Airports Council International - North America
American Public Power Association
Council of Development Finance Agencies
Council of Infrastructure Financing Authorities
Council of State Governments
Government Finance Officers Association
Large Public Power Council
National Association of Counties
National Association of Higher Educational Facilities Authorities
National Association of State Auditors Comptrollers and Treasurers
National Association of State Treasurers
National Council of Health Facilities Finance Authorities
National League of Cities
US Conference of Mayors

April 28, 2005

The Honorable Connie Mack III
Chairman
President's Advisory Panel on Federal Tax Reform
1440 New York Avenue, NW Suite 2100
Washington, DC 20220

The Honorable John Breaux
Vice-Chairman
President's Advisory Panel on Federal Tax Reform
1440 New York Avenue, NW Suite 2100
Washington, DC 20220

Dear Chairman Mack and Vice-Chairman Breaux:

On behalf of the organizations listed above, we would like to thank the Advisory Panel for seeking comments on federal tax reform measures. As was stated by Timothy Firestine during his testimony before the Panel on April 18th, we are very interested in this discussion, specifically, the impact that any changes to the current federal tax system will have at the state and local levels, and how major tax reform could dramatically impact state and local tax revenues and services.

An area of great interest to local and state governments is preserving the tax-exempt status of municipal bonds. **We cannot emphasize enough the importance of the tax-exempt bond market and the need to keep its integrity intact as major tax reform is discussed.** Tax-exempt bonds are the mechanism used to provide for essential infrastructure at the local and state level. Nearly all schools, transportation infrastructure, water and wastewater facilities, colleges and universities, health care institutions, jails, airports, and municipal utility facilities exist today because of tax-exempt bond financing. Altering the federal income tax or imposing new limitations on issuers or purchasers of tax-exempt bonds would cause a significant increase in bond interest costs. At a time when direct aid from the federal government is decreasing, it is imperative for local and state governments and other governmental entities to be able to provide the essential infrastructure and services to their citizens at the lowest possible cost. Without the ability to access the low cost, tax-exempt bond market, communities across the United States would suffer, and greater demands would be placed on the federal government to provide additional direct funding to local and state governments.

In addition, we would like to submit proposals that we believe would promote economic growth and job creation through **simplification measures in the tax-exempt bond market**. We believe that to foster long-term growth in the United States economy, federal, state and local governments must act in concert rather than at odds with each other. These proposals would help increase flexibility and reduce costs for state and local governments – and taxpayers – and expand the positive characteristics of the tax-exempt bond market for the future.

Our organizations are also concerned about any changes to the existing state and local income/sales/property taxpayer deductions Deductibility preserves the ability of state and local governments to raise revenues and to provide services, promotes equity in the federal taxing system, discourages the migration of businesses and individuals for tax purposes, avoids excessive cumulative federal/state/local income tax rates, and preserves the autonomy of state and local governments. We urge you to consider the ramifications that would impact nearly every community if limits to these deductions are made.

In addition to the attached recommendations there are a number of other issues that we would like to raise with the panel at the appropriate time Thank you for your consideration of these matters

Sincerely,

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American Public Power Association, Joe Nipper, 202-467-2900
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Council of Development Finance Agencies, Toby Rittner, 202-457-1128
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Large Public Power Council, Noreen Roche Carter (Sacramento Municipal Utility District), 916-732-6509
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National League of Cities, Janine Jones-Smith, 202-626-3194
US Conference of Mayors, Larry Jones, 202-861-6709

I. SIMPLIFY ARBITRAGE INVESTMENT RESTRICTIONS

A. Provide a Streamlined 3-Year Spending Exception to the Arbitrage Rebate Requirement in Lieu of the Present 2-Year Construction Spending Exception

Present law. Generally, interest earnings on investments of tax-exempt bond proceeds in excess of the bond yield must be rebated to the Federal Government The main exception to arbitrage rebate is a complex 2-year spending exception that applies only to governmental bonds and qualified 501(c)(3) bonds issued to finance certain construction projects

Reason for Change. The present 2-year rebate spending exception is unduly complex due to unrealistic spending periods, complex bifurcations, difficult computations, and unclear multipart definitions. Thus, the permitted prompt spending period should be extended from two to three years. The recommended streamlined 3-year rebate spending exception should apply as broadly as possible, recognizing that limited arbitrage potential exists for short-term investments in most long-term tax-exempt bond issues This exception should also be broadened to include both governmental and private activity bonds and both acquisition and new construction of capital projects. A rarely-used election to pay a penalty in lieu of rebate should be removed. A de minimis rule for minor amounts of unspent bond proceeds should be added. This 3-year rebate spending exception would provide meaningful administrative relief from complex arbitrage calculations and related burdens to a broad number of tax-exempt bond issuers This exception could be limited to fixed rate tax-exempt bonds in recognition of some possible arbitrage potential with short-term floating rate bonds.

B. Increase the Small Issuer Exception to the Arbitrage Rebate Requirement from $5 Million to $25 Million and Remove the General Taxing Power Condition

Present Law. A small issuer exception to arbitrage rebate applies to governmental units with general taxing powers that reasonably expect to issue not more than $5 million in tax-exempt bonds (excluding private activity bonds and most current refunding bonds) in a calendar year

Reason for Change. The size of this small issuer exception to rebate should be increased from $5 million to $25 million in recognition of the dramatic increases in capital costs since the enactment of this exception in 1986 and the disproportionately-broad relief from this change The increased size of this exception will substantially reduce the administrative burden imposed on a large number of small issuers while affecting a disproportionately smaller amount of tax-exempt bond dollar volume In 2003, tax-exempt issuers of $10 million or less of bank purchase qualified bonds represented about 32% of the total number of like bond issues but only about 4% of tax-exempt bond dollar volume. Further, the general taxing power constraint unfairly narrows the use of this exception for many common tax-exempt bond programs. This exception should be broadened to cover other State or local governmental entities eligible to issue tax-exempt bonds which lack general taxing powers.

C. Add an Exception to the Arbitrage Rebate Requirement for Equity-Funded Reserve Funds

Present law. Although present law limits the amount of tax-exempt bond proceeds that may be used to fund a debt service reserve fund to 10% of the bond proceeds, the arbitrage rebate requirement nonetheless continues to apply to debt service reserve funds for most bond issues. The rebate requirement will continue to apply to these reserve funds throughout the term of the bonds even if all other bond proceeds are spent promptly under a rebate spending exception.

Reason for Change. Most tax-exempt bond proceeds typically are spent within the first several years. During the remainder of the term of the bonds, the ongoing costs and administrative tracking burdens of the arbitrage rebate requirement result mainly from debt service reserve funds. These reserve funds remain unspent (except to pay debt service on the bonds in the event of unforeseen financial difficulties). To relieve these administrative burdens, an exception to the arbitrage rebate requirement should be created for debt service reserve funds that are funded from sources besides tax-exempt bonds. This change would provide an incentive to issuers to reduce the size of tax-exempt borrowings.

II. SMALL ISSUER BANK BOND PURCHASE EXCEPTION

Increase the Small Issuer Bank Purchase Exception from $10 Million to $25 Million and Conform it to the Parallel Small Issuer Exception to the Arbitrage Rebate Requirement

Present law. Banks generally cannot deduct interest on loans used to carry tax-exempt bonds. A small issuer bank purchase exception allows banks to deduct these carrying costs for purchases of tax-exempt bonds issued by certain small issuers which issue not more than $10 million in tax-exempt bonds (excluding private activity bonds and most current refunding bonds) in a calendar year

Reason for Change. This small issuer bank purchase exception aims to preserve the ability of small issuers, with limited access to the capital markets, to place bonds with local banks. The size of this exception should be increased from $5 million to $25 million in recognition of the dramatic increases in capital costs since the enactment of this exception in 1986 and the disproportionately-broad relief from this change. The slightly different eligibility requirements for this exception and the small issuer exception to arbitrage rebate (a trap for these unsophisticated issuers) should be conformed with a single, simplified definition of a "small issuer." Moreover, increasing this exception would provide access to bank purchasers for a disproportionately large number of issuers while affecting a comparatively small amount of bond dollar volume. Despite the increase in state bond banks and pooled loan programs, many states have no such programs. Many small issuers still rely heavily on local banks as their main financing source. Also, for bond-financed loan programs, an issuer should be permitted to elect to treat each conduit borrower as the issuer of a separate issue under this exception.

III. SIMPLIFY RULES FOR GOVERNMENTAL TAX-EXEMPT BONDS

A. Repeal 5% Unrelated or Disproportionate Private Business Limit on Governmental Bonds

Present law. If private business use is unrelated or is disproportionate to the governmental use of tax-exempt bond proceeds, then a more restrictive 5% private business use restriction applies to tax-exempt governmental bonds instead of the general 10% private business restriction on such bonds.

Reason for Change. The unrelated or disproportionate use test is cumbersome, vague, arbitrary, and especially complex in multiple-project financings. Out of an abundance of caution, some issuers automatically reduce their otherwise-permitted level of private business involvement from 10% to 5% to avoid the interpretative difficulties of this requirement. The general 10% private business use limit effectively controls excess private business use of governmental tax-exempt bond issues.

B. Repeal Volume Cap Requirement for Governmental Bond Issues with a Nonqualified Private Business Amount in Excess of $15 Million

Present law. Tax-exempt governmental bond issues are subject to volume cap for private business use or private payments that exceed $15 million, even if it is within the general permitted 10% threshold.

Reasons for Change. This special volume cap requirement has no sound tax policy justification in traditional governmental tax-exempt bond issues. The general 10% private business limits adequately address the level of private business involvement in traditional governmental tax-exempt bond issues.

C. Modify Private Loan Financing Limit on Governmental Bonds

Present law. If more than the lesser of 5% or $5 million of the proceeds of a tax-exempt bond issue are used to finance a loan to a private person, the bonds generally are treated as private activity bonds (even if there is no private business use).

Reason for Change. The private loan test should be modified to be a straight 10% limitation that corresponds to the general private business limitation. The Federal tax distinction between a "use" and a "loan" of bond proceeds is complex. The main intent of the private loan test was to limit the use of proceeds to finance non-business loans (e.g., consumer loans), such as single-family housing and student loans. The existing provision inappropriately could be interpreted to impose an additional, lower private business restriction on loans made to private businesses.

IV. ALTERNATIVE MINIMUM TAX

Repeal the Alternative Minimum Tax Preference on Private Activity Bonds

Present law. Interest on qualified tax-exempt private activity bonds is excluded from Federal gross income but is included in a bondholder's tax base for purposes of the Federal alternative minimum tax.

Reason for Change. The repeal of the alternative minimum tax preference on tax-exempt qualified private activity bonds will simplify the tax-exempt interest exclusion, enhance market demand for these bonds, and increase market efficiency. Private activity bonds that are subject to the alternative minimum tax carry a punitive higher interest rate. This higher interest cost adds to Federal tax expenditures without a corresponding increase in Federal tax revenues because investors subject to the alternative minimum tax generally do not purchase these bonds. The increased demand for tax-exempt private activity bonds from this proposed change should have the effect of lowering the interest rates on private activity bonds by an estimated 10 to 25 basis points and a positive Federal revenue impact.

<u>V. ADVANCE REFUNDING</u>

<u>Permit One More Advance Refunding of Governmental Bonds and Qualified 501(c)(3) Bonds</u>

<u>Present Law.</u> In general, issuers of tax-exempt governmental bonds (i.e., excluding most private activity bonds) and qualified 501(c)(3) bonds are provided one "advance refunding" for new money tax-exempt bond issues issued after December 31, 1985. Here, an "advance refunding" means an issuance of refunding bonds used to refund or refinance other bonds ("refunded bonds") where the refunding bonds are issued more than 90 days before the redemption of the refunded bonds.

<u>Reason for Change.</u> Presently, because State and local governments and Section 501(c)(3) exempt organizations generally have only one opportunity to advance refund their debt, they are put in the inflexible position of having essentially to guess when would be the optimum time to do that advance refunding to achieve the lowest net borrowing costs. These entities should be allowed one additional advance refunding to give them more flexibility to lower their borrowing costs, to restructure their debt service payments, and to incorporate more flexible and modern financing techniques. Debt service represents one of the most significant items of operating expense for these entities, and they need more flexibility to enable them to finance the nation's public infrastructure at the lowest possible cost.