generally applicable taxes are not treated as payments for purposes of the security interest test*; however, special charges imposed on persons satisfying the use test (but not on members of the public generally) are so treated if the charges are in substance fees paid for the use of bond proceeds.[1]

[1] H. Rep. No. 99-841, 99th Cong. 2d Sess. at Page II-688, 1986-3 C.B. Vol 4 688 (1986) (emphasis added)

4

Consistent with this legislative history, Treasury Regulations define a generally applicable tax as an enforced contribution imposed under the taxing power that is imposed and collected for the purpose of raising revenue to be used for a governmental purpose. A generally applicable tax must have a uniform tax rate that is applied equally to everyone in the same class subject to the tax and that has a generally applicable manner of determination and collection. By contrast, a payment for a special privilege granted or service rendered is not considered a generally applicable tax. Special assessments imposed on property owners who benefit from financed improvements are also not considered generally applicable taxes. For example, a tax that is limited to the property or persons benefiting from an improvement is not considered a generally applicable tax. Although taxes must be determined and collected in a generally applicable manner, the Treasury Regulations permit certain agreements to be made with respect to those taxes. An agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose is such a permissible agreement. Thus, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

In addition, the Treasury Regulations treat certain "payments in lieu of taxes" and other tax equivalency payments ("PILOTs") as generally applicable taxes.[2] Under the current Treasury Regulations, a PILOT is treated as a generally applicable tax if the payment is "commensurate with and not greater than the amounts imposed by a statute for a tax of general application." For instance, if the payment is in lieu of property tax on the bond-financed facility, it may not be greater in any given year than what the actual property tax would be on the property. In addition, to avoid being a private payment, a PILOT must be designated for a public purpose and not be a special charge. Under this rule, a PILOT paid for the use of bond-financed property is treated as a special charge.

In 2006, the Treasury Department and the Internal Revenue Service (IRS) published Proposed Regulations to modify the standards for the treatment of PILOTs to ensure a close relationship between eligible PILOT payments and generally applicable taxes. Under the Proposed Regulations, a payment is commensurate with general taxes only if the amount of the payment represents a fixed percentage of, or a fixed adjustment to, the amount of generally applicable taxes that otherwise would apply to the property in each year if the property were subject to tax. For example, a payment is commensurate with generally applicable taxes if it is equal to the amount of generally applicable taxes in each year, less a fixed dollar amount or a fixed adjustment determined by reference to characteristics of the property, such as size or employment. The Proposed Regulations permit the level of fixed percentage or adjustment to change one time following completion of development of the property. The Proposed Regulations also provide that eligible PILOT payments must be based on the current assessed value of the property for property taxes for each year in which the PILOTs are paid, and the assessed value must be determined in the same manner and with the same frequency as property subject to generally applicable taxes. A payment is not commensurate if it is based in any way on debt service with respect to an issue or is otherwise set at a fixed dollar amount that cannot vary with the assessed value of the property. The Treasury Department and the IRS are in the process of reviewing the public comments on the Proposed Regulations regarding the treatment of PILOTs.

Governmental Bonds for Public Infrastructure Projects and Private Stadiums Under the Existing Legal Framework

A. Public Infrastructure Projects

[2] In general, the treatment of payments, including PILOTs, as taxes based on their substance is grounded in longstanding Federal income tax principles. *See, e.g.*, Rev. Rul. 71-49, 1971-1 C.B. 103 (PILOTs treated as taxes in substance for purposes of deductibility of taxes under Code Section 164).

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For public infrastructure projects, qualification for Governmental Bond financing focuses on limiting private business use to not more than 10-percent private business use under the first prong of the Private Activity Bond definition In general, Governmental Bonds are an important tool that State and local governments use to finance public infrastructure projects to carry out traditional governmental functions, such as providing public roads, bridges, courthouses, and schools Typically, State and local governments finance public infrastructure projects with Governmental Bonds based on predominant State or local governmental use of the projects and limited private business use within the permitted 10-percent private business use limitation for Governmental Bonds Often, State and local governments finance public infrastructure projects with Governmental Bonds based in part on reliance on the general public use exception to private business use Thus, for example, public roads may be financed with Governmental Bonds even if private businesses use them in the same way as individual members of the general public.

The tax policy justification for a Federal subsidy for tax-exempt bonds is strongest in circumstances where State or local governments use Governmental Bonds to finance public infrastructure projects and other traditional governmental functions to carry out clear public purposes

B. Private Stadiums

For stadium projects that are acknowledged to exceed the 10-percent private business use limitation, qualification for Governmental Bond financing depends on limiting private payments to comply with the 10-percent private payments under the second prong of the Private Activity Bond definition. Here, it is important to recognize that, under the existing legal framework, bonds are classified as Private Activity Bonds only if they exceed *both* the 10-percent private business use limitation and the 10-percent private payments limitation. Thus, a State or local government may issue tax-exempt Governmental Bonds to finance a project that is 100-percent used for private business use, such as a stadium that a private professional sports team uses 100-percent for private business use, provided that the issuer does not receive private payments from the team or elsewhere that in the aggregate exceed the 10-percent private payments limitation. Alternatively, a State or local government may issue tax-exempt Governmental Bonds to finance a stadium to be used for private business use if it subsidizes the repayment of the bonds with State or local governmental funds, such as generally applicable taxes. For example, a city could pledge revenues from a city-wide sales tax, hotel tax, car tax, property tax, or other broadly based generally applicable tax to pay the debt service on Governmental Bonds to finance a stadium.

The tax policy justification for a Federal subsidy for tax-exempt bonds is weaker when State or local governments use Governmental Bonds to finance activities beyond traditional governmental functions, such as the provision of stadiums, in which the public purpose is more attenuated and private businesses receive the benefits of the subsidy.

Certain Tax Policy and Regulatory Authority Considerations Regarding Tax-Exempt Bond Financing

A. Targeting the Federal Subsidy for Tax-Exempt Bonds in General

In general, it is important to ensure that the Federal subsidy for tax-exempt bonds is properly targeted and justified. A rationale for a Federal subsidy for tax-exempt bonds for State and local governmental projects and activities exists when they serve some broader public purpose. The tax policy justification for a Federal subsidy for State or local governmental projects and activities is clearest in the case of traditional public infrastructure projects to carry out traditional governmental functions where the public purpose is clear, particularly when the Federal subsidy is necessary to induce the projects to be undertaken

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The tax policy justification for this Federal subsidy becomes weaker, however, in circumstances that are more attenuated from traditional State or local governmental activities, such as circumstances that lack a clear public purpose justification, provide significant benefits to private businesses, or involve projects that might have been undertaken in any event without the benefit of the Federal subsidy.

In addition, it also is important to recognize that, in general, the Federal subsidy for tax-exempt bonds is less efficient than that for direct appropriations because of the inefficiency of pricing in the tax-exempt bond market. In this regard, since some bond purchasers have higher marginal tax rates than those of the bond purchasers needed to clear the market, tax-exempt bonds cost the Federal government more in foregone revenue than they deliver to State and local governments in reduced interest expenses. Thus, for example, if taxable bonds yield 10 percent and equivalent tax-exempt bonds yield 7.5 percent, then investors whose marginal income tax rates exceed 25 percent will derive part of the Federal tax benefits, resulting in a subsidy to the State and local governmental issuer that is less than the reduction in Federal revenue

At the same time, it is important to point out that tax-exempt bond financing has advantages over the use of appropriated funds by government agencies. The involvement of private investors in the decision-making process for infrastructure investment can bring with it greater sensitivity to actual project costs and returns than in public sector investment decision-making. In some cases, this enhanced sensitivity to project costs and returns may compensate for the somewhat lower tax efficiency of tax-exempt bonds and lead to a more efficient investment outcome overall. In 2005, the Administration supported legislation that extended Private Activity Bond authority to qualified highway and surface freight transfer facilities in the highway and transit reauthorization based in part on these considerations

B. Certain Tax Policy Considerations regarding Tax-Exempt Bond Financing of Stadiums

From a tax policy perspective, the ability to use Governmental Bonds to finance stadiums with significant private business use when the bonds are subsidized with State or local governmental payments, such as generally applicable taxes, arguably represents a structural weakness in the targeting of the Federal subsidy for tax-exempt bonds under the existing legal framework.

At the same time, the tax policy justification in favor of the existing two-pronged Private Activity Bond definition is that it gives State and local governments appropriate flexibility and discretion to finance with Governmental Bonds a range of projects in public-private partnerships with significant private business use when the projects are sufficiently important to warrant subsidizing them with State and local governmental funds, such as generally applicable taxes. Here, political constraints against commitment of such governmental funds ordinarily serve as a sufficient check against excess financing of such projects. An argument can be made, however, that this justification may be debatable in certain cases, such as in the case of certain stadium financings

Several options could be considered to address the possible structural weakness in the targeting of the tax-exempt bond subsidy relative to tax-exempt Governmental Bonds for stadium financings.

First, Congress could consider repealing the private payments prong of the Private Activity Bond definition for stadiums only. This possible change would prevent use of tax-exempt Governmental Bonds to finance a stadium whenever the stadium has more than 10 percent private business use, as would typically be the case with any professional sports stadium. This option would preserve the ability of State and local governments to use Governmental Bonds to finance stadiums used primarily for governmental use (e.g., stadiums for state universities or city-sponsored amateur sports). This option would ensure targeting of the Federal subsidy for tax-exempt Governmental Bonds to circumstances

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involving predominant State or local governmental use of stadiums In its Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05, January 27, 2005), the Congressional Joint Committee on Taxation included this option to repeal the private payments limitation for stadium financings

Second, Congress could consider combining the first option described above with an amendment to Section 142 of the Code to allow the use of tax-exempt Private Activity Bonds to finance stadiums used primarily for private business use within the constraint of the annual State tax-exempt Private Activity Bond volume caps. This measured option would constrain stadiums to compete with other eligible projects for allocations of this bond volume cap.

Third, Congress could consider banning tax-exempt bond financing for stadiums altogether. In 1996, Senator Patrick Moynihan sponsored a widely-publicized legislative proposal to this effect, which was never enacted into law.

Fourth, Congress could consider a broader option to repeal the private payments prong of the Private Activity Bond definition altogether. This possible change would treat bonds as Private Activity Bonds whenever private business use exceeded the 10 percent private business use limitation. This broader option would have an effect well beyond stadiums. This broader option would affect all types of projects with significant private business use that otherwise could be financed currently with Governmental Bonds based on payments from governmental funds. In its 2005 tax compliance options mentioned above, the Joint Committee on Taxation also discussed this broader option to repeal the private payments limitation altogether.

At this time, the Administration does not take a position on any specific policy option with respect to possible legislative changes to the tax-exempt bond provisions relative to stadium financings. This topic raises difficult questions which require balancing the interests of State and local governments in flexibility to finance projects they deem sufficiently important to subsidize with governmental funds and the Federal interest in ensuring effective targeting of the Federal subsidy for tax-exempt bonds. The Administration recognizes that review of this important Federal subsidy may be appropriate in considering ways more generally to simplify this area and to ensure effective targeting of this subsidy for public infrastructure in order to justify its cost.

C. Certain Regulatory Authority Considerations

The question has been raised whether the Treasury Department has the regulatory authority to restrict the use of tax-exempt bond financing for professional sports stadiums. The existing legal framework allows the use of Governmental Bonds to finance professional sports stadiums when the bonds are payable from governmental sources of funds, such as generally applicable taxes. In the legislative history to the present tax-exempt bond provisions of the Code, Congress clearly stated its intent to allow Governmental Bonds when secured by generally applicable taxes. The Treasury Department's and the IRS's roles in providing regulatory guidance are to interpret the Code in a manner consistent with Congressional intent.

Therefore, while the Treasury Department and the IRS have broad regulatory authority to interpret the Code, neither the Treasury Department nor the IRS has regulatory authority so broad as to read the private payments limitation out of the Private Activity Bond definition under Section 141 of the Code or to disregard Congress' expressed intent to exclude generally applicable taxes from private payments for this purpose. Thus, we do not believe the Treasury Department has the regulatory authority to prohibit use of Governmental Bonds to finance stadiums under the existing statutory structure.

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Certain Statistical Data on Tax-Exempt Bonds

The Treasury Department estimates that Federal tax expenditures for the Federal subsidy for tax-exempt bonds grew from about $26 billion in 1998 to about $30.9 billion in 2006 This tax expenditure is estimated to grow to about $41 1 billion in 2012 Attached to my testimony is certain statistical data on tax-exempt bonds One chart provides information on long-term new money (versus refinancing) tax-exempt bond issuance from 1991-2005, derived from IRS Statistics of Income data, and shows that annual total tax-exempt bond issuance grew from about $100 billion in 1991 to over $200 billion in 2005 Two additional charts provide breakdowns of the types of projects financed with Governmental Bonds and Private Activity Bonds from 1991-2005

Although the Treasury Department has no specific data on tax-exempt bond usage for stadiums, in a U S. Government Accounting Office ("GAO") Report entitled "Federal Tax Policy: Information on Selected Capital Facilities Related to the Essential Governmental Function Test" (GAO-06-1082, dated September 2006), the GAO estimated that, during the period from 2000 through 2004, approximately $5 3 billion in tax-exempt bonds were issued in about 119 bond issues to finance stadiums and arenas.

Conclusion

The Administration recognizes the important role that tax-exempt bond financing plays in providing a source of lower-cost financing for critical public infrastructure projects and other significant public purpose activities. It is important to ensure that the tax-exempt bond program is properly targeted so that it works most effectively and that the Federal subsidy for tax-exempt bonds is justified in light of the revenue costs and other costs imposed. The Administration would be pleased to work with the Congress in reviewing possible options to try to improve the effectiveness of this important Federal subsidy.

Thank you again, Mr Chairman, Ranking Member Issa, and other Members of the Subcommittee for the opportunity to appear before you today. I would be pleased to answer any questions.

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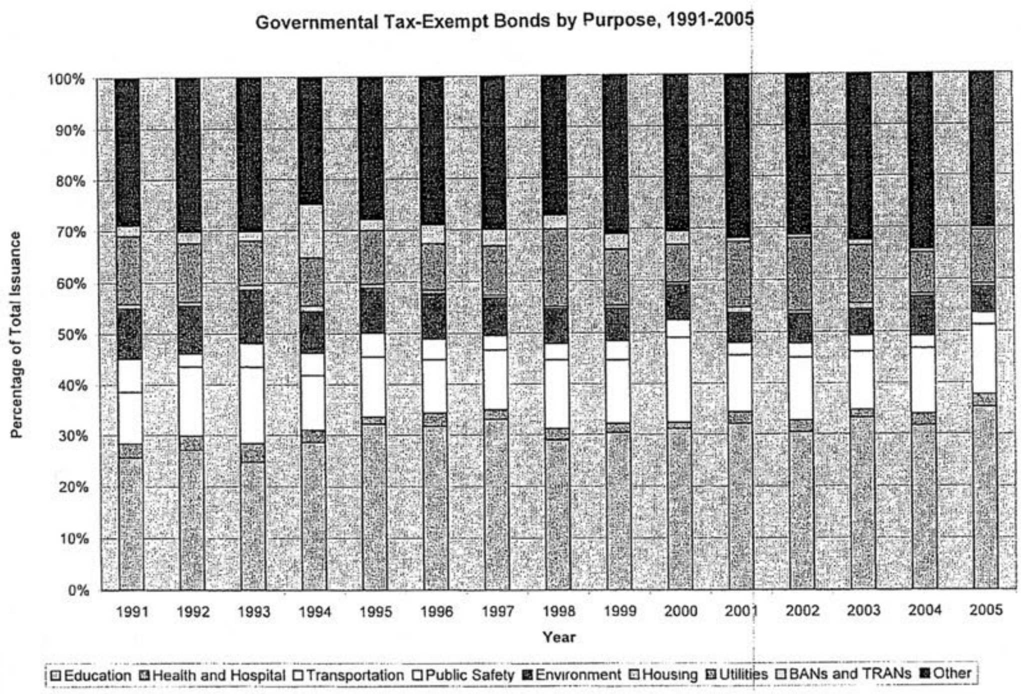
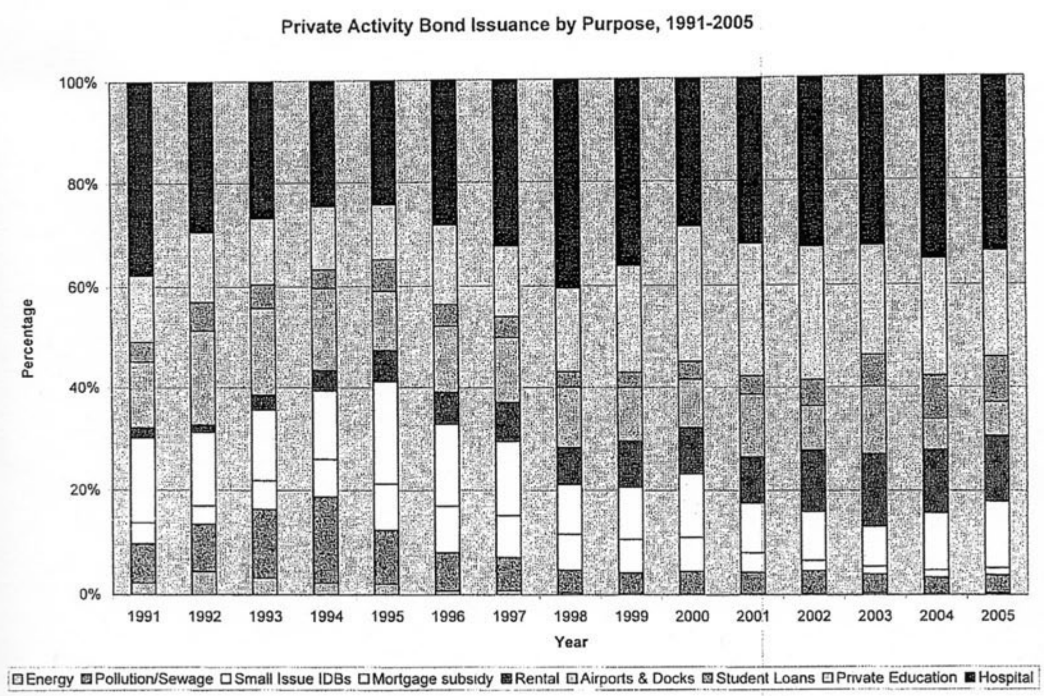
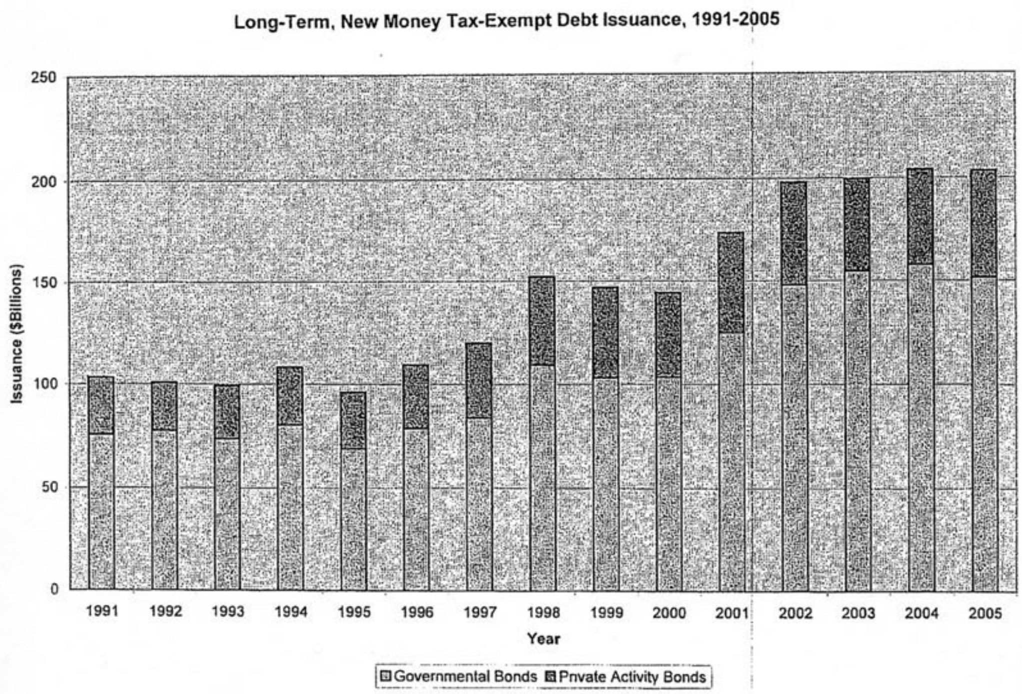

Governmental Tax-Exempt Bonds by Purpose, 1991-2005
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Percentage of Total Issuance
1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005
Year
Education Health and Hospital Transportation Public Safety Environment Housing Utilities BANs and TRANs Other


Private Activity Bond Issuance by Purpose, 1991-2005
100%
80%
60%
40%
20%
0%
Percentage
1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005
Year
Energy
Pollution/Sewage
Small Issue IDBs
Mortgage subsidy
Rental
Airports & Docks
Student Loans
Private Education
Hospital


Long-Term, New Money Tax-Exempt Debt Issuance, 1991-2005
250
200
150
100
50
0
Issuance ($Billions)
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
Year
Governmental Bonds
Private Activity Bonds

Appendix VIII: GAO Contact and Staff Acknowledgments

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