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INDUSTRIAL DEVELOPMENT BOND FINANCING AFTER THE DEFICIT REDUCTION ACT OF 1984: THE FINAL CHAPTER?

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INDUSTRIAL DEVELOPMENT BOND FINANCING AFTER THE DEFICIT REDUCTION ACT OF 1984: THE FINAL CHAPTER?

I. Introduction

Approximately sixteen years after Congress purportedly divested industrial development bonds (IDB)[1] of the general tax exemption accorded interest on state and local obligations,[2] President Reagan signed into law the Deficit Reduction Act of 1984 (1984 Act)[3] which contains a substantial number of provisions affecting IDB financing. Title VII of the 1984 Act places a ceiling on the total dollar amount of IDBs that each state can issue per calendar year, further restricts the use of tax-exempt IDB proceeds, and eliminates various loopholes in the Internal Revenue Code pertaining to IDBs.[4] Ironically, the Congressional Joint Committee on Taxation projected, in a report issued November 15, 1984, that tax-exempt bonds will cost the federal government more money than it estimated would have been lost had the Act not been passed.[5] Coincidentally, on November 27, 1984, the Treasury Department, in its plan to simplify the tax laws, proposed that virtually all tax-exempt bonds be eliminated.[6]

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1. Section 103(b)(2) of the Internal Revenue Code (the Code) defines the term "industrial development bond" for federal income tax purposes. I.R.C. § 103(b)(2) (1982). See *infra* notes 63-75 and accompanying text for an explanation of section 103(b)(2). The definition was originally added to the Code as section 103(c)(2) by the Revenue and Expenditure Control Act of 1968. Pub. L. No. 90-364, § 107(a), 82 Stat. 251, 266-68 (1968). Industrial development bonds come in two forms, either (1) general obligations, secured by the taxing power of the issuing government unit, or (2) revenue bonds, secured only by the property acquired with the bond proceeds and the income produced by the property. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, INDUSTRIAL DEVELOPMENT BOND FINANCING 37 (Report A-18, 1963) [hereinafter cited as ADVISORY COMMISSION]. See *infra* note 26 for a discussion of the effect of the distinction.

2. Interest paid on municipal bonds is exempt from federal income tax pursuant to section 103(a) of the Code. I.R.C. § 103(a) (1982). See *infra* notes 31-32 and accompanying text for a discussion of the historical development of the interest exemption. Code section 103(b)(1) read in conjunction with section 103(a) provides, generally, that interest derived from IDBs is taxable. *See* I.R.C. §§ 103(a), 103(b)(1) (1982).

3. Pub. L. No. 98-369, 98 Stat. 494 (1984).

4. See *infra* notes 126-95 and accompanying text for a discussion of the provisions enacted by the Deficit Reduction Act affecting IDB financing.

5. Bond Buyer, Nov. 16, 1984, § 1, at 1, col. 1.

6. Bond Buyer, Nov. 28, 1984, § 1, at 1, col. 1.

This Note explores the development and financial and tax ramifications of IDB financing. It then examines the extent to which the 1984 Act affects traditional uses of IDBs and the future of tax-exempt industrial development bond financing in light of the Treasury's proposal. This Note concludes that IDBs should remain a viable mechanism for financing industrial expansion and essential public facilities.

II. The Development of IDB Financing

A. Historical Background

An industrial development bond is a debt obligation issued in the name of a state or local government or its instrumentalities for the benefit of a private company.[7] The classic IDB financing scenario develops when a municipality sells the bonds to finance the acquisition, construction, or rehabilitation of industrial facilities.[8] The facilities then are leased to a private company which in turn pays rent in an amount sufficient to cover interest and amortization of the bonds.[9] Generally, bond purchasers look only to the company's credit rating in assessing the merits of the bond as an investment since the obligations are secured by the facility constructed and its anticipated revenues.[10] Typically, issuers employ IDB financing as part of a multi-faceted program to attract industry into a particular community[11]

7. Ritter, *Federal Income Tax Treatment Of Municipal Obligations: Industrial Development Bonds*, 25 TAX LAW. 511, 513 (1972) (general discussion of IDB financing structure) [hereinafter cited as Ritter].

8. *See* ADVISORY COMMISSION, *supra* note 1, at 37. Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, there were no restrictions on the type of facility, commercial or residential, that could be financed with tax-exempt IDBs. See *infra* notes 108-25 for a discussion of the restrictions imposed by TEFRA and notes 126-95 for the restrictions imposed by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

9. Ritter, *supra* note 7, at 513; Note, *The Limited Tax Exempt Status of Interest on Industrial Development Bonds Under Subsection 103(c) of The Internal Revenue Code*, 85 HARV. L. REV. 1649, 1650 (1972) [hereinafter cited as *Exempt Status*].

10. Ritter, *supra* note 7, at 513. Opponents of tax-exempt IDB financing persuasively argue that the debtor, in reality, is the private company which will use the facility constructed with the proceeds of the bond. Hence, interest paid on IDBs should not be exempt under section 103(a) of the Code. *See infra* notes 44-63.

11. Two basic theories explain the industrial location decision making process: revenue maximization and cost minimization. Under the former, firms locate in areas with the maximum demand for their product. Under the latter, firms build

for the purposes of promoting economic development[12] and alleviating unemployment.[13]

New industries can be attracted to a community because IDBs offer significant economic advantages for private companies.[14] Under certain circumstances, interest paid on the bonds is exempt from federal income taxation.[15] The bonds' tax-exempt status allows the municipality to borrow at an interest rate approximately two to four percent below that paid on the lessee's taxable bonds.[16] The reduction in financing costs is passed on to the private enterprise in the form

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facilities where the costs are lowest. Synthesized, companies locate where the difference between the two are the greatest. Note, *State and Local Industrial Location Incentives—A Well Stocked Candy Store*, 5 J. CORP. L. 517, 522 (1980) [hereinafter cited as *Location Incentives*]. IDBs affect the latter by reducing the cost of acquisition or construction. Despite the fact that IDB financing can result in substantial cost savings to industry its effectiveness in inducing new industrial location is uncertain. *Id.* at 545. In Mississippi, as a result of an industrial development program, enough companies were attracted to the state to increase manufacturing employment forty percent between 1957 and 1965. 114 CONG. REC. 7688 (1968) (statement of Senator Eastland). Senator Hollings, however, contends that his state, South Carolina, competed with Mississippi for industry and for four years attracted more industry than Mississippi without issuing IDBs. *See* 114 CONG. REC. 7686 (1968) (statement of Senator Hollings).

12. *See* ADVISORY COMMISSION, *supra* note 1, at 3-4. Initially IDBs were predominantly issued by underdeveloped states such as Alabama, Arkansas, Kentucky, and Mississippi. *Exempt Status, supra* note 9, at 1651 n.13. These states had surplus farm labor problems. *See* ADVISORY COMMISSION, *supra* note 1, at 38. IDBs have cured these problems to some extent. *See* discussion *supra* note 11.

13. *See* ADVISORY COMMISSION, *supra* note 1, at 3-4. "[T]he beneficial impact on employment is proportionately most significant in smaller projects financed by IDBs; as the size of the projects increases their relative return in creating jobs diminishes." *Exempt Status, supra* note 9, at 1660.

14. Non-economic attractions offered by a community include the existence of a skilled labor force, the availability of raw materials, utilities and transportation. ADVISORY COMMISSION, *supra* note 1, at 14. These factors are given primary attention when a firm chooses a new plant location. They are determinative when the firm is choosing among nations or regions of a country. *Location Incentives, supra* note 11, at 522-24. Once a region has been selected, factors such as financial incentives, taxes, and business climate play an important role in the selection of a particular community within the region. *Id.*

15. *See infra* notes 64-101.

16. *Location Incentives, supra* note 11, at 536 n.150. The yield differential between tax-exempt and taxable bonds depends on the supply of each and the amount of tax which is expected to be avoided. Assuming that the supply of each is equivalent and will remain constant, the differential then depends upon the marginal tax rate. For example, if an investor is in the fifty percent bracket a tax exempt bond of eight percent will net him the same as a taxable bond paying sixteen percent. As the investor's marginal tax rate decreases the spread narrows. Therefore, municipal bonds can be marketed at a lower interest rate than corporate bonds. *See generally* Note, *The Taxability of State and Local Bond Interest by the Federal Government*, 38 U. CIN. L. REV. 703 (1969) (discussion of municipal obligations).

of lower rental payments.[17] Thus, under a long term lease with an option to purchase, the lessee has acquired a newly constructed facility at a discounted price.[18] Moreover, for tax and accounting purposes, the tenant treats the lease arrangements as a purchase allowing the company to deduct a reasonable allowance for the structure's depreciation.[19] In most circumstances, lessees also are relieved of the burdensome expense of registration under the Securities Act of 1933[20] as well as state and local property taxes.[21]

IDBs were developed in what has been characterized as a counterrevolutionary response to state constitutional limitations which restricted the ability of certain states and their political subdivisions to aid private entities by incurring debt.[22] In 1936, Mississippi became

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17. *See supra* note 9 and accompanying text.

18. The discount is the difference between the interest paid on the lessee's taxable bonds multiplied by the costs being financed and the interest paid on the issuer's tax-exempt bonds multiplied by the costs being financed.

19. The Code provides that "there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income." I.R.C. § 167(a) (1982). As a general rule, lessees with leases for thirty years or longer are treated as the owner of the facility for depreciation purposes. Rev. Rul. 68-590, 1968-2 C.B. 66.

20. As long as the IDBs are exempt from federal income taxation they are exempt from registration pursuant to § 3(a)(2) of the Securities Act of 1933. *See* [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,924 (Nov. 6, 1970) (discussion of IDB exemption from registration); *see also* 15 U.S.C. § 77(c)(a)(2) (1982).

21. Generally, the facilities are owned by the issuing governmental unit, which invariably is exempt from state and local property taxes. *Location Incentives, supra* note 11, at 537. Often these property tax exemptions offer the lessee more in terms of reduced costs than the reduced financing costs attributable to IDBs. *See id.* Many states require the lessee to pay additional rental in an amount equal to what the taxes would be if the project was taxable. *See* Mumford, *The Past, Present and Future of Industrial Development Bonds*, 1 URB. LAW. 147 (1969) [hereinafter cited as Mumford].

22. Pinsky, *State Constitutional Limitations On Public Industrial Financing: An Historical and Economic Approach*, 111 U. PA. L. REV. 265 (1963). The restrictions can be classified into four categories: (1) the imposition of debt ceilings; (2) the creation of restrictive procedures for incurring debt, e.g., electorate approval; (3) the imposition of credit clauses which prohibit loans or donations to private individuals or corporations; and (4) restrictions on the purposes for which public funds could be expended or for which taxes could be levied and debt incurred. *Id.* at 277-81. Many of the early programs did not present a constitutional problem because they were based on newly adopted constitutional amendments. *Id.* at 265-66. Others did present a constitutional problem which was resolved by the respective

the first state to successfully invoke the interest exemption[23] when it authorized the issuance of IDBs to finance the acquisition of land and the construction of commercial facilities for lease or operation by the issuing municipality.[24] Ten years elapsed, however, before the next state, Kentucky, established a similar program.[25] Pioneering the industrial revenue bond,[26] Kentucky authorized the issuance of bonds which were to be repaid solely from rents received from the lessee of the facility.[27] In 1949, Alabama revolutionized the technique by approving the formation of industrial boards which could issue bonds for the purpose of inducing industrial location.[28] Notwithstanding these innovations, IDB financing expanded only gradually during

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state court. *See* Albritton v. City of Winona, 181 Miss. 75, 107, 178 So. 799, 807, *appeal dismissed,* 303 U.S. 627 (1938). In *Albritton*, the court ruled that the program was constitutional because the user of the financed facility was merely an agent of the municipality, and, therefore, the bonds were indeed issued for a public purpose. *Id.*

23. Generally, interest paid on obligations of states and municipalities is exempt from taxation under I.R.C. § 103(a) (1982). *See infra* notes 31-32.

24. 1936 Miss. Laws, 1st Ext. Sess. ch. 1. The constitutionality of the program was upheld in *Albritton*, 181 Miss. 75, 178 So. 799, *appeal dismissed,* 303 U.S. 627 (1938). Prior to *Albritton*, the Supreme Court on several occasions had invalidated bond issues because the proceeds were found to be for a private purpose and not a "public purpose." Cole v. La Grange, 113 U.S. 1 (1885); Parkersburg v. Brown, 106 U.S. 487 (1883). Following the "public purpose" doctrine, courts in Tennesee and Mississippi ruled that their states were precluded from issuing bonds to induce industrial locations. Ferrell v. Doak, 152 Tenn. 88, 275 S.W. 29 (1925); Caruthers v. Town of Booneville, 169 Miss. 511, 153 So. 670 (1934). In *Albritton*, however, the Mississippi court approved the issuance of industrial development bonds because the public purpose of aiding industry was legislatively declared. *Albritton*, 181 Miss. at 83, 178 So. at 805. Moreover, the Supreme Court dismissed the appeal for lack of a substantial federal question, thus precluding further federal court review of the validity of IDB financing. *Albritton*, 303 U.S. 627.

25. KY. REV. STAT. §§ 103.200 to .285 (1982 & 1984 Supp.) (enacted 1946). The legislative authorization for the plan was upheld in Faulconer v. City of Danville, 313 Ky. 468, 232 S.W.2d 80 (1950).

26. See *supra* note 2 for a discussion of the difference between general obligation IDBs and revenue IDBs (IRBs). The Mississippi program, *supra* notes 23 and 24, involved bonds which were secured by the full faith and credit of the issuing unit. While technically there is a distinction between IDBs and IRBs, section 103(b)(2) of the Code does not draw a distinction and the regulations hold that the distinction is without tax effects. I.R.C. § 103(b)(2) (1982); Treas. Reg. § 1.103-7(b)(4), T.D. 7869, 1983-1 C.B. 18 (1983).

27. KY. REV. STAT. §§ 103.200 to .285 (1982 & 1984 Supp.) (enacted 1946).

28. ALA. CODE tit. 11, §§ 11-54-80 to -101 (1975 & 1984 Supp.) (enacted 1949). For the first time, the function of inducing industrial development was severed from the other operations of the municipality.

the forties and fifties.[29] During the sixties, however, IDB financing mushroomed.[30]

B. Tax Treatment of Interest on IDBs Prior to 1968

The most significant factor in the development of IDB financing was the tax treatment afforded interest paid on the bonds. In 1895, the Supreme Court ruled that the tenth amendment prohibited imposition of a federal tax on income derived from state and municipal bonds.[31] Accordingly, the federal income tax laws, when drafted in 1913, excluded interest on municipal bonds from gross income.[32] The Internal Revenue Service (IRS) did not publicly recognize the tax-exempt status of IDBs, however, until 1954 when it determined that these bonds were exempt even though the financed facilities would be leased to a private enterprise, and interest on the bonds

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29. The annual totals for all forms of IDBs, in millions of dollars, are as follows:

Year	Amount	Year	Amount
Pre 1951	7.25	1965	216.16
1951	9.62	1966	504
1952	7.60	1967	1315
1953	5.27	1968	1606
1954	5.02	1969	51
1955	7.28	1970	115
1956	8.23	1971	207
1957	7.08	1972	335
1958	25.84	1973	573
1959	17.99	1974	493
1960	41.02	1975	455
1961	41.27	1976	484
1962	65.93	1977	4697
1963	119.78	1978	2522
1964	192.64	1979	3837

Location Incentives, supra note 11, at 535 n.140.

30. *See* chart, *supra* note 29.

31. Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895). In *Pollock*, certain provisions of the Revenue Act of 1894, Act of 1894 ch. 349, § 28, 28 Stat. 509, 553-54 (1895), were declared unconstitutional. The Court concluded that the Act's tax on income derived from municipal bonds was a tax on the power of the states to borrow money and, therefore, was repugnant to the Constitution. *Id.* at 586. See *infra* notes 196-232 and accompanying text for a discussion of the vitality of the *Pollock* decision.

32. The interest exemption was initially codified in the original income tax act, the Revenue Act of 1913. Pub. L. No. 63-16, ch. 166, 38 Stat. 114, 168 (1913). It is now found in § 103(a) which provides that "[g]ross income does not include interest on—(1) the obligations of a State . . . or any political subdivision of . . . the foregoing. . . ." I.R.C. § 103(a) (1982).

would be paid solely from the lease revenues.[33] Revenue Ruling 57-187,[34] issued in 1957, expanded the scope of the IDB tax exemption to include interest on obligations issued by industrial development authorities pursuant to enabling legislation.[35]

While these determinations had a slight impact on the growth of IDB issues,[36] Revenue Ruling 63-20,[37] was the impetus to a substantial increase in IDB financing.[38] This ruling set out prospective guidelines to be met by industrial development authorities for their bonds to qualify for tax-exempt status.[39] The proliferation of IDB-financed projects dismayed Congress[40] and the Treasury Depart-

33. Rev. Rul. 54-106, 1954-1 C.B. 28.

34. Rev. Rul. 57-187, 1957-1 C.B. 65.

35. *Id.* The IRS ruled that bonds issued by an industrial development board formed pursuant to Alabama legislative authority, *see supra* note 28, are considered issued on behalf of a municipality and interest thereon is exempt from federal income taxes under I.R.C. § 103(a). Rev. Rul. 57-187, *supra* note 34.

36. *See* chart, *supra* note 29.

37. Rev. Rul. 63-20, 1963-1 C.B. 24.

38. *See* chart, *supra* note 29. The practice spread to industrialized states such as Michigan and Ohio. Both the number and the size of issues grew markedly. *Exempt Status, supra* note 9, at 1651.

39. In 1956, the I.R.S. promulgated Treas. Reg. § 1.103-1, T.D. 6220, 1957-1 C.B. 35, 38, which expanded I.R.C. § 103(a) to exempt obligations issues "on behalf of" a state. *Id.* Under Rev. Rul. 63-20, if a non-profit corporation was formed under a state's general non-profit corporation law for the purpose of stimulating industrial development and satisfied five requirements, its bonds would be considered as being issued "on behalf of" the state for purposes of Treas. Reg. § 1.103-1. Rev. Rul. 63-20, *supra* note 37. The five requirements were the following: (1) the corporation must engage in activities which are essentially public in nature; (2) the corporation must be one which is not organized for profit; (3) the corporate income must not inure to any private person; (4) the state or its political subdivisions must have a beneficial interest in the corporation while the indebtedness remains outstanding, and it must obtain full legal title to the corporation's property with respect to which the indebtedness was incurred upon the retirement of such indebtedness; and (5) the corporation must have been approved by the state or political subdivision thereof, either of which must also have approved the specific obligations issued by the corporations. *Id.*; 1963-1 C.B. at 24. One commentator referred to this ruling as "a kind of . . . industrial revenue bond legislation." Nelson, *Tax Considerations of Municipal Industrial Incentive Financing*, 45 TAXES 941, 944 (1967).

40. Representative John Byrnes introduced legislation to amend § 103(a) to exclude from the exemption future IDBs, and commented that IDBs

> pervert the tax-exemption privilege enjoyed by State and municipal governments. The exemption privilege . . . was never intended as a means whereby private corporations could borrow money at low interest rates using governmental units as an "umbrella" . . . . This practice . . . makes a mockery of our tax laws. The tax-exempt status of interest on municipal bonds must be limited to legitimate governmental functions where it is the credit of the municipality that supports the bond not the credit of some second party beneficiary.

ment[41] and caused scrutinization of this "truckhole"[42] in the law.[43] Debate over remedial measures and reform to narrow the "truckhole" soon followed.

Proponents of reform raised many cogent objections to the tax exemption for IDBs. First, the exemption was considered a perversion of the tax law since the private enterprise was actually the obligor and the issuing governmental unit a mere conduit for tax-exempt financing.[44] Second, the exemption eroded the federal tax base by excluding a substantial block of capital.[45] Moreover, the resulting loss in federal tax revenues often exceeded the additional federal revenues produced by the industrial expansion.[46] In effect, the IDB tax exemption became an indirect federal subsidy because the federal government's loss resulted in the private enterprise's gain.[47] This indirect federal subsidy was without federal controls,[48] undercut those competitors who financed their own plant construction[49] and was

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113 CONG. REC. 19,877 (1967). Senator Abraham Ribicoff, introducing a companion bill, added that the abuses were "undermining the usefulness of this method of helping our State and local government finance their functions at the lowest possible cost." 113 CONG. REC. 31,612 (1967).

41. The Treasury Department in Technical Information Release No. 972, dated March 6, 1968, announced that it was reconsidering its position on the applicability of § 103 to IDBs because the corporation was, in reality, the primary obligor. STAND. FED. TAX REP. (CCH) ¶ 6648 (1968). Proposed regulations providing that interest on IDBs would no longer be exempt from gross income were published on March 23, 1968. Proposed Treas. Reg. 4950 (1969). Congress obviated promulgation by passing the Revenue and Expenditure Control Act of 1968. Pub. L. No. 90-364; 82 Stat. 251, 266-68 (1968); *see infra* notes 64-107.

42. Spiegel, *Financing Private Ventures With Tax-Exempt Bonds: A Developing "Truckhole" In The Tax Law*, 7 STAN. L. REV. 224 (1965).

43. *Id.*

44. *See supra* notes 40-41.

45. *See* McDaniel, *Federal Income Taxation Of Industrial Bonds: The Public Interest*, 1 URB. LAW. 157, 163-64 (1969) [hereinafter cited as McDaniel].

46. The government[']s revenue loss . . . is partially offset . . . by the revenue gain resulting from the fact that the private business enterprise which receives the benefits of tax-exempt borrowing . . . is a taxable entity. To the extent that tax-exempt borrowing increases the business firm's taxable net income, its [f]ederal tax liability is increased.

ADVISORY COMMISSION, *supra* note 1, at 13 n.2.

47. The enterprise does not receive all the benefits of the federal revenue loss. The purchaser of the bonds receives tax-exempt income. *See* McDaniel, *supra* note 45, at 163-64.

48. *See* Hendricks, *Reconsideration of Industrial Development Bond Income Tax Exemption*, 48 OR. L. REV. 168, 179-81 (1969) [hereinafter cited as Hendricks]. Opponents contend that this is an argument in favor of the tax exemption since states and municipalities have the right to make their own determinations about industrial development. *Id.*

49. *Id.* at 182. A company which uses IDBs gains a competitive advantage in

inefficient because lost federal tax revenues exceeded the benefits derived by the private enterprise.[50] Third, proponents of reform contended that the IDB exemption undermined the municipal bond tax exemption.[51] IDBs exhaust the available market for tax-exempt bonds and inflate interest rates thereby increasing the costs of state and local borrowing for traditional public purposes.[52] Thus, taxpayers are burdened either by increased taxes to meet increased financing costs or reduced governmental services.[53] Fourth, the exemption was regressive and counteracted the progressive nature of the tax structure.[54] Lastly, the IDB was "a weapon in the war raging among our States and municipalities to win new industries by offering subsidies and special privileges."[55] This process of pirating industry wasted valuable resources and had a tendency to cause communities to neglect longer range economic development.[56]

Opponents of reform felt that the exemption was successful in reducing rural unemployment.[57] Many depressed areas had untrained work forces, lacked proper facilities to lease to companies and had

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at least two ways: (1) rental for the facilities is lower than fair market value rentals; and (2) the plant is generally exempt from state and local property taxes. TAX REVISION COMPENDIUM, COMMITTEE ON WAYS AND MEANS 729, 731 (1959) (statement of Solomon Barkin) [hereinafter cited as TAX COMPENDIUM].

50. *Location Incentives, supra* note 11, at 544-45; *Exempt Status, supra* note 9, at 1664-66. The difference between the two figures "leaks" to the purchaser. *See supra* note 44 and accompanying text.

51. *See supra* note 47 and accompanying text.

52. *See* 114 CONG. REC. 7681 (statement of Senator Proxmire). In 1967, it was estimated that tax-free IDBs "raised the cost of local government borrowing on full-faith-and-credit bonds by about [one quarter of one] percent, and the cost of other local government borrowing by . . . twice that much . . . ." *Id.* at 7682 (statement taken from panel discussion at the Investment Bankers Association's Convention held in December, 1967)..

53. Hendricks, *supra* note 48, at 179-80 (discussion of general objections to tax-exempt IDB financing).

54. *Exempt Status, supra* note 9, at 1652. *But see* TAX COMPENDIUM, *supra* note 49, at 763-66 (statement of Cushman McGee).

55. *Id.* at 733 (statement of Solomon Barkin). Many of the northern industrialized states joined with organized labor to oppose IDB financing on this ground. *See* 114 CONG. REC. 7686 (statement of Senator Clark of Pennsylvania and resolution of AFL-CIO submitted by Senator Clark).

56. TAX COMPENDIUM, *supra* note 49, at 733-34 (statement of Solomon Barkin). When companies are pirated away from a community, many people are left unemployed and facilities left unused. When, however, IDB financing results in industrial expansion, the opposite is true. *See generally* 114 CONG. REC. 7688 (statement of Senator Eastland). Evidence gathered during the sixties indicates that plant pirating is the exception and not the general rule. ADVISORY COMMISSION, *supra* note 1, at 14.

57. See *supra* note 11 for a discussion of the alleged impact of IDB financing on rural unemployment.

insufficient resources to sustain industrial development.[58] Therefore, to attract industry and to have any chance of alleviating unemployment, these areas needed IDB financing.[59] Creating jobs in these communities also helped to reduce emigration to urban centers.[60] Furthermore, it was improper for Congress to restrict the practice since the power of states, local governments and their political subdivisions was "being exercised in the financing of public purposes as determined by the highest courts of the respective States."[61] Ultimately, the debate led to the enactment of section 107 of the Revenue and Expenditure Control Act of 1968 (Act of 1968)[62] which eliminated some of the undesirable aspects of IDB financing and, at the same time, retained its perceived benefits.[63]

III. The Tax-Exempt Status of IDBs Prior to the Enactment of the Deficit Reduction Act of 1984

A. The 1968 Reform

The Revenue and Expenditure Control Act of 1968 vitiated the undesirable aspects of IDB financing by eliminating the federal tax exemption for interest earned on IDBs.[64] Moreover, it retained the benefits of IDBs by reserving the small issue exemption[65] and the activities exemption[66] from the general rule of taxability. Inquiry

58. ADVISORY COMMISION, *supra* note 1, at 38-40.

59. *See* 114 CONG. REC. 7686-87 (statement of Senator Fulbright). IDB financing is a desirable method of inducing industrial location because the state or community's out-of-pocket costs are minimal. *Location Incentives, supra* note 11, at 554. See *supra* notes 14-21 and accompanying text for a discussion of the economic attractions of IDB financing from the perspective of a private company.

60. *Exempt Status, supra* note 9, at 1655. The flight of laborers from rural areas to cities is well documented. *See* J. HEILBRUN, URBAN ECONOMICS AND PUBLIC POLICY 48-55 (1974) (discussion of migration and urban growth).

61. TAX COMPENDIUM, *supra* note 49, at 766 (statement of Cushman McGee). See *supra* note 24 for a discussion of the genesis of the public purpose doctrine and its application to states' financing activities.

62. Pub. L. No. 90-364, § 107(a), 82 Stat. 251, 266-68 (1968).

63. *Exempt Status, supra* note 9, at 1655-57.

64. Section 103(a) excludes from gross income interest on certain governmental obligations. I.R.C. § 103(a) (1982); *see supra* notes 31-32. Section 103(b)(1) provides that "(except as otherwise provided) . . . any industrial development bond shall be treated as an obligation not described in subsection [103](a)(1) or (a)(2)." I.R.C. § 103(b)(1) (1982).

65. The small issue exemption is codified in I.R.C. § 103(b)(6) (1982). See *infra* notes 94-101 and accompanying text for a discussion of this provision.

66. The activities exemption is codified at sections 103(b)(4) and (b)(5) of the Code. I.R.C. § 103(b)(4), (b)(5) (1982). See *infra* notes 83-93 for a discussion of these provisions.

into the availability of these exemptions is necessary only after it is determined that the obligations meet the statutory definition of "industrial development bond."[67]

Section 103(b)(2) of the Internal Revenue Code of 1954 (the Code)[68] defines "industrial development bond" as any obligation:

> (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. . . and (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—(i) secured by an interest in property used or to be used in a trade or business or in payments in respect of such property, or (ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.[69]

The Treasury regulations characterize the requirements of subsection 103(b)(2)(A) as the "trade or business test"[70] and the requirements of subsection 103(b)(2)(B) as the "security interest test."[71] Both of these tests must be satisfied before a governmental obligation, normally tax-exempt, is deemed to be a taxable IDB.[72]

The trade or business test focuses on the use of the proceeds of the bond issue and prevents financing of most corporate expansions with tax-exempt IDBs.[73] If all or a major portion of the proceeds of the issue are used directly or indirectly in a trade or business of a nonexempt person, the test is satisfied.[74] The regulations define

67. *See generally* I.R.C. § 103(b) (1982) (general Code provisions affecting IDBs).

68. I.R.C. § 103(b)(2) (1982).

69. I.R.C. § 103(b)(1) (1982); *see supra* note 64.

70. Treas. Reg. § 1.103-7(b)(3), T.D. 7869, 1983-1 C.B. 18; *see infra* notes 73-76 and accompanying text.

71. Treas. Reg. § 1.103-7(b)(4), T.D. 7869, 1983-1 C.B. 18; *see infra* notes 77-82 and accompanying text.

72. *See generally* I.R.C. § 103(b)(2) (1982) (Code definition of IDB).

73. *Exempt Status*, *supra* note 9, at 1657.

74. In determining whether a debt obligation meets the trade or business test, the indirect, as well as the direct, use of the proceeds is to be taken into account. For example, the debt obligations comprising a bond issue do not fail to satisfy the trade or business test merely because the State or local governmental unit uses the proceeds to engage in a series of financing transactions for property to be used by private business users in trades or businesses carried on by them. Similarly, if such proceeds are to be used to construct facilities to be leased or sold to any nonexempt person for use in a trade or business it carries on . . . the debt obligations comprising such issue satisfy the trade or business test.

Treas. Reg. § 1.103-7(b)(3)(ii), T.D. 7869, 1983-1 C.B. 18.

a "major portion" as "more than 25 percent of the bond proceeds."[75] A nonexempt person is any person who uses the proceeds of the issue in a related trade or business other than a governmental unit or a tax-exempt organization described in section 501(c)(3).[76]

Satisfaction of the "trade or business test" alone will not result in IDB characterization since the "security interest test" also must be met. The "security interest test" looks to the nature of the security and the source of payment for the principal or interest on the obligation.[77] It seeks to curtail the classic IDB financing arrangement where the bonds are secured only by the project and the revenues it produces.[78] If, as determined by the bond indenture[79] or the underlying agreement,[80] all or a major portion of the payment of the principal or interest is secured either by an interest in or derived from payments with respect to property or borrowed money used in a trade or business, the "security interest test" has been met.[81] For purposes of this test, a "major portion" is twenty-five percent.[82] The major consequence of satisfying both the "trade or business test" and the "security interest test" is that interest on the obligation is not tax-exempt under section 103(a)[83] unless it qualifies for one of the exceptions to the general rule.

Once it is detemined that an obligation is an IDB within the meaning of section 103(b)(2),[84] attention must be focused on qualifying it for one of the statutory tax exemptions. One of the tax

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75. Treas. Reg. § 103-7(b)(3)(iii), T.D. 7869, 1983-1 C.B. 18.

76. Section 103(b)(3) defines an exempt person as:

> (A) a governmental unit, or (B) an organization described in section 501(c)(3) and exempt from tax under section 501(a) (but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business, determined by applying section 513(a) to such organization).

I.R.C. § 103(b)(3) (1982).

77. Treas. Reg. § 1.103(b)-7(b)(4), T.D. 7869, 1983-1 C.B. 18.

78. *See supra* notes 7-13 and accompanying text.

79. A bond indenture is "a written agreement under which bonds . . . are issued, setting forth maturity date, interest rate, and other terms." BLACK'S LAW DICTIONARY 693 (5th ed. 1979).

80. To ascertain the nature of the security and source of payment for the debt service, the security interest test also requires an examination of any underlying agreement as determined by the separate agreement of the parties of the facts and circumstances surrounding the issuance. Treas. Reg. § 1.103-7(b)(4), T.D. 7869, 1983-1 C.B. 18.

81. *Id.*

82. *See supra* note 75.

83. I.R.C. § 103(a) (1982).

84. I.R.C. § 103(b)(2) (1982).

exemptions for interest on IDBs arises where the proceeds of the IDBs are used for certain exempt activities.[85] This exemption reflects a congressional determination not to impede the use of IDBs to finance certain activities.[86] Two alternative rationales have been advanced for its existence.[87] "The first . . . assume[s] . . . a federal interest in encouraging private parties to undertake projects in the areas of the activities specified. . . . Under this assumption, the exemption[] can be viewed as a subsidy program . . ."[88] designed to induce participation through a reduction in financing costs.[89] The second rationale is that the activities exempted are the type which state or local governments have traditionally undertaken.[90] Thus, consistency and notions of federalism require that the treatment of the bonds used to finance these activities be the same as the treatment afforded bonds which finance ordinary government activities.[91]

Under the activities exemption, interest on IDBs is tax-exempt if the bond proceeds are used to finance: (1) low income residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities or parking facilities relating thereto; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of water; (6) qualified hydro-electric generating facilities; (7) qualified mass commuting vehicles; or (8) local district heating or cooling facilities.[92] Addi-

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85. I.R.C. § 103(b)(4), (b)(5) (1982).

86. This exemption may be required by the Constitution. *See infra* notes 215-32.

87. *Exempt Status, supra* note 9, at 1664.

88. *Id.*

89. *Id.*; *see supra* notes 15-18 and accompanying text.

90. *Exempt Status, supra* note 9, at 1666.

91. *Id.*

92. I.R.C. § 103(b)(4) (1982). In addition to financing one of the exempt activities to qualify for this exemption, the following rules must be satisfied: (1) substantially all of the proceeds must be used to finance the exempt activity, Treas. Reg. § 103-8(a)(4), T.D. 7869, 1983-1 C.B. 18 ("substantially all" test); (2) the facility must be available on a regular basis for general public use or is to be part of a facility which meets this requirement, Treas. Reg. § 1.103-8(a)(2), T.D. 7869, 1983-1 C.B. 18 ("public use" requirement); and (3) ninety percent or more of the bond proceeds must be for facilities constructed after the adoption of a bond resolution or some other official action by the issuer indicating its present intent to issue the bonds. Treas. Reg. § 1.103-8(a)(5), T.D. 7869, 1983-1 C.B. 18 (timing requirement). The timing requirement prevents reimbursement of costs incurred prior to official action and is sometimes referred to as the "official action" requirement. The treasury regulations define "substantially all" as ninety percent or more of the proceeds of a issue. Treas. Reg. § 1.103-8(a)(1), T.D. 7869, 1983-1 C.B. 18 (1983).

tionally, interest on IDBs used to acquire or develop land as a site for an industrial park is exempt.[93]

If a project is not an exempt activity, it may still qualify for the small issue exemption, which is designed to preserve IDB financing as a method of combating unemployment.[94] The law provides a tax exemption for interest on IDBs if the aggregate authorized face amount of the IDBs together with certain outstanding prior issues[95] is one million dollars or less and ninety percent or more of the proceeds[96] are used to acquire, construct, or improve land or depreciable property.[97] Alternatively, if the issue does not qualify as a one million dollar small issue because the dollar limit is exceeded, the issuer may elect to use a ten million dollar small issue exemption.[98] To qualify for the election, however, the sum of the face amount of the issue together with certain prior outstanding issues[99] and certain capital expenditures[100] must not exceed ten million dollars.[101]

The exemptions authorized under the Act of 1968 were very broad, permitting the tax-exempt financing for an infinite variety of projects.[102] Because of the ceiling placed on IDBs by the small issue exemptions, the volume of IDBs fell precipitiously in the years immediately following the passage of the Act.[103] Soon, however, the

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93. I.R.C. § 103(b)(5) (1982). To qualify for this exemption the issue must satisfy the "substantially all" test, and the "public use" and "official action" requirements. *See supra* note 92.

94. *Exempt Status, supra* note 9, at 1660-62; *see supra* note 13.

95. Any prior tax-exempt small issue must be taken into account if the proceeds were used primarily to finance a facility in the same jurisdiction and if the principal user of both facilities is the same entity or a related person. I.R.C. § 103(b)(6)(B) (1982).

96. Section 103(b)(6)(A) requires that

> substantially all of the proceeds [be] used (i) for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or (ii) to redeem part or all of a prior issue which was issued for purposes described in clause (i) or this clause.

I.R.C. § 103(b)(6)(A) (1982).

97. *Id.*

98. I.R.C. § 103(b)(6)(D) (1982).

99. Those issues considered under § 103(b)(6)(B) are also considered under § 103(b)(6)(D). I.R.C. § 103(b)(6)(D)(ii) (1982); *see supra* note 95 and accompanying text.

100. Capital expenditures "paid or incurred during the six year period beginning three years before the date of such issue and ending three years after such date" are considered in determining whether or not the ten million dollar limit is met. I.R.C. § 103(b)(6)(D)(ii) (1982).

101. I.R.C. § 103(b)(6)(D) (1982).

102. *See generally* I.R.C. § 103(b)(6) (1982) (small issue exemption).

103. *Location Incentives, supra* note 11, at 543.

overall volume of IDBs reached a new high.[104] From 1962 to 1982, the volume of IDBs increased almost seven-fold to forty-four billion dollars.[105] Moreover, the amount of IDBs and other private bonds as a percentage of total borrowing by states and localities increased from 21 to 51.7%.[106] The growth of IDBs concerned Congress because of increasing federal revenue losses and its tendency to inflate tax-exempt interest rates.[107]

B. The 1982 Reform

In 1982, Congress responded by further restricting the issuance of tax-exempt IDBs. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[108] imposed several new restrictions and requirements on IDBs.[109] It restricted small-issue IDBs in several ways. First, it added a "sunset provision"[110] withdrawing the small issue exemption from obligations issued after December 31, 1986.[111] Second, the "piggy-backing"[112] of the one million dollar small issue was prohibited.[113] The ten million dollar exemption, however, remains available for combined issues.[114] Third, the exemption was eliminated for

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104. *Id.*

105. H.R. REP. No. 432, 98th Cong., 2d Sess. 612 [hereinafter cited as H. REP. No. 432].

106. *Id.*

107. *Id.*

108. Pub. L. No. 97-248, 96 Stat. 324 (1982).

109. TEFRA imposed general restrictions which apply to all § 103 obligations and specific ones which apply solely to obligations classified as industrial development bonds. One general restriction is that certain tax-exempt obligations must be issued in registered form to retain their tax-exempt status. I.R.C. § 103(j) (1982) (added by § 310(b)(1) of TEFRA); *see infra* notes 225-28.

110. A sunset law is "a statute which requires administrative bodies to justify periodically their existence to [the] legislature." BLACK'S LAW DICTIONARY 1288 (5th ed. 1979).

111. I.R.C. § 103(b)(6)(N)(i) (1982) (added by § 214(c) of TEFRA).

112. "Piggy-backing" is a practice whereby the one million dollar small issue is combined with an exempt activity issue, with the one million dollars being used to finance a part of the project which does not qualify for the activities exemption. Under the law prior to TEFRA, proceeds of IDBs used to finance exempt activities were not taken into account when determining if the small issue limits were met. *See* Treas. Reg. § 1.103-10(d), T.D. 7840, 1982-2 C.B. 38. Therefore, piggy-backing was permitted.

113. Section 103(b)(6)(M) provides that the small issue exemption is not available if the obligation "is issued as part of an issue (other than an issue to which subparagraph (D) applies) if the interest on any other obligation which is part of such issue is excluded from gross income under any provision of law other than this paragraph.". I.R.C. § 103(b)(6)(M) (1982) (added by § 214(b) of TEFRA).

114. While a small issue cannot be tacked on to an exempt activities issue, it can be used in conjunction with a ten million dollar small issue. *Id.*

bonds issued after December 31, 1982, if (1) more than twenty-five percent of the proceeds of the issue are used to provide a facility the primary purpose of which is retail food and beverage services, automobile sales or service or the provision of recreation or entertainment; or (2) any portion of the proceeds is used to provide golf courses, country clubs, massage parlors, racquet sport facilities, skating facilities, hot tub or sun tan facilities or racetracks.[115]

In addition to restricting the small issue exemption, TEFRA made several general changes in the rules concerning IDBs. First, it required issuers to make quarterly information reports to the IRS.[116] Second, TEFRA required that IDB issuances be approved either by an elected official in the issuing jurisdictions where the facilities would be located or by voter referendum.[117] Third, TEFRA required that property placed into service on or after January 1,1983 be depreciated using the straight line method.[118] Low income residential rental property, public sewage or solid waste disposal facilities, air or water pollution control facilities and facilities with respect to which an Urban Development Action Grant (UDAG) has been made, however, could be depreciated under accelerated formulas.[119]

The TEFRA limitations restricted the benefits associated with certain IDB-financed projects and eliminated some of the worst abuses associated with IDBs.[120] Yet, as Congress increasingly tried to curtail these abuses, the rate at which IDBs were issued by state and local governments also increased.[121] In 1983, approximately twenty-eight billion dollars in IDBs were issued, which was roughly double the amount issued in 1980.[122] Moreover, IDBs cost the federal government nearly five billion dollars in foregone revenues in fiscal

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115. I.R.C. § 103(b)(6)(O) (1982) (added by § 214(e) of TEFRA).

116. I.R.C. § 103(l) (1982) (added by § 215(b)(1) of TEFRA). These reporting requirements also apply to issuers of IDBs and issuers of other obligations. *Id.* Although an issue of IDBs fits into one of the statutory exemptions, interest thereon will not be exempt unless the requirements of this section are met. *Id.* Generally, the section requires issuers to report information concerning the obligations issued, the issuer, and the private company which is to use the finance facility. *Id.*

117. I.R.C. § 103(k) (1982) (added by § 215(a) of TEFRA). This is commonly referred to as the public approval requirement.

118. I.R.C. § 168(f)(12)(A), (B) (1982) (added by § 216(a) of TEFRA).

119. I.R.C. § 168(f)(12)(C) (1982) (added by § 216(a) of TEFRA). *See infra* notes 153-56 for discussion of changes in the depreciation rules enacted under the Deficit Reduction Act.

120. H. REP. No. 432, *supra* note 105, at 612.

121. Saunders, *"$150 A Head, and Not A Penny More,"* FORBES, Nov. 19, 1984, at 56.

122. *Id.*

year 1984.[123] In response to this dilemma and to prevent further unrestrained growth in IDBs, Congress enacted new limitations and restrictions on the issuance of IDBs as part of the Deficit Reduction Act of 1984.[124] This Note continues with an evaluation of the new "IDB killing provisions"[125] and concludes with analysis mandating the retention of tax-exempt IDB financing.

IV. The Deficit Reduction Act of 1984

To further curtail unrestrained growth in IDBs, the Tax-Exempt Bond Provisions[126] of the Deficit Reduction Act of 1984 (1984 Act) place extirpative restrictions and limitations on the issuance of IDBs.[127] Congress restricted both the supply of and demand for these obligations. The former is achieved through a state wide ceiling on the issuance of tax-exempt private activity bonds.[128] Restrictions on the users of the bonds proceeds and the projects which could be financed accomplishes the latter.[129]

The maximum amount of private activity bonds that a state and its localities can issue per calendar year is the greater of (1) $150 multiplied by the state's population and (2) $200 million dollars.[130] The $150 ceiling will continue until 1987 when it will be reduced to $100 per capita.[131] Interest on bonds issued in excess of the state's allotment will not be exempt from federal taxes[132] unless such bonds are exempt from the ceiling determination.[133] Bonds used to finance the following facilities are not counted in determining a state's level of private activity bonds: (1) low income residential rental property

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123. *Id.*

124. Pub. L. No. 98-369, 98 Stat. 494 (1984).

125. Froehlich, *Congress Adopts IDB Restrictions: The Tax-Exempt Bond Provisions of the Deficit Reduction of 1984*, 25 MUN. ATTY. 7-9 (1984).

126. Title VI of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

127. H. REP. No. 432, *supra* note 105, at 1682.

128. *See infra* notes 130-52 and accompanying text.

129. *See infra* notes 153-95 and accompanying text.

130. I.R.C. § 103(n)(4)(A) (West Supp. 1984) (added by § 621 of the Deficit Reduction Act (DRA)).

131. I.R.C. § 103(n)(4)(c) (West Supp. 1984) (added by § 621 of DRA).

132. I.R.C. § 103(n)(1) (West Supp. 1984) (added by § 621 of DRA).

133. The state ceiling applies to "private activity bonds." I.R.C. § 103(n)(1) (West Supp. 1984) (added by § 621 of DRA). IDBs generally are private activity bonds. I.R.C. § 103(n)(7)(A) (West Supp. 1984) (added by § 621 of DRA). Certain IDBs, however, are excluded from the definition of a private activity bond. *See* I.R.C. § 103(n)(7)(B)-(D) (West Supp. 1984) (added by § 621 of DRA).

as defined in section 103(b)(4)(A);[134] (2) public housing pursuant to section 11(b) of the Housing Act of 1937;[135] (3) convention or trade facilities; and (4) airports, docks, wharves and mass commuting facilities.[136] While the ceiling is generally effective for obligations issued after 1983, there are exceptions.[137] Moreover, for those states whose annualized per capital issuance of IDBs and student loan bonds subject to the volume limitation during the first nine months of 1983 was more than $150, a special phase-in rule applies.[138]

The Deficit Reduction Act allocates the ceiling among the various governmental units.[139] As a general rule, fifty percent of the volume ceiling is allocated to the state agency or agencies with authority to issue the bonds.[140] The remaining fifty percent is assigned to local jurisdictions based on the ratio of their population to that of the state's total population.[141] Where there are overlapping governmental units, an area will be treated as being only within the jurisdiction of the unit having the smallest geographic area.[142] However, one unit can surrender all or part of its jurisdiction for a calendar year to the unit with which it shares overlapping jurisdiction.[143]

A state may elect to carry forward unused portions of its annual private activity bond ceiling for specific projects usually for up to three years.[144] Once the election is made, it is irrevocable.[145] Obligations issued in the carry forward periods are not counted toward the state's ceiling for those years to the extent that the proceeds from the obligations are used to finance the project specified in the election.[146] The unused bond ceiling is absorbed in the order in which the obligations for the specified projects are issued.[147]

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134. I.R.C. § 103(b)(4)(A) (1982).

135. U.S. Housing Act of 1937, Pub. L. No. 412, ch. 896 (1937).

136. I.R.C. § 103(n)(7)(B)-(C) (West Supp. 1984) (added by § 621 of DRA).

137. Exceptions from the state ceilings exist with respect to bonds preliminarily approved by inducement resolution or other means prior to June 19, 1984, *id.*, and those considered refunding issues. Under section 103(n)(7)(D), the term private activity bond does not include any obligation to the extent that the obligation generally is issued to refund another obligation. I.R.C. § 103(n)(7)(D) (West Supp. 1984) (added by § 621 of DRA); *see supra* note 133.

138. I.R.C. § 103(n)(4)(B) (West Supp. 1984) (added by § 621 of DRA).

139. I.R.C. § 103(n)(2)-(3) (West Supp. 1984) (added by § 621 of DRA).

140. *Id.*

141. I.R.C. § 103(n)(3) (West Supp. 1984) (added by § 621 of DRA).

142. I.R.C. § 103(n)(3)(B) (West Supp. 1984) (added by § 621 of DRA); I.R.C. § 103A(g)(3)(B) (West Supp. 1984) (as amended by § 614 of DRA).

143. *Id.*

144. I.R.C. § 103(n)(10) (West Supp. 1984) (added by § 621 of DRA).

145. I.R.C. § 103(n)(10)(D) (West Supp. 1984) (added by § 621 of DRA).

146. I.R.C. § 103(n)(10)(C)(i) (West Supp. 1984) (added by § 621 of DRA).

147. I.R.C. § 103(n)(10)(C)(ii) (West Supp. 1984) (added by § 621 of DRA).

In accord with congressional intent, the volume ceilings will restrain growth of tax-exempt bonds without unnecessarily impinging on state and local prerogatives.[148] Congress recognized that the decision as to which projects should be financed would best be made by the appropriate state or local agency.[149] Nevertheless, the ceiling is clearly the most destructive provision of the 1984 Act especially with respect to small communities. IDBs often represent the primary means by which state and local governments attract industry to a particular location.[150] Rural areas often are deficient in credit facilities and leasable structures of substantial size.[151] IDBs allow these underdeveloped areas to compete with larger urban centers for the location of industrial expansion. The 1984 Act, however, has handicapped small communities' efforts to develop economically by allocating them a relatively small share of the local portion of the state bond ceiling, especially where a substantial project is contemplated.[152] They are forced, therefore, to develop strong ties with state agencies so that they can utilize these agencies' share of the ceiling. It is unfortunate that Congress chose to curtail the growth of IDBs at the expense of those communities which need to use the technique the most.

To complement the supply restriction effected by the volume ceiling, the 1984 Act attempts to curtail the demand for tax-exempt financing as well. In part, this curtailment is accomplished by extending restrictions and limitations already in the Code.[153] Previously, all but four categories of facilities financed with IDBs were required to be depreciated under the straight line method.[154] The 1984 Act, however, extends the straight line depreciation requirement to three of the four exemptions, retaining only the exception for low income rental residential projects.[155] With respect to the other facilities—municipal sewage or solid waste facilities, air or water pollution control facilities and facilities also financed with a UDAG— Congress

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148. H. REP. No. 432, *supra* note 105, at 1683.

149. *Id.*

150. *See* 114 CONG. REC. 7688 (statement of Senator Eastland) (discussion of economic development that occurred in Mississippi as result of IDB financing).

151. ADVISORY COMMISSION, *supra* note 1, at 11. A study of the factors influencing industrial location revealed that the availability of buildings and other property ranked near the top and financial aid near the bottom. *Id.* at 39.

152. *See* I.R.C. § 103(n)(2)-(3) (West Supp. 1984).

153. *See supra* notes 108-25 and accompanying text.

154. *See supra* notes 118-19 and accompanying text.

155. *See* I.R.C. § 168(f)(12)(C) (West Supp. 1984) (as amended by § 628(b)(1) of the DRA).

concluded that the benefits of tax-exempt financing and accelerated depreciation were unnecessarily large.[156]

The 1984 Act also broadened the "substantial user"[157] restrictions.[158] Currently, interest on IDBs, which otherwise would be tax-exempt, is taxable for any period during which the bonds are held by a person who is a substantial user of the financed property or is a person related to the substantial user.[159] Prior law defined related persons to include family members, individuals and controlled corporations or controlled partnerships, and corporations or partnerships subject to common control.[160] The 1984 Act extended this definition to include a partnership, general or limited, and all of its partners and their spouses and minor children and an "S corporation"[161] and each of its shareholders and their spouses and minor children.[162]

The 1984 Act also restricted the amount of IDB proceeds which could be used to acquire land and existing property.[163] Under prior law, IDBs could be used to finance the aquisition of land if the land were used for an exempt purpose[164] or if the small issue exemption rules were met.[165] Section 103(b)(16)(A) now denies IDB tax exempt status if (1) any portion of the proceeds is used to acquire land used for farming; or (2) if twenty-five percent or more of the proceeds are used to acquire land not used for farming.[166] The terms of the bond indenture, generally, will govern in determining which proceeds are allocable to the purchase of land.[167] If the

156. H. REP. No. 432, *supra* note 105, at 1685.

157. A "substantial user" is any nonexempt person who regularly uses such facility in his trade or business. If the facility is constructed, reconstructed or acquired specifically for a nonexempt person, such person is a substantial user. *See* Ltr. Rul. 813214.

158. I.R.C. § 103(b)(13) (West Supp. 1984) (as amended by § 628(d) of the DRA).

159. *Id.*

160. *See* I.R.C. § 103(b)(7)-(10) (1982).

161. "[T]he term 'S corporation' means, with respect to any taxable, a small business corporation for which an election under section 1362(a) is in effect." I.R.C. § 1361 (1982).

162. I.R.C. § 103(b)(13) (West Supp. 1984) (as amended by § 628(d) of the DRA).

163. I.R.C. § 103(b)(16)-(17) (West Supp. 1984) (added by §§ 627(a) and 627(b) of the DRA, respectively).

164. See *supra* notes 84-93 and accompanying text for discussion of activities exemption.

165. See *supra* notes 94-101 and accompanying text for discussion of small issue exemption.

166. I.R.C. § 103(b)(16)(A) (West Supp. 1984) (added by § 627(a) of the DRA). Exceptions exist for first time farmers and for certain land acquired in connection with an airport, mass transit, or port development, if such land is acquired essentially for environmental purposes, for example, wetland preservation or noise abatement. I.R.C. § 103(b)(16)(B)-(C) (West Supp. 1984) (added by § 627(a) of the DRA).

167. H. REP. No. 432, *supra* note 105, at 1692-93.

indenture makes no provision for this allocation, the proceeds will be deemed to be used for the purchase of land and other property in relation to the fair market values of the properties.[168]

Similar restrictions are placed on the aquisition of existing property. Under the 1984 Act, interest on IDBs will not be excluded from gross income if any portion of the proceeds of the issue is used to acquire existing facilities.[169] This prohibition does not apply where expenses incurred for rehabilitating any property, buildings and equipment, are fifteen percent or more of the portion of the cost of acquiring the property financed with IDBs.[170] The rehabilitation expenditures need not be financed with the tax-exempt bond proceeds.[171] Additionally, no portion of the bond proceeds may be used to finance airplanes, stadium luxury boxes, health clubs, gambling establishments or liquor stores.[172]

Restricting the amount of small issue IDBs on per beneficiary and per project bases is another method employed by Congress to constrict demand for IDB financing.[173] Where a beneficiary of a proposed issue already has received significant tax-exempt proceeds in a given period, he will be denied use of the small issue exemption.[174] During the three year period described in the Code,[175] the maximum amount of IDB financing that any one beneficiary is entitled to receive is forty million dollars.[176] A beneficiary is defined as any person who

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168. *Id.*

169. I.R.C. § 103(b)(17)(A) (West Supp. 1984).

170. I.R.C. § 103(b)(17)(B) (West Supp. 1984). The Code defines rehabilitation expenditure as "any amount properly chargeable to capital account[s] which is incurred by the person acquiring the building or property." I.R.C. § 103(b)(17)(C)(i) (West Supp. 1984). The expenditure must be incurred within two years of the later of the date when the property was acquired or the date the obligations were issued. I.R.C. § 103(b)(17)(C)(iii) (West Supp. 1984).

171. H. REP. No. 432, *supra* note 105, at 1692. For example, assume the cost of acquiring is one million dollars and eight hundred thousand dollars of the cost of the building is financed with IDBs. To qualify for this exemption, at least one hundred and twenty thousand dollars must be spent for rehabilitating the property. The one hundred and twenty thousand dollars may be spent from either the remaining proceeds of an IDB issue or from the developers own funds.

172. I.R.C. § 103(b)(18) (West Supp. 1984) (added by § 627(c) of the DRA). The Act is not intended to prohibit IDB financing of a stadium solely because sky boxes are included in the project. The Act merely prohibits the use of IDB proceeds to finance the sky boxes. H. REP. No. 432, *supra* note 105, at 1693.

173. *See infra* notes 174-82 and accompanying text.

174. I.R.C. § 103(b)(15)(A) (West Supp. 1984) (added by § 623 of the DRA).

175. I.R.C. § 103(b)(15)(D) (West Supp. 1984). The three-year period begins on the later of the date such facilities were placed into service or the date of the issue. *Id.*

176. I.R.C. § 103(b)(15)(A) (West Supp. 1984). The small issue exemption will

is a user of the bond financed facilities.[177] This per beneficiary ceiling favors first time users and reflects congressional animus for large projects.[178]

Implicit in the small issue exceptions are per project limitations.[179] Nevertheless, under prior law, developers could circumvent these limitations through division of ownership.[180] Under current law, where multiple issues of IDBs are used to finance a single building, an enclosed shopping mall, or a strip of offices, stores or residential property which use substantially common facilities, the issues are treated as a single issue for the purpose of determining whether it qualifies under the small issue exemption. Also, all principal users of any of the facilities financed with the issue are treated as principal users of a single facility.[181] Thus, qualification for the small issue exemption is determined by measuring the capital expenditures and outstanding obligations of all principal users of that project.[182]

Finally, the 1984 Act seeks to prevent the use of two practices which magnify the financial benefits associated with tax-exempt financing. It denies IDBs tax-exempt status where the proceeds are federally guaranteed,[183] and it limits arbitraging.[184] Congress was

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not apply to an issue if the portion of the issue allocable to a beneficiary, increased by portions of other outstanding issues allocable to him under I.R.C. § 103(b)(15)(B), exceeds forty million dollars. I.R.C. § 103(b)(15)(A) (West Supp. 1984). Generally, where two or more persons are owners or users of a facility financed with IDBs which remain outstanding, a person is allocated a portion of the outstanding issues in proportion to his use or ownership of the facility. I.R.C. § 103(b)(15)(C)(ii) (West Supp. 1984).

177. I.R.C. § 103(b)(15)(D) (West Supp. 1984). All related persons are treated as one user. H. REP. No. 432, *supra* note 105, at 1691.

178. While the fact that "the beneficial impact on employment is proportionately most significant in the smaller projects financed by IDB's," *Exempt Status, supra* note 9, at 1660, there is no evidence that there are diminishing returns on a per beneficiary basis. Therefore, this restriction may be unwarranted.

179. The overall dollar limitations of the exemptions coupled with the rules for determining whether or not the dollar limitations have been exceeded, generally, limit the amount of IDB proceeds which can be expended for a given project. *See supra* notes 94-101 and accompanying text.

180. Under prior law, in applying the limits small issues were taken into account if they were located in the same incorporated municipality or same county as the facility and the principal user of such facility was the same person or two or more related persons. I.R.C. § 103(b)(6)(E) (1982). Thus, developers of shopping centers, for example, could avoid these limitations by dividing ownership of the stores among various unrelated companies and each could qualify for a small issue exemption.

181. I.R.C. § 103(b)(6)(P) (West Supp. 1984) (added by § 628(c) of the DRA).

182. H. REP. No. 432, *supra* note 105, at 1694.

183. I.R.C. § 103(h) (West Supp. 1984) (added by § 622 of the DRA).

184. See *infra* note 190 and accompanying text for definition of arbitrage. *See generally* I.R.C. § 103(c) (1982) (arbitrage provisions).

concerned about the double subsidy created when tax-exempt financing is combined with federal guarantees.[185] Since federally guaranteed tax-exempt bonds are more attractive than United States treasury securities, which are taxable, and other state and local obligations which do not have federal guarantees, the proliferation of such bonds would make it difficult for both federal and state governments to raise needed funds.[186] The 1984 Act, therefore, eliminates the tax exemption for bonds where a substantial portion of the issue is to be guaranteed directly or indirectly by the federal government.[187] This change applies to tax-exempt bonds the proceeds of which are deposited in federally insured financial institutions.[188]

The 1984 Act also tightened the arbitrage provisions which apply to IDBs.[189] Arbitrage is the difference between the interest paid on the obligations and the rate of income earned on investments made with the bond proceeds.[190] A tax-exempt issue of IDBs must satisfy the arbitrage rules to retain its tax-exempt status.[191] Prior law permitted investment of IDB proceeds for a temporary period at an unrestricted yield while the project was diligently pursued.[192] The Bond Provisions reduce the temporary and minor portion periods to six months after their issuance.[193] Profits made thereafter must be rebated to the United States Treasury.[194] The new arbitrage provisions do not, however, apply to obligations issued to provide low income residential rental property or any obligation issued pursuant to section 11(b) of the United States Housing Act of 1937.[195]

V. Justifying Retention of the IDB Tax-Exemption

The limitations and restrictions imposed on the issuance of tax-exempt IDBs under TEFRA and the 1984 Act undoubtedly will curtail the growth in the dollar volume of IDBs. In this respect, the sunset provision for the small issue exemption[196] and the state

185. H. REP. No. 432, *supra* note 105, at 1685-86.
186. *Id.*
187. I.R.C. § 103(h) (West Supp. 1984).
188. I.R.C. § 103(h)(2)(B) (West Supp. 1984).
189. I.R.C. § 103(c)(6)(F) (West Supp. 1984) (added by § 624(a) of the DRA).
190. *See* I.R.C. § 103(c)(2) (1982).
191. I.R.C. § 103(C)(6)(A) (1982).
192. I.R.C. § 103(c) (1982); H. REP. No. 432, *supra* note 105, at 1678-79. A minor portion could be invested for a longer period. *Id.*
193. I.R.C. § 103(c)(6)(F)(ii) (West Supp. 1984).
194. I.R.C. § 103(c)(6)(D) (West Supp. 1984).
195. U.S. Housing Act of 1937, Pub. L. No. 412, ch. 896 (1937); I.R.C. § 103(c)(6)(B) (West Supp. 1984).
196. *See supra* note 111 and accompanying text.

volume ceilings[197] are the most devastating Code modifications. The small issue exemption will expire, generally, at the end of 1986,[198] but it will remain effective until the end of 1988 for obligations issued to finance manufacturing facilities.[199] Under current law, since the small issue exemption ultimately will expire, the future of tax-exempt IDB financing lies in the acquisition, construction and rehabilitation of exempt activities. Unfortunately, however, the Treasury's tax reform plan contains a two-pronged attack on tax-exempt bonds and, if enacted, the plan would virtually eliminate the activities exemption.[200] This Note concludes that the activities exemption should be retained and the small issue exemption for manufacturing facilities extended on grounds of efficiency and notions of state sovereignty.

A. Efficiency

The Treasury's plan to simplify the tax laws would, if enacted, eliminate tax-exempt financing of "private purposes." A "private purpose" is defined as the use of more than one percent of the proceeds of the bonds, directly or indirectly, by any person other than a state or local government.[201] The plan would deny the use of tax-exempt IDBs to finance activities such as publicly owned convention and trade show facilities, airports, docks, wharves, mass transportation, and water, sewage, and solid waste facilities.[202] The Treasury Department contends that these projects do not serve a public purpose.[203] This contention is incorrect because the same types of projects financed at the federal level are deemed to serve a valid public purpose.[204] Essentially, the plan would eliminate the IDB activities exemption. Such a result would undermine the two rationales which allegedly mandate the existence of this exemption.[205] One rationale for the existence of the small issue exemption and the activities exemption reflects a congressional determination to subsidize indirectly economic development and the construction of

197. *See supra* notes 130-52 and accompanying text.
198. I.R.C. § 103(b)(6)(N) (1982); *see supra* note 111 and accompanying text.
199. I.R.C. § 103(b)(6)(N)(ii) (West Supp. 1984) (as amended by § 630 of the DRA). "Manufacturing facility" is defined as "any facility which is used in the manufacturing or production of tangible personal property." I.R.C. § 103(b)(6)(N)(iii) (1982).
200. *See infra* notes 201-05.
201. Bond Buyer, Dec. 4, 1984, § 1, at 1, col. 1.
202. Bond Buyer, Feb. 8, 1985, § 1, at 1, col. 1.
203. Bond Buyer, Jan. 3, 1985, § 1, at 14, col. 3.
204. *Id.*
205. *See infra* notes 206-32.

essential facilities.[206] Under this rationale, the exemptions should be retained if IDB financing is an efficient method to achieve either economic development or the construction of essential facilities. Critics of the IDB tax-exemption contend that IDB financing is an inefficient subsidy.[207] The inefficiency lies in the fact that a portion of the tax-exempt benefit "leaks" to the purchaser of the bonds.[208] They conclude that because a direct payment to the private enterprise will cost the federal government less money than tax-exempt IDBs, the tax-exemption should be revoked in favor of a direct subsidy program.[209]

Although the contention of inefficiency is correct, it is not clear that direct federal subsidies are a proper substitute for IDBs. Federal subsidy programs are extremely inefficient since large portions of the appropriated funds are allocated to administrative costs.[210] Moreover, it is difficult for federal administrators to deploy the program's resources optimally because they must speculate as to the relative needs of states and their municipalities. Federal programs react slowly to perceived local needs, and when the federal government is financing the facility, local governments tend to be less cautious when deciding which projects really need to be built.[211] Alternatively, IDBs are issued and administered by state and local officials who are more attuned to the needs of their respective communities.[212] Self-determination of needs using tax-exempt financing to respond to these needs leads to a much shorter period between recognition and provision.[213] Thus, there is justification under this rationale to urge Congress to continue the existence of the activities exemption. Moreover, since newly-constructed manufacturing facilities spur economic development and alleviate unemployment,[214] the small issue exemption should be extended beyond 1988 for manufacturing facilities. The trend in Congress over the past sixteen years, however, has been to

206. *See supra* notes 88-89 and accompanying text.

207. *See supra* note 50 and accompanying text.

208. *See supra* note 47 and accompanying text.

209. McDaniel, *supra* note 45, at 163-65.

210. *But see* URBAN DEVELOPMENT ACTION GRANT PROGRAM, U.S. DEP'T. OF HOUSING AND URBAN DEVELOPMENT, FIRST ANNUAL REPORT (1979) (discussion of effectiveness of UDAG program).

211. Friedlander, *A Case For Municipal Bond Tax Exemption*, Bond Buyer, Nov. 26, 1984, §1, at 8, col. 1 [hereinafter cited as Friedlander].

212. 114 CONG. REC. 7686-87 (statement of Senator Fulbright); *id.* at 7688-90 (statement of Senator Eastland) (discussing that it is best to allow local officials to respond to needs of their communities).

213. Friedlander, *supra* note 211, at 14, col. 1.

214. *See supra* notes 12-13, 57-59.

limit the tax-exempt status of IDBs making continuation of the exemptions under this rationale unlikely.

B. Notions of State Sovereignty

A second rationale for the existence of the activities exemption is based on principles of state sovereignty; since the IDBs are used to finance "quasi-governmental public functions, the treatment of the bonds used to finance them should be the same as the treatment given to bonds which finance ordinary government activity."[215] This rationale assumes, therefore, that *Pollock v. Farmers Loan and Trust Co.*[216] still prohibits a tax on interest derived from governmental obligations[217] and that *Pollock* protects interest on IDBs used to finance public activities in which private participation is indispensible to their operation.[218]

The only attempt by the federal government to impose a tax on state and local bond interest was declared unconstitutional in *Pollock.*[219] The *Pollock* decision was based on the theory of intergovernmental tax immunity first enunciated in *McCulloch v. Maryland.*[220] Although the vitality of the theory has "waned,"[221] *Pollock* repeatedly has been cited as good law.[222] In *South Carolina v. Regan*,[223] the Supreme Court will have the opportunity to reconsider the *Pollock* decision.[224] South Carolina filed a petition with the Court requesting it to exercise original jurisdiction and hold that section 310(b)(1) of TEFRA is unconstitutional.[225] Section 310(b)(1)

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215. *Exempt Status, supra* note 9, at 1666.

216. Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429, 586, *aff'd on rehearing*, 158 U.S. 601 (1985).

217. *See supra* notes 31-32 and accompanying text.

218. *Exempt Status, supra* note 9, at 1667.

219. *Pollock*, 157 U.S. at 586.

220. 17 U.S. (4 Wheat.) 316 (1819). In *McCulloch*, the Court held that Maryland constitutionally could not tax the Bank of the United States because the power to tax could be used to undermine the Supremacy Clause by destroying the Bank. *Id.* at 425-37.

221. Powell, *The Waning of Intergovernmental Tax Immunities*, 58 HARV. L. REV. 633 (1959).

222. *See* Helvering v. Gerhardt, 304 U.S. 405, 417 (1938); Helvering v. Mountain Producers Corp., 303 U.S. 376, 386 (1938); Indian Motorcycle Co. v. United States, 283 U.S. 570, 577 (1931); Evans v. Gore, 253 U.S. 245, 255 (1920); South Carolina v. United States, 199 U.S. 437, 453 (1905); Plummer v. Coler, 178 U.S. 115, 117 (1900). Although cases have narrowed the intergovernmental theory, they have repeatedly cited *Pollock* as good law. *Id.*

223. 104 S. Ct. 1107 (1984) (petition for original jurisdiction granted).

224. *Id.*; *see infra* notes 225-28 and accompanying text.

225. *South Carolina*, 104 S. Ct. at 1124. The Court granted the petition. *Id.*

provides that the federal income tax exemption for interest on certain municipal bonds will not be allowed unless they are issued in registered form.[226] South Carolina raises two constitutional claims:

> [First,] [v]iewing its borrowing power as essential to the maintenance of its separate and independent existence, South Carolina contends that the condition imposed by 310(b)(1) on the exercise of that power violates the Tenth Amendment.[[227] Second,] . . . relying on *Pollock v. Farmer's Loan and Trust Company* South Carolina argues that Congress may not tax the interest on the obligations of a state. Because section 310(b)(1) imposes a tax on the interest earned on state obligations issued in bearer form, the state argues that the section is unconstitutional.[228]

The classic statement of the constitutional basis of the immunity of the states and their municipalities from federal taxation of their bond interest is that

> [a] municipal corporation is the representative of the [s]tate and one of the instrumentalities of state government. It was long ago determined that the property and revenues of municipal corporations are not subjects of federal taxation. . . . It is contended that although the property or revenues of the States or their instrumentalities cannot be taxed, nevertheless the income derived from . . . municipal securities can be taxed. But we think the same want of power to tax . . . exists in relation to a tax on the income from their securities, and for the same reason, and that reason is given by Chief Justice Marshall in *Weston v. Charleston* . . . where he said: "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. . . . To any extent . . . it is a bur[d]en on the operations of government. It may be carried to an extent which shall arrest them entirely". . . . Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution.[229]

Pollock should not be overruled, for even today, "the power to tax is the power to destroy."[230] If taxation of interest were permitted,

226. The provision was codified in I.R.C. § 103(j)(1) (1982).
227. *South Carolina*, 104 S. Ct. at 1111.
228. *Id.*
229. *Pollock*, 157 U.S. at 584-86.
230. *McCulloch*, 17 U.S. (4 Wheat.) 316.

the federal government taking this power to the extreme, could effectively destroy states' and municipalities' ability to borrow money. Although Justice Stevens recently questioned its vitality,[231] presumably *Pollock* is still, and will remain, good law. A continued exemption for interest paid on exempt activity IDBs, therefore, may be justifiable under *Pollock* if the projects to be financed are public projects in which private participation is indispensible.[232]

Certainly, IDBs providing mass commuting facilities, sewage and solid waste disposal facilities and facilities for the furnishing of water are as necessary and benefit the public as much as municipal bonds used to finance new roads and parks. Once it is agreed that a facility is necessary, the fact that facilities are to be run by private entities should not be dispositive of whether *Pollock* protects interest paid on these obligations. Instead, the practical realities of these arrangements should govern. Where a project is necessary, it should be provided by a state or its instrumentalities, especially where the issuing unit is relieved of the burden of managing the facility, in same manner that it provides its other essential facilities— through tax-exempt financing. Therefore, since the states are exercising their power to borrow money in the financing of public purposes as determined by the legislatures and the highest courts of their respective states, principles of state sovereignty as enunciated in *Pollock* require that certain IDBs remain tax-exempt.

VI. Conclusion

For almost fifty years, industrial development bonds have provided state and local governments and their instrumentalities with a useful means of facilitating economic development and alleviating unemployment. Although Congress has uncovered abuses connected with the use of this financing technique, it should remain a viable mechanism for financing industrial expansion and essential public facilities. Rather than completely withdrawing the small issue exemption in 1988, Congress should retain the exemption for obligations issued to finance manufacturing facilities. Moreover, in light of notions of state sovereignty, legislators should resist the temptation to abrogate the entire activities exemption under the guise of major tax reform.

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231. *South Carolina*, 104 S. Ct. at 1127.
232. *Id.*