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Reform or Revolution? Tax-Exempt Bonds, The Legislative Process, and the Meaning of Tax Reform

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INTRODUCTION

In the aftermath of the Tax Reform Act of 1986 (the "Act"),[1] the sacrosanct character of the tax exemption for state and local government bond interest appears to be gone forever. The Act's volume limitations on private activity bonds have contributed to a sharp decline in bond issues, reversing two decades of accelerating growth.[2] Inclusion of private activity bond interest in the individual and corporate minimum

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[1] Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[2] According to an industry publication, new issues of tax-exempt bonds declined from a $203.95 billion high in calendar year 1985 to $142.54 billion in 1986 and $98.67 billion in 1987. CREDIT MARKETS: THE FIXED-INCOME SECURITIES WEEKLY, Oct. 10, 1988, at 27. For the first eleven months of 1988 (Jan.-Nov.), the figure was $95.00 billion. *Id.*, Dec. 5, 1988, at 15. Comparable figures were $46.13 billion for 1981, $77.18 billion for 1982, $83.35 billion for 1983, and $101.88 billion for 1984. Most of the decline in volume was attributable to a reduction in private activity bond issuance. For further statistics regarding the volume of tax-exempt bond issuance, see *infra* notes 37-38, 54-57 & 247-48 and accompanying text.

tax, together with new rules affecting arbitrage earnings and bank acquisitions of tax-exempts, make bonds less attractive both to buyers and issuers. Lower tax rates further reduce the advantages of tax exemption. The 1986 changes also have had an important psychological impact, as some individuals regard them as the first step toward taxation of all municipal bond interest. Judicial decisions have conspired with legislative developments, with the Supreme Court holding in *South Carolina v. Baker*[3] that state and local bonds are not constitutionally entitled to tax-exempt status.

Most analyses of tax-exempt bonds have emphasized their economic or constitutional implications. However, the 1986 changes also provide an illuminating case study of the theory and practice of tax reform. Two main themes predominate.

First, the assault on tax-exempt bonds demonstrates the successes and limitations of the effort to restrict tax subsidies, the principal focus of recent tax legislation. As an area that was "reformed" in three major tax bills — in 1982, 1984, and 1986 — bonds provide a unique perspective from which to evaluate the changing significance of tax reform, and how the 1986 meaning of tax reform differs from its meaning in previous years.[4] The question arises whether the 1986 Act was really reform legislation or an unprecedented overhaul that would be better judged by a new and different set of standards.

Second, the continuing distinction between "public" and "private" purpose municipal bonds raises fundamental questions regarding the proper scope of public (or governmental) activities. Congressional consideration of tax-exempt bonds suggests the difficulty of reconciling traditional concepts of public and private with the realities of modern government. This issue intersects with the first issue because Congress's approach to reform in the bond area reflects its inability to resolve the

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[3] 108 S. Ct. 1355 (1988).

[4] The Revenue Act of 1987, Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987), contained only two bond-related provisions. One concerned bonds issued by Indian tribal governments, and the other concerned the use of tax-exempt bonds to acquire nongovernmental output (*e.g.*, electricity-, gas-, or water-furnishing) facilities. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 102 Stat. 3342 (1988), made more extensive but still modest changes. These included extending authority to issue qualified mortgage bonds through December 31, 1989, together with amendments to the qualified mortgage bond requirements; clarifying the definition of manufacturing for purposes of small issue bonds, creating a new category of bonds to finance intercity high-speed rail facilities, and various arbitrage-related amendments. TAMRA also made technical amendments to the bond (and other) provisions of the Tax Reform Act of 1986.

underlying philosophical questions.

This Article investigates the particular and universal lessons of the 1986 bond provisions. Part I of the Article provides a brief review of pre-1986 bond legislation, including the extensive changes made by the Deficit Reduction Act of 1984.[5] Part II gives a detailed description of the 1985-1986 legislative process, together with the Author's evaluation of each stage of that process. This Part traces the 1986 legislation from President Reagan's tax reform proposal, which would have repealed the tax exemption for all bonds used by private persons, through the House and Senate versions of the bill, to the final legislation signed by President Reagan in October 1986. The circularity of the legislative process — its tendency to return to established ideas in ever-changing combinations — is a major theme of this Part.

Part III of the Article analyzes the 1986 changes in the context of previous bond legislation. Specifically, this Part examines the continuing distinction between public and private activity bonds. It concludes that the President's proposal reflected a pre-New Deal conception of the proper scope of governmental activities, under which government was limited to certain core functions, while keeping overlap between public and private activities to a minimum. Congress rejected this view, but was unable to agree on a coherent alternative, forcing it to rely on volume restrictions in order to limit private activity bonds. Part of the President's view survived in (1) new volume limitations that prevent or discourage issuance of many private activity bonds and (2) seemingly technical amendments to the private activity bond definition, which suggest that profit-making activities are inherently less governmental than other, money-losing ventures.

Part III then evaluates the 1986 bond provisions as a case study of tax reform. Prior to 1986, tax reform generally meant the correction of particular abuses in the tax code. By contrast, the 1986 Act sought to reduce tax subsidies and lower tax rates, improvement of individual tax provisions generally being secondary to these goals. This change of focus substantially altered the concept of "reform" which had been employed in other acts. While necessary to achieve systemic reform, the new strategy resulted in imperfect changes in many areas, particularly areas such as tax-exempt bonds which were deemed peripheral to the general reform package. Such imperfection may be acceptable, if the purpose of the Act is seen not as correcting individual abuses, but as creating a new structure in which tax rates are lower and tax subsidies

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[5] Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

(whether or not abusive) become less politically and economically attractive. In this respect, the psychological aspects of tax reform are as important, and as intentional, as individual statutory changes; criticism of allegedly "unfair" or "unintended" outcomes misses this central point and is more often than not unpersuasive.

I. BACKGROUND: TAX-EXEMPT BONDS TO 1985

A. Origins: Until 1968

Interest on state and local obligations has been tax-exempt since the original income tax was enacted in 1913.[6] Originally,[7] legislators believed that the exemption was required by the Constitution, which was thought to prohibit federal interference with state borrowing.[8] Later, the exemption came to be viewed as primarily a statutory matter. Finally, in *South Carolina v. Baker*,[9] the Supreme Court eliminated any remaining constitutional protection for tax-exempt bonds. Despite periodic proposals to repeal the exemption,[10] Congress retained it under both the 1939 and 1954 Internal Revenue Codes, without significant change.

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[6] The current exemption is contained in I.R.C. § 103, with related provisions in I.R.C. §§ 141-150. *See* I.R.C. § 103; *id.* §§ 141-150.

[7] For the pre-1976 history of tax-exempt bonds, see H. ZARITSKY, THE LEGISLATIVE HISTORY OF THE INCOME TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BOND INTEREST (1977).

[8] The constitutional argument was based on the doctrine of intergovernmental immunities, under which the federal government may not abridge legitimate state interests. *See* Pollock v. Farmers Loan & Trust Co., 157 U.S. 429, *modified*, 158 U.S. 601 (1895) (holding earlier income tax unconstitutional for various reasons, including the taxation of municipal bond interest). As is often the case, constitutional appeals mixed with politics — the sixteenth amendment, which made the modern income tax possible after *Farmer's Loan & Trust Co.*, required approval by state legislatures, which understandably preferred to let state bond interest remain untaxed. The constitutional argument was rejected by the Supreme Court in South Carolina v. Baker, 108 S. Ct. 1355 (1988); *see infra* note 9.

[9] 108 S. Ct. 1355 (1988). The *South Carolina* Court held that the Constitution does not prohibit taxing state or local government bonds, thus reversing *Farmer's Loan & Trust Co.* The *South Carolina* decision involved the application of registration requirements, enacted in 1982, for state and local government bonds. However, the Court stated that any nondiscriminatory tax on state or local bonds would not constitutionally be prohibited.

[10] Proposals to eliminate the exemption were advanced as early as the 1920s. At that time, most observers believed that a constitutional amendment would be necessary to tax municipal bond interest. The most serious effort came in 1942 when the Treasury Department, needing money for the war effort, sought to repeal the exemption, but Congress did not enact this proposal.

The exemption for municipal bond interest was simple enough as long as these bonds were used for "traditional" public purposes — schools, roads, governmental operations, etc. Such bonds typically are repaid from either the general revenues of the issuing governmental unit, or from revenues associated with a particular public project being financed (for example, bridge or highway tolls).

During the Depression, states began to use tax-exempt bonds for what might be called industrial aid. Bond proceeds would be used to finance a project for a private business. The bonds would be repaid from revenues generated by that business. For example, a county might lend bond proceeds to a company to construct a new factory (alternatively, the county might build the factory and lease it to the company). The tax-exempt status of the bonds would enable the company to borrow at reduced interest rates (or to make reduced rental payments). At a certain point, these transactions began to look less like municipal financings and more like private borrowings, as the proceeds merely passed through a governmental unit so as to receive a tax-exempt rate. Moreover, the bonds were frequently secured by private business property, the governmental unit having only limited if any liability for the debt.

A series of IRS rulings in the 1950s and 1960s explored the limits of the municipal bond interest exemption in such cases. Two of these rulings held that the exemption remained applicable, even though the property was leased or sold to private businesses and repayment was limited to the lease or sale proceeds.[11] A 1963 ruling[12] stated that bonds issued by a nonprofit industrial development corporation — as distinguished from a governmental unit — were tax-exempt only if five conditions were met.[13] Even this ruling, however, was primarily concerned with the identity of the issuer. If the bonds were truly being issued by, or "on behalf" of, a state or local government, the use of the bond

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[11] Rev. Rul. 57-187, 1957-1 C.B. 65 (concerning facilities constructed by municipally chartered, industrial development boards and leased or sold to private businesses); Rev. Rul. 54-106, 1954-1 C.B. 28 (concerning facilities constructed by municipality and leased to private businesses).

[12] Rev. Rul. 63-20, 1963-1 C.B. 24.

[13] The five conditions were: (1) the corporation must engage in activities that are essentially public in nature; (2) it must not be organized for profit (except to the extent of retiring debt); (3) corporate income must not inure to any private person; (4) the state or a political subdivision must have a beneficial interest in the corporation while the bonds remain outstanding, and must be able to obtain full legal title to the financed property by repaying the bonds; and (5) the corporation, and the bond issue, must have been approved by the state or a political subdivision. Rev. Rul. 63-20, 1963-1 C.B. 24.

proceeds remained outside the scope of the tax law.

B. The New Framework: 1968

1. The Proposed Regulations

The introduction of "industrial development bonds" in 1968 created the first statutory distinction among categories of tax-exempt bonds. This concept was originally a Treasury Department invention, which was included in proposed regulations that were announced on March 6, 1968,[14] and issued on March 22 of that year.[15] Essentially, the concept distinguished bonds that were used and repaid by private businesses (industrial development bonds) from other state and local obligations.

Under the proposed Treasury regulations, interest on industrial development bonds issued by state or local governmental units was to be taxable. A bond was an industrial development bond if one or more identifiable private persons used, or had the right to use, all or a major portion of bond-financed property, and the same person or persons provided all or a major portion of the funds necessary to repay the bonds. Additionally, the payment of principal and interest had to be secured, in whole or in major part, by an interest in the bond-financed property or payments with respect to the property. "Such indebtedness," the proposed regulations explained, "although issued by a governmental unit, is in reality the indebtedness of a person other than a governmental unit since under the terms of the indebtedness or [other underlying arrangement] . . . the governmental unit serves as a conduit for disbursing funds provided by such person, and the liability for providing the funds to pay the principal and interest on the indebtedness is that of such person."[16]

Under the proposed regulations, an important characteristic of industrial development bonds was the reliance on private business revenues to ensure repayment of the bonds. Thus, industrial development bonds were used in various cases when property was leased or sold, or money lent, to a specific private business.[17] By contrast, bonds to finance a governmentally owned apartment building were not industrial development bonds. The proposed regulations explained that, in this instance, bond purchasers relied on the governmental unit's rent revenues to re-

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[14] Tax Info. Rel. 972 (March 6, 1968).

[15] 33 Fed. Reg. 4950 (1968).

[16] Prop. Treas. Reg. § 1.103-7(b)(1), 33 Fed. Reg. 4950 (1968).

[17] Prop. Treas. Reg. § 1.103-7(b)(4), Examples 1-5, 33 Fed. Reg. 4950 (1968).

pay the bonds, rather than on an identifiable lessee.[18]

The proposed regulations did not provide any permanent exceptions to the denial of tax exemption for interest on industrial development bonds.[19]

2. The 1968 Legislation

Congress responded to the proposed regulations before they were even issued. On March 15, 1968,[20] the Senate Committee on Finance approved legislation overruling the proposed regulations and directed that the tax-exempt status of industrial development bonds be determined in a manner consistent with previous rulings.[21] This legislation was, in turn, replaced by a Senate floor amendment introduced by Senator Ribicoff (D-Conn.). The Ribicoff amendment denied tax exemption to industrial development bonds — defined in a manner similar to the proposed regulations — while providing exemptions for five specified categories of obligations.[22] A House-Senate conference committee then modified these provisions,[23] creating the basic structure of section 103 until 1986.

Under the 1968 legislation,[24] and subject to specified exceptions, interest on industrial development bonds (IDBs) was no longer to be tax-exempt. The exemption for other, traditional state or local bonds was not affected. As in the proposed regulations, the legislation defined IDBs by means of a two-part test:

> (2) INDUSTRIAL DEVELOPMENT BOND — For purposes of

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[18] *Id.*, Example 6.

[19] Transitional exceptions were provided for certain in-progress projects.

[20] At this point, the Treasury had announced that it would be issuing proposed regulations rendering interest on industrial development bonds taxable, but had not yet issued the regulations.

[21] S. REP. NO. 1014, 90th Cong., 2d Sess. 6-8 (1968). The Committee Report expressed concern that the Treasury Department, in preparing the proposed regulations, "is, in effect, legislating on this subject." *Id.* at 7.

[22] 114 CONG. REC. 8147 (1968). Under the Ribicoff amendment, exceptions were provided for bonds to finance entertainment (including sports) or recreational facilities for the general public; convention, trade show, or similar facilities; airports, flight training facilities, docks, wharves, grain storage facilities, parking facilities, or similar transportation facilities; furnishing or sale of electric energy, gas, water, sewage or solid waste disposal services; air or water pollution abatement facilities; or any property to be used in a governmentally owned and operated active trade or business. Similar exceptions were later adopted by Congress. *See infra* text accompanying note 31.

[23] The House version of the Bill did not include the Senate IDB provision.

[24] Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, 82 Stat. 251 (1968).

> this subsection, the term 'industrial development bond' means any obligation —
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> (A) which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person . . .,[25] and
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> (B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part —
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> (i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or
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> (ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.[26]

The first part of the two-part test focused on the use of a major portion[27] of bond proceeds by a private trade or business. It came to be known as the "trade or business use" or, simply, the "use" test. The second part required that the bonds be repaid with, or their repayment secured by, money or property used in a private trade or business.[28] It came to be known as the "security interest" test. IDBs were thus essentially conduit financings — the benefits of the bonds flowed through to a private business, and the repayment flowed back to the bondholders, with the governmental unit acting as a mere intermediary in each case.

The committee report provided a number of examples describing what constituted, and what did not constitute, an IDB.[29] These examples illustrated that a lease or sale of bond-financed property to a private business, as well as a direct loan of bond proceeds, could cause bonds to be IDBs. General obligation bonds[30] could also be IDBs, if the bonds were secured by private money or property, as well as by government funds. Similar to the proposed Treasury regulations, bonds for a

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[25] Exempt persons, for this purpose, included state or local governmental units and organizations exempt from tax under I.R.C. § 501(c)(3). Thus, bonds for section 501(c)(3) organizations remained exempt from the IDB rules.

[26] I.R.C. § 103(c)(2) (redesignated § 103(b)(2)), as added by section 107(a) of The Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, 82 Stat. 251 (1968). I.R.C. § 141(b), defining private activity bond, replaced this provision in 1986. *See infra* notes 138-41 and accompanying text.

[27] Regulations subsequently defined a major portion as any amount in excess of 25%. Treas. Reg. § 1.103-7(b)(3) (1972).

[28] The statute did not require that the party using the bonds and the party repaying the bonds be the same (or a related) person; however, this is the most common transaction.

[29] Several of these examples were similar to examples previously included in the proposed Treasury regulations.

[30] General obligation bonds are bonds backed by the full faith and credit of the issuing government. These are distinguished from revenue bonds, which are secured only by revenues from a particular project or projects.

governmentally owned and operated housing project were not IDBs, since the bond proceeds were not used in a private trade or business.

Unlike the proposed regulations, the 1968 legislation provided various exceptions to the new IDB rules, conferring tax-exempt status on IDBs issued for specified "exempt activities." These activities included residential rental property; sports facilities; convention or trade show facilities; airports, docks, wharves, mass commuting facilities, or parking facilities (together with related storage or training facilities); sewage or solid waste disposal facilities; facilities for the local furnishing of electric energy, gas, or water; and air or water pollution control facilities. Additional exceptions were provided for industrial parks and for "small issue" IDBs, a catch-all category including any issue of $1 million or less (taking into account certain related issues) used to acquire land or depreciable property.[31] The small issue exception allowed financing for all types of small industrial or commercial projects, although not for business working capital.

3. The Legacy of 1968

The 1968 legislation provided the basic structure of section 103 for almost two decades. Hence, it provided the starting point for all future reform endeavors. Two decisions made in 1968 were particularly significant for the future of tax-exempt bonds.

First, the 1968 legislation adopted the "double negative" structure of all subsequent bond provisions. Under this structure, obligations of state and local governments were presumptively tax-exempt, unless they met the definition of industrial development bonds or, later, mortgage subsidy or private loan bonds. Bonds in these latter categories could also be tax-exempt, but only if they were used for specified purposes and met various additional tests. As a result, two categories of tax-exempt obligations were created — a privileged class of "traditional" obligations, and a new class of private purpose bonds. The implication was that the former were tax-exempt by right, and the latter by legislative grace. Inevitably this distinction cast doubt on the legitimacy of the overall bond exemption. Such bifurcation ultimately suggested an incremental reform strategy, under which new requirements — arbitrage rules, information reporting, and eventually volume limits — could first be applied to one or more categories of private bonds and

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[31] The Renegotiation Amendments Act of 1968, Pub. L. No. 90-634, 82 Stat. 1345 (1968), added an alternate $5 million limit for small issue bonds, which required that certain related capital expenditures (whether or not bond-financed) be included in this total. This amount was increased in 1978 to $10 million.

later, if appropriate, extended to all tax-exempt bonds.

A second innovation was the listing of specific activities that could benefit from tax-exempt IDB financing. Previous approaches had focused on the nature of the bond issuer (in Treasury rulings) and the benefits to identifiable private persons (in the proposed Treasury regulations). For example, under the proposed regulations, a governmentally operated airport or stadium was not treated as a private project if no one user derived a substantial portion of the overall economic benefit from the facility.[32] This same generic test was to apply to other types of facilities.[33] By contrast, the 1968 legislation simply listed airports, stadiums, and certain other facilities as exempt activities, which qualified for IDB financing.[34]

The listing of exempt activities was perhaps a concession to reality. State and local governments — and members of Congress — generally do not think in terms of substantial portions, indirect benefits, and other abstract concepts. They want to know what kinds of facilities (airports, stadiums, etc.) can be financed with tax-exempt bonds. This certainty was accomplished by the legislation. The listing of exempt activities also allowed flexibility in the structuring of projects to conform to local conditions, which could have been more difficult under a generic test.[35]

The "exempt activities" approach suggested an unprecedented Federal interference in state and local bond issuance, at least as far as private activities were concerned.[36] Essentially, the Federal Government

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[32] Prop. Treas. Reg. § 1.103-7(b)(4) (1968), Examples 9 and 11, 33 Fed. Reg. 4951 (1968). The stadium example refers to a "major portion" of the economic benefit.

[33] Prop. Treas. Reg. § 1.103-7(b)(3) (1968), 33 Fed. Reg. 4950 (1968).

[34] Treasury regulations subsequently added a requirement that facilities financed with IDBs "must serve or be available on a regular basis for general public use . . . , as contrasted with similar types of facilities which are constructed for the exclusive use of a limited number of nonexempt persons in their trades or businesses." Treas. Reg. § 1.103-8(a)(2) (1972). In contrast to the 1968 proposed regulations, "public use" for this purpose is determined in an ultimate sense. Thus, while a private landing strip does not qualify for financing, an airport serving the general public qualifies under the regulations even if the relevant facilities (*e.g.*, an airport terminal) are both owned and operated by a private, commercial airline. (The Tax Reform Act of 1986 amended the statute to require that bond-financed airport facilities be owned by a governmental unit.)

[35] For example, under the proposed Treasury regulations, an airport might have qualified for tax-exempt financing if it served a number of smaller airlines, but not if it served one or two major carriers. By contrast, the legislation allowed financing in either of these cases.

[36] The legislation did not affect bonds used for "traditional" governmental activities.

supplanted the state's right to decide what constituted a legitimate purpose for issuing bonds. Housing, transportation, and various utilities, together with stadiums and convention centers, were approved purposes, as well as any small-sized project. Most other purposes were not approved. IDBs thus came to resemble less a tax provision than a disguised spending program for Federally approved objectives. The emphasis was no longer on the governmental nature of the bond issuer, but on the governmental purpose of the issue. While the 1968 legislation itself was generous, the implication was clear: if Congress chose to give statutory tax exemptions, could it not someday take them away?

C. The Expanding Market: 1968 to 1980

1. Growth and Response

After 1968, the volume of tax-exempt bonds for private activities grew prodigiously. By 1975, according to Treasury Department figures, $8.9 billion of "nongovernmental" tax-exempt bonds[37] were being issued. By 1980, the annual amount had reached $32.5 billion, or more than half the total tax-exempt market. Of these, nearly $10 billion were small issue IDBs, and $14 billion were single- or multi-family housing bonds.[38]

The growing market did not occasion an immediate legislative response. On the contrary, new categories of tax-exempt IDBs were still being added in the early 1980s — small-scale hydroelectric projects in 1980,[39] mass commuting vehicles in 1981,[40] and local district heating or cooling facilities in 1982.[41] Amendments were also made to certain ex-

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[37] These included IDBs, single-family housing bonds, student loan bonds, and bonds for section 501(c)(3) tax-exempt organizations. Reporting of tax-exempt bond issues to the Federal Government generally was not required until 1983 (for certain private activity bonds) or 1987 (for all tax-exempt bonds); accordingly, earlier figures rely on unofficial data.

[38] JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS: TAX TREATMENT OF STATE AND LOCAL GOVERNMENT BONDS 60 (1985) [hereafter TAX REFORM PROPOSALS] (based on figures supplied by the Treasury Department's Office of Tax Analysis). The Tax Reform Proposals pamphlet also lists "other" tax-exempt bonds, at a volume in 1975 of $21.6 billion and in 1980 of $22 billion; a footnote states that some of these may have been additional nongovernmental bonds.

[39] Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 242, 94 Stat. 229, 283-85 (1980).

[40] Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 811, 95 Stat. 172, 349-50 (1981). The 1968 mass commuting exception had covered only mass commuting terminals.

[41] Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-

isting categories, allowing more facilities to qualify for exempt financing.[42]

One should not conclude from the above discussion that no new limitations were imposed. The first statutory arbitrage rules were enacted in 1969. Subsequent regulations provided issuers with a maze of legal and mathematical concerns.[43] Treasury rulings and regulations also put additional meat on the bones of the 1968 legislation.[44] However, the basic structure of section 103 remained unchanged, and the market was permitted to grow.[45] This result was consistent with the overall pattern

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248, § 217(a), 96 Stat. 324, 472-73 (1982). The limiting provisions of TEFRA are discussed below.

[42] A case in point is the exception for water-furnishing facilities, originally limited to facilities serving no more than two contiguous counties. This exception was extended in 1971 to cover all facilities providing water on reasonable demand to the general public, *see* Revenue Act of 1971, Pub. L. No. 92-178, § 315, 85 Stat. 497, 529 (1971), and again in 1975 to allow financing of irrigation dams having a subordinate use in generating electricity. *See* Revenue Adjustment Act of 1975, Pub. L. No. 94-164, § 7, 89 Stat. 970, 976 (1975). Finally, in 1978, the provision was rewritten to clarify that facilities will be considered to serve the general public, even if up to 75% of capacity is reserved for a single industrial user. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 333, 92 Stat. 2763, 2840 (1978); S. REP. NO. 95-1263, 95th Cong., 2d Sess. 141-43 (1978).

[43] Arbitrage is the investment of tax-exempt bond proceeds in higher-yielding, taxable obligations, with the issuer profiting from the spread between the higher yield on these investments and the lower yield on the bonds. (Because issuers are governmental units, the taxable character of the investments does not affect them.) During the 1960s, questions arose whether bonds issued to earn arbitrage were really obligations of a state or local government, and hence eligible for tax exemption. However, the practice was not statutorily prohibited until the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969). Most arbitrage rules were provided by regulation, until Congress extensively revised the statute in 1984.

[44] While the regulations are generally beyond the scope of this Article, a few points should be noted. First, regulations adopted in 1972 defined a "major portion" of bond proceeds to be anything over 25%. Treas. Reg. § 1.103-7(b)(3)(iii) (1972). Thus, up to 25% of bond proceeds could violate the private trade or business or security interest tests, without the bonds being considered IDBs. Once a bond was an IDB, 90% of the proceeds had to be used to finance an exempt facility or "functionally related and subordinate" property (*e.g.*, an airport hotel or parking lot). Treas. Reg. § 1.103-8(a) (1972). The definition of functionally related and subordinate, and use of the 10% "bad money" portion, tested the ingenuity of countless bond attorneys in designing bond financings.

[45] Proposals to replace tax-exempt bonds with a direct federal subsidy to state and local issuers (the so-called "taxable bond option") were advanced in Congress at various times between 1969 and 1978. Under these proposals, state and local governments would issue taxable bonds, with the federal government compensating them for the difference between taxable and tax-exempt interest costs. No such proposal was ever

of the 1970s, a decade in which inflation pushed taxpayers into higher tax brackets while Congress distributed much of the resulting revenue windfall in the form of generous tax subsidies.

2. The 1980 Mortgage Bond Legislation

Even though most of the decade was quiet, the 1970s ended with a development that presaged later events. In the latter part of the decade, as interest rates rose, states began issuing large quantities of bonds to finance home mortgages. Proceeds of the bonds would be lent to qualifying homebuyers, with the tax-exempt financing allowing a below-market interest rate. (Because these bonds were not used in a trade or business, they were not affected by the 1968 limitations.) The volume of these "mortgage subsidy bonds" increased from a negligible amount in 1975 to $10.5 billion in 1980.[46]

To cope with this situation, Congress passed, as part of a larger measure, the Mortgage Subsidy Bond Tax Act of 1980.[47] The 1980 Act imposed various new restrictions on mortgage subsidy bonds, including purchase price restrictions (for bond-financed residences); a limitation to first-time homebuyers; and special arbitrage rules. More important, a volume limitation was imposed on these bonds, equal to the greater of $200 million or 9% of average mortgage activity in the state during the preceding three years. Finally, the authority to issue any mortgage bonds was scheduled to expire ("sunset") after 1983. A special rule allowed states to issue veterans' mortgage bonds without regard to the volume cap and sunset provisions.

The 1980 legislation was a specific response to a specific problem. It also foreshadowed broader developments. Specifically, the 1980 law marked the first time a volume limitation had been imposed on any category of tax-exempt bonds. This development conflicted with the approach of the 1968 legislation, which legitimized specific types of bonds without regard to volume limits. In a sense, Congress was admitting that it had made a mistake in allowing mortgage bonds to be issued; however, because the program was so politically popular, Congress

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enacted.

[46] *See* TAX REFORM PROPOSALS, *supra* note 38, at 60.

[47] Subtitle B of Title XI of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599 (1980). The 1980 Act also imposed new restrictions on bonds for rental housing, generally limiting them to projects 20% or more of whose tenants had incomes at or below 80% of the area median. Most rental housing bonds already were considered IDBs because, unlike mortgage bonds, they were used in the trade or business of the project owner.

agreed to allow a limited exception.

The 1980 legislation also demonstrated the limitations of the "trade or business" approach to defining IDBs, which had been adopted in 1968. Not really public, but not used in a private business either, mortgage bonds had slipped through the cracks of the 1968 definitions. Only special legislation had been able to limit them. The closing of loopholes in the private activity bond definition, followed by the discovery and exploitation of new loopholes, became a repeated theme of bond legislation.

Finally, the 1980 law featured an extraordinary volume of transition rules, a harbinger of an unfortunate trend.[48] Originally intended to protect investments made in reliance on previous law, transition rules became a method for exempting any politically attractive item from the effect of statutory changes. By relying on transition rules, legislators may vote in favor of a provision with the assurance that it will not actually affect a company or project in their district. Transition rules thus tend to distort the legislative process;[49] under certain circumstances, the availability of such rules may even encourage more projects than would have taken place under the previous law. Despite this, Congress has found transition rules indispensable to the passage of tax legislation, particularly in the depreciation and tax-exempt bond areas. The trend reached a sort of peak in the Tax Reform Act of 1986,[50]

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[48] Transition rules are exceptions to new statutory provisions, either for companies or projects for which specified actions have been taken by a given date ("generic" transition rules), or for specifically identified companies or projects ("project-specific" rules). The Mortgage Subsidy Bond Tax Act of 1980 included both generic transitions and an extraordinary number of project-specific rules. Documentation was so elusive that, for one category of projects, officials were required to file affidavits indicating that they had intended to issue bonds (or to establish a program to do so) as of a specified cutoff date.

[49] Professor Michael Graetz has identified four costs associated with "grandfathered" effective dates (*i.e.*, transition rules): (1) they significantly delay and sometimes permanently reduce the benefits expected to be realized from a change in the law; (2) they substantially increase complexity; (3) they often rewards taxpayers who have taken extremely aggressive planning positions; and (4) they may be unnecessary and even wasteful compared to available alternatives such as delay or phased-in effective dates. Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1825 (1985); *see also* Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977). Graetz is concerned primarily with what I term "generic" transition rules, *i.e.*, exemptions from new law for transactions with respect to which specified actions have been taken prior to a given date. His objections would appear even stronger for project-specific transition rules; they are at least as costly as generic rules and often lack the sympathetic element of reliance on pre-existing law.

[50] *See infra* notes 163-66 and accompanying text.

although more recently it has shown signs of abating.[51]

D. Prelude: 1981 to 1984

1. 1981: ERTA

The Economic Recovery Tax Act of 1981 (ERTA)[52] made virtually no changes to the law regarding tax-exempt bonds. Only two minor provisions were included, relating to volunteer fire departments and leased mass commuting facilities. By enacting a huge tax reduction, however, ERTA contributed to an environment which made significant reforms more likely.

2. The New Playing Field

By 1982, the "playing field" for tax legislation had shifted dramatically. Instead of tax cuts, mounting budget deficits demanded increased revenues. (The deficits resulted, in large measure, from the 1981 rate cuts.) Because of President Reagan's opposition to increased tax rates, revenue increases could come about only by reducing tax preferences, provisions which benefitted some taxpayers or industries at the indirect expense of the remaining taxpayers.[53] The assault on tax preferences

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[51] An April 1988 weeklong series in the *Philadelphia Inquirer* focused attention on special tax breaks included in the 1986 Act and attempts to win additional breaks through later, "technical" legislation. Bartlett & Steele, *The Great Tax Giveaway*, Philadelphia Inquirer, Apr. 10, 1988, at 1-A (*How the Influential Win Billions in Special Tax Breaks*); *id.*, Apr. 11, 1988, at 1-A (*A Millionaire Businessman and His Island Tax Shelter*); *id.*, Apr. 12, 1988, at 1-A (*How Businesses Influence the Tax-Writing Process*); *id.*, Apr. 13, 1988, at 1-A (*Disguising Those Who Get Tax Breaks*); *id.*, Apr. 14, 1988, at 1-A (*Congress Can't Add, So the Taxpayer Pays*); *id.*, Apr. 15, 1988, at 1-A (*One Firm's Huge Tax Break*); *id.*, Apr. 16, 1988, at 1-A (*Cruising, at Taxpayers' Expense*). Responding, in part, to the publicity generated by this series, Congress did not include additional project-specific rules in The Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 102 Stat. 3325 (1988).

[52] Pub. L. No. 97-34, 95 Stat. 172 (1981).

[53] The terms "tax subsidy" and "tax preference" are used, essentially interchangeably, to refer to such provisions. Related to tax subsidies or preferences is the more systematic concept of tax expenditures, pioneered by Professor Stanley Surrey as Assistant Secretary for Tax Policy in the 1960s and developed in his later writings. Tax expenditure theory holds that tax provisions benefitting particular groups or activities may be analyzed in a manner similar to government spending programs. Under this theory, the tax code is really two systems: a "normative" system which raises revenue and a series of special provisions (*i.e.*, tax expenditures) which spend a portion of that revenue for specified purposes. A frequent corollary is that tax expenditures are less efficient than direct expenditure programs and are, therefore, undesirable.

The tax expenditure theory provides a useful tool for policy analysis. A limitation is

was also fueled by concerns for tax equity and efficiency, concerns which were to find their fullest expression in the 1986 Act.

As attention focused on tax preferences, the private activity bond[54] market continued to grow. The Senate Committee on Finance report on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[55] cited statistics indicating that private activity bond issuance had grown to an estimated $35 billion in 1982, over 55% of the overall tax-exempt market.[56] By 1983, the equivalent figure was over $60 billion per year.[57] The annual revenue loss from private purpose bonds outstanding in fiscal 1982 was estimated at $4.2 billion.[58]

This coincidence of a demand for revenues and increasing revenue losses associated with private activity bonds made bonds an irresistible target of reform legislation. There was also a long-standing litany of criticisms regarding tax-exempt bonds. Many commentators argued that tax-exempt bonds were inefficient, since a large portion of the subsidy flowed to the bondholders, rather than the state or local govern-

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that, in order to measure the extent of tax expenditures, one must first agree on what constitutes a "normative," expenditureless system — something often difficult to do. For example, many advocates of tax-exempt bonds believe that bond interest should be exempt for constitutional reasons or as a matter of intergovernmental comity; they accordingly object to any characterization of the exemption as an expenditure item.

For the classics of tax expenditure scholarship, see S. SURREY & P. MCDANIEL, TAX EXPENDITURES (1985); S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973). For a skeptical view, see Bittker, *Accounting for Federal Tax Subsidies in the National Budget*, 22 NAT'L TAX J. 244 (1969). For a response, see Surrey & Hellmuth, *The Tax Expenditure Budget — Response to Professor Bittker*, 22 NAT'L TAX J. 529 (1969). *See generally* Wolfman, *Tax Expenditures: From Idea to Ideology*, 99 HARV. L. REV. 491 (1985) (reviewing S. SURREY & P. MCDANIEL, *supra*).

[54] Private activity bonds generally include IDBs, mortgage subsidy bonds, student loan bonds, and bonds to benefit section 501(c)(3) tax-exempt organizations. On occasion, such bonds have also been referred to as private purpose or "nongovernmental" bonds. *See supra* note 37 and accompanying text.

[55] Pub. L. No. 97-248, 96 Stat. 324 (1982). *See infra* note 61.

[56] S. REP. NO. 97-494, 97th Cong., 2d Sess. 167 (1982). Figures cited by the Joint Committee on Taxation in 1985 indicated that a total of $49.6 billion in "nongovernmental" tax-exempt bonds were issued in 1982. *See* TAX REFORM PROPOSALS, *supra* note 38, at 60. The difference between these figures partly results from different definitions of private activity (or nongovernmental) bonds.

[57] *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 930 (1984) (citing figure of $62.4 billion for 1983, or 68% of the overall tax-exempt market). In 1985, the Joint Committee estimated 1983 nongovernmental bond issuance at $57.1 billion.

[58] S. REP. NO. 97-494, 97th Cong., 2d Sess. 167 (1982).

ment.[59] Moreover, private activity bonds competed with "traditional" governmental financing, raising borrowing costs for all municipalities. Tax-exempt bonds further contributed, as do all subsidies, to economic distortions. Bonds were also associated with any number of specific abuses, ranging from the financing of luxury sports boxes to excessive arbitrage profits.[60]

3. 1982: TEFRA

The first round came in 1982. In enacting TEFRA,[61] Congress imposed a series of new limitations on IDBs, without affecting the basic statutory structure.

First, most IDB-financed property was limited to straight-line depreciation, rather than the accelerated cost recovery (ACRS) method. This limitation curtailed the "double dip" of accelerated depreciation and tax-exempt financing, which resulted in excessive subsidies for some projects. ACRS remained in place for IDB-financed rental housing, public sewage and solid waste facilities, and certain other IDB categories.

Second, the small issue exception — considered the most abused IDB category[62] — was scheduled to "sunset" at the end of 1986. In the in-

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[59] The efficiency of tax-exempt bonds is a function of the relative interest rate on taxable and tax-exempt obligations. Assume, for example, that the marginal tax rate is 50%, the interest rate on long-term taxable obligations is 10%, and the rate on long-term tax-exempt bonds is 7%. The subsidy resulting from exempt financing flows two-fifths to the bondholder (in the form of an increase in after-tax yields, from 5% to 7%), and three-fifths to the borrower (in the form of reduced interest costs). Only if the tax-exempt interest rate were 5% would the full subsidy flow to the borrower. Because tax-exempt yields have generally moved closer to taxable yields over the past two decades, the efficiency of tax-exempt bonds, measured in this manner, has generally declined.

[60] For the "reasons for change" associated with bond-related reforms in the 1982 and 1984 legislation, *see* S. REP. NO. 98-169, 98th Cong., 2d Sess. 696-97 (1984) (Deficit Reduction Act of 1984); H. REP. NO. 98-432, 98th Cong., 2d Sess. 1683-85 (1984) (Tax Reform Act of 1984); S. REP. NO. 97-494, 97th Cong., 2d Sess. 167-69 (1982) (TEFRA). Separate reasons were provided for the mortgage bond amendments and for certain other provisions of these acts.

[61] Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1982). TEFRA included a potpourri of tax provisions, emphasizing compliance measures, estimated to raise $98.3 billion over a three-year period for purposes of deficit reduction. TEFRA was essentially a Senate bill, modified by a House-Senate conference committee; thus, there is no meaningful House legislative history.

[62] The Senate Finance Committee report indicated that small issues had increased from $1.4 billion in 1976 to $10.5 billion in 1981, and would reach over $30 billion by 1987 unless restrained. The report also expressed concerns regarding the lack of targeting for small issue bonds and their use by large corporations. S. REP. NO. 97-494, 97th

terim, TEFRA restricted certain perceived small issue abuses, including the financing of restaurants, automobile dealerships, and recreational facilities.

Third, TEFRA restricted the maturity of IDBs to 120% of the economic life of the property financed.[63]

In addition to the changes above, TEFRA imposed new procedural rules, including a requirement that IDB issues be approved by an elected official or legislative body, or else by popular referendum. TEFRA also mandated information reporting requirements for various private activity bonds. The committee report stated that information was necessary "to monitor the use of tax-exempt bonds for private activities and to help in enforcing other restrictions on industrial development bonds. . . ."[64] In other words, Congress would seek further, more substantive limits if the market continued to grow.

4. The 1984 Act

The Deficit Reduction Act of 1984 (the "1984 Act")[65] picked up where TEFRA left off. If they could not raise net revenues from new bond provisions, reformers now wished at least to offset anticipated losses from the extension of the mortgage subsidy bond program,[66] which they considered a political certainty. This offset could be accomplished in one of two ways: further limitations on the attractiveness of IDB financing (*e.g.*, more restrictive depreciation rules), or some type of volume limitation. (A third alternative, the elimination of entire bond categories, was not yet considered realistic.)

The House Committee on Ways and Means, and eventually the full House of Representatives, came down in favor of a volume limit. The Senate, warier of reforms, adopted further depreciation rules and certain other provisions. The House won, although not before significantly

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Cong., 2d Sess. 168-69 (1982).

[63] While restricting IDBs, TEFRA liberalized the targeting rules applicable to mortgage subsidy bonds. This change was intended to stimulate a depressed housing market.

[64] S. REP. NO. 97-494, 97th Cong., 2d Sess. 167 (1982).

[65] Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984). (The tax provisions are also known as the Tax Reform Act of 1984). The 1984 Act included a vast number of unrelated tax provisions, with a general though not exclusive emphasis on limiting tax shelter and accounting abuses. Intended as a "down payment" on future deficit reduction, the tax provisions of the Act were estimated to raise $50.7 billion over a four-year period.

[66] *See supra* notes 46-51 and accompanying text.

loosening the volume cap[67] and agreeing to very liberal transition rules.

The 1984 Act imposed a statewide $150 per capita limit on annual issuance of most IDBs. The limit also included all student loan bonds. Small states qualified for a minimum of $200 million in bond authority. The new volume limit did not apply to IDBs for multifamily rental housing, or for publicly owned airports, docks, mass commuting facilities, or convention and trade show facilities. The limit also did not apply to mortgage subsidy bonds, which remained subject to their own generous limits.[68] Bonds for section 501(c)(3) organizations were also not affected. The $150 per capita limitation was to be reduced to $100 after 1986, to reflect the sunset for most small issue IDBs.

In addition to the volume cap, the 1984 Act imposed a host of new restrictions designed to prevent perceived abuses and to target remaining bonds more effectively. These restrictions included a general ban on Federally guaranteed tax-exempt bonds, with exceptions for guarantees by certain housing and student loan-related agencies.[69] The 1984 Act also required straight-line depreciation for all IDB-financed property (except rental housing)[70] and restricted the use of IDBs to acquire land or existing property.[71] The 1984 Act further imposed various new restrictions on small issue IDBs, including a limitation of $40 million in

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[67] As originally approved in 1983 by the Committee on Ways and Means, the volume cap would have applied to all IDBs and student loan bonds. (The 1983 bill was never approved by the House.) The bill passed by the House in 1984 added exceptions for housing and various other IDBs, as described in the text. The conference agreement generally adopted the House limits, but with much more liberal transition rules.

[68] The 1984 Act extended the mortgage subsidy bond program through 1987, using the same volume and targeting rules as applied before the 1984 Act. Issuance of veterans' mortgage bonds was limited to states already having programs in existence by 1984, at their previous issuance levels.

[69] Federally guaranteed tax-exempt bonds were considered dangerous because they might prove more attractive than Treasury securities, which are not tax-exempt, or other state and local obligations, which lack a comparable guarantee. Congress became particularly alarmed by an explosion during 1983 and 1984 of bonds backed by Federal Savings and Loan Insurance Corporation (FSLIC) and Federal Deposit Insurance Corporation (FDIC) insurance. In these ingenious transactions, bond proceeds would be deposited in federally insured depositary institutions, which would then lend the money to the intended beneficiaries. Under then-prevailing interpretations, the deposits were insured up to $100,000 per bondholder, while the bond interest remained tax-exempt.

[70] This amendment repealed three of the four exceptions to this rule originally included in TEFRA.

[71] Use of bonds to acquire existing facilities was considered unproductive since it did not stimulate new economic activity. The 1984 Act provided exceptions for "first-time farmers" and for significant rehabilitation projects.

financing per company. Rules were also established to prevent the carving up of larger facilities into small issue-financed projects. The small issue program itself was extended for two years, through 1988, but only for manufacturing facilities. For IDBs that could still be issued, the 1984 Act added tough new arbitrage rules, including a requirement that most otherwise permitted arbitrage profits be rebated to the Federal Government.[72]

Looking ahead to potential new loopholes, the 1984 Act denied tax exemption for interest on consumer loan bonds, defined as bonds 5% or more of the proceeds of which were to be used to make loans to nonexempt private persons.[73] This rule was intended to avert a repetition of the 1970s mortgage bond experience; it meant that, before inventing new bond-financed loan programs, issuers would have to seek Congressional approval. In a similar spirit, the 1984 Act extended Internal Revenue Code rules to tax-exempt bonds previously authorized under non-tax statutes, and required that all future tax exemptions be contained in a revenue act.[74]

To ease the implementation of these provisions — and to render them politically palatable — the 1984 Act adopted a very liberal set of transition rules. In addition to the usual "binding contract" rules,[75] the 1984 Act exempted from the volume cap, for 1984 only, any project for which an inducement resolution[76] had been adopted before June 19 of that year, the date of conference committee action on the bond provisions and eight months after approval of the original Ways and Means package. These generous transition rules were in addition to a two-year phase-in of the volume cap for states which would have exceeded their respective limits in 1983, and various project-specific rules. The effect of this largesse was that the volume cap had little impact until perhaps 1986, by which time it had already been supplanted.

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[72] The rebate requirement exempted rental housing bonds.

[73] Exceptions were provided for bonds issued under the existing IDB and mortgage subsidy bond programs and for qualified student loan bonds.

[74] This provision also assured that the taxwriting committees — the Committee on Ways and Means in the House and the Committee on Finance in the Senate — would have jurisdiction over any grant of tax exemption.

[75] The 1984 Act generally adopted a January 1, 1984, effective date for provisions (including the volume cap) that were included in the original Ways and Means bill. Transitional exceptions were provided for projects (1) for which a binding contract was in existence by October 18, 1983, or (2) on which construction had commenced by that date. Provisions added later in the process generally had later effective dates.

[76] An inducement resolution is a formal (but nonbinding) statement by a governmental entity of its intent to issue tax-exempt bonds. Entities frequently adopt inducement resolutions at a time when little or no physical activity on a project has been completed.

5. The Legacy of 1984

The 1984 Act attempted to freeze the IDB program at its then-current issuance levels. This intention was most apparent in the $150 per capita volume cap, which roughly approximated the existing annual volume. But a similar approach was followed elsewhere in the 1984 Act. For example, in restricting Federal guarantees, Congress "grandfathered" most of the significant existing programs, but prevented the development of new types of guarantees.

In normal times, issuers might have been allowed a reasonable period to adjust to the 1984 changes before new legislation was enacted. However, the package was unstable on several levels. In part, this instability resulted from the volume limits themselves. The exceptions to the volume caps, particularly for housing and airport bonds, made the caps considerably looser than originally intended. Bond volume thus might continue to grow, attracting renewed Congressional attention. If the caps did prove effective, there would be strong political pressure to increase them. Such pressure was especially likely, as Congress had imposed the caps without repealing any of the existing categories of IDBs.

The 1984 legislation also suffered from structural difficulties. While imposing the most stringent limits on tax-exempt bonds to date, the 1984 Act left the basic structure of section 103 essentially unchanged. In particular, it retained the prior law definition of an IDB, which remained the basic test for distinguishing public from private bonds. As described above, a bond was an IDB only if, *inter alia*, the bondholders had a "security interest" in private business payments or property. A security interest could exist under the terms of the bond itself or under any "underlying arrangement,"[77] but usually implied some sort of legal relationship between the bondholders and the business being financed. Arrangements that fell short of this relationship might sidestep the security interest test and escape characterization as IDBs, thereby avoiding the volume limit, even though the proceeds of the bonds were used by private businesses. For example, private business payments might be commingled with general tax revenues, the bonds being repaid out of the commingled fund. The pre-1986 treatment of such cases was unclear.

The security interest test was not new; it had survived since 1968. However, it had never been subject to the pressure brought on by the new volume cap. For example, under pre-1984 law, it made relatively

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[77] *See, e.g.*, Treas. Reg. § 1.103-7(c), Example 14 (1972); Rev. Rul. 80-251, 1980-2 C.B. 40.

little difference whether a bond for a sports stadium was or was not an IDB; the bond could be issued in either case, without regard to volume limits. Now, most IDBs were subject to a cap, while most other bonds were not. Thus, the pressure grew on issuers to "flunk" the security interest test and thereby to avoid characterization as an IDB. One possible method involved the use of tax-increment financing, under which increased tax revenues resulting from a project, rather than direct payments from the project users, are pledged as security for the bonds.[78] Pressure also rose on issuers to use the 25% "minor portion" of an otherwise public issue to fund private business projects.

II. THE 1986 ACT

A. Breaking with the Past: The President's Proposal

1. The Proposed Tax Overhaul

In November 1984, the Treasury Department presented President Reagan with a three-volume document entitled "Tax Reform for Fairness, Simplicity, and Economic Growth."[79] It contained a comprehensive proposal for an overhaul of the federal income tax, requested by the President in his 1984 State of the Union Address. The proposal featured dramatic rate cuts for individuals and corporations in return for the elimination or curtailment of nearly all major tax preferences. Among other things, it called for the elimination of private activity tax-exempt bonds, and strict arbitrage restrictions on remaining, public purpose bonds.

The Treasury report was subsequently distilled into the President's own tax reform proposal, released in May 1985.[80] The President's proposal also traded reduced tax preferences for substantially lower rates: a maximum of 35% for individuals and 33% for corporations. In many areas, the President's proposal compromised between the idealism of the Treasury report and political realities. The tax-exempt bond provisions of the two documents were, however, virtually identical. The

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[78] The private or consumer loan bond rule, adopted in 1984, cast doubt on the exemption for tax-increment bonds, but did not definitively resolve the issue. *See supra* note 73 and accompanying text. For a discussion of tax-increment financing under the Tax Reform Act of 1986, see *infra* text accompanying notes 189-90 & 232-34.

[79] OFFICE OF THE SECRETARY, DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984) [hereafter TREASURY REPORT].

[80] THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) [hereafter PRESIDENT'S PROPOSAL].

President's proposal also retained the Treasury's suggestion to repeal the deduction for state and local taxes, unless incurred in a business context.[81]

The President's proposal initiated a process that in many respects differed from previous reform efforts.[82] The proposal was designed to be "revenue neutral." In other words, it was intended to raise approximately the same amount of revenue as existing law. Yet, it proposed to raise this money using substantially lower tax rates. It was thus perhaps the first tax reform proposal to require massive tax increases just to stay even. In this context, the question was no longer which tax preference was abusive, but what was available to pay for a broad-based tax reduction; not which provisions could be eliminated, but which needed to be kept. This shift was of course the point of the proposal — to place tax preferences on the defensive, and thereby succeed where piecemeal efforts had failed. However, the comprehensive nature of the proposal ran against the grain of previous legislative experience. It was an adjustment that Congress and the bond community would each find difficult to make.

2. Proposals for Tax-Exempt Bonds

Under the President's proposal, interest on "nongovernmental" bonds issued by state or local governments was no longer to be tax-exempt.[83] Bonds were nongovernmental if more than 1% of the proceeds were used, directly or indirectly, by any nongovernmental person. There were no exceptions for any particular type of facility.[84] Thus, the proposal would have eliminated IDBs, mortgage subsidy bonds, student loan bonds, and even bonds for section 501(c)(3) organizations — in short, all private activity bonds. Tax-exempt bonds could continue to be

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[81] The proposal for state and local taxes was to become the principal target of many state and local governments, thus distracting at least some attention from the bond provisions. *See infra* note 98 and accompanying text.

[82] For a further discussion of the differences between tax reform in 1986 and in previous years, see *infra* notes 214-21 and accompanying text.

[83] *See* PRESIDENT'S PROPOSAL, *supra* note 80, at 282-87, for proposals regarding nongovernmental tax-exempt bonds. For arbitrage proposals, see *id.* at 288-92.

[84] The proposal did say that governmental facilities could be managed under private management contracts of up to one year's duration without being considered privately used. A facility could also privately be leased for up to one year, immediately after it was completed, with the same result. Exceptions also were made for certain temporary investments and reserve and debt service funds; these paralleled exceptions to the existing arbitrage rules and concerned temporary investments of bond proceeds rather than their ultimate use.

issued to finance ordinary government operations, including schools, roads, tax anticipation notes, and so forth, or the acquisition or construction of government buildings.

The proposal did permit bond-financed facilities to be used by a nongovernmental person "if the facilities were available for use by the general public on the same basis."[85] A facility was not available on the same basis if there was a formal or informal agreement with a particular nongovernmental person, or if the facility was located at a site that was inaccessible to the general public. For example, according to the proposal, extension of a public road or sewer to a new home or business could be financed with tax-exempt bonds. However, an airstrip adjacent to a business which would be its primary user could not be so financed.[86] Although styled as an exception, the "same basis" provision in fact stated a general rule: facilities equally available to the general public qualified for financing, while those specially used by one or more persons did not.[87]

In addition to eliminating private activity bonds, the President's proposal would have extended tough arbitrage and other rules to remaining tax-exempt issues. In particular, the requirement to rebate arbitrage profits — which previously had applied only to IDBs and mortgage subsidy bonds — was to be extended to all tax-exempt bonds. Advance refundings of tax-exempt bonds were also to be prohibited.[88] The proposal further limited the "early issuance" of tax-exempt bonds by requiring specified portions of the bond proceeds to be spent within specified periods.[89] The new arbitrage restrictions were intended to re-

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[85] PRESIDENT'S PROPOSAL, *supra* note 80, at 285.

[86] A facility used by a nongovernmental person could not be financed simply because the general public also made some lesser use of it. For example, a private airline terminal did not qualify for financing since it was used on a different (*i.e.*, profit-making) basis by the airline than by the general public. *Id.*

[87] If only a portion of a facility were used by a nongovernmental person, an allocable portion of the facility could be financed with tax-exempt bonds. For example, a government-owned and operated electric generating facility that was under contract to sell 10% of its lifetime output to a private utility but that sold the remaining 90% directly to the general public could have 90% of its costs financed with tax-exempt bonds. *Id.* at 286.

[88] Advance refunding involves the issuance of refunding bonds without retiring the previous bonds, so that two or more sets of bonds remain outstanding for more than a specified period. (The pre-1986 cutoff was 180 days.) The practice frequently presents significant arbitrage opportunities. Advance refunding of IDBs and mortgage subsidy bonds was prohibited prior to 1986, but the practice was permitted for other tax-exempt bonds.

[89] The early issuance proposal was intended to prevent transactions in which bonds

duce the incentives for issuing those categories of tax-exempt bonds still permitted under the proposal. According to the proposal, the advantages of tax exemption should be limited to the ability to borrow at lower interest rates, and should not include the opportunity to earn arbitrage profits.[90]

To round out the assault, the banking section of the President's proposal recommended elimination of financial institutions' deductions for interest used to purchase or carry tax-exempt bonds.[91]

3. Brave New World

In keeping with the spirit of the President's proposal, the bond provisions made a clean break with the past. The concepts of exempt and nonexempt activities, of "good" and "bad" private uses, were swept neatly away. In their place was a simple test. Anything used by a government, and only by a government, was good. Anything privately used was bad. From a twenty-year preoccupation with the subjective question of what activities were public, the law would turn to the theoretically objective question of who was using the facilities. All private uses would be restricted to private financing. This proposal would also have the effect of completely eliminating the subsidy for private activity bonds, resulting in a substantial revenue gain.[92]

The problem with this approach — even aside from politics — is readily apparent. Everything is used by somebody. People drive on

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were issued well in advance of a project, or before the details of the project had even been agreed to. The issuers might earn substantial arbitrage profits during this interim period. The proposal caused significant political problems, as it conflicted with established practices and, in some cases, with local expenditure laws. Ultimately, it was not included in the 1986 Act.

[90] *See* PRESIDENT'S PROPOSAL, *supra* note 80, at 290-91 (discussing the reasons for the arbitrage proposals).

[91] PRESIDENT'S PROPOSAL, *supra* note 80, at 243-47 (provisions relating to financial institutions). To prevent taxpayers from earning tax-exempt income while deducting interest attributable to the same funds, I.R.C. § 265 prohibits taxpayers from deducting interest on money borrowed to acquire or to hold tax-exempt obligations. Because banks were not considered to accept deposits with the purpose of acquiring tax-exempt bonds, they generally escaped the application of this rule until 1982. *See* Rev. Proc. 70-20, 1970-2 C.B. 499. TEFRA reduced financial institutions' deduction for interest allocable to tax-exempt obligations by 15%. The 1984 Act increased this to a 20% disallowance.

[92] Estimated revenue gain from the President's bond proposals was $4.7 billion over a five-year period, of which $4.5 billion was to result from repeal of the exemption for nongovernmental bonds and $0.2 billion from new arbitrage restrictions. PRESIDENT'S PROPOSAL, *supra* note 80, app. C, at 458.

roads. People use airports. Private homes, as well as businesses, require sewage facilities. To say that nothing bond-financed can be used by private persons would mean, literally, that nothing useful to anyone — save, perhaps, government office buildings — could qualify for financing.

To cope with this problem, the proposal invoked the concept of use "on the same basis" as the general public, which it continued to permit. To a large extent, this concept was borrowed from prior regulations,[93] under which "use" had become a term of art, generally connoting some type of preferential arrangement. For example, under prior law, publicly owned roads and bridges were not treated as used in a private trade or business, since such facilities, although used by business travellers, were available to the general public, too.[94]

The problem was that the use concept had previously been buttressed by the trade or business and security interest tests. This two-part test permitted the finer points of the use definition to be ignored (1) when businesses were not involved or (2) when no particular business or businesses had an obligation to repay the bonds. For example, even if use of a highway had been taken into account under prior law, bonds to finance the highway would have remained tax-exempt unless some specific business user was committed to repaying the bonds. This result was consistent with the purposes of the 1968 legislation, which sought to restrict blatant conduit financings, rather than eliminating all private use. Even if a conduit financing was identified, the 1968 rules permitted many bonds to be issued as exempt-activity or small issue IDBs, although after 1984 most of these were subject to volume limits.

By contrast, the Administration now sought to eliminate completely the subsidy for private business activities. This intention forced it to rely heavily on the "same basis" criterion, and led to almost philosophical questions. Was a strip of highway, used two-thirds of the time by employees of one business, really being used "on the same basis" by everyone? What of an industrial waste facility, in a town that had only one industry? Did a hospital actually have to be used by everyone in the community, or merely to offer itself to everybody, in order to meet the requirement? What of a convention center? An airport? Supposing not everybody has an airplane? The test was, ultimately, a circular one, requiring a definition of public availability in order to define what is public. Without additional backing, it was all but impossible to pin

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[93] Treas. Reg. § 1.103-7(b)(3) (1972). For discussion of pre-1986 legislation, see *supra* notes 6-78 and accompanying text.

[94] *Id.* § 1.103-7(b)(3)(i) (1972).

down. Congress was eventually to conclude that the use concept could not stand alone and that some version of the security interest test needed to be reinstated.

B. Return to Normalcy: The House Bill

Whatever the philosophical difficulties with the President's proposal, its most immediate problems were political. Congress simply would not agree to eliminate all private activity bonds. Bond programs — especially housing bonds and large-scale public projects — were too popular with too many people. Despite the President's efforts, the debate thus slipped back inexorably to the question of what types of bonds should continue to be issued and what types, if any, should be eliminated.

1. The Rostenkowski Proposal

The first round came in the House. Before consideration by the Committee on Ways and Means, Committee Chairman Dan Rostenkowski (D-Ill.) put forward his own, modified version of the President's proposal.[95] The "chairman's mark," as it came to be known, featured the same individual tax rates as the President's proposal, but with the higher rates taking effect at somewhat lower income levels. It also included a 35% maximum corporate rate. Money raised by these and other changes was used, in part, to reduce taxes on lower-income individuals. The proposal thus attempted, among other things, to place a Democratic political stamp on the tax reform process.

The Rostenkowski plan significantly liberalized the President's bond proposals. Under the plan, interest on state or local bond issues was taxable only if 5% or $5 million of bond proceeds were used by a nongovernmental person. (This limit replaced the President's 1% test.) Exceptions for various types of bonds also reappeared, including bonds for airports, docks, sewage and solid waste disposal facilities, and water facilities (but not if used for irrigation). Mortgage and rental housing bonds were also back, subject to stricter targeting rules. Bonds for section 501(c)(3) organizations were permitted, subject to a $40 million per institution limit on outstanding bonds. These 501(c)(3) bonds were also treated, for the first time, as private activity bonds. The proposal

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[95] *See* JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON WAYS AND MEANS MARKUP (1985). The Rostenkowski alternative is presented as the right-hand column ("Possible Option") of a side-by-side comparison.

eliminated small issues, student loan bonds, and various types of exempt facility bonds, including bonds for sports stadiums and convention centers. All exempt facilities, except housing projects, were required to be governmentally owned.[96]

The toughest part of the chairman's mark was its proposed volume cap. Under this provision, the statewide annual issuance of all "nonessential function," *i.e.*, private activity, bonds was to be limited to $150 per capita.[97] This provision was to replace the separate IDB and mortgage bond limits under existing law. The $150 amount was to be reduced to $100 per capita after 1987, to reflect the sunset for mortgage subsidy bonds. Most airport bonds were exempt from the cap. The proposal required that 50% of each state's volume limit (25% after 1987) be reserved for housing bonds, unless the state adopted legislation providing a different rule.

The Rostenkowski proposal also retained most of the President's arbitrage proposals, and the denial of bank interest deductions for debt allocable to tax-exempt bonds.

2. Committee on Ways and Means: In General

The House Committee on Ways and Means considered the tax reform bill in the fall of 1985. At some points, the deliberations appeared to be permanently stalled. The committee gained momentum, however, once Rostenkowski agreed to restore a full deduction for state and local income taxes. (The chairman's mark had allowed only a limited deduction.) Eventually, the committee ordered a bill reported on December 3, 1985, approving the measure by a vote of 28 to 8.

As the Ways and Means "mark-up" progressed, a familiar pattern developed. Rostenkowski would submit a controversial area to a task force of selected committee members. Using the Rostenkowski proposal as its starting point, the task force would propose a compromise with the affected industry, usually preserving at least something of the original proposal. The task force report would then be considered by the full committee, which generally, although not always, accepted its main recommendations.

Revenues lost by these compromises were largely paid for with rate increases. As an example, the 25% rate in the committee's bill took effect at $22,500 (as opposed to $27,300 under the chairman's mark),

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[96] I.R.C. § 501(c)(3) organization projects could be owned by a governmental unit or by the tax-exempt organization.

[97] The cap also applied to the nongovernmental portion, in excess of $1 million, of an otherwise governmental issue.

and the 35% rate at $43,000 (as opposed to $62,300).[98] These changes meant that a larger number of taxpayers would be paying the higher rates. The committee's bill also added a 38% rate for income in excess of $100,000. The maximum corporate rate was increased to 36%. Nevertheless, the tax rates remained significantly lower than under existing law, and by the end of the markup, nearly all industries had suffered some reduction in tax preferences in order to make this possible.

3. Committee on Ways and Means: Tax-Exempt Bonds

The tax-exempt bonds task force was headed by Rep. J.J. Pickle (D-Tex.), considered fair-minded but generally loyal to Rostenkowski. The task force modified the Rostenkowski proposal in several respects. Other amendments were made by the full committee.[99] However, the provisions passed by the committee retained the basic outline of the Chairman's proposals.

4. Overview of House Bond Provisions

H.R. 3838, as the committee's bill was numbered, imposed unprecedented restrictions on tax-exempt bonds. The bill denied the tax exemption for interest on "nonessential function bonds," which were defined as bonds 10% or $10 million of the proceeds of which were used in a trade or business of any nongovernmental person. The same result obtained if 5% or $5 million of bond proceeds was used to make private loans. There was no security interest test. Bond counsel would thus need to consider whether 10% of public buildings, electric facilities, and so forth were used by one or more businesses on a preferential basis, even if no private business was responsible for repaying the bonds.[100] This consideration was particularly important in the case of facilities — *e.g.*, stadiums and convention centers — which if privately used could no longer qualify for any form of tax-exempt financing.[101] Because use by all nongovernmental persons was considered, bonds for

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[98] Figures cited are for married individuals and surviving spouses.

[99] The task force and full committee meetings took place in closed session; and no official record of the proceedings is available. For a lively description of the bond task force, see J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 136-39 (1986).

[100] *Cf.* I.R.C. § 103(b) of pre-1986 law, under which private use did not result in bonds being IDBs unless the security interest (*i.e.*, repayment) test was satisfied. For the significance of this distinction, see discussion of PRESIDENT'S PROPOSAL, *supra* notes 92-94 and accompanying text.

[101] Transitional exceptions were provided for certain of these and other facilities.

section 501(c)(3) organizations were treated as nonessential function bonds.

As under the Rostenkowski proposal, the House bill retained most of the existing categories of private activity bonds. Thus, "exempt-facility bonds" (akin to exempt activity IDBs) could be issued under the bill to finance airports, docks and wharves,[102] mass commuting facilities, water facilities (other than for irrigation), sewage and solid waste facilities, and multifamily rental housing. Remaining exempt activity categories were eliminated.[103]

The bill retained the tax exemption for interest on mortgage subsidy bonds,[104] small issue bonds, and qualified student loan bonds, expanded to include state as well as federal loan programs. New categories were created for bonds to benefit section 501(c)(3) organizations (previously treated as if used by governments)[105] and for certain tax-increment financing bonds, known as qualified redevelopment bonds. Redevelopment bonds qualified for tax exemption only if used for specified redevelopment and rehabilitation purposes within blighted areas designated pursuant to state law.

The bill imposed a stringent new volume limitation on all nonessential function bonds.[106] Each state's limitation was equal to the greater of $175 per resident of the state or $200 million. Of this amount, $25 per capita was reserved for section 501(c)(3) organizations,[107] although part of the remaining $150 could also be used on their behalf.[108] Most airport, dock and wharf bonds were exempt from the cap. Nonetheless, the cap was far tougher than under the 1984 Act because it included rental housing bonds (previously exempt from volume limits), mortgage subsidy bonds (previously subject to a separate limit), and bonds for

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[102] Airports were redefined to exclude airport hotels, food preparation facilities, and shops. Docks excluded long-term storage facilities. Airports, docks, and mass commuting facilities were required to be governmentally owned.

[103] The repealed categories included sports stadiums; convention centers; pollution control; parking (unless part of a larger facility); local furnishing of electricity or gas; and local district heating or cooling facilities.

[104] The bill provided stricter targeting rules for mortgage subsidy and rental housing bonds.

[105] Under the bill, no institution could benefit from more than $150 million of outstanding section 501(c)(3) organization bonds at any time. Hospital bonds were exempt from this rule.

[106] As under the Rostenkowski proposal, the volume limit also applied to the nonessential portion (in excess of $1 million) of an otherwise governmental bond.

[107] An equivalent amount was reserved in states subject to the $200 million limit.

[108] There were also set-asides for housing and, in some states, redevelopment bonds, but these (unlike the section 501(c)(3) set-aside) could be overridden by state statute.

section 501(c)(3) organizations, as well as other IDBs and all student loan bonds. To make sure that it stayed tough, the $175 limit was scheduled to be reduced to $125 after 1987, to coincide with the mortgage subsidy bond sunset.

Arbitrage restrictions were similar to those proposed by the President and by Chairman Rostenkowski. These restrictions included a rebate requirement for all tax-exempt bonds and a prohibition of early issuance. Up to two advance refundings were permitted for governmental bonds, subject to various restrictions. Other bonds could not be advance refunded at all.

While restricting the supply of tax-exempt bonds, the House bill reduced the demand for them in several ways. First, it prevented financial institutions from deducting interest used to purchase or carry tax-exempt bonds, as in the President's and the Rostenkowski proposals. An exception was provided for certain tax anticipation notes and public project bonds, not exceeding $10 million per issuer, that were issued in 1986, 1987, or 1988. The bill also reduced the loan loss reserve deduction of property and casualty insurance companies by a percentage of tax-exempt income.

Finally, interest on nonessential function bonds issued after December 31, 1985, was to be included in the tax base for both the individual and corporate alternative minimum tax.

5. House Floor

The Ways and Means bill went to the House floor in mid-December, 1985. It nearly died when Republicans, angry about various tax and nontax matters, succeeded in ambushing the Democratic House leadership on a procedural vote. President Reagan then paid a rare personal visit to the Hill, and succeeded in changing sufficient votes to ensure passage of the bill. The bill finally passed the House by voice vote, a motion to recommit being rejected by a vote of 256 to 171.

In contrast to 1984, the bond provisions were not a significant factor on the House floor.

C. Interlude: The Senate Bill

To most of the bond community, the House package was about as bad as it could be. Issuers of private activity bonds were particularly upset about the new volume cap. "Traditional" public issuers — and the investment companies they worked with — opposed the arbitrage and early issuance rules. All were concerned by the new minimum tax provisions, although these provisions applied only to nonessential func-

tion bonds. To make matters worse, most provisions had an effective date of January 1, 1986, making it difficult to issue any bonds during 1986 until the matter was resolved.

In this environment, the bond community pinned its hopes on the Senate to preserve something closer to existing law. The Senate had historically been protective of tax-exempt bonds, and was to prove so again in 1986. For a variety of reasons, however, the Senate was ultimately able to do little more than ameliorate the more drastic provisions of the House bill. The reasons for this outcome had less to do with the bond provisions themselves than with the political context in which tax reform generally was to play itself out.

1. Committee on Finance: In General

The Senate Committee on Finance considered tax reform in the spring of 1986, under the stewardship of Chairman Bob Packwood (R-Ore.). The mark-up was really two mark-ups. First came a false start in March and April, during which the committee largely expanded existing tax preferences, and which was finally suspended by Packwood. The Chairman and his advisers then devised a radical reform plan along lines similar to those suggested by Sen. Bill Bradley (D-N.J.) and Rep. Richard Gephardt (D-Mo.) in their original tax reform bill.[109] This plan involved a sharp reduction in tax rates — a maximum of 27% for individuals and 33% for corporations, in the committee's eventual bill — in return for an equally sharp reduction in tax preferences. Vital to the plan was a new "passive loss" rule, which curtailed tax shelter deductions. This provision both provided needed revenues and made the package significantly more progressive with respect to income classes. The new Packwood plan garnered more and more support until a unanimous committee ordered it reported on May 19, 1986.

2. Tax-Exempt Bonds: The Durenberger Proposal

Tax-exempt bonds were considered in the earlier, pre-breakthrough stage of the Committee on Finance markup.[110] Sen. Dave Durenberger (R-Minn.) emerged as the chief supporter of more lenient legislation. Durenberger put forward a proposal, supported by industry groups, that was substantially less restrictive than the House bill and fre-

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[109] H.R. 800, 99th Cong., 1st Sess. (1985); S. 409, 99th Cong., 1st Sess. (1985).

[110] Certain provisions adopted during this stage were included in the committee's final bill.

quently less restrictive than existing law. It divided tax-exempt bonds into governmental and "quasi-governmental" bonds, only the latter being subject to a volume cap.[111] Governmental bonds included bonds for publicly available utility and transportation facilities — including airports, docks, mass commuting facilities, and sewage, solid waste and water facilities — together with rental housing bonds. Quasi-governmental bonds included small issue, student loan, mortgage subsidy, and section 501(c)(3) organization bonds, as well as bonds for other exempt facilities — pollution control, convention or trade show facilities, etc. Thus, the proposal favored "privatization"[112] of large-scale infrastructure projects, which were treated as governmental, over subsidies for individual consumers or businesses. The proposal also toned down the arbitrage and certain other provisions in the House bill. The Durenberger proposal took the form of a complete statutory draft, and was intended to be a comprehensive alternative to the House bill.

3. Tax-Exempt Bonds: The Committee Bill

The bond provisions in the Committee on Finance bill resulted from a compromise between Durenberger and Packwood. (Packwood's own proposals had been more lenient than the House bill, but much less so than Durenberger's.) Instead of drafting a new statutory framework — as in the House bill and the Durenberger proposal — the committee settled for limited changes in existing law. The pre-1986 IDB and mortgage bond volume limits were retained, as were most existing bond categories. These included most exempt-facility[113] and small issue[114] IDBs, student loan bonds (expanded to include state loan programs),

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[111] The cap was to be the greater of $225 per capita or $260 million per state, or half again the per capita amount in the House bill.

[112] "Privatization" refers to the private management and in some cases ownership of facilities (mass transit, utilities, prisons) ordinarily owned and operated by a governmental unit. *See infra* text accompanying note 175. Although privately owned and/or operated, such facilities deliver services to the general public in much the same manner as governmental facilities. By contrast, the ultimate recipients of bond-financed housing, student loans, etc. are individual private citizens. For a further discussion of this distinction, see *infra* notes 235-39 and accompanying text.

[113] The bill did eliminate IDBs for sports, convention or trade shows, mass commuting, and pollution control facilities, as well as for independent parking facilities, subject to transition rules. It also denied financing to airport hotels.

[114] Unlike the House bill, the Senate bill retained the 1986 sunset date for small issue bonds (1988 in the case of manufacturing facilities) contained in existing law. Bonds for first-time farmers were extended through 1988.

and mortgage subsidy bonds.[115] The bill also added new categories for hazardous waste treatment facilities and qualified redevelopment bonds, defined somewhat less stringently than in the House bill.

Taking a cue from the Durenberger proposal, the committee's bill exempted publicly owned, but privately operated, sewage, solid waste, and water facilities from the volume limit. This exemption was in addition to the volume cap exemptions for airport and port bonds, as well as rental housing bonds, contained in pre-1986 law. Hence, the cap was significantly more generous than under existing law. The bill also continued to treat section 501(c)(3) organizations as exempt persons so that bonds for these organizations remained outside the cap.[116]

The committee's bill defined IDBs in the same manner as under pre-1986 law, using a 25% use and security interest test.[117] This required that both elements of a conduit financing — private use of bond proceeds and private repayment — be present before the bonds were treated as private. (The House bill required only private use.) However, the bill did attempt to eliminate two of the more obvious deficiencies in the existing test. First, the bill clarified that private business payments could be treated as a security interest, even if they were not formally pledged toward repayment of the bonds. For example, a bond used to finance a downtown redevelopment project could be an IDB even though incremental property tax revenues, rather than rents paid by private businesses, were the official security for the bonds.[118] The law would assume that, in economic terms, the rental payments were being used to repay the bonds. This amendment made it more difficult for parties to structure financings so as to evade the IDB restrictions. Second, the bill added a "related use" requirement, preventing more than 5% of bond proceeds from being used for projects unrelated to a governmental purpose of the issue.

The committee retained most of the House arbitrage provisions, including the expanded rebate requirement. However, it deleted the early issuance rule. Up to three advance refundings were allowed for govern-

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[115] The bill retained the existing targeting rules for mortgage subsidy bonds but strengthened, along the same lines as the House bill, those for rental housing IDBs.

[116] The committee voted to delete a $150 million per institution limit on section 501(c)(3) organization bonds (other than hospital bonds) as contained in the House bill.

[117] The bill liberalized the conditions under which public facilities could enter into private management contracts without being considered privately used. *Cf. infra* note 238 (discussing treatment of management contracts under the 1986 Act).

[118] Such a project could then be financed only if it complied with the targeting rules applicable to qualified redevelopment bonds, and with the state volume limitation.

mental and 501(c)(3) bonds, subject to various new restrictions.

The bill did not include the House financial institution or insurance company provisions, the former being deleted late in the markup. It also did not subject any tax-exempt bond interest to the minimum tax.[119] However, excess "book income" of a corporation, including tax-exempt income, was treated as a preference item.

4. Senate Floor

The Senate considered the tax bill in June, 1986. While Senators discussed the bill at great length,[120] its passage was virtually assured. This was especially true, after Packwood and Majority Leader Robert Dole (R-Kan.) succeeded in requiring that all amendments to the bill be revenue neutral, providing a dollar in new revenues for every dollar they lost.[121] The requirement of neutrality helped the bill escape the endless amendments for which tax legislation is justifiably famous.

On June 24, 1986, the Senate approved the bill by a vote of 97-3. There were no significant floor amendments to the bond provisions.

5. Limitations of the Senate Approach

The Senate bond provisions represented a good-faith effort toward compromise legislation. The effort was weakened, however, by at least three factors. Each of these placed the Senate provisions in a disadvantaged position as the conference approached.

First, the bond provisions were a holdover from the earlier, unsuccessful phase of the Finance Committee markup. They were retained because of a political agreement between Packwood and Durenberger,

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[119] In his original proposal to the committee, Sen. Packwood had suggested including all tax-exempt interest — including interest on already outstanding bonds — in the minimum tax base. The committee rejected this "retroactive" proposal by a unanimous vote. Eventually, it dropped tax-exempt income completely from the minimum tax base.

[120] The Senate has historically considered tax and other matters without a limit on time or amendments, or subject only to self-imposed limits. *See infra* note 121. By contrast, each House bill comes to the floor under a "rule" limiting the time of debate and the number and type of amendments. Legislation is thus far more likely to be amended on the Senate than on the House floor.

[121] The Balanced Budget and Emergency Deficit Control Act of 1985, Title II of Pub. L. No. 99-177, 99 Stat. 1037 (Gramm-Rudman) made it out of order for the House or Senate to consider certain amendments that would increase the federal budget deficit. These technical provisions did not apply to the Tax Reform Act of 1986, but the atmosphere created by Gramm-Rudman resulted in strong political pressure to keep amendments revenue-neutral. *See* J. BIRNBAUM & A. MURRAY, *supra* note 99, at 237.

and because they involved relatively little revenue as compared to the overall bill. Consequently, the bond provisions were only marginally associated with the main Senate package, and were inconsistent with its preference-reducing philosophy.

Second, the bond provisions lacked a strong supporter in the upcoming conference. Durenberger was not, and was never expected to be, a conferee.[122] Other Senators had an interest in protecting particular types of bonds, but not in the overall agreement.

Finally, and most important, the Senate provisions lost money. The Joint Committee on Taxation estimated that they lost $1.7 billion as compared to existing law, and much more when compared to the House bill, which significantly tightened the existing bond provisions.[123] The provisions lost money primarily because of the volume cap exceptions for categories that were previously included under the cap. This generosity contrasted with a sharp cutback in most other tax preferences under both the House and Senate bills. With the conferees desperate for revenue, it was unlikely that a loss could be tolerated in so highly visible an area.

The Senate had, in a sense, ignored these considerations. What it had really done was to rewrite the 1984 Act, based on suggestions of the bond community and its own sense of public purposes. As part of this effort, it had corrected potential loopholes left by the 1984 changes (the definition of IDBs); loosened the more onerous provisions of that Act (the volume cap); and accepted many of the less onerous provisions of the 1985 House bill. The bond community appreciated this effort, and generally favored the Senate bill.

Unfortunately, the effort came two years too late. 1986 was not 1984. The dramatic rate reductions envisioned by President Reagan, and by Congressional leaders, required extensive new revenues, from all available sources. In this environment, a reshuffling of the 1984 deck was not so much wrong as irrelevant. Bonds were ultimately just another tax subsidy, to be reduced in order to pay for rate cuts. The playing field had changed once again.

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[122] For a listing of the House and Senate conferees, see *infra* text accompanying note 124.

[123] S. REP. NO. 99-313, 99th Cong., 2d Sess. 13 (1986) (indicating that Senate bond provisions lost $1.7 billion compared to existing law); H. REP. NO. 99-426, 99th Cong., 2d Sess. 572 (1985) (indicating that House bond provisions raised $3.1 billion compared to existing law). The figures are for a five-year period. These figures are not precisely comparable because the tax rates in each bill were different and because the bills had different effective dates and transition rules. *See infra* note 126. The Durenberger proposal would have lost even more revenue.

D. Climax: The Conference Agreement

1. Atmosphere of the Conference

The tax reform conference convened in July, 1986. Representing the Senate were Chairman Packwood, Majority Leader Dole, and Senators Roth (R-Del.), Danforth (R-Mo.), Chafee (R-R.I.), Wallop (R-Wyo.), Long (D-La.), Bentsen (D-Tex.), Matsunaga (D-Hawaii), Moynihan (D-N.Y.), and Bradley (D-N.J.). The House conferees were Chairman Rostenkowski, Rep. Pickle, and Reps. Rangel (D-N.Y.), Stark (D-Cal.), Gephardt (D-Mo.), Pease (D-Ohio), Russo (D-Ill.), Duncan (R-Tenn.), Archer (R-Tex.), Vander Jagt (R-Mich.), and Philip Crane (R-Ill.). While the Senate conferees were generally based on seniority,[124] the House Democrats were chosen, at least in part, based on loyalty to Rostenkowski and support for tax reform.

The two houses entered the conference with somewhat different philosophies. As a general rule, the House bill was tougher on business tax preferences, while the Senate was tougher on tax shelter investments by individuals, particularly in real estate. The House bill also targeted somewhat more relief to lower income taxpayers. The Senate bill was attractive, however, because of its lower marginal rates, and it entered the conference with the greater political momentum.

The House opened the bidding by restructuring its bill into a package that matched the low Senate rates, but was even more restrictive of business preferences. This strategy was intended to force the Senate into openly defending business tax breaks at the expense of individual relief. There followed a lengthy process of offers and counteroffers, each side attempting to develop a package that positioned it for the most favorable compromise. This process differed from previous tax conferences, in which the conferees had typically resolved a series of smaller issues before tackling major differences. In part, this difference resulted from the need to develop an overall, revenue-neutral plan. As a result of the package approach, the conferees resolved relatively few issues until very late in the conference.

2. Toward a Bond Agreement

Until late in the conference, the House and Senate offers used only "plug" numbers for tax-exempt bonds. In other words, the offers stated how much money they planned to raise from the bond provisions, without saying how they would raise it. Eventually the conferees agreed on

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[124] Senators Wallop and Bradley were chosen over more senior members.

a figure of $2.0 billion, which was somewhat less than the amount raised by the House bill.[125] (This figure did not take into account anticipated losses from transitional exceptions.) The $2.0 billion amount meant that the Senate, whose bond provisions were estimated to lose money, would have to come a significant portion of the way toward the House revenue target.[126] The Senate wished to do this, however, without compromising its core objectives, which included protecting smaller states and bonds for section 501(c)(3) tax-exempt organizations.

To reconcile these objectives the staff devised a plan that compromised most of the technical differences between the House and Senate bills.[127] The plan included a modified security interest test for distinguishing public from private bonds, as in the Senate bill. (All parties now accepted the need for some form of this test.) The plan further required a significant tightening of volume limits. The members themselves, however, would have to decide the major issues: How large was the cap to be? What if anything was to be exempted, at the expense of a smaller cap for what remained? Were bonds for section 501(c)(3) organizations to be placed under a unified cap, a separate cap, or no cap at all, the last requiring the most stringent limitations on other types of bonds?

3. The Last Mile

Meanwhile the process of offers and counteroffers had exhausted itself. The conference now came down to a series of one-on-one meetings between Rostenkowski and Packwood, only limited staff being present. On the night of August 15, the final marathon took place. Tax-exempt bonds were considered well after midnight.

At this late-night session, the two chairmen agreed to a formula that strongly favored smaller states. The volume cap was to be only $75 per capita, but with a $250 million minimum for smaller states. These amounts were to be reduced to $50 and $150 million, respectively, after

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[125] These and other figures were for a period of slightly over five years (fiscal years 1986-1991). Unless otherwise noted, the figures represent anticipated revenues compared to existing (*i.e.*, pre-1986) law.

[126] The House bond provisions had originally been estimated to raise $3.1 billion and the Senate provisions to lose $1.7 billion compared to existing law and after accounting for transitional exceptions. *See supra* note 123. Later estimates modified these figures to take into account revised economic estimates and, in the case of the House bill, to reflect the reduced tax rates in the Senate (and later the conference) bill. Additionally, to compare the substantive provisions of each bill, it was necessary to eliminate the effect of transition rules.

[127] The Author played a supporting role in this process.

1987. The cap was to include mortgage subsidy and rental housing bonds, as well as most bonds included under the existing IDB cap. Bonds for section 501(c)(3) organizations remained exempt from any volume limit, as part of a larger compromise involving such organizations.[128]

The two chairmen agreed that the bond provisions would generally be effective for bonds issued after August 15, 1986. They did not consider transition rules for specific projects. Instead, a $10 billion "fund" was created for all bond and other transition rules.

By the morning of Saturday, August 16, Rostenkowski and Packwood had resolved the remaining tax reform issues. The two chairmen spent Saturday securing agreement from their conferees, or a majority of them, on the overall package.[129] The full Conference Committee approved the agreement at a public meeting on Saturday night. There remained a month of drafting and working out details, as well as furious competition for transition rules. But approval of the conference report was never in serious doubt. It passed both houses of Congress easily, and was signed by the President at a White House ceremony on October 22, 1986.

E. Overview of the 1986 Act

1. General Provisions

The Tax Reform Act of 1986[130] was the most comprehensive overhaul of the tax code in almost 50 years. The Act established a system of only two tax brackets for individual taxpayers, with tax rates of 15% and 28%.[131] The maximum corporate rate was also reduced, from 46% to 34%. The Act "paid" for these reductions by eliminating or reducing numerous tax preferences, which included special capital gains rates, the investment tax credit, individual retirement accounts (IRAs) for upper-income taxpayers,[132] and various industry-specific provisions. The

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[128] As part of the same compromise, the conferees agreed to treat certain gifts of appreciated property to tax-exempt organizations as minimum tax preference items. I.R.C. § 57(a)(6). A $150 million per institution limit applies to section 501(c)(3) organization bonds, other than hospital bonds.

[129] Senators Roth, Danforth, and Wallop, and Reps. Archer and Crane, did not sign the conference report.

[130] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[131] A 38.5% maximum rate applied only in 1987. Because the 15% rate is phased out for middle-income taxpayers, the effective marginal rate for many such taxpayers, beginning in 1988, is 33%.

[132] The repeal applied to only taxpayers having an alternate employee retirement

Act severely restricted tax shelters by imposing a limitation on passive activity losses. It also phased out nonbusiness interest deductions (other than for home mortgages) and revamped the minimum tax. According to contemporaneous estimates, over a five-year period the Act transferred an aggregate $120 billion of tax liability from individuals to corporations.[133]

2. Tax-Exempt Bonds

The 1986 Act made far-reaching changes in the rules regarding tax-exempt bonds. Nearly all the new provisions restricted the availability of tax-exempt financing, especially for private activities.

a. Private Activity Bond Volume Limitation

The Act drastically reduced the amount of private activity bonds that can be issued in most states. This amount cannot exceed the greater of $50 per capita or $150 million for the state.[134] The limitation applies to all types of private activity bonds, including exempt-activity and small-issue bonds; mortgage subsidy bonds;[135] student loan bonds; qualified redevelopment bonds; and bonds issued under certain miscellaneous State programs. Exceptions are provided for airports, ports, and governmentally owned solid waste facilities.[136] Bonds for section 501(c)(3) organizations are also exempt from the cap.

The volume cap is significantly tougher than under prior law because it puts mortgage subsidy, rental housing, and redevelopment bonds[137] under a unified cap, while reducing the previous IDB limit

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plan. These taxpayers may still make nondeductible IRA contributions.

[133] For a comprehensive description of the 1986 Act, see STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987) [hereafter GEN. EXPLANATION]. For a description of the bond provisions, see *id.* at 1128-1242.

[134] These amounts in 1987 only were $75 and $250 million, respectively. The reduction of these amounts was originally planned to coincide with the mortgage subsidy bond sunset, but it was kept in place although the Act ultimately extended the mortgage bond program through 1988. The mortgage subsidy bond program was further extended, through December 31, 1989, by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 102 Stat. 3342 (1988).

[135] Veterans' mortgage bonds remain subject to separate caps, based on pre-1984 issuance levels. This effectively limited the program to five states.

[136] All bond-financed airports and ports are required to be governmentally owned.

[137] Mortgage subsidy bonds were previously subject to a separate cap, which for most states was $200 million. Rental housing bonds, and redevelopment (tax-increment) bonds, had been exempt from any volume limit. *See supra* text accompanying

from $150 to $50 per capita. Even in smaller states, the $150 million allowance applies to all private activity bonds. By contrast, prior law reserved at least $200 million per state for mortgage subsidy bonds alone.

As under prior law, traditional public or governmental purpose bonds, *i.e.*, any state or local bonds that are not private activity bonds, are exempt from volume limitations.

b. Definition of Private Activity Bond

The Act defined private activity bonds by means of a 10% use and security interest test.[138] Thus, a bond is a private activity bond if (1) more than 10% of the proceeds are to be used by any private business,[139] and (2) more than 10% of principal or interest on the bonds is repaid from, or secured by, private business money or property. Private activity bonds may be issued only for specified purposes, as described below, and are generally subject to the volume cap.

The private activity bond tests are similar to the IDB definition of prior law, but have reduced the percentage of permitted private use from 25% to 10%.[140] Moreover, the Act incorporated the Senate rule that "direct or indirect" repayment satisfies the security interest test. Under this rule, private activity bonds include bonds that are economically, even if not legally, repaid by a private business.[141] The effect is that, while the Act tightened the volume and other limits on private activity bonds, it made it significantly more difficult to avoid these limits.

In addition to the 10% use test, a bond is a private activity bond if more than 5% or $5 million of proceeds are used to make loans to private persons.

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note 68.

[138] The redefinition of private activity bonds was part of an overall redraft of the bond provisions of the Internal Revenue Code, encompassing sections 103, 103A, and new sections 141-150. To the extent not amended, prior law rules remain in effect.

[139] The Act explicitly stated that "use" does not include use as a member of the general public. I.R.C. § 141(b)(6)(A). The Act also liberalized the conditions under which the existence of a private management contract is ignored in determining private use. *See infra* note 238. This liberalization was intended to allow more flexibility in "privatizing" the management of government-owned facilities.

[140] Of the 10% permitted private use, at least 5% must be related to a governmental purpose for the issue. Private use of certain "output" facilities (*e.g.*, municipal power plants) is limited to $15 million per facility.

[141] *See supra* text accompanying note 118 (discussing Senate bill).

c. Permitted Categories of Private Activity Bonds

As under prior law, only specified categories of private activity bonds are permitted to be issued, subject to targeting (*i.e.*, eligibility) requirements and, in most cases, to the volume cap. The Act strengthened the targeting rules applicable to various types of these bonds. These include exempt-facility bonds for airport, port, and mass commuting facilities[142] and for multifamily rental housing,[143] as well as qualified mortgage bonds, the issuance of which was extended through 1988.[144] In addition to the above categories, the Act permitted issuance of exempt-facility bonds for sewage and solid waste facilities, water-furnishing facilities (including irrigation systems), local furnishing of electric energy or gas, and local district heating or cooling facilities, plus a new category for certain hazardous waste facilities. The exemptions for sports facilities, convention centers, pollution control, parking facilities,[145] and industrial parks[146] were repealed.

The Act extended the authority to issue small-issue bonds through 1989 for manufacturing facilities and first-time farmers only. Otherwise, the program was allowed to expire at the end of 1986. Student

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[142] The Act excluded hotels, disproportionately large retail facilities, and most office buildings from being financed with these three types of bonds. Similar limitations were imposed on the financing of office buildings with other exempt-facility bonds.

[143] The Act required that 40% of units in bond-financed projects be occupied by tenants having 60% or less of area median income, or else that 20% of units be occupied by tenants with incomes equal to 50% or less of that figure. (Prior law required only that 20% of units be occupied by tenants having 80% or less of area median income.) The Act further required that projects comply with income limits on a continuing basis (*i.e.*, excessive increases in income can disqualify a previously low- or moderate-income tenant) and that the limits be adjusted for family size.

[144] The Act reinstated the purchase price limitations for mortgage bond-financed residences that existed before 1982, *i.e.*, a maximum of 90% (110% in statutory "targeted" areas) of the average area purchase price. TEFRA had increased these limits to 110% and 120%, respectively. Bond financing was further limited to borrowers having family income not exceeding 115% of area or (if higher) state median income, with a special rule for geographically targeted areas. These changes did not affect veterans' mortgage bonds.

TAMRA extended the mortgage subsidy bond program through December 31, 1989, and made various other amendments, including adjustments of income limits in high-cost areas and recapture of the subsidy in certain cases when a recipient's income substantially increases after purchasing the home.

[145] This repeal does not affect parking that is part of a larger exempt facility, *e.g.*, airport parking lots.

[146] TAMRA added a new category of bonds to finance intercity high-speed rail systems. Of each issue of such bonds, 25% must be issued under the respective state volume cap.

loan bonds were permitted in connection with federally guaranteed and state supplemental loan programs, the latter an expansion of prior law. The Act also created a new category for qualified redevelopment (tax-increment) bonds, using criteria somewhere between the House and Senate bills.[147] Because redevelopment bonds had previously been considered public, at least until 1984,[148] this change represented a tightening, rather than a liberalization, of pre-existing law.

d. Bonds for Section 501(c)(3) Organizations

The Act displayed a split personality with respect to section 501(c)(3) organizations.[149] On the one hand, bonds to benefit these organizations are treated as private activity bonds, and are subject to certain new limitations. These include limits on private, nonexempt use of bond-financed facilities (*e.g.*, for construction of doctors' offices), and a $150 million per organization limit on bonds (not including hospital bonds) outstanding at any one time. On the other hand, section 501(c)(3) organization bonds are not subject to state volume caps. The conference agreement further stated that the use of the term private activity bonds to classify section 501(c)(3) organization bonds "in no way connotes any absence of public purpose associated with their issuance."[150]

e. Arbitrage and Miscellaneous Restrictions

Under the Act, issuers of all tax-exempt bonds — including public and private activity bonds — are required to rebate arbitrage earnings to the federal government. An exception is provided for small governmental units.[151]

Advance refundings are permitted for governmental and section 501(c)(3) organization bonds only — up to two advance refundings for

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[147] Under the Act, qualified redevelopment bonds may be used to acquire and rehabilitate real property in a locally designated blighted area, and to transfer such property to private developers for fair market value. No new structures may be financed with these bonds. Redevelopment bonds must be primarily secured by general or by incremental tax revenues (*i.e.*, additional revenues attributable to the rehabilitation); they are thus the only type of private activity bond whose financing structure, as well as use, is specified by federal tax law.

[148] The private loan bond rule had earlier cast doubt on this assumption. *See supra* note 77.

[149] *See supra* note 128.

[150] H.R. CONF. REP. NO. 99-841, Vol. II, 99th Cong., 2d Sess. 687 (1986).

[151] This exception is in addition to exceptions applying under the prior law IDB rebate rule. TAMRA made minor amendments to the arbitrage rebate provisions.

pre-1986 bonds, and one for later-issued bonds[152] — subject to various arbitrage-related restrictions. The Act also redefined the term "yield" for arbitrage purposes so that issuance and other costs may no longer be recovered from arbitrage profits. In addition, the Act prevented further issuance of "pension arbitrage" bonds, which had threatened to became a major new type of issue.[153]

Under the Act, 95% of private activity bond proceeds must be used for the relevant exempt purpose, as opposed to 90% under prior law.[154] Of the remaining 5%, not more than 2% may be used to finance issuance-related costs, including attorneys' and underwriters' fees, underwriters' spread, and bond-related feasibility studies.[155] This provision, which was not included in the House or Senate bills, resulted from a congressional perception that law and investment firms were earning exorbitant profits on bond-related transactions. Congress believed that the ability to finance such costs with bond proceeds contributed to unnecessary bond issuance.

Miscellaneous provisions of the Act included an extension of public hearing and approval requirements to all private activity bonds; information reporting requirements for all tax-exempt bonds;[156] and "change in use" rules, which provide for denial of interest and other deductions when property financed with private activity bonds is converted to a non-exempt use.[157]

f. Collateral Provisions: Carrying Charges and Minimum Tax

The provisions described above generally restrict the supply of tax-exempt obligations. The Act also contained several rules that tend to reduce the demand for such obligations. Among these rules are a denial of financial institution interest deductions in proportion to tax-exempt

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[152] Bonds that were advance refunded two or more times before March 15, 1986, are allowed one additional advance refunding.

[153] In a pension arbitrage transaction, a governmental unit uses bond proceeds to purchase annuity contracts having a higher yield than the bonds, which are used to defray pension (or similar) liabilities. The Act prevented such transactions by treating annuities as "investments" of bond proceeds that are subject to arbitrage yield restrictions.

[154] A 90% rule was retained for certain student loan bonds.

[155] This percentage is increased to 3.5% for mortgage revenue bond issues not exceeding $20 million.

[156] Prior law required public approval of only IDBs. Information reporting was required for IDBs, student loan bonds, and bonds for section 501(c)(3) organizations.

[157] These consequences are in addition to the denial of tax exemption on bond interest, when applicable.

holdings[158] and a cutback in loss reserve deductions by property and casualty insurance companies by an amount equal to 15% of tax-exempt income.[159] The Act also required, as under prior law, that slower depreciation be taken on most bond-financed property.[160]

Under the Act, interest on private activity bonds (other than section 501(c)(3) organization bonds) issued after August 7, 1986, is treated as a preference item for purposes of the individual and corporate minimum taxes. Although not part of the bond title of the Act, this provision has attracted perhaps the most attention of any bond-related rule. It has been criticized as a first step toward including all tax-exempt income in the minimum tax base, and a psychological blow to the general tax-exempt market. Issuers even brought a law suit asserting that the provision was unconstitutional.[161] The suit was ultimately dismissed following the Supreme Court's holding in *South Carolina v. Baker*.[162]

g. Effective Dates of Bond Provisions

Most of the bond provisions were effective for bonds issued after August 16, 1986.[163] Projects for which a binding contract existed by September 25, 1985,[164] were excepted under a generic rule. The Act also set a dubious record by including more than 300 project-specific exceptions from the bond section of the Act alone. Beneficiaries of this lar-

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[158] This provision applies to tax-exempt obligations acquired after August 7, 1986. An exception is provided for governmental or section 501(c)(3) bonds if the issuing jurisdiction (together with subordinate entities) issues $10 million or less of such bonds during the calendar year. For the background of the disallowance provision, see *supra* note 91.

[159] This provision applies to income on obligations acquired after August 7, 1986.

[160] I.R.C. § 168(g). Bond-financed rental housing qualifies for normal depreciation deductions.

[161] *See infra* note 230.

[162] 108 S. Ct. 1355 (1988); *see supra* note 9. In addition to the preference for private activity bond interest, corporate purchasers are subject to the so-called "book income" preference for corporations (I.R.C. § 56(f)), which treats as a preference item one-half the excess of (i) income reported to shareholders (book income) over (ii) the otherwise applicable minimum tax base. Since book income includes tax-exempt (as well as taxable) interest, this amounts to an indirect tax on tax-exempt bonds held by a corporation regardless of the type of bond and regardless of when acquired. The book income preference is to be replaced beginning in 1990 by a preference based on corporate earnings and profits, which also include tax-exempt income. (I.R.C. § 56(g)).

[163] This effective date was extended to September 1, 1986, for certain governmental bonds. Separate effective dates applied, as indicated in the text, for the financial institution, insurance, and minimum tax provisions.

[164] This corresponds to the date of action on the bond provisions by the Committee on Ways and Means.

gesse included projects that could not otherwise be financed under the Act (*e.g.*, sports stadiums and convention centers); that could not meet stiffened targeting requirements (*e.g.*, housing or redevelopment projects); or that otherwise needed or wanted special relief. The effect of these transitions is somewhat muted because many transitioned projects are included in state volume caps.[165] Nevertheless, transition rules reduced the estimated revenue gain from the bond provisions, over a five-year period, to only $600 million.[166] Bond advocates were to ask whether the entire effort had been worth it for so relatively small a sum.

III. Reform or Revolution?

The President's proposal attempted to make a fresh start with tax-exempt bonds.[167] By contrast, the 1986 Act fell back on familiar themes. It raised money from bonds primarily by slashing volume, which it accomplished by means of a stricter volume cap. Subject to a few modifications, the same types of bonds could be issued after the Act as before, using the same, or similar, definitions. Even the means for distinguishing public from private bonds were largely unchanged. Arbitrage changes also reflected familiar themes, particularly the rebate requirement. None of this is to say that the 1986 changes were minor, for they represent the most dramatic cutback in tax-exempt bonds to date.[168] However, the changes reflect a striking circularity in bond legislation.

What accounts for this circularity? Part of the answer is politics. Congress is not given to grand solutions of most problems. It prefers compromises that sacrifice neatness to consensus, ideological purity to

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[165] As under the House bill, transitioned projects generally are exempt from the volume cap only if (1) similar projects would have been exempt from the prior law volume cap, or (2) the bonds are issued pursuant to a carryforward of volume authority from a previous year. These rules were intended to avoid a repeat of the 1984 experience, when a large number of transitioned bonds were issued outside the cap.

[166] H.R. Conf. Rep. No. 99-841, Vol. II, 99th Cong., 2d Sess. 880 (1986) (table providing estimate of the Joint Committee on Taxation). These figures do not include estimated gains from the financial institution, insurance, and minimum tax provisions.

The Treasury Department subsequently estimated that the bond provisions raised approximately $7 billion as compared to prior law, or more than ten times the amount assumed by the Joint Committee on Taxation. Part of this difference resulted from substantially different assumptions regarding the volume of bonds, particularly refunding bonds, that would have been issued under prior law.

[167] *See supra* notes 80-94 and accompanying text.

[168] For the industry reaction to the 1986 changes, see *infra* notes 240-43 and accompanying text.

political reality. There is a tendency to fall back on established themes.[169] Yet it seems facile to say that "politics" alone is to blame. In my view, there are identifiable reasons for the circular nature of recent bond legislation. These include factors specific to tax-exempt bonds, and more general trends in tax — and other — legislation.

The remainder of this Article attempts to identify these factors, and to assess the broader implications of the 1986 bond provisions. The first Subpart discusses tax-exempt bonds in the context of changing conceptions of public or governmental responsibility. The second Subpart approaches tax-exempt bonds as a case study in the dynamics of tax reform generally. The Article concludes with an evaluation of the meaning of the 1986 Act for bonds and other areas, and its implications for future legislation.

A. Don't Tell Me What's Public: Tax-Exempt Bonds and the Concept of Public Purpose

A recurring theme of tax-exempt bond legislation is the question of what activities qualify as public. The distinction between public and private activity bonds is important because (1) only certain types of private activity bonds may be issued and (2) those private activity bonds which may be issued are usually subject to volume limitations and other special rules.

Before considering its application to bonds, it is useful to consider how the term "public" is defined in other, non-tax contexts.

1. The Problem: What's Public?

a. A Traditional View

American democracy began with a relatively limited view of the role of government, drawn primarily from eighteenth-century sources.[170] For simplicity's sake, I will refer to this as the "traditional" view.

Under the traditional view, government exists to provide the minimum of peace and security necessary for a productive society. The most obvious example is providing for national defense and the protection of public safety. This protection includes the enforcement of legal standards — especially the sanctity of contract — so that orderly business may proceed.

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[169] *See infra* notes 187 & 224-26 and accompanying text (discussing pre-1986 tax acts).

[170] For an expression of these ideas in a contemporary context, see R. NOZICK, ANARCHY, STATE, AND UTOPIA (1974).

Under an expanded version of the traditional view, government could also promote the physical conditions that make private enterprise possible. This endeavor might include, for example, the building of roads, harbors, and similar projects — which we now call "infrastructure" — which are a prerequisite to general economic development. Education also may be regarded as a public function because of its importance in building a modern, democratic society.[171] These expansions of the traditional view are often associated with nineteenth-century America.

The traditional view is related to, but distinct from, the economist's concept of "public goods," a relatively recent invention. This approach justifies a public role in undertaking activities that benefit a general class of users, but could not be profitably undertaken by any individual member of that class. For example, public construction of a road might be justified on the grounds that the road benefits everyone who drives on it, but no individual driver derives sufficient benefit to make it profitable for her to build the road on her own.[172] The public goods theory may be used as a rationalization of traditional governmental activities (including defense and police powers) or as an argument for more extensive involvement.

b. New Deal and Beyond

Beginning with the New Deal, and accelerating with World War II,[173] the role of government in American life expanded significantly. A catalogue of these developments is beyond the scope of this article. Nevertheless, a few basic themes may be identified.

First, government came to play a major role in the economy by means of fiscal and monetary policy. As a part of this, it sought to stimulate the economy with unprecedented public spending. Government spent funds not only on social programs (discussed below), but also on large-scale public works projects, and for various other purposes. The most enduring (if unfortunate) form of expenditure has proved to be military spending.

Second, government undertook a major role in providing social insur-

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[171] The public character of education reflects both its general importance and a peculiarly American need to spread civic consciousness in a large, heterogeneous country. In recent years, university as well as elementary and secondary education has come to be seen as a quasi-public responsibility.

[172] For an introduction to public goods theory, see M. OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2d ed. 1971).

[173] While several of these developments predate the 1930s, the major trends either originated or gained momentum in this period.

ance by means of the social security and, later, federal welfare programs. These programs provided a relatively mild redistribution of income and stimulated the economy by increasing purchasing power.

Third, and more recently, government implemented programs for providing specific benefits — housing, health care, etc. — to specified groups of beneficiaries. These programs deviated from the traditional view of government in that nothing prevented the relevant type of benefits from being supplied by the private sector. The issue was distribution: Was enough housing or health care being provided to poorer or older people at a cost that they could afford? This type of program is particularly identified with the Great Society proclaimed by President Johnson in the 1960s.[174]

The major programs in each of the above areas were established at the federal level. Yet, state and local governments have grown more rapidly than the Federal Government. Such growth has resulted, in large part, from the increased costs of services traditionally financed at the state or local level. However, states have also expanded their role considerably. They have tried to stimulate economic development by means of tax relief and other business incentives, and by improving their local infrastructures. States and cities have undertaken large-scale housing efforts, and retain primary responsibility for welfare programs. Many of these activities have been financed with tax-exempt bonds.

With the relative decline in federal involvement during the 1980s, the state role in such areas has become even more important. Various administrations, including that of President Reagan, have talked of transferring federal programs to the states, although this has proved difficult in practice.

c. The Conservative Reaction

The 1980s witnessed a reaction against the expansive economic view of government, spearheaded by the Reagan Administration. In part, this reaction took the form of repealing or severely limiting existing federal programs. As a general rule, the Reagan Administration had more success in limiting later Great Society programs than in limiting those of the New Deal period, which have stronger middle-class constituencies. Thus, while federal welfare and housing programs were severely curtailed, social security remained largely untouched.

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[174] In addition to expenditure programs, the Federal Government has come to regulate nearly every United States industry and numerous forms of social behavior. Because tax subsidies are more commonly compared to expenditure programs, these other areas are not discussed.

Some observers have suggested that even traditional governmental functions can be performed better by the private sector. At the state and local level, "privatization" of governmental services — transportation, waste disposal, even prisons — has become something of a national rage. While it has ideological overtones, privatization more often results from cost-cutting and efficiency efforts undertaken regardless of political inclination. Privatization also reflects financial pressure on state and local governments, which have been called upon to bear an increasing share of governmental responsibility but have received diminished federal assistance in doing so.

2. Public and Private Bonds

Each of the approaches above suggests a possible test, or tests, for distinguishing public from private bonds. Thus, tax-exemption might be limited to bonds used for traditional public purposes (schools, roads, etc.); extended to bonds for various social or economic development purposes; or used to encourage (or discourage) privatization efforts. Alternatively, the Federal Government might defer to the states' judgment, assuming that any bond issued by a governmental unit must have some governmental purpose.[175] Each of these approaches, and various combinations of them, have been attempted at one time or another.

a. Background to 1986

As we have observed,[176] interest on state and local bonds was originally tax-exempt regardless of the purpose for which the bonds were used. Throughout this period, the majority of bonds were in fact used for traditional public purposes.

The 1968 legislation changed this situation by denying the tax exemption for interest on most bonds used to benefit private businesses (IDBs). Exceptions were provided for projects — utilities, airports, etc. — that were used or managed by private businesses, but were deemed to serve some public interest. Bonds for these projects became a sort of middle category: the law classified them as private purpose bonds but continued to permit their issuance under the statutory exceptions.[177]

Each of the 1968 exceptions had an arguable logic. Thus, utilities

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[175] Because tax-exemption constitutes a federal subsidy for the bond-financed activity, the Federal Government will never be completely indifferent to the use of bond proceeds. *See supra* note 59.

[176] *See supra* notes 6-13 and accompanying text.

[177] *See supra* notes 32-36 and accompanying text.

have traditionally been a quasi-governmental function;[178] airports are arguably modern highways;[179] stadiums and convention centers are frequently thought of as civic projects. However, the approach appears to have been largely historical: activities that had developed strong constituencies by 1968 were protected, while other activities were not. This result is suggested particularly by the allowances for housing and small issue bonds, each of which subsidize private, but politically popular, activities. The legislation thus avoided a truly comprehensive definition of appropriate governmental activities. The same pattern, or non-pattern, continued through the 1970s.

The 1984 Act did not change this pattern. To be sure, the 1984 Act magnified the distinction between IDBs and bonds for traditional public purposes, since only the former were subjected to volume limitations. However, the 1984 Act did not redefine the existing bond categories. The issue of public and private bonds was not really revisited until 1986.

b. The President's Proposal: Back to 1930?

The 1985 debate opened with the President's proposal, which would have eliminated the tax exemption for any bond issue more than 1% of the proceeds of which was used, directly or indirectly, by any nongovernmental person.[180]

Like many aspects of the President's proposal, the bond provisions were a two-edged sword, having both a reformist and a politically conservative aspect. While eliminating a long-standing tax subsidy, the proposal also suggested a pre-New Deal view of appropriate governmental activities. The key here was the distinction between use on the same basis as the general public (which was to be permitted) and use on a different basis (which was not). What this meant, effectively, was that private businesses could not benefit, other than incidentally, from

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[178] Bonds for public utilities (*e.g.*, publicly owned and operated sewage works, municipal electric companies, etc.) are treated as public purpose bonds. The exceptions for utility IDBs allowed financing for privately owned or operated facilities or facilities more than 25% (now 10%) of which were used by private businesses on a preferential basis.

[179] Airports, like highways, are necessary for modern transportation. The difference is that relatively few people own their own airplanes. Thus, most air travel is by commercial carriers, whose business use of airports causes them to be treated as private projects.

[180] *See supra* notes 80-91 and accompanying text (discussing PRESIDENT'S PROPOSAL).

tax-exempt financing.[181] Only benefits delivered by state or local governments directly to the public, without benefit of private intermediaries, would qualify for such financing.

This proposal is not troublesome if one accepts a strict distinction between public and private activities. Thus, if government is limited to schools, roads, courthouses, and the like — the traditional view — the overlap of public and private can be kept to a minimum. These benefits generally can be delivered without private intermediaries. Indeed, according to public goods theory, it is the very unattractiveness of these activities to private investors that requires the government to engage in them.[182]

The problem is that the line between public and private begins to break down once governments become involved in less traditional activities. Under the President's proposal, what would happen to sophisticated infrastructure projects, which may require active cooperation between governments and private business? What of urban redevelopment? What especially of situations (housing, health care, etc.) in which the government is concerned not merely with the existence of a good or service, but with its distribution? In these cases, it may be far more efficient, not to say politically popular, to deliver benefits through the medium of private business. To require a strict choice between private profits and government assistance may be to deny any realistic governmental role in these areas. By requiring such a choice, the proposal would have turned the clock back to a more limited view of government.

This view was, of course, consistent with the overall purpose of the President's proposal: to get the tax code out of social policy and allow the private sector to make its own investment decisions. (A further purpose was to reduce tax subsidies to allow for reduced tax rates.) But here, the Federal Government was not only establishing its own priorities; it was extending them to state and local governments as well.[183] Moreover, the proposal infringed not only on hypothetical programs,

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[181] *See supra* notes 92-94 and accompanying text.

[182] *See supra* note 172 and accompanying text.

[183] The President's proposal to repeal the deduction for state and local income taxes would have even more dramatically affected state and local governments, by discouraging high state taxes and, indirectly, high levels of state and local spending. PRESIDENT'S PROPOSAL, *supra* note 80, at 62-66. This proposal was rejected by the Committee on Ways and Means, *see supra* subpart II.B.2., and ultimately was not included in the 1986 Act, although the Act did eliminate the deduction for state sales taxes.

but on activities actually engaged in by state and local governments, generally without regard to political coloration.[184]

c. An Uneasy Compromise

Given the above, it is not surprising that both the House and Senate modified the President's proposal. The priorities here were different. House members, at least the Democratic majority, were generally committed to a more liberal view of governmental activities, but wished to reduce bond volume as part of a general reform package. The House bill attempted to reconcile these goals by retaining most categories of private activity bonds but adopting a tighter volume cap.

The Senate, at least initially, was most concerned with protecting the ability of state and local governments to privatize large-scale infrastructure projects. Not seeing a need to reduce bond volume, it actually liberalized the law in this area.[185]

By the time the conference committee convened, there was little left to the President's original proposal. Attention focused (as in 1984) on the volume cap, a device for limiting the total amount of bonds without actually choosing between them.[186] In part, the volume cap approach resulted from the time pressure on the members, which made it easier to return to simple, established themes.[187] The cap was relatively easy

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[184] Of course, the President's proposal (or for that matter the 1986 Act) did not force any choices on state and local governments; it merely restricted the activities for which a federal tax subsidy would be provided. But this is the point — that the tax code can be used to subsidize activities that conform to a particular view of government and to avoid subsidizing activities that do not. In this manner, the federal government's priorities are extended, albeit indirectly, to the other levels of government.

[185] *See supra* notes 100-119 and accompanying text (discussing Senate Committee on Finance mark-up). Liberalizing provisions in the Senate bill included a volume cap exception for publicly owned sewage, solid waste, and water facilities, and new management contract rules.

[186] *See infra* notes 224-26 and accompanying text (discussing tax reform strategies and the 1986 Act).

[187] One difficulty with new approaches is that legislators tend to focus only on the politically attractive parts of the approaches. The Durenberger proposal to the Senate Committee on Finance, *see supra* notes 111-12 and accompanying text, is a case in point. The proposal would have reshuffled tax-exempt bonds based on their perceived importance to the operation of government. For example, the proposal would have placed mortgage subsidy bonds and section 501(c)(3) organization bonds (previously outside the IDB cap) under a unified volume cap, and taken publicly owned sewage, solid waste, and water facilities (previously subject to the cap) outside of the cap, thus allowing unlimited issuance. The Committee accepted only the liberalizing (and therefore politically popular) half of this change, exempting publicly owned sewage, solid waste, and water facilities from the IDB cap while also leaving mortgage subsidy and

to calibrate so as to produce the desired revenue.[188] But reliance on the cap also reflected an inability to agree, philosophically, on what constituted an appropriate purpose for bond issuance. The cap offered something for everyone: Congress could assert a more "liberal" view of governmental activities while restricting the actual amount of the subsidy, effecting a "conservative" result. At the same time, it could also raise money needed for an overall tax reform package. In this way, the process largely recreated the structure of prior law; there was simply that much less of prior law to go around.

d. But Some Are More Equal Than Others

Although the Act retained most pre-existing bond categories, the shrunken volume cap serves to heighten the difference between private activity bonds (which are subject to the cap) and bonds for more traditional activities (which are not). To paraphrase George Orwell, all bonds are equal, but some are more equal than others. Something of the President's original proposal thus survives, albeit in attenuated form.

The Act also makes an amendment to the definition of private activity bonds that is technical in nature, but potentially far-reaching in consequence. This is the amendment to the security interest test to take into account both direct and indirect repayments by private persons. As we have seen, this amendment clarifies that the economic, as well as legal, substance of a transaction may be examined to determine if a bond is a private activity bond.

This amendment is significant because it removes the last link with pre-1968 law. As long as a legal security interest was present, the law could pretend to be dealing with purely conduit financings — in a sense, sham transactions.[189] After all, if a bond is used by a private business, and the bondholders have recourse to the money or property of that business, it can be argued that it is not really a governmental obligation at all. It is, in effect, a private debt. By restricting such financings, the law was arguably just treating the transaction according

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section 501(c)(3) organization bonds outside the cap. This action in turn caused a large revenue loss for the Senate bill, placing it in a weakened position for the eventual conference.

[188] A capped program is perhaps the classic tax expenditure: a set volume of subsidy is allocated, state by state, much as in a direct spending program. *See supra* note 53; *infra* note 220.

[189] On the pre-1986 security interest test, see *supra* notes 77-78 and accompanying text.

to its substance, rather than its form.

Under the new law, however, the questions do not stop there. Even if a bond is secured by tax revenues, and even if there is no formal arrangement with a private business, the transaction must be economically analyzed to determine if a private business is making payments to the issuing (or related) governmental unit. For example, assume that a city wishes to redevelop its downtown area. If the city issues bonds to finance the purchase of land, which it then develops and transfers to private businesses free of charge, the bonds are treated as public purpose bonds. However, if the city sells the redeveloped land to private parties, the bonds are private activity bonds. This result holds true, regardless of how the bonds are secured. These bonds may still be issued, in appropriate cases, as qualified redevelopment bonds, but will be subject to volume limits.

In this example, it is obvious that most cities would prefer to sell the land than to give it away. The same would be true in any case involving a potentially profitable activity; the government would prefer to recoup part of its costs by means of private participation, and may decide not to enter into the transaction if it cannot do so.[190] The law thus comes close to saying that governments should stay out of profit-making activities, or at least that these are somehow less governmental than other, money-losing activities. This statement sounds suspiciously like the traditional view above, in which government limits itself to services that cannot profitably be performed by private business. It does not consider that the government may care very much *which* profitable investments are made. For example, in the redevelopment case, it may be extremely important to the city that development occur downtown, rather than in a suburban shopping mall that will contribute to the city's decline. In this area, as in several others, a conservative philosophy lurks beneath the surface of the bipartisan reform effort.

B. Of False Paradigms and Grandfathering the Worst Abuse: The Meaning of Tax Reform

Reform has been defined as "to amend or improve by change of form or removal of faults and abuses." An alternate definition is "to put an end to (an evil) by enforcing or introducing a better method or course of action."[191] As opposed to revolution, reform carries a connotation of

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[190] For this purpose, an activity may be considered "profitable" if the government recoups more than 10% of its costs from private business.

[191] WEBSTER'S NEW COLLEGIATE DICTIONARY 964 (1973).

improvement within an existing system, of bringing the system closer to its original goals by adjusting elements that have become incompatible with those goals.

Three acts in the past thirteen years have borne the title "tax reform" — in 1976, 1984, and 1986. Two other acts, in 1981 and 1982, had catchier titles.[192] The type and extent of reform has varied among these acts, and sometimes between different parts of the same legislation. In general, though, reform has involved the correction of perceived abuses, supposedly resulting in a better system.

1. Approaches to Tax Reform

Tax reform may be described as the pursuit of an ideal, such as a comprehensive tax base[193] or the Haig-Simons definition of income;[194] as the reduction of tax expenditures;[195] or as anything that moves the system closer to fairness, simplicity, and economic efficiency.[196] On its most basic level, however, tax reform involves the correction of abuses.[197] A provision of the tax code has become separated from its original purpose, or from the purposes of the provision as currently understood. The provision has come to provide the wrong benefits, or to provide benefits to the wrong people; or perhaps the right benefits are being provided, but too many of them, so that the overall system becomes unbalanced. The abuse is beyond the scope of regulations, so that

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[192] Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1982); Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 172 (1981). Persistent budget deficits have dimmed enthusiasm for such pretentious titles. Thus, 1987 legislation was modestly called the Revenue Act of 1987, while the 1988 version was known as the Technical and Miscellaneous Revenue Act of 1988. *See supra* note 4.

[193] *See, e.g.*, Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967) (assessing limitations of comprehensive tax base movement).

[194] *See* H. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938).

[195] *See supra* note 53.

[196] *See, e.g.*, W. KLEIN, B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 19-24 (7th ed. 1987) (describing goals for good income tax as fairness, administrative feasibility, and sound economic effects).

[197] As used in this Article, the term "abuse" indicates a result that Congress considers to be inconsistent with the purposes of a provision, and therefore wishes to modify. "Abuse" is thus an inherently subjective concept; its distinguishing feature is the perception that a result is improper rather than a deviation from any objectively defined norm. For the changes in the concept of abuse during consideration of the Tax Reform Act of 1986, see *infra* notes 214-21 and accompanying text.

legislation is required.

In this situation, Congress has surprisingly few options. Congress can eliminate the offending provision or drastically restrict its scope. It can add a new layer of requirements that must be satisfied in order to receive the benefit of the provision. It can adopt an historical approach, protecting abuses that are already entrenched, but preventing further damage. Each of these alternatives offers distinct benefits, but also special risks. Nearly all tax reform measures fall into one or more of these categories.

a. A (Related) Example: Tax Shelter Partnerships

A good example of the choices above, and worth a brief digression, is the Congressional response to tax shelter partnerships. This issue attracted attention in the late 1970s and early-to-middle 1980s, when many high-bracket taxpayers sought to reduce their taxes by purchasing interests in limited partnerships, particularly in the oil and gas and real estate areas. Limited partnership investments were attractive[198] because, as is the case in the purchase of corporate stock, a limited partner had only limited liability for the partnership's debts. However, unlike a corporation, a partnership could pass through deductions and other tax benefits directly to the partners.[199] For example, in a real estate partnership, each partner could deduct an allocable share of interest, depreciation, and other deductions incurred by the partnership during the taxable year. Since such deductions frequently exceeded the taxable income of the partnership, especially in its early years, the investor was able to reduce taxes attributable to salary and other income — the essence of the tax shelter phenomenon.[200]

One can debate the merits of tax shelters from a legal, economic, or tax policy perspective. But it is interesting, and entirely typical of tax abuses, that no one really planned the situation above. Instead, tax planners took advantage of provisions that were designed with a some-

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[198] Many of the benefits associated with limited partnership investments were eliminated by the Tax Reform Act of 1986. *See infra* notes 206-08 and accompanying text.

[199] A partnership is not treated as an entity for tax purposes; instead, each of the partners is treated as if they personally incurred their allocable share of partnership income and deductions. This contrasts with a corporation, which is treated as an entity and is subject to the corporate income tax.

[200] For the characteristic elements of a tax shelter, see JOINT COMM. ON TAXATION, TAX REFORM PROPOSALS: TAX SHELTERS AND MINIMUM TAX (1985). The passive loss rules prevent the use of most tax shelter deductions to reduce taxes on salary and other "active" income. *See infra* note 208 and accompanying text.

what different context in mind. Thus, in a business controlled by a small group of persons, each of whom is involved in the daily running of the business, the partnership tax rules work quite well. These partners are properly treated as if they personally incurred partnership gains or losses. The same is arguably true in small-scale limited partnerships. But in a partnership with hundreds of members, in which the interests may even be traded on a public exchange, the provisions begin to look out of place. The "partnership" now appears to exist in name only, providing a convenient device for transferring deductions to wealthy investors. The paradigm, or model, underlying the partnership tax rules has begun to lose its relevance.

b. A First Approach: Frontal Assault

Faced with this situation, Congress has a limited number of alternatives. The first is a frontal assault. Congress could, in theory, repeal the partnership provisions of the Code as applied to limited partnerships. These partnerships could instead be treated as corporations, preventing the pass-through of deductions to their shareholders (formerly limited partners), and imposing a second level of tax at the corporate level. If it did not wish to be this sweeping, Congress could repeal the partnership provisions as applied to limited partnerships with 35,[201] or 50, or 100 or more members.

The frontal assault is rarely used in tax legislation, for a number of reasons. One is that it tends to throw away the baby with the bathwater. Thus, in the limited partnership case, many smaller, non-tax-shelter partnerships would be affected by a full-scale repeal. The alternative, a numerical cutoff, appears somewhat arbitrary; it may simply punish those industries which, by custom and practice, tend toward larger partnerships. A numerical cutoff may also be possible to avoid, by dividing large partnerships into a number of smaller ones having the same or a similar purpose.

As it happens, a version of frontal assault was included in the Treasury Department's 1984 tax reform proposal, which would have treated as corporations any partnerships having more than 35 limited partners.[202] This item quickly encountered political difficulties and was not included in the President's proposal or the 1986 Act.[203]

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[201] The number 35 is suggested by the maximum number of shareholders in an "S" corporation under I.R.C. § 1361. S corporations are treated, for tax purposes, in a manner similar to partnerships.

[202] TREASURY REPORT, *supra* note 79, vol. 2, at 146.

[203] The Revenue Act of 1987 added a provision treating certain publicly traded part-

c. A Second Approach: More Hoops to Jump Through

Instead of deleting an offending provision, Congress may add a new layer of tests that must be satisfied in order to benefit from the position. Ideally, these tests will allow the relevant benefit only if the facts conform to the original, or currently understood, reason for providing the benefit. For example, in the case of tax shelters, deductions might be allowed only to the extent of the investor's personal liability. Or, deductions might be allowed only to the extent that the investor actively participates in the relevant activity. These criteria would, in theory, distinguish substantive investments from those entered into primarily for tax purposes.

The "new layer" approach is perhaps the most popular in tax legislation. It offers the possibility of selective surgery, correcting an abuse while retaining the underlying legal structure. One difficulty with the approach is that new tests tend to be no less arbitrary than old ones. A further danger is that multiple layers will make the law unbearably complicated, rewarding those who can manipulate such complexity at the expense of everyone else. In extreme cases, this may make the law even more unfair than it was before the reform.

Tax shelters provide a case study in such complexity. Beginning in 1976, Congress passed a series of requirements known as the "at risk" rules,[204] which limited deductions to an investor's actual economic stake in an activity.[205] These rules proved functional, but extraordinarily complex, and they dealt with only a portion of the tax shelter problem. Additionally, the rules exempted real estate, which eventually became the largest tax shelter category. Further tax shelter provisions were added in the early 1980s. When it reconsidered the issue in 1986, Congress took no chances: it extended the at-risk rules to real estate, limited nonbusiness interest deductions,[206] other than for home mortgage inter-

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nerships as corporations for Federal income tax purposes (I.R.C. § 7704). Nonpublicly traded partnerships (regardless of size) are not affected. This provision may be described as a frontal assault, but on one relatively small part of the problem; it restricts a particularly egregious abuse (*i.e.*, publicly traded partnerships) without really addressing the underlying classification issue.

[204] I.R.C. § 465.

[205] For example, the at-risk rules allow deductions to the extent that an investor has contributed cash to an activity or is personally liable to repay debts. Deductions are generally not allowed for activities supported by nonrecourse debts. This disallowance has the effect of restricting "multiple writeoff" transactions, in which deductions exceed the amount actually contributed by the investor.

[206] These deductions were phased out over a five-year period.

est,[207] and restricted all deductions arising from "passive" activities (including limited partnerships), prohibiting their use to offset other, "active" income.[208] In case these restrictions still allowed excessive benefits, Congress significantly tightened the individual and corporate minimum tax. These rules, especially the passive loss limitation, appear finally to have put a lid on tax shelters, but at a cost of unprecedented complexity.

d. A Third Approach: Grandfathering (Some) Abuses

In some cases, reformers may wish to terminate an abuse, but be politically unable to do so. Congress may then adopt an historical approach, restricting the abuse only for new transactions. The most obvious example is the adoption of transition or "grandfather" rules, which preserve existing law for specified transactions or categories of transactions.[209] But Congress may effectively grandfather an entire category of abuses, either (1) by adopting substantive rules that protect the preferred types of transactions, or (2) in rare cases, by specifically limiting an abuse to an indicated volume level. An example of the former is the 1968 bond legislation, which exempted entire bond categories from its general IDB restrictions.[210] An example of the latter is the 1984 volume cap, which froze IDBs at a specified issuance level.[211]

If multiple layers benefit the clever, grandfathering benefits the quick. In its purest form, it allows the first taxpayers to discover an abuse to continue to make use of it, while others are effectively foreclosed. This augments the advantage that sophisticated taxpayers already have over everyone else.[212] Selective grandfathering especially fa-

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[207] The Act placed limitations on deductions for home equity loans. The Revenue Act of 1987 imposed additional restrictions on the deduction of home mortgage interest, including a denial of deductions on acquisition indebtedness in excess of $1 million and home equity loans in excess of $100,000. I.R.C. § 163(h).

[208] I.R.C. § 469. The passive loss rule was related to an earlier concept, known as the limitation on artificial losses (LAL), which would have restricted the use of accelerated deductions to offset income from other property. LAL had been included in the House version of the Tax Reform Act of 1976, only to be rejected in conference.

[209] *See supra* notes 48-51 and accompanying text.

[210] *See supra* notes 20-31 and accompanying text.

[211] *See supra* notes 65-76 and accompanying text.

[212] Two dynamics are at work here. First, sophisticated taxpayers tend to discover new abuses faster than Congress can end them. The law is thus typically one step or more behind the abusers. Second, when the law does catch up, Congress may protect transactions (or types of transactions) favored by the sophisticates, while proscribing those that would benefit other taxpayers. The effect may be to ration tax advantages to those who need them the least.

vors those with strong Washington connections, who may influence both specific exceptions and the way in which general rules are drafted.

A perverse variant of grandfathering is the phenomenon known as "grandfathering the worst abuse." In this situation, most varieties of an abuse are closed down. However, the quintessential, worst example of the abuse is so attractive, and hence so politically popular, that it becomes impossible to stop. The exemption of real estate from the original at-risk rules is an example of this phenomenon.[213] An additional example is the favored treatment of mortgage subsidy bonds, quintessential private purpose bonds which became extraordinarily popular.

2. The New Approach: The System as Abuse

The 1986 Act differed from previous tax reform efforts, because it did not limit itself to specific abuses. Instead it treated the entire tax system as an abuse, providing too many subsidies for special interests and implicitly cheating the majority of taxpayers. Thus, President Reagan's message to the Congress described the pre-1986 tax code as "a source of ridicule and resentment, violating our Nation's most fundamental principles of justice and fair play."[214] The drastic remedy this required was a full "overhaul" of the existing tax system. This overhaul was to include both a reduction in tax preferences and a dramatic reduction in individual and corporate tax rates.[215]

By adopting a systemic approach, the President implicitly recognized the limitations of piecemeal reform as attempted in earlier acts. Piecemeal reform has always been difficult because the defenders of each special tax break can mobilize to protect it. Only by focusing on an overall package could the political momentum to overcome such objections be generated.

The systemic approach made the 1986 tax reform process markedly different from that of previous years. For one thing, it became feasible to mount direct or near-direct attacks on various tax subsidies, when other approaches (multiple layers, grandfathering, etc.) might previously have been followed. For example, the Act completely eliminated

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[213] *See supra* notes 204-05 and accompanying text.

[214] Transmittal message from President Reagan to the Congress, accompanying PRESIDENT'S PROPOSAL, *supra* note 80. Hyperbole in tax matters was not limited to President Reagan; his predecessor, President Carter, proclaimed the tax code "a disgrace to the human race." Carter, Acceptance Speech at 1976 Democratic National Convention, *reprinted in* 32 CONG. Q. ALMANAC 852 (1976).

[215] *See supra* notes 80-82 and accompanying text (discussing PRESIDENT'S PROPOSAL).

the investment tax credit[216] and special capital gains rates, and repealed deductions for nonbusiness personal interest expenses, other than for home mortgage interest.[217] The passive loss rule, while adding a new layer of complexity, was more stringent than any previous tax shelter limitation.[218] Such changes would have been difficult to make in a "normal" year, but were rendered politically palatable by the lower tax rates that came with a comprehensive package.

A second difference was that "reform" itself took on a new meaning. Until 1986, tax reform had been judged largely by subjective standards: fairness, simplicity, and economic efficiency.[219] Now, a more objective measure was introduced: reform was to make possible a substantial reduction in tax rates.[220] In this environment, provisions were judged not only, or even primarily, on their internal merits, but on how much money they could contribute toward an overall package. By the end of the process, it sometimes appeared that reform meant anything that raised revenue as compared to the existing system. For example, tax-exempt bonds were expected to contribute a specified amount to the tax reform package, before the bond provisions had even been considered.[221]

Herein lay the seeds of a contradiction: while the depth of tax reform suggested a direct assault on tax preferences, its breadth encouraged more traditional revenue-raising strategies. This was especially true of areas like bonds that were peripheral to the main legislative package, and from which relatively limited revenues were expected. Rather than rethinking these areas, Congress frequently reverted to previous (and sometimes to previously rejected) incremental approaches, relying on the sheer volume of changes to create a revenue-neutral bill. The outcome in these areas was likely to be unsatisfying intellectually, al-

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[216] This elimination was subject to various transitional exceptions.

[217] *See supra* notes 206-07.

[218] *See supra* note 208 and accompanying text.

[219] *Cf. supra* note 196 and accompanying text.

[220] To an extent, the systemic approach to tax reform marked a triumph for tax expenditure analysis. *See supra* note 53. Reform in this view consisted of reducing tax expenditures, which allowed the "normative" system to raise less money while still producing the same net revenues. However, tax expenditure analysis could not predict which expenditures would be targeted for reform. For example, both public and private purpose tax-exempt bonds lose revenue; a decision to target the latter, and not the former, must be based on political and value judgments rather than pure economic analysis. *See supra* notes 170-90 and accompanying text. Tax expenditure theory also does not require that tax rates be cut in return for reduced expenditure; rather, it would treat the reduction of (undesirable) expenditures as an end in itself, with the use of resulting revenues constituting a separate political choice.

[221] *See supra* note 125 and accompanying text.

though the cumulative effect was vital to the political success of the Act.

3. New and Old in Tax-Exempt Bonds

a. Bonds to 1986: A Series of Grandfathers

Pre-1986 bond legislation illustrated various strategies of tax reform, but emphasized a grandfather approach.[222] The "abuse" in this case began in the Depression era, when state and local governments started to issue bonds for the benefit of private business users. These bonds met the formal requirements for tax exemption, but seemed inconsistent with the purpose of the provision — to allow tax-free borrowing by the governments themselves. Action was ultimately required to limit the provision to the original paradigm.

The 1968 legislation attempted to accomplish this by adding an additional layer of tests to the requirements for tax exemption. The new test excluded IDBs that had the clearest indicia of private conduit financings. On the other hand, the legislation also had the flavor of a large-scale grandfather as it continued to allow tax-exempt IDBs for many popular purposes.

The 1984 legislation was more purely a grandfather affair; however, it grandfathered a specific level of bond issuance rather than specified types of bonds. This result was accomplished primarily by means of the IDB volume limit.[223] Earlier legislation (in 1980) had adopted a similar approach with respect to mortgage bonds. These solutions were politically acceptable, but they had the usual limitation of the grandfather approach: they prevented the growth of an abuse without resolving the underlying problems that had caused it in the first place.

b. From Grandfather to Phaseout: 1986

For a time, it appeared that the 1986 bond provisions would break out of the grandfathering pattern. In particular the President's proposal suggested a direct assault on private activity bonds.[224] Eventually, however, the direct assault failed. Old themes reasserted themselves in the form of the volume cap and related provisions. This return to old

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[222] For the history of pre-1986 legislation, see *supra* notes 6-78 and accompanying text.

[223] Because various categories of bonds were excepted from volume limits, and because of transitional exceptions, the 1984 Act allowed limited growth beyond existing issuance levels. *See supra* notes 65-78 and accompanying text (discussing the 1984 Act).

[224] *See supra* notes 80-94 and accompanying text (discussing *President's Proposal*).

themes resulted in part from the difficulty in agreeing on what constituted an appropriate public purpose for bond issuance.[225] But the dynamics of the reform process also contributed to this failure: it was simply easier to raise money with a volume cap than to rethink the entire bond area. If intellectually unsatisfying, the cap at least made its contribution toward an overall revenue package.[226]

The 1986 volume cap differed from the 1984 version in that it required a reduction, rather than a freeze, in private activity bond issuance. The cap was thus less a grandfather than a phase-down — perhaps foretelling a phaseout — of private activity bonds. Other provisions of the Act are consistent with this approach. Thus, the minimum tax and bank interest deduction rules decrease the incentive to buy private activity bonds; arbitrage rules reduce the incentive to issue them; and stricter targeting rules attempt to steer the remaining bonds toward the most worthwhile projects.[227]

c. After 1986

Three years after the 1986 Act, the future of the bond provisions remains uncertain. The bond community, while it would like to undo the more onerous aspects of the Act, has been concerned about the possibility of still further limitations.[228] One group of issuers brought a lawsuit asserting that the minimum tax and arbitrage rebate provisions of the Act were unconstitutional; the suit was dismissed after the Supreme Court held, in *South Carolina v. Baker*,[229] that the Constitution

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[225] *See supra* notes 170-90 and accompanying text.

[226] Old themes also prevailed over new themes in the arbitrage area. For example, the Act extended the arbitrage rebate requirement (which already applied to IDBs and mortgage subsidy bonds) to all tax-exempt bonds, but it did not include the Administration's proposal to restrict early issuance of bonds. *See supra* notes 89 & 151 and accompanying text.

[227] The arbitrage rebate and bank deductibility rules apply to both private activity and traditional public purpose bonds, subject to exceptions for small governmental issuers. *See supra* notes 151 & 158 and accompanying text. In addition to reducing the incentive to issue tax-exempt bonds, the arbitrage rebate prevents arbitrage profits from being used to finance private projects, which might otherwise accomplish a similar result to issuing additional private activity bonds.

[228] The Revenue Act of 1987 and TAMRA made only modest bond-related amendments and did not affect the basic structure of the 1986 provisions. *See supra* note 4; *see also* Daily Tax Report, March 29, 1989, at G-2 (quoting Joint Committee on Taxation staff member as stating that tax-exempt bond legislation will not be a high priority for Congress in 1989).

[229] 108 S. Ct. 1355 (1988); *see supra* note 9.

does not prohibit taxation of state and local government bonds.[230] A mixed public-private commission, chaired by Rep. Beryl Anthony (D-Ark.), is studying the effect of recent tax changes on the state and local bond markets, but the commission has no official authority and the effect of its recommendations, once issued, is unclear.[231]

Assuming that the major 1986 bond provisions continue in effect, a few observations are in order. First, the private activity bond volume limits are likely ultimately to lead to political conflict. This outcome is likely because Congress has — as in 1984 — reduced volume while retaining most categories of bonds. The post-1987 volume cap ($50 per capita) is only one-third the prior law IDB limit in the larger states, and also includes rental housing, redevelopment, and mortgage subsidy bonds. The situation in smaller states, where a flat $150 million limit applies, is only slightly better. Ideally, the volume limits would force states to choose the more deserving projects; in fact, political pressure may build to increase the amount of the caps, or exempt specified bonds from them. If the caps are not raised, a converse question arises: with volume restricted, anyway, why do we need such strict targeting rules?

A second, more technical problem involves the definition of private activity bonds. In particular, Treasury regulations must establish what type of "indirect" repayment will cause bonds to be considered private under the expanded security interest test. The problem is most acute in the area of redevelopment (tax-increment) bonds, in which localities may be tempted to stretch the limits of permitted payments and thereby keep bonds outside the volume limits.[232] For example, cities may construct projects to be sold to developers after a "decent interval" has

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[230] Government Finance Officers Ass'n v. United States, 688 F. Supp. 901 (N.D. Ga. 1988). The suit alleged that these provisions were unconstitutional under the tenth amendment, which reserves to the states all rights not specifically provided to the Federal Government, and the sixteenth amendment, which authorizes the federal income tax. The District Court first dismissed the claim with respect to arbitrage rebate, finding that the plaintiffs had the alternative remedy of actually paying the rebate and suing for a refund. Government Finance Officers Ass'n v. United States, 630 F. Supp. 1538 (1988). The minimum tax claim was subsequently dismissed, at the plaintiffs' request, following the Supreme Court's decision in South Carolina v. Baker, 108 S. Ct. 1355 (1988).

[231] The Anthony Commission is comprised of 21 members, 12 (including Rep. Anthony) representing various levels of government and nine representing the bond industry, and is financed primarily by trade groups. The Commission is expected to issue its final report in 1989. *See* Ferris, *Is Beryl Anthony's Campaign to End Bond Curbs Saving the Muni Market or Tilting at Windmills?*, Credit Markets: The Fixed-Income Securities Weekly, Aug. 29, 1988, at 1.

[232] *See supra* note 190 and accompanying text.

elapsed, asserting that the bonds are not being repaid with the proceeds of the sale.[233] The Treasury (and the Congress) may be expected to take a hard line in such cases, consistent with the congressional intent to characterize transactions according to their economic substance; when they do, they may be accused of exceeding the statutory language, or at least of creating harsh results. It remains to be seen whether the Treasury will attempt a comprehensive definitional framework for the revised security interest test or will respond to specific fact patterns on a case-by-case basis.[234]

The 1986 Act may also stimulate changes in the second prong of the private activity bond definition, the private use test. "Use" for this purpose is an amalgam of various concepts. It encompasses activities that provide goods or services to private persons — for example, bond-financed housing,[235] student loans, or a manufacturing facility financed with small issue bonds. "Use" also encompasses projects that provide services to the general public, but utilize private businesses in delivering those services — for example, privately operated sewage or solid waste facilities. These are in many respects different types of projects, but they have been lumped together on the theory that each involves use by one or more private person(s) on a basis different from that available to others.[236]

Future years may see a growing distinction between these types of use. The beginnings are visible in the 1986 Act, which liberalizes the rules pertaining to private management contracts[237] and exempts privately managed solid waste facilities from the volume cap. These changes favor private participation in the delivery of services, as opposed to private benefit from the actual services provided. A similar distinction underlay the Durenberger proposal in 1986. There is likely to be pressure for further adjustments in this area, as states and cities

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[233] Issuers have also argued that only a portion of bonds should be counted under the volume cap when bond proceeds are used to pay part of the cost of land which is then sold, at a discount, to private developers. This position was rejected by the legislative history. *See* 136 CONG. REC. H8362 (daily ed. Sept. 25, 1986) (statement of Mr. Rostenkowski). It may be revived as part of an argument for revised legislation.

[234] A 1987 IRS notice, released in advance of regulations, provides technical guidance for implementing the revised use and security interest test but does not address the tax increment problem. I.R.S. Notice 87-69, 1987-2 C.B. 378.

[235] Owner-occupied housing is not used by a private person in a trade or business; accordingly, a special code provision was required to restrict mortgage subsidy bonds. *See supra* notes 46-51 and accompanying text.

[236] *Cf.* PRESIDENT'S PROPOSAL, *supra* note 80.

[237] *See infra* note 238.

seek to "privatize" the delivery of additional municipal services. Congress will resist changes, here and elsewhere, that undermine the 1986 volume limits. But on the whole, the distinction between different types of use appears to be a reasonable development.[238] Further elaboration of the use concept would also be desirable at the administrative level.[239]

4. Living with Tax Reform

Perhaps the greatest significance of the 1986 bond provisions lies not in any of the individual rules described above, but in the psychological impact of the provisions taken as a whole. Put simply, there is a lingering perception that tax-exempt bonds — at least bonds for private activities — are doomed. Proponents of this view cite not only the volume cap and targeting restrictions on private activity bonds, but also the arbitrage, minimum tax, and bank interest deduction rules.[240] Some believe that the minimum tax, while as yet limited to private activity bonds,[241] may be a first step toward the taxation of all municipal bond interest. Beyond these specific changes, there is a sense that the sanctity of tax-exempt bonds has been irrevocably compromised; that no type of

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[238] It is difficult to draw a clean line in this area because all privately operated facilities provide some benefit to the private operator. For example, a privately managed sewage plant benefits the general public but also earns profits for the operating company. One distinction here involves the question of risk: is the private manager merely being paid a fee for services, or does it have an effective investment in the financed facilities? This concern is reflected in the new management contract rules, which specify that certain short-term management contracts will not be treated as private trade or business use if, *inter alia*, at least half of compensation is on a periodic, fixed-fee basis and no compensation is based on a share of net profits. Tax Reform Act of 1986, § 1301(e) (non-I.R.C. provision).

[239] The significance of administrative decisions in this area was demonstrated by Priv. Ltr. Rul. 87-04-049 (Oct. 28, 1986), which stated that a developer "used" public road improvements in the vicinity of an office, hotel, and shopping complex being constructed by the developer. The ruling appears reasonable in light of its unusual facts, under which the developer was obligated to pay the costs of the improvements as a condition for governmental approval of the project. Nevertheless, the ruling alarmed bond lawyers by suggesting that public access to a facility does not preclude a finding of private use.

[240] The arbitrage-rebate and bank-interest deduction rules have attracted broad attention because they apply both to private activity and to traditional public purpose bonds, subject to exceptions for small governmental issuers. *See supra* notes 151 & 158 and accompanying text. For an early but reasonably balanced assessment of the impact of the 1986 Act, see Haas, *Ready for Assessment: The Final Tax Bill*, Credit Markets: The Fixed-Income Securities Weekly, Aug. 25, 1986, at 1.

[241] *See supra* notes 161-62 and accompanying text.

bond is safe from further reform efforts. *South Carolina v. Baker*[242] did little to allay such fears.[243]

One problem in evaluating the 1986 bond provisions is that it is difficult to separate the effect of these provisions from other tax and non-tax developments. For example, the Act lowered marginal tax rates, reducing the incentive to purchase tax-exempt bonds.[244] However, other tax preferences were restricted even further, making tax-exempt bonds reasonably attractive by comparison.[245] Market developments — especially the 1987 stock crash — have aggravated and in some cases obscured the effect of tax changes.[246] Nevertheless, the long-term trend is clear: a shrinkage of at least the private activity bond market,[247] made inevitable by the 1986 volume limits.[248] While taxation of traditional

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[242] 188 S. Ct. 1355 (1988); *see supra* note 9.

[243] After the *South Carolina* decision, Sen. Lloyd Bentsen (D-Tex.), Chairman of the Senate Committee on Finance, and Rep. Dan Rostenkowski (D-Ill.), Chairman of the House Committee on Ways and Means, each denied that the decision will prompt new legislative curbs on tax-exempt bonds, although Rostenkowski emphasized that the decision would not deter further changes, either. *See* Pryde, *High Court's Sickle Leaves Municipals Exposed for Tax Harvest by Congress*, Credit Markets: The Fixed Income Securities Weekly, Apr. 25, 1988, at 1.

[244] Assuming a 33% marginal tax rate, a tax-exempt bond paying 7% interest is equivalent to a taxable return of 10.5%, as opposed to 14% under prior law (which imposed a maximum 50% marginal rate).

[245] For example, the Act severely restricted the tax incentives for real estate investment because of reduced tax rates, longer depreciation, and the effect of the passive loss rules. *See supra* note 208 and accompanying text.

[246] Reeling from the effects of the crash, and with bond volume reduced by the 1986 Act, several major investment firms cut back or eliminated their municipal bond operations. *See* Yacik, *Municipals Turned Aside in Wall Street Shake-Up*, Credit Markets: The Fixed Income Securities Weekly, Nov. 2, 1987, at 1; *1987: A Year to Forget*, Credit Markets, The Fixed Income Securities Weekly, Dec. 28, 1987, at 1.

[247] Aggregate new issues of tax-exempt bonds (including public and private purpose bonds) declined from a 1985 high of $203.95 billion to $142.54 billion in 1986, $98.67 billion in 1987, and $95.00 billion for the first eleven months of 1988 (Jan.-Nov.). *See supra* note 2.

[248] Responding to the limitations on tax-exempt financing, state and local governments issued $4.13 billion of taxable debt in 1986, but this amount declined to $2.89 billion in 1987 and $1.84 billion for the first eleven months of 1988. *See* Datta, *Analysts Call Second-Quarter Rise in Taxable Munis a Fluke*, Credit Markets: The Fixed-Income Securities Weekly, July 18, 1988, at 1; Nasella and Kreps, *Municipal Bond Issuance Volume Declines by 33%, to $7.3 Billion, in November*, Credit Markets: The Fixed-Income Securities Weekly, Dec. 5, 1988, at 15. Taxable bonds must pay a higher interest rate than equivalent tax-exempt bonds, but they are not subject to Code limitations. Taxable bonds are sometimes marketed to foreign investors, who generally do not pay U.S. taxes and accordingly have no reason to purchase tax-exempt bonds.

public purpose bonds seems unlikely, the arbitrage and other restrictions pertaining to such bonds are likely to remain in force and may even be tightened in the years to come.

CONCLUSION

In sum, while rumors of the death of tax-exempt bonds are exaggerated, the effects of the 1986 Act are real. These effects have prompted bond advocates to raise two related objections. One is that the Act is "unfair" because it restricts practices that were not abusive as that term was previously understood. A second is that the cumulative weight of changes discourages the issuance of tax-exempt bonds even when they are still permitted, an allegedly "unintended" result. For example, in the rental housing area, the new targeting restrictions are said to make bond issuance unattractive, even if the issuer is able to secure an allocation of the state volume cap.[249] The passive loss rules aggravate this tendency by reducing the overall tax incentives associated with real estate transactions. Lower tax rates further dilute these incentives. Surely, it is argued, Congress did not intend to make things so difficult; if it had, it would have repealed the tax exemption for housing bonds outright.

I think that these complaints miss two basic points about tax reform. First, the 1986 Act was aimed not at individual abuses, but at a systemic overhaul. Tax preferences, whether or not abusive on their own terms, were to be restricted in order to reduce tax rates. This point has been discussed at some length.[250]

Second, reducing the attractiveness of tax preferences (when not repealed outright) was a major goal of the 1986 Act. From this perspective, reform is a dynamic process: the point of the Act was not to eliminate all tax preferences but to achieve a critical mass of changes that allowed the reduction of tax rates to a politically irresistible level. The lower rates themselves, together with other changes, would then make

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[249] The volume of multifamily rental housing bonds has in fact declined dramatically since the 1986 Act, from a record of $21.8 billion in 1985 to $3.37 billion in 1986, $2.84 billion in 1987 and $1.81 billion for the first nine months of 1988. *See* Datta, *Housing Volume, Up 3.3% in 1987, Is Buoyed by Single-Family Issues*, Credit Markets: The Fixed-Income Securities Weekly, Mar. 14, 1988, at 1; Kreps, *Housing Bond Sales Rose by 28%, to $9.65 Billion, in First 9 Months of 1988*, Credit Markets: The Fixed-Income Securities Weekly, Oct. 31, 1988, at 1. The figures in the titles include mortgage subsidy bonds. While restricting tax-exempt bonds, the 1986 Act added a new credit for investments in low-income housing. *See* I.R.C. § 42.

[250] *See supra* notes 214-21 and accompanying text.

the remaining preferences less attractive, and reduce the tax law's role in economic decisions.[251] Together with the continuing budget deficit, they would also discourage legislative attempts to reinstitute prior largesse. Reform would thus do for taxes what the 1981 budget cuts did for spending — break the cycle of increased expenditures, although this time with a reformist as well as a conservative appeal.[252] Tax-exempt bonds are only one example of this process.

This process suggests the logic not of reform, but of revolution — a break with the past that is by definition incomplete, but that is also, once undertaken, extremely difficult to reverse. It is thus somewhat beside the point that all tax subsidies were not eliminated in 1986, or that some were affected only indirectly. The Act sought systemic change and, by and large, it achieved it. When it was politically possible to eliminate tax subsidies, the Act did so; when this was not possible, as in the case of tax-exempt bonds, it restricted the subsidy and made what was left less attractive. By doing so it succeeded where more idealized reform efforts would have failed. The complaints of those who previously benefitted from these provisions are the best indication of the Act's success.

For the bond community, a measure of frustration is understandable; it was forced to weather two legislative assaults in three years, culminating in an Act that raised as many questions as it provided answers. Other industries are in a similar position. Yet bemoaning the unfairness of the 1986 changes is like yearning for the *ancien regime*, and likely to be as unproductive. Congress simply cannot reconsider the bond provisions without reopening countless other portions of the 1986 Act, something it still shows little inclination to do.[253] In this respect, the reformist and conservative aspects of the Act complement each other — both liberal reformers and conservative tax-cutters have a stake in the Act's survival. Bonds are not dead yet. But bond advocates would

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[251] Any tax incentive becomes less valuable as the taxpayer's marginal rate declines. Thus, at a 50% tax rate, a $100 deduction is worth $50 to the taxpayer, while at a 33% rate the same deduction is worth $33. The lower rate thus tends to reduce the effect of tax considerations in making economic decisions. *Cf. supra* note 244.

[252] In this political respect, at least, the analogy between tax and direct expenditures appears valid. *See supra* notes 53 & 220 and accompanying text.

[253] Reinstatement of a reduced capital gains rate, as proposed by President Bush, could lead to a partial unraveling of the 1986 Act. For that reason, however, the proposal is likely to meet stiff opposition on Capitol Hill. Assuming that significant changes are made in the 1986 Act, the continuing deficit and Bush's "read my lips" opposition to tax rate increases leave little room for liberalization of the rules pertaining to bonds and to other tax subsidies.

do better to work constructively on the problems left unresolved by the Act[254] than to attempt to reestablish the past. Sooner or later, they must adjust to a new reality. If not now, when?

[254] *See supra* notes 232-39 and accompanying text.