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Fact Sheet for the Chairman, Subcommittee on Human Resources and Intergovernmental Relations, Committee on Government Operations, House of Representatives

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TAX POLICY

Internal Revenue Code Provisions Related to Tax-Exempt Bonds

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The Honorable Ted Weiss
Chairman, Subcommittee on Human
Resources and Intergovernmental
Relations
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

As part of the work that you requested on the Internal Revenue Service's (IRS) oversight of tax-exempt bonds, we agreed to provide you with information on the tax-exempt bond provisions that are contained in the Internal Revenue Code (IRC). As you know, legislation has been introduced in Congress aimed at simplifying the tax-exempt bond laws. Given congressional interest in tax code simplification and your interest in federal oversight of tax-exempt bonds, this fact sheet provides a quick reference to the relevant tax code provisions that IRS is responsible for administering to ensure that bonds qualify for tax-exempt status.

This fact sheet should prove useful to those in Congress who are interested in reviewing the cumulative array of statutory conditions and requirements affecting tax-exempt bond issues. It may also be useful as a guide for public and private tax-exempt bond issuers, bond counsels, and other participants in the marketing or oversight of bonds. This fact sheet also provides a brief perspective on how the use of tax-exempt bonds has changed over the years and how Congress has reacted to these changes by adding legislative restrictions.

We obtained information for this fact sheet by reviewing the tax-exempt bond provisions contained in the IRC as of the Omnibus Budget Reconciliation Act, passed in November 1990. We also reviewed the Federal Reserve Board of Governors' data to obtain information on the growth of tax-exempt bond usage and to calculate the percentage of outstanding tax-exempt bonds that were issued for private activities. Lastly, we reviewed existing literature on municipal financing and relevant congressional reports to gain a perspective on how Congress reacted to changes in the usage of tax-exempt bonds. The summary of the tax-exempt bond provisions presented in appendix I includes the major subsections contained in IRC section 103 and sections 141 through 150. However, the appendix does not detail other related laws and regulations, such as applicable Treasury regulations, anti-fraud and securities law, and state and local laws.

BACKGROUND

The IRC allows state and local governments to issue bonds that provide investors with interest income that is exempt from federal income tax. As a result, state and local governments can finance projects at lower interest rates because investors are willing to accept lower interest rates to obtain tax-exempt income. State and local governments can then issue tax-exempt bonds to finance public-purpose projects such as schools, roads, and water and sewer facilities. State and local governments may also issue tax-exempt bonds on behalf of certain nonprofit organizations (e.g., charitable organizations, specified under IRC section 501(c)(3)) and private for-profit persons or organizations if the bonds are used for certain activities that are specified in the IRC. In addition, state or local law may establish special authorities and districts to issue tax-exempt bonds.

Generally, tax-exempt bonds in which 90 percent or more of the proceeds are used by governmental entities are referred to as governmental bonds. Private activity bonds (PAB) are bonds in which (1) more than 10 percent of the proceeds are used by a nongovernmental private entity and more than 10 percent of the principal or interest is directly or indirectly paid from, or secured by, revenues from a private trade or business or (2) more than 5 percent of the proceeds or $5 million is used for loans to private persons. These PABs can be tax-exempt, subject to certain restrictions, if the proceeds are used for qualified activities that are specified in the tax code, such as for industrial development, student loans, and mortgage loans.

CHANGES IN THE TAX-EXEMPT BOND MARKET AND INCREASED CONGRESSIONAL CONCERNS WITH TAX-EXEMPT BOND USAGE

When the 1913 federal income tax law was passed, interest earned from state and local government bonds was deemed tax-exempt. Since 1968, state and local government use of tax-exempt bond financing has increased substantially. The Federal Reserve Board of Governors' data showed that in 1968 the volume of outstanding long-term tax-exempt bonds was about $114 billion, whereas at the end of 1990, the volume of outstanding tax-exempt bonds had increased to about $796 billion.[1] This growth in tax-exempt bond volume represented an increasingly greater federal subsidy because of the forgone tax revenue due to the tax-exempt nature of the interest earned. The Department of the Treasury estimated that the forgone tax on outstanding tax-exempt bonds for fiscal year 1990 was about $24 billion.

The growth in the use of tax-exempt bonds over the years concerned Congress, not only because of the forgone tax revenue, but particularly because of the volume of tax-exempt bonds that were issued primarily to benefit private parties and organizations (such as private recreational facilities and fast food restaurants) rather than to fulfill traditional government purposes. For example, according to the Federal Reserve Board of Governors' data, about 5 percent of the long-term tax-exempt bonds outstanding in 1975 were used for private activities. This percentage gradually increased until it peaked in 1985 at about 33 percent. Congress was also concerned that issuers were issuing tax-exempt bonds primarily for the purpose of earning profits (arbitrage), rather than for the financing of public-purpose projects as Congress had intended. State and local governments would issue a tax-exempt bond and earn arbitrage profits by investing the proceeds in taxable securities at interest rates higher than the tax-exempt bond rate.

As a result of its concerns about the use of tax-exempt bonds, Congress passed a number of laws to better target the use of these bonds for public purposes by establishing restrictions on their use for non-public purposes. These restrictions began in the late 1960s and have continued through 1990.[2] For example, Congress first restricted the use of tax-exempt bonds for private activities in 1968. Basically, the restriction provided that interest on bonds that were issued to benefit private persons was generally taxable unless the proceeds were used for purposes specified in the IRC, such as sports facilities, sewage and solid waste facilities, airports, and parking facilities. Another exception to the restrictions on the use of tax-exempt bonds for private activities was made for small-issue bonds

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[1]Using the Gross National Product price deflator, $114 billion in outstanding tax-exempt bonds is equivalent to about $398 billion in 1990 dollars.

[2]See Dennis Zimmerman, The Private Use of Tax-exempt Bonds, (Washington, D.C.: The Urban Institute, 1990), pp.175-191, for a more detailed discussion of the changes to the tax-exempt bond laws.

(initially, bonds issued for $1 million or less). In 1969, Congress limited the ability of state and local governments to issue tax-exempt bonds for the purpose of earning arbitrage profits.

Over the next 15 years, Congress continued to revise the tax-exempt bond laws. In some cases, Congress specified additional types of private activity projects that would be eligible for tax-exempt bond financing (e.g., certain mass commuting vehicles) and increased the dollar limit for the small-issue exception in certain cases. In most cases, however, Congress added other restrictions to help eliminate what it believed to be inappropriate uses of tax-exempt bond financing and to reduce the volume of tax-exempt private activity bonds. For example, in 1982, Congress eliminated the tax-exempt status of certain small-issue private activity bonds in which more than 25 percent of the bond proceeds went to finance activities, such as fast food facilities and car dealerships. Congress also eliminated tax-exemption for bond issues if any of the proceeds were used to finance specified recreational facilities, such as racetracks, golf courses, and skating rinks. In 1984, Congress further restricted the use of small-issue bonds and placed a volume cap limiting the issuance of tax-exempt bonds for certain private activities and student loan bonds within a state. Moreover, additional arbitrage restrictions were added.

The Tax Reform Act of 1986 further targeted tax-exempt bond financing to recognized public purposes rather than private purposes. For example, Congress eliminated the use of private activity bonds for certain uses, such as sports facilities and parking facilities. The act placed more types of private activity bonds under a volume cap and reduced the dollar limit of the cap. Again, new arbitrage restrictions and procedures were added. Congressional restrictions that have been placed on tax-exempt bond financing appear to have reversed the growth in outstanding long-term tax-exempt bonds issued for private activities. Since 1985, when about 33 percent of these outstanding long-term tax-exempt bonds were issued for private activities, the Federal Reserve Board of Governors' data show that the percentage has gradually decreased to about 23 percent in 1990.

Over the last 20 years, tax-exempt bond law has expanded and become more complicated. At present, tax-exempt bond provisions are contained in 11 different sections of the IRC. Tax-exempt bond industry participants are expected to adhere to the laws if interest is to be tax-exempt. Appendix I contains a table that summarizes the sections of the IRC relating to tax-exempt bonds as of the passage of the Omnibus Budget Reconciliation Act of 1990. The table shows the multitude of federal restrictions that IRS is responsible for administering to ensure that bond industry participants are complying with the federal tax-exempt bond laws.

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A copy of this fact sheet is being sent to the Commissioner of Internal Revenue and other interested parties, and we are making copies available to others upon request.

Major contributors to this fact sheet are listed in appendix II. If you have any questions concerning the above information, please call me or Mike Brostek at (202) 272-7904.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

SUMMARY OF TAX-EXEMPT BOND PROVISIONS CONTAINED IN THE INTERNAL REVENUE CODE

The Internal Revenue Code (IRC) contains 11 sections (sections 103 and 141 through 150) that comprise the primary statutory provisions on tax-exempt bonds. Table I.1 summarizes the major subsections related to the 11 sections that were updated through the passage of the Omnibus Budget Reconciliation Act of 1990. The table does not (1) detail all of the technical intricacies of the tax laws, (2) include references to the Department of the Treasury's authority to prescribe regulations and certain definitions, or (3) represent a legal interpretation of the various tax-exempt bond provisions. Consequently, the IRC should be consulted for details on the full legal requirements associated with the use of tax-exempt bonds. Additionally, this table does not detail the myriad of other laws and regulations that may apply, such as applicable Treasury regulations, anti-fraud and securities law, and state and local laws.

The tax-exempt bond provisions shown in the table are presented in four categories. We did not present the provisions sequentially as ordered in the IRC because the provisions related to each type of tax-exempt bond are not necessarily grouped together. The four categories are as follows:

-- the overall tax exemption (section 103);

-- the sections of the code that apply to all governmental and private activity bonds (sections 148 and 149);

-- the sections of the code that generally apply to all tax-exempt private activity bonds (sections 141, 146, 147, and 150); and

-- the sections of the code that apply to specific qualified private activity bonds (142, 143, 144, and 145).

Table I.1: Summary of Tax-Exempt Bond Provisions

Overall Tax Exemption

Section 103: Interest on state and local bonds

Tax code	Explanation
Overall tax exemption	Gross income does not include interest on any state or local bond.
Exceptions	Nonqualified private activity bonds (PAB) A PAB must be qualified to be tax-exempt.
	Arbitrage bonds A bond cannot be issued for the purpose of earning arbitrage.
	Nonregistered bonds Bonds must generally be issued in registered form.

Sections Applicable to All Tax-Exempt Bonds

Section 148: Arbitrage requirements

Tax code	Explanation
Arbitrage bond	Any bond that is issued as part of an issue of which any portion of the proceeds are reasonably expected to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investments.
Higher yielding investment	Any "investment property"[1] producing a yield over the term of issue that is materially higher than the yield on the issue. In certain cases, investment property includes tax-exempt bonds in which an alternative minimum tax must be paid on the interest as defined in section 57(a)(5)(c).
Temporary period exception	The period before the spending of bond proceeds when arbitrage can be earned without rebating. The length of the period differs for various types of bonds.
Special rules for reserve and replacement allowances	These rules permit 10 percent of bond proceeds to be invested in higher yielding investments that are part of a reasonably required reserve or replacement fund. Additional requirements and exceptions are specified for bond proceeds that are invested in investments that are not related to the purpose for which a bond is issued.
Minor portion--lesser of 5 percent or $100,000	Notwithstanding other restrictions, a de minimis amount of 5 percent or $100,000 may be used for higher yielding investments.

Section 148: Arbitrage requirements

Tax code	Explanation
Arbitrage rebate[2]	The IRC requires that the issuer rebate to the U.S. excess profits when the bonds are called or once every 5 years in installments of 90 percent of the rebatable portion. In determining whether the arbitrage is rebated and if so, how much, several special rules must be followed. For determining the arbitrage amount, exemptions from the rebate requirements are specified for the following: certain temporary investments, proceeds used to finance certain construction expenditures, governmental units using $5 million or less of bonds, and certain qualified student loan bonds. Certain issuers may elect to pay a penalty instead of a rebate.
Student loan incentive payments exclusion	Except to the extent that is otherwise provided in regulations, payments that are made according to section 438 of the Higher Education Act of 1965 are not considered for purposes of acquiring higher yielding investments in determining yields on student loan notes.
Determination of yield	The yield will be determined on the basis of the issue price within the meaning of IRC sections 1273 and 1274.

Section 149: Other requirements that apply to tax-exempt bonds in general

Tax code	Explanation
Registration requirement	A bond must generally be in registered form unless it is of a type that is not offered to the public; matures in less than 1 year; is sold or resold to a non-U.S. person, and the interest is payable only outside the U.S. (and its possessions); and includes on its face a statement that any U.S. person who holds the obligation will be subject to limitations under U.S. tax laws. Certain exceptions and special rules apply.
No federal guarantee allowed[3]	Interest and principal payments may not be backed by the federal government, with certain exceptions, such as certain insurance programs (including Federal Housing Administration, Federal Home Loan Mortgage Corporation), debt service, housing programs, and loans or guarantees to financial institutions.
Tax exemption must be derived from this title	Generally, no interest on any bond, except as provided in section 149(c)(2), shall be exempt from taxation under this title unless the interest is exempt from tax under this title without regard to other provisions of law. Certain prior exemptions are excluded.
Advance refunding bonds	An advance refunding is a bond issued more than 90 days before the redemption of the refunded bond (i.e., the original issue). However, no exemption is provided under section 103 for advance refundings of certain PABs, certain other bonds, and abusive transactions. Rules specify additional conditions for exemption, such as limits on the number of times an original issue can be refinanced through advance refunding.

Section 149: Other requirements that apply to tax-exempt bonds in general

Tax code	Explanation
Information reporting	Certain information must be reported by the issuer to IRS concerning the bond issue in a stated time period that may be extended by the Secretary of Treasury through IRS if willful neglect is not involved.
Treatment of pooled financing bonds	Pooled financing bonds are generally bonds that are issued as part of an issue when more than $5 million of the proceeds are reasonably expected to be used directly or indirectly to make or finance loans to two or more borrowers. Restrictions govern the manner and timing of the payment of issuance costs. Another restriction, the reasonable expectation requirement, requires that the issuer reasonably expects that 95 percent of the net proceeds will be loaned within 3 years of issuance.
Treatment of hedge bonds	The IRC places certain conditions on the tax-exemption for interest on bonds that are issued before they are needed to take advantage of lower interest costs. Hedge bonds must meet the reasonable expectations criteria as to when proceeds will be spent, what determines a hedge bond, and other special rules.

Sections of the Code That Apply Exclusively to PABs

Section 141: Private activity bond; qualified bond

Tax code	Explanation
Private activity bond determination	A PAB is any bond that meets the private business use and private security or payment test or that meets the private loan financing test.
Qualified bonds	Once a bond is deemed a PAB it must meet the requirements for one of the seven types of qualified bonds that are specified in section 141(e)(1)(A-G) to be tax-exempt. The seven types of qualified bonds are exempt facilities, qualified mortgage bonds, qualified veterans mortgage bonds, qualified small-issue bonds, qualified student loan bonds, qualified redevelopment bonds, or qualified 501(c)(3) bonds.[4]
Private business tests	<u>Private business use test</u> More than 10 percent of the proceeds of the issue are used for any private trade or business use. <u>Private security or payment test</u> The payment of the principal or interest on more than 10 percent of the proceeds is directly or indirectly (a) secured by any interest in the property used or that is to be used for a private business use, or that is secured by any interest in payments from the property, or (b) to be derived from the payments from the property or from borrowed money that is used or that is to be used for a private business use.

Section 141: Private activity bond; qualified bond

Tax code	Explanation
Private business tests	Five percent test for business use not related or disproportionate to government use An issue meets the private business use and private security or payment tests if more than 5 percent of the proceeds, payments, property, and borrowed money from any use of proceeds are used for private business in which (1) the proceeds that are used for any private use are not related to any government use, and (2) the proceeds that are used for private business exceed the proceeds used for related government use. Coordination with volume cap if nonqualified amount exceeds $15 million Any bond will be treated as a PAB if the portion of the bond that is used for private or business purposes (nonqualified amount) exceeds $15 million, even if it does not exceed the other previously discussed private business tests. Issuers can avoid PAB designation if they use a portion of the state volume cap for PABs to cover this amount. Lower limitation for certain output facilities Any issue using 5 percent or more of the proceeds for any output facility, such as electric energy or gas, shall be treated as meeting the private business tests if the nonqualified amount exceeds $15 million minus the aggregate nonqualified amounts of all prior tax-exempt issues of which 5 percent or more of the proceeds were used to finance such a facility (or any other facility that is part of the same project).

Section 141: Private activity bond; qualified bond

Tax code	Explanation
	Qualified 501(c)(3) exception The private business test and the private loan financing test will not apply to the portion of the proceeds that are elected to be treated as a qualified 501(c)(3) bond.
Private loan financing test	An issue meets the private loan financing test if the amount of the proceeds that are to be used to make or finance loans to persons other than governmental units exceeds the lesser of 5 percent or $5 million.
Issues used to acquire nongovernmental output property[5]	PABs include bonds that are used by a governmental unit to acquire nongovernmental output property if the bond proceeds exceed the lesser of 5 percent or $5 million, with certain exceptions for output to certain areas and property that is converted to nonoutput use.

Section 146: Volume cap restrictions for qualified PABs

Tax code	Explanation
General rule for volume cap	The amount of PABs that are issued during any calender year cannot exceed the volume cap for the state agency and other issuing authorities, such as local governments within the state.
State ceiling	The ceiling for any state is $75 multiplied by the state population or $250 million through 1987 and $50 multiplied by the state population or $150 million after 1987. Certain other restrictions apply for constitutional home rule cities, and special rules apply for U.S. possessions.
Volume cap for state agencies	A state agency is allocated 50 percent of the state ceiling for the year. If a state has multiple agencies that are authorized to issue PABs, the agencies will be treated as a single agency.
Volume cap for other issuers within the state	The cap for issuing authorities other than state agencies is 50 percent of the state ceiling. The ceiling for each of the issuing authorities will be the ratio of the authority's population to the state's population.
State may provide for different allocation	States may provide a different volume allocation for authorities or government units. Exceptions apply to constitutional home rule cities.

Section 146: Volume cap restrictions for qualified PABs

Tax code	Explanation
3-year unused carryforward election for specified purpose	An issuer may elect to carryforward all or any portion of its unused volume cap for up to 3 years for one or more of the following qualified carryforward purposes: exempt facility bonds, qualified mortgage bonds, mortgage credit certificates, qualified student loan bonds, or qualified redevelopment bonds. Carryforward is used in the order in which it arises, and carryforward that is used for bonds that are issued does not affect the volume cap.
Exception for certain bonds	PABs that are excluded from the volume cap are qualified veterans' mortgage bonds, any qualified 501(c)(3) bonds, any exempt facility bonds of subsection 142(a)(1) (airports) or (2) (docks and wharves), and 75 percent of any bond that is issued as described in section 142(a)(11) (high-speed intercity rail facilities).
Exception for governmental solid waste disposal	For volume cap purposes, PABs do not include exempt facility bonds as described in section 142(a)(6) (solid waste disposal) that are issued as part of an issue if all of the property to be financed by the net proceeds is to be governmentally owned using a safe harbor test to determine ownership.
Treatment of refunding issues	Refunding bonds will not affect the volume cap provided that they do not exceed the amount of the refunded bond. Special rules apply to refunding bonds for student loan and qualified mortgage bonds and for determining average maturity. This exclusion does not apply to advance refunding bonds.

Section 146: Volume cap restrictions for qualified PABs

Tax code	Explanation
Facility must be located within the state	No portion of the state ceiling can be used to finance a facility outside of the state. An exception is made for water furnishing, sewage, solid waste disposal, or qualified hazardous waste facilities if the issuer establishes that the state's share of use or output will equal or exceed the state's share of PABs issued for the facility. Bonds for certain output facilities and for other exempt facilities are also excepted from this rule.
Issuer of qualified scholarship funding bonds	Qualified scholarship funding bonds are to be treated as issued by a state or local issuing authority (whichever is appropriate).
Treatment of amounts allocated to private activity portion of government use bonds	The volume cap shall be reduced by the amount allocated by the issuer to an issue where the private activity portion exceeds $15 million. Any advance refundings will be taken out of the volume cap to the extent that it was or would have been allocated for this purpose.
Reduction for mortgage credit certificates	The volume cap of any issuing authority shall be reduced by the sum of the amount of qualified mortgage bonds not issued under section 25(c)(2)(A)(ii) (qualified credit certificate programs) during the year, plus the amount of any qualified mortgage bonds used for certificates that do not meet requirements in section 25(d).

Section 147: Other restrictions for PABs

Tax code	Explanation
Substantial user restriction	PABs must not be held by the person who is the substantial user of the facilities (or related person of such substantial user).
Maturity limits	For certain bonds, the IRC restricts the maximum allowable average maturity of bonds to 120 percent of the reasonably expected average economic life of facilities that are being financed. Certain special rules apply, such as the treatment of pooled financing of 501(c)(3) bonds and Federal Housing Administration insured loans.
Limitation on use for land acquisition	The IRC provides that 25 percent or more of the proceeds cannot be used to acquire land and that no percentage can be used to buy land for farm use. An exception is made for first-time farmers and certain land acquired for environmental purposes, such as noise abatement and wetland preservation, or for future specified transportation facilities.
Acquisition of existing property not permitted	The use of net proceeds to cover the cost of previously purchased property is not allowed, except for certain rehabilitations. A special rule applies for certain projects.
Disallowed usages of proceeds	A PAB shall not be a qualified bond if it is issued as part of an issue from which any portion of the proceeds is to be used to provide an airplane, a skybox or other luxury box, a health club facility, a facility that is used primarily for gambling, or a store that is primarily in business for the sale of off-premises alcohol consumption.

Section 147: Other restrictions for PABs

Tax code	Explanation
Public approval	A bond must be publicly approved by the appropriate governmental unit either by an applicable elected representative or by voter referendum. Special rules define the governmental unit that must approve PABs for (1) airports or high-speed intercity rail facilities and (2) scholarship funding bond issues and volunteer fire department bonds.
Cost of issuance (2 percent and 3.5 percent)	The IRC restricts the amount of bond proceeds that can be used for issuance costs to 2 percent (or 3.5 percent in the case of qualified mortgage bonds or qualified veterans' mortgage bonds if the proceeds of the issue do not exceed $20 million).
Certain rules not to apply to mortgage revenue bonds, qualified student loan bonds, and qualified 501(c)(3) bonds	Certain subsections (substantial user restriction, maturity limits, land acquisition, and acquisition of existing property) do not apply to mortgage revenue bonds and qualified student loan bonds; and certain subsections (substantial user restriction, land acquisition, acquisition of existing property, and the "health club facility" portion of the disallowed usages restriction) do not apply to qualified 501(c)(3) bonds.

Section 150: Definitions and special rules

Tax code	Explanation
Change in use	The IRC restricts the changing of use or ownership of most PAB-acquired property and projects. Mortgage revenue bonds Special rules apply that result in the nondeductibility of interest (that accrues during a continuous period of at least 1 year when the residence is not the principal residence for at least one original mortgagor) paid on mortgage or veterans' mortgage bond-financed residences. Qualified residential rental projects Special rules apply for bonds that are used to finance qualified residential rental projects that result in the nondeductibility of interest paid, which accrues during the period beginning on the first day of the taxable year in which the project fails to meet elected set-asides for low-income tenants and ending on the date the project meets such requirements. Exceptions are provided for advance refundings. Qualified 501(c)(3) bonds Special rules apply that result in the nondeductibility of interest paid during the time that a portion of a 501(c)(3) or governmentally owned unit is used in a trade or business of any person other than a 501(c)(3) or governmental unit but continues to be owned by the 501(c)(3) or governmental unit. The 501(c)(3) will also have to recognize unrelated trade or business income with respect to such portion in an amount not less than its fair rental value.

Section 150: Definitions and special rules

Tax code	Explanation
Change in use	Certain exempt facilities and small-issue bonds Facilities that are financed with proceeds from exempt facility bonds or qualified small-issue bonds must be used for a purpose for which a tax-exempt bond could have been issued, or the interest is not deductible during the period that this facility is not so used. Facilities financed by PABs required to be owned by 501(c)(3)s or governmental units The facilities must be so owned or the deduction of interest is not allowed during the period that the facilities are not so owned. Certain small-issue bonds that exceed capital expenditure limitation In the case of financing that is provided from the proceeds of any purported small-issue bond, no deduction is allowed for interest that is accrued during the period that such a bond is not a qualified small-issue bond.
Exceptions and special rules for changes in use contained in subsection 150(b)	Change in use requirements only apply to the portion of a facility that is financed by bond proceeds and that is not used for the exempt purpose. Proceeds that are not required to be used for the exempt purpose are excepted from the change in use restrictions. Special rules apply to the treatment of amounts other than interest.
Qualified scholarship funding bond	Bonds falling within the defined meaning of qualified scholarship funding bonds are treated as state or local bonds, not as PABs.

Section 150: Definitions and special rules

Tax code	Explanation
Bonds of certain volunteer fire departments	These bonds are to be treated as bonds of a political subdivision of a state if certain qualifications are met. However, these bonds are treated as PABs for the purposes of public approval (section 147(f)) and advance refundings (section 149(d)).

Sections of the Code That Apply to Specific PABs

Section 142: Exempt facility bonds

Tax code	Explanation
Exempt facility bonds	Exempt facility bonds include the following: airports, docks and wharves, mass commuting facilities, facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified residential rental projects, facilities for the local furnishing of electric energy or gas, local district heating or cooling facilities, qualified hazardous waste facilities, or high-speed intercity rail facilities.
95 percent or more of the proceeds are used to provide for an exempt activity	The IRC restricts to no more than 5 percent the amount of bond proceeds that can be used for nonexempt activities and still qualify as an exempt facility bond.
Special exempt facility bond rules	The IRC requires that certain facilities (airports, docks and wharves, and mass commuting facilities) be governmentally owned and restricts the location and use of office space that can be treated as an exempt facility.
Airports, docks and wharves, mass commuting facilities, and high-speed intercity rail facilities	The IRC defines eligibility for exempt financing of storage and training facilities that are related to airports, docks and wharves, mass commuting facilities, and high-speed intercity rail facilities. It denies exempt financing for certain private establishments that are associated with these exempt facilities, such as lodging and certain retail establishments (in excess of the size needed to serve passengers and employees of the exempt facility).

Section 142: Exempt facility bonds

Tax code	Explanation
Qualified residential rental project	The IRC requires that 95 percent or more of the bond proceeds be used for qualified residential rental projects and that certain occupancy requirements, special rules, current income eligibility determinations, and certifications be met throughout the qualified project period.
Special facility restrictions	Subsections 142(e) through 142(i) of the IRC contain restrictions and definitions that specify how certain exempt facilities are to be operated. For example, exempt financing will be available only for the local furnishing of electric energy or gas within an area consisting of (1) a city and one contiguous county or (2) two contiguous counties.

Section 143: Mortgage revenue bonds: qualified mortgage bonds and qualified veterans' mortgage bonds

Qualified mortgage bonds[6]

Tax code	Explanation
Qualified mortgage bond requirements	The IRC requires that a qualifying bond meet certain requirements and other specified good-faith tests, such as using all of the proceeds, except issuance costs and a reasonably required reserve, to finance owner-occupied residences. Proceeds must generally be used within 42 months of issuance.
3-year requirement	95 percent or more of the proceeds must be used to finance residences for mortgagors who had no prior ownership interests in their principal residence during the 3-year period ending on the mortgage execution date. Exceptions exist for targeted areas, qualified home improvement loans, and qualified rehabilitation loans.
Purchase price requirement	The IRC restricts the acquisition cost to 90 percent of the average area purchase price (except for qualified home improvement loans) or 110 percent in the case of targeted areas. The average purchase price is determined separately for new versus previously occupied residences and for single- to four-family residences.
Income requirements	Generally, the purchasers' income cannot exceed 115 percent of the applicable family median income. Special rules apply for targeted area residences and to the adjustments of income requirement based on the relationship of high housing costs to income and family size.

Section 143: Mortgage revenue bonds: qualified mortgage bonds and qualified veterans' mortgage bonds

<u>Qualified mortgage bonds</u>

Tax code	Explanation
Portion of loans required to be placed in targeted areas	The IRC requires that a certain amount of proceeds be set aside for targeted area residences for a prescribed period of time.
Recapture of federal subsidy	If a taxpayer disposes of a federally subsidized property, then he or she must pay a recapture amount. A number of exceptions, limitations, and special rules apply.

<u>Qualified veterans' mortgage bonds</u>

Qualified veterans' mortgage bonds	The IRC requires that a qualifying bond meet certain requirements, such as that at least 95 percent of the proceeds must be used to provide residences for veterans and good-faith tests.
Additional requirements	Additional restrictions apply to qualified veterans' mortgage bonds including (1) that the mortgagor be a qualified veteran, (2) that the state program be effective before June 22, 1984, and (3) that the volume does not exceed the state veterans' limit. A special rule applies for short-term bonds.

<u>Qualified mortgage and veterans' mortgage bonds</u>

Residence requirement	The IRC requires that the mortgagor live principally in the mortgaged residence and that it is located within the jurisdiction of the issuing authority.

Section 143: Mortgage revenue bonds: qualified mortgage bonds and qualified veterans' mortgage bonds

Qualified mortgage and veterans' mortgage bonds

Tax code	Explanation
Additional arbitrage restrictions	Additional arbitrage restrictions apply to qualified mortgage and veterans' mortgage bonds. The effective rate of mortgage interest cannot exceed the bond yield by more than 1.125 percentage points. Any arbitrage and investment gains from qualified veterans' mortgage bonds must be used to reduce costs of owner-financing.
Other requirements	Mortgages must generally be new mortgages. Certain requirements must be met where the mortgage is assumed for qualified mortgage bonds.

Section 144: Qualified small-issue bonds; qualified student loan bonds; qualified redevelopment bonds

Qualified small-issue bonds[7]

Tax code	Explanation
Qualified small-issue bonds	Small-issue bonds are bonds that are issued as part of an issue not exceeding an aggregate face amount of $1 million. At least 95 percent of the net proceeds must be used to finance manufacturing facilities or land for first time farmers.
	Prior issues (aggregate) Under certain circumstances, prior issues are aggregated with any later issue in determining the aggregate amount of that issue, such as facilities located in the same incorporated municipality or county or the principal user being two or more related persons.
	$10 million special case limit The limit is increased to $10 million in certain cases for the aggregate face amount.
	5 percent residential purpose limit Bonds where 5 percent or more of the proceeds are used for residential property do not qualify as small-issue bonds.

Section 144: Qualified small-issue bonds; qualified student loan bonds; qualified redevelopment bonds

Qualified small-issue bonds

Tax code	Explanation
	<u>Limitations on treatment of bonds as part of the same issue</u> Generally, bonds that would be treated as part of the same issue, will be treated as separate issues unless the proceeds of such bonds are to be used for two or more facilities located in more than one state, or which have the same person or related persons as the principal user. Special restrictions exist for franchises.
	<u>Subsection not to apply if bonds are issued with certain other tax-exempt bonds</u> The small-issue bond subsection does not apply to bonds that are issued as part of other tax-exempt issues (other than those applicable under the $10 million limit).
	<u>Restrictions on certain facilities</u> The IRC restricts the amount of proceeds that can be used for facilities having certain retail or recreational facilities as their primary purposes.
	<u>Aggregation of issues with respect to single project</u> Two or more issues will be treated as one issue if part or all of the net proceeds are to be used for a single building; enclosed mall; or strip of offices, stores, or warehouses using common facilities.
	<u>$40 million taxpayer limit</u> The IRC limits the amount that a facility owner or principal user can be allocated to $40 million during an initial 3-year period.

Section 144: Qualified small-issue bonds; qualified student loan bonds; qualified redevelopment bonds

Qualified small-issue bonds

Tax code	Explanation
	$250,000 limit on depreciable farm property The IRC limits to $250,000 the amount of proceeds that can be used to provide depreciable farm property whether the principal user will be the same person or two or more related persons.

Qualified student loan bonds

Qualified student loan bonds	The proceeds of qualified student loan bonds are to be used directly or indirectly for student loans.
	Higher Education Act of 1965 applies A qualified student loan bond must be issued under a student loan program that (1) meets the requirements of the Higher Education Act of 1965 or (2) is approved by the state if certain limitations are imposed.
	Applicable percentages for qualifying status 90 percent or more of the proceeds must be used to finance student loans under the Higher Education Act programs and 95 percent or more for state-approved programs.
	Residence and nonbias requirement The student must be a resident or student in the issuing state and the program may not discriminate on the basis of the location of the school.

Section 144: Qualified small-issue bonds; qualified student loan bonds; qualified redevelopment bonds

Qualified redevelopment bonds

Tax code	Explanation
Qualified redevelopment bonds	95 percent or more of the proceeds must be used in areas that are designated by the local governing body as blighted for one or more redevelopment purposes. Additional restrictions The IRC requires that state laws authorize redevelopment bonds that are secured by the general taxing authority of the governmental unit; that local redevelopment plans must be adopted before issuance; that sales of property acquired by the local government must be at fair-market value; and that no additional charges are required of owners or users of property located in the financed area. Redevelopment purposes The IRC defines what represents redevelopment purposes, including the acquisition of real property in blighted areas, the clearing and preparation of property, the rehabilitation of property, and the relocation of occupants. New construction is not included. Designated blighted areas Generally, the IRC restricts the amount of real property that can be designated as blighted to 20 percent of the total assessed real property in the jurisdiction and quantifies what constitutes a minimum designated blighted area.

Section 144: Qualified small-issue bonds; qualified student loan bonds; qualified redevelopment bonds

Qualified redevelopment bonds

Tax code	Explanation
	No additional charge requirements The IRC requires that users or owners of property that is located in a financed area not be charged fees or be assessed differently (with respect to the property) than owners or users of property of the same type that lies within the jurisdiction of the governmental unit but outside of the area that is financed with bond proceeds.
	Use of proceeds requirements The IRC restricts the amount of proceeds that can be used for certain types of activities, such as retail food establishments and recreational facilities.
	Restriction on acquisition of land not to apply The 25-percent land limit restriction of section 147(c) does not apply to redevelopment bond proceeds.

Section 145: Qualified 501(c)(3) bonds

Tax code	Explanation
Qualified 501(c)(3) bond	A qualified 501(c)(3) bond is any PAB that is issued where (1) all of the property is to be owned by the 501(c)(3) or a governmental unit and (2) 5 percent or less of the proceeds are used for private business and private security or payment and the 501(c)(3) organization is treated as a governmental unit with respect to its tax-exempt activities.
Qualified hospital bond	When 95 percent or more of the proceeds are to be used for hospital purposes, a bond is a qualified hospital bond.
$150 million limit on non-hospital bonds	The IRC restricts the amount of nonhospital bonds that can be outstanding at one time to $150 million for each exempt organization. Other restrictions include a requirement that two or more organizations under common management or control be treated as one organization.
Restrictions on residential rental housing for family units	The IRC restricts the amount of proceeds that can be used for housing,[8] except for qualified residential rental housing bonds that are to be used for family units or property that is scheduled for rehabilitation. This section also defines when certain property is to be treated as new or substantially rehabilitated, with certain exceptions.

Section 145: Qualified 501(c)(3) bonds

Tax code	Explanation
Election out	Qualified 501(c)(3) bond restrictions do not apply to bonds if the issuer elects not to have this section apply and if such issue is an exempt facility bond or qualified redevelopment bond to which the volume cap applies.

1. Investment property is defined as follows: any security that falls within the meaning of section 165(g)(2)(A) or (B); any obligation (excluding tax-exempt bonds, except any PAB that is issued after August 7, 1986, and interest of which is not includable in gross income under section 103); any annuity contract; any investment-type property; or, for non-PABs, any residential rental property that is used for family units outside of the jurisdiction of the issuer and that is not acquired to implement a court-ordered or -approved housing desegregation plan.

2. The rebate is equal to the amount earned on all nonpurpose investments minus the amount that would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue, plus any income attributable to the excess described above.

3. Certain exceptions exist. See section 149(b)(3).

4. See IRC section 501(c)(3) for an explanation of these tax-exempt organizations.

5. An issue in which 5 percent or more of the proceeds are to be used for any output facility will be deemed a PAB if the nonqualified amount exceeds the excess of $15 million over the aggregate nonqualified amounts of all prior issues, in which 5 percent or more of the proceeds are or will be used for the same facility.

6. The tax exemption for qualified mortgage bonds is due to expire on December 31, 1991, unless reauthorized by Congress.

7. The tax exemption for qualified small-issue bonds is due to expire on December 31, 1991, unless reauthorized by Congress.

8. Section 145(d)(2) addresses restrictions to this section of the code.

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