



Issue Brief: NON-GOVERNMENTAL BONDS

Updated March 2010

Background

Aside from governmental bonds that are issued to finance facilities that are owned, controlled and/or operated by a state or local government, there are a variety of private-activity bonds that are used to meet certain policy goals. A private-activity bond is any bond where more than 10 percent of the proceeds is used by an entity other than a governmental unit and is directly or indirectly repaid from or secured by revenues from a private trade/business.

Absent an exception, these private-activity bonds may not be used on a tax-exempt basis. However, Congress has recognized that certain private-activity bonds should be issued in a tax-exempt manner when they meet certain conditions and limitations. This brief strives to outline most of the rules for private activity bonds of interest to state and local governments that are issued in a tax-exempt manner. Readers should also review the *Private Activity Volume Caps Issue Brief* as well.

Limits on private-activity bonds

- Interest on tax-exempt private-activity bonds must be included in an individual's and corporation's Alternative Minimum Tax (AMT) calculation. With the AMT capturing many more individuals today than ever before, many issuers of these bonds – especially airports and ports – have grown concerned that the pricing of their bonds is hurt by this classification. This also disqualified the bonds from being eligible for “bank qualified” status. *The American Recovery and Reinvestment Tax Act of 2009* eliminated the application of AMT on private activity bonds issued in 2009 and 2010 and also to refundings done in 2009 and 2010 (on bonds that were initially issued after Dec. 31, 2003).
- Some private-activity bonds (PAB) are subject to a statewide volume cap – a ceiling on the aggregate amount of tax-exempt private-activity bonds that may be used in a state in any given year. This 2010 amount for each state is whichever is greater - \$273.775 million or \$90 per resident (based on 2009 population data).

The following private-activity bonds are not counted against a state's volume cap: airports, ports, government-owned solid waste facilities, some high-speed rail facilities, veterans' mortgages, and 501(c)(3) organizations (e.g., hospitals and universities). A change in the 2008 Housing bill permanently exempts all housing bonds from the cap and allows mortgage revenue and rental property bonds to be issued outside the volume cap for three years (until 2011). If a state does not use the amount permitted by the cap, it may carry forward the difference for up to three years. Under current law, to qualify for the three-year carry-forward, a state must designate a specific issuer and specific type of function to be financed. If a designated facility cannot be financed during the subsequent three years due to changes in the market conditions, the state cannot reallocate the bond authority to another type of project elsewhere in the state.

- Private-activity bonds, with the exception of 501(c)(3) bonds, may not be advance refunded.
- In March 2010, the House of Representatives passed the Small Business and Infrastructure Jobs Act (H.R. 4849) which would exempt private activity water and sewer bonds from the volume cap.
- There are other technical requirements placed upon most tax-exempt, private-activity bonds including: maturity of bond, restriction on use for land acquisition, and a prohibition on use of proceeds to acquire existing property.

Most of the restrictions listed above and the implementation of a unified volume cap began with the *Tax Reform Act of 1986*. Since that time, there have been various changes to the code relating to tax-exempt bonds, but the nature of the tax treatment remains the same.

Types of Private Activity Bonds

Mortgage Revenue Bonds are issued to finance owner-occupied residential property and are used by both state and local housing agencies to provide housing for low incomes citizens.

Industrial Development Bonds (IDBs, also referred to as Industrial Revenue Bonds) provide small and mid-size manufacturers the opportunity to issue bonds for manufacturing facilities. They are occasionally used in conjunction with a state or local government's economic development plan and are issued by a state or local government economic development finance authority. IDBs also are counted against a state's volume cap. Small issue IDBs can be issued in amounts up to \$1 million or, if certain capital expenditures are taken into account, \$20 million in 2009.

IDBs may be issued for a "manufacturing facility" defined as any facility used in manufacturing or producing tangible personal property, and, through a change in the 2009 *American Recovery and Reinvestment Tax Act*, includes facilities that are used in the manufacturing, creation or production of intangible property.

Student loan bonds are issued to finance student loans for attendance at higher education institutions and are counted against a state's volume cap.

501(c)(3) organizations may issue tax-exempt bonds but are not under a state's volume cap. The most commonly issued 501(c)(3) bonds are for higher education and health care facilities. Many states have higher education and health care financing authorities that issue bonds for various institutions across their states.

Bonds for water facilities, sewage facilities, airports, ports, mass commuting (rail) facilities, electric and gas output facilities and solid waste facilities may be issued in a variety of ways:

- When a facility is governmentally owned and governmentally operated, government bonds, not private activity bonds, may generally be issued to finance the project.
- When the facility is governmentally owned and operated pursuant to a under a qualified management contract (under rules set forth in IRS Revenue Procedure 97-13), governmental, not private activity, bonds may generally be issued to finance the project.
- When a facility is governmentally owned but operated by a private entity pursuant to a contract that does not qualify as a qualified management contract, private-activity bonds may generally be issued to finance the project, provided that only certain types of projects may be financed with tax-exempt bonds. Water, sewage, electric and gas facility bonds are subject to the volume cap.
- Except for airports, ports and mass commuting facilities, which must be government owned, when a facility is privately owned and privately operated, private-activity bonds generally may be issued for the project, noting that only certain kinds of such projects may be financed with tax-exempt bonds. These bonds are all subject to the volume cap.

Outlook 2009

Efforts to increase the private use limit and increase or eliminate the private-activity bond cap may be introduced in the 111th Congress. GFOA will closely monitor these activities.

- Federal Tax Policy and Preserving the Tax-Exempt Status of Municipal Bonds (2005)