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Private Activity Bonds: An Introduction

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Summary

The federal tax code classifies state and local bonds as either governmental bonds or private activity bonds. Governmental bonds are intended for governmental projects, and private activity bonds are for projects that primarily benefit private entities. Typically, the interest earned by holders of governmental bonds is exempt from federal income taxes.

The federal tax code allows state and local governments to use tax-exempt bonds to finance certain projects that are considered private activities. The private activities that can be financed with tax-exempt bonds are called "qualified private activities." Congress uses an annual state volume cap to limit the amount of tax-exempt bond financing generally and restricts the types of qualified private activities that qualify for tax-exempt financing to selected projects defined in the tax code.

The economic rationale for the federal limitation on tax-exempt bonds for private activities stems from the inefficiency of the mechanism to subsidize private activity and the lack of congressional control of the subsidy absent a limitation. This report explains the rules governing qualified private activity bonds, describes the federal limitations on private activity bonds, lists the qualified private activities, and reports each state's private activity bond volume cap.

Since private activity bonds were defined in 1968, the number of eligible private activities has been gradually increased from 12 activities to 30. The state volume capacity limit has increased from $150 million and $50 per capita in 1986 to the greater of $335 million or $110 per capita in 2022. Because of the $335 million floor, many smaller states are allowed to issue relatively more private activity bonds (based on the level of state personal income) than larger states. Also, more recent additions to the list of qualified activities have been exempt from a state-by-state cap and subject to a national aggregate cap.

For more on tax-exempt bonds generally, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Grant A. Driessen.

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Overview and Issues for Congress

State and local governments issue debt for most large public capital projects such as new schools, public buildings, and roads. On occasion, state and local governments will issue debt for projects whose purpose is less public in nature, such as privately owned and operated multifamily residential housing. Nevertheless, these projects are often afforded the same tax privilege as debt issued for strictly government-owned and -operated projects. Congress limits the use of tax-exempt bonds for private activities because of concern about the overuse of tax-exempt, private activity bonds. The tax-exempt bonds issued for qualified private activities are limited by the type of activity financed and the volume of debt used for such activities.

Overview

The federal tax code classifies state and local government bonds as either governmental bonds or private activity bonds. Generally, the interest on state and local governmental bonds is exempt from taxation whereas the interest on private activity bonds is not tax-exempt.[1] However, the federal tax code allows state and local governments to use tax-exempt bonds to finance certain projects that would otherwise be classified as private activities.[2] The private activities that can be financed with tax-exempt bonds are called "qualified private activities."[3]

The current tax exemption for qualified private activities has evolved over time. Two events, however, critically shaped the current treatment of private activity bonds. First, in 1968, Congress passed the Revenue and Expenditure Control Act of 1968 (P.L. 90-364), which established the basis for the current definition of private activity bonds. Second, after persistent challenges to the right of the federal government to restrict state and local government debt following the 1968 act, the Supreme Court heard a case in 1988 that addressed the nature of the federal tax treatment of state and local government debt. In that case, the state of South Carolina challenged the provision in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) requiring that state and local government tax-exempt debt must be registered.[4] The registration requirement was viewed by the states, South Carolina in particular, as an unconstitutional intrusion on the ability of states to issue debt. The Supreme Court held that the registration requirement for nonfederal government debt, though federally tax-exempt, was constitutional. In somewhat of a surprise to observers at the time, the Court went beyond the registration ruling and also stated the following:

> The owners of state [and local] bonds have no constitutional entitlement not to pay taxes on income they earn from the bonds, and states have no constitutional entitlement to issue bonds paying lower interest rates than other issuers.[5]

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[1] The tax exemption is provided for in 26 U.S.C. 103.

[2] In general, a two-part test is used to classify an activity as a private activity. This test will be explained in more detail later in the report. Generally, activities are classified as "private" because private individuals and businesses benefit directly from debt issued by the state or local government.

[3] 26 U.S.C. 141 describes requirements for qualified private activity bonds.

[4] Before this act was passed, state and local government usually issued bearer bonds that paid principal and interest to whomever presented the bond to the issuer (or the issuer's agent, usually a bank). In contrast, a registered bond includes the owner's name on the bond and a change in ownership must be registered with the issuer (or the issuer's agent). For a full discussion of the impact of the *South Carolina vs. Baker* case on tax-exempt bonds, see Bruce Davie and Dennis Zimmerman, "Tax-Exempt Bonds After the South Carolina Decision," *Tax Notes*, vol. 39, no. 13, June 27, 1988, p. 1573.

[5] *State of South Carolina vs. J.A. Baker, Secretary of the Treasury*: Supreme Court of the United States, April 20, 1988. 485 U.S. 505.

Under the ruling, Congress can restrict issuance of state and local tax-exempt debt and could even rescind the tax exemption altogether.[6] Nevertheless, outright repeal of the tax exemption is unlikely. Instead, Congress has used legislative action to modify the existing rules and definitions governing tax-exempt bonds for private activities. Generally, Congress limits the *amount* of tax-exempt debt that can be used for private activities and restricts the *type* of private activities that can be financed with tax-exempt bonds. Congress can, and does, encourage selected private activities by exempting the activity from the volume cap or by allowing tax-exempt financing for the private activity.

Issues for Congress

As noted above, Congress uses two primary means to restrain the use of state and local debt for private activities: an annual state volume limit (or separate national aggregate limit) and restrictions on the type of qualified private activities. The private activity bond volume limit, which originated in the Deficit Reduction Act of 1984 (P.L. 98-369), was implemented because "Congress was extremely concerned with the volume of tax-exempt bonds used to finance private activities."[7] The limit and the list of qualified activities were both modified again under the Tax Reform Act of 1986 (TRA 1986, P.L. 99-514). At the time of the TRA 1986 modifications, the Joint Committee on Taxation identified the following specific concerns about tax-exempt bonds issued for private activities:[8]

- the bonds represent "an inefficient allocation of capital";
- the bonds "increase the cost of financing traditional governmental activities";
- the bonds allow "higher-income persons to avoid taxes by means of tax-exempt investments"; and
- the bonds contribute to "mounting [federal] revenue losses."

The inefficient allocation of capital arises from the economic fact that additional investment in tax-favored private activities will necessarily come from investment in other public projects. For example, if bonds issued for mass commuting facilities did not receive special tax treatment, some portion of the bond funds could be used for other government projects such as schools or other public infrastructure.

The greater volume of tax-exempt private activity bonds then leads to the second Joint Committee on Taxation concern listed above, higher cost of financing traditional government activities. Investors have limited resources, thus, when the supply of tax-exempt bond investments increases, issuers must raise interest rates to lure them into investing in existing government activities. In economic terms, issuers raising interest rates to attract investors are analogous to a retailer lowering prices to attract customers. The higher interest rates make borrowing more expensive for issuers.

The final two points are less important from an economic efficiency perspective but do cause some to question the efficacy of using tax-exempt bonds to deliver a federal subsidy. Tax-exempt interest is worth more to taxpayers in higher brackets, thus, the tax benefit flows to higher-income taxpayers, which leads to a less progressive income tax regime.

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[6] Ibid.

[7] U.S. Congress, Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2nd sess. (Washington: GPO, 1984), p. 930.

[8] U.S. Congress, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st sess. (Washington: GPO, 1987), p. 1151.

The revenue loss generated by tax-exempt bonds also expands the deficit (or shrinks the surplus). A persistent budget deficit ultimately leads to generally higher interest rates as the government competes with private entities for scarce investment dollars. Higher interest rates further increase the cost of all debt-financed state and local government projects.

Supporters of tax-exempt bonds for private activities counter that the benefit from tax-exempt bonds exceeds both the explicit (the revenue loss) and implicit (the inefficient allocation of capital) costs of the tax exemption.

The debate surrounding use of tax-exempt bonds will continue well beyond the current Congress. Proponents and opponents of tax-exempt bonds generally, and private activity bonds specifically, both explore methods of modifying the rules for private activity bonds to advance their respective positions. Because the rules and definitions for private activity bonds are complex, uncertainty about the potential effects of the proposed modifications to those rules is common. This report provides a brief review of bond fundamentals and a more detailed examination of the rules and definitions surrounding private activity bonds to help clarify the impact of proposed modifications.[9]

Fundamentals of Private Activity Bonds

What Is a Private Activity Bond?

A private activity bond is one that primarily benefits or is used by a private entity. The tax code defines *private business (or private entity) use* as "use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For purposes of the preceding sentence, use as a member of the general public shall not be taken into account."[10] Two conditions or tests are typically used to assess the status of a bond issue with regard to the private entity test. Satisfying both conditions would mean the bonds are private activity bonds. Bonds are *private activity bonds* if both of the following conditions are met:

> (1) [use test] more than 10% of the proceeds of the issue are to be used for any *private business use*.... [and]
>
> (2) [security test] if the payment on the principal of, or the interest on, more than 10% of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly—
>
> (A) secured by any interest in
>
> (i) property used or to be used for a private business use, or
>
> (ii) payments in respect to such property, or
>
> (B) Or [if the payment is] to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.[11]

If a bond issue passes both tests, the bonds are taxable and carry a higher interest rate. Nevertheless, bond issues that pass both tests can still qualify for tax-exempt financing if they are identified in the tax code as *qualified* private activities. Thus, when those in the bond community

[9] For a comprehensive economic assessment of private activity bonds, see Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds: Controlling Public Subsidy of Private Activity* (Washington, DC: The Urban Institute Press, 1991).

[10] 26 U.S.C. 141(b)(6)(A).

[11] 26 U.S.C. 141(b).

refer to tax-exempt private activity bonds, the more technically correct reference is tax-exempt, *qualified* private activity bonds.

There is also a private loan financing test that is less commonly relevant. Under this test, a bond is *not* tax-exempt if more than the lesser of 5% or $5 million of the proceeds of the issue is to be used directly or indirectly to make or finance loans to persons other than governmental persons.[12] For example, an issuer could not use the proceeds from a tax-exempt bond to loan money to small businesses for capital improvements.[13]

Interest Rates on Tax-Exempt vs. Taxable Bonds

Tax-exempt bonds for governmental purposes and for qualified private activities are special because, unlike corporate bonds or U.S. Treasury bonds, the bond buyer does not have to include the interest income from the bond in federal gross income.[14] The bond buyer is willing to accept a lower interest rate because the interest income is not subject to federal income taxes. The lower interest rate arising from the tax-exempt status subsidizes state and local investment in capital projects. For example, if the taxable bond interest rate is 5.00%, the after-tax return for a taxpayer in the 37% income tax bracket who buys a taxable bond is 3.15%.[15] Thus, a tax-exempt bond that offers a 3.15% interest rate would be just as attractive to the investor as the taxable bond, all else being equal.[16] Researchers can derive an implied marginal tax rate based on current market data for taxable and tax-exempt debt. For more on tax-exempt bonds generally, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Grant A. Driessen.

Interest Rate Spread

The "interest rate spread" is the difference between the interest rate on tax-exempt bonds and some other taxable bond. **Table 1** below compares tax-exempt bonds to high-grade corporate bonds over the past 40 years.[17] The difference between the two interest rates is smaller empirically than the previous example because a large share of tax-exempt bond buyers is below the 37% marginal income tax bracket. Individuals in income tax brackets below 37% would require a higher tax-exempt bond interest rate because lower tax rates mean less tax savings from tax-exempt bonds. The lower tax bracket taxpayers bid up the tax-exempt bond interest rate closer to the taxable bond interest rate. Generally, the two rates move in tandem, with the taxable corporate bond interest rate always higher than the tax-exempt municipal bond interest rate.[18]

[12] 26 U.S.C. 141(c).

[13] The tax code does allow some loan programs to be financed with tax-exempt bonds, such as mortgage bonds. These special cases are described in more detail later in the report.

[14] The discussion here does not address the effect of state taxes on the tax-exempt debt of other states. For example, taxpayers in Virginia must pay Virginia income taxes on the tax-exempt (exempt from federal income taxes) debt of other states. However, Virginia taxpayers do not have to pay income taxes on interest earned on Virginia bonds.

[15] The calculation is 5.00% multiplied by (1.00-.37) equals 3.15%.

[16] Clearly, there are significant differences between corporate bonds and bonds issued by a governmental entity extending beyond the tax status. For example, a typical tax-exempt bond will include a call provision allowing the issuer to recall the bond after a fixed period (often 10 years). In addition, disclosure requirements for municipal issuers are usually less transparent than for public corporations.

[17] Market participants also use the comparison between the interest rate on tax-exempt bonds and 10-year Treasury bonds.

[18] A persistent anomaly exists for long-term, tax-exempt municipal bonds. The interest-rate spread between tax-exempt bonds and taxable bonds is smaller for long-term bonds (the long end of the so-called yield curve) than for short-term

In December of 2008, during unprecedented turmoil in financial markets and the economy, the average high-grade corporate bond rate was 5.05% and the average high-grade municipal (tax-exempt) bond rate was 5.56%.[19] The lower interest rate for taxable corporate bonds than for tax-exempt bonds in December 2008 was a short-lived phenomenon that can be traced to the interaction of at least two factors. First, the Federal Reserve Bank (Fed) was injecting as much liquidity into the economy as possible, setting interest rates at their lowest level ever.[20] This tended to keep market interest rates on taxable debt low. Second, state and local governments were facing significant fiscal stress and the bond market reacted by requiring a risk premium on its debt. The risk premium means a higher interest rate for municipal debt. In addition, the municipal bond insurance market collapsed, further elevating the perceived risk of municipal bonds.

The spread between tax-exempt and taxable debt has remained below historical levels in recent years, with spread values of around 0.4% in 2017 and 2018, dropping to 0.01% in 2019. A continued risk premium for municipal debt and portfolio shifts in response to the tax changes enacted through P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA), are among the perceived causes of the recent drop in that spread.

Table 1. Yield on Tax-Exempt and Corporate Bonds, the Yield Spread, and the Yield Ratio: 1980 to 2019

Year	High Grade Tax-Exempt Yield (%)	AAA Corporate Yield (%)	Yield Spread (%)	Yield Ratio (tax-exempt/ corporate)
1980	8.51	11.94	3.43	0.71
1981	11.23	14.17	2.94	0.79
1982	11.57	13.79	2.22	0.84
1983	9.47	12.04	2.57	0.79
1984	10.15	12.71	2.56	0.80
1985	9.18	11.37	2.19	0.81
1986	7.38	9.02	1.64	0.82
1987	7.73	9.38	1.65	0.82
1988	7.76	9.71	1.95	0.80
1989	7.24	9.26	2.02	0.78
1990	7.25	9.32	2.07	0.78
1991	6.89	8.77	1.88	0.79
1992	6.41	8.14	1.73	0.79
1993	5.63	7.22	1.59	0.78

bonds. Thus, the implicit tax rate for long-term municipal bonds is smaller than for shorter term bonds. One explanation is that the tax treatment of tax-exempt bonds and taxable bonds is not symmetrical through the yield curve. The lower tax rate for capital gain income plays a role in this phenomena. For more, see Green, Richard C., "A Simple Model of the Taxable and Tax-Exempt Yield Curves," *The Review of Financial Studies*, vol. 6, no. 2, summer 1993, pp. 233-264.

[19] Interest rate averages are composites of a variety of bond issues and provide a good benchmark for market interest rates for municipal bonds.

[20] For more, see CRS Report R44591, *Natural Gas Discoveries in the Eastern Mediterranean*, by Michael Ratner and CRS Report 98-856, *Federal Reserve Interest Rate Changes: 2001-2009*, by Marc Labonte

Year	High Grade Tax-Exempt Yield (%)	AAA Corporate Yield (%)	Yield Spread (%)	Yield Ratio (tax-exempt/ corporate)
1994	6.19	7.96	1.77	0.78
1995	5.95	7.59	1.64	0.78
1996	5.75	7.37	1.62	0.78
1997	5.55	7.26	1.71	0.76
1998	5.12	6.53	1.41	0.78
1999	5.43	7.04	1.61	0.77
2000	5.77	7.62	1.85	0.76
2001	5.19	7.08	1.89	0.73
2002	5.05	6.49	1.44	0.78
2003	4.73	5.67	0.94	0.83
2004	4.63	5.63	1.00	0.82
2005	4.29	5.24	0.95	0.82
2006	4.42	5.59	1.17	0.79
2007	4.42	5.56	1.14	0.79
2008	4.80	5.63	0.83	0.85
2009	4.64	5.31	0.67	0.87
2010	4.16	4.94	0.78	0.84
2011	4.29	4.64	0.35	0.92
2012	3.14	3.67	0.53	0.85
2013	3.96	4.24	0.28	0.94
2014	3.78	4.16	0.38	0.91
2015	3.48	3.89	0.41	0.90
2016	3.07	3.67	0.60	0.84
2017	3.36	3.74	0.38	0.90
2018	3.53	3.93	0.40	0.90
2019	3.38	3.39	0.01	1.00

Source: Council of Economic Advisors, *Economic Report of the President*, 2021, Table B-42.

Tax-Exempt Bonds and the Alternative Minimum Tax

The alternative minimum tax (AMT) treats the interest income from qualified private activity bonds differently than the interest income from governmental bonds. The AMT is an income tax that is levied in parallel with the income tax and is intended to ensure that taxpayers with many deductions and exemptions pay a minimum percentage of their gross income in taxes.

The interest income from governmental-purpose bonds is excluded from the AMT. The interest income from tax-exempt private activity bonds is generally included in the AMT base and thus taxable.[21] Because private activity bonds are included in the AMT, the bonds carry a higher interest rate (approximately 50 basis points)[22] than do tax-exempt government-purpose bonds, all else being equal.[23] However, the tax-exempt private activity bond rate is still lower than the taxable bond rate. For more on the AMT, see CRS Report R44494, *The Alternative Minimum Tax for Individuals: In Brief*, by Donald J. Marples.

Repealing the AMT or exempting some bonds issued for qualified private activities from the AMT would increase investor demand for those bonds. The increased attractiveness of those bonds would eventually lead to lower interest costs for the issuer of qualified private activity bonds.

What Are the Qualified Private Activities?

A number of private activities are granted special status in the tax code (see **Table 2**). These activities are called "qualified private activities" because they qualify for tax-exempt financing even though they would likely "pass" the two-part private activity test or the private loan test, which would otherwise disallow tax-exempt financing. The list of qualified private activities has gradually expanded to 30 activities from the 12 that were originally defined by the Revenue and Expenditure Control Act of 1968. The Tax Reform Act of 1986 kept most of the activities listed in the 1968 act and reorganized the private activity bond section of the federal tax code. To qualify for tax-exempt financing, at least 95% of the net bond proceeds must be used for qualified purposes.[24] Issuance costs such as brokerage and accounting fees are generally not treated as a qualifying purpose.[25] Furthermore, the amount of net bond proceeds used to finance issuance costs may not exceed 2%.[26]

The Revenue and Expenditure Control Act of 1968

The 1968 act legislated that the interest payments on industrial development bonds (IDBs, the original private activity bonds) were to be included in taxable income. This was a shift from the previous Internal Revenue Service (IRS) position, which held that the interest on these bonds was not taxable income. The motivation behind the change offered in the 1968 act was based "on the theory that industrial development bonds described in the proposed [IRS] regulations were not 'obligations of a State or any political subdivision' within the meaning of section 103 since the primary obligor was a not a State or political subdivision."[27] The 1968 act also (1) established the basis for the current private use and private security tests; (2) created exceptions to the taxability provision for small issuers; and (3) specified a group of private activities that would qualify for tax-exempt bond financing.

[21] Interest income from qualified private activity bonds for 501(c)(3) projects and housing projects is excluded from the AMT. Additionally, the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) excludes the interest income from private activity bonds issued in 2009 and 2010 from the AMT.

[22] 50 basis points is equivalent to one-half of a percentage point or 0.50%.

[23] Jacob Fine, "AMT Spreads on the Rise," *The Bond Buyer*, July 26, 2000, p. 1.

[24] 26 U.S.C. 142(a).

[25] See *IRS Publication 4078* for detailed information on issuance costs: https://www.irs.gov/pub/irs-pdf/p4078.pdf.

[26] 26 U.S.C. 147(g). In the cases of qualified mortgage bonds and qualified veterans' mortgage bonds, the issuance cost limit is 3.5% if net bond proceeds do not exceed $20,000,000.

[27] U.S. Congress, Conference Committees, 1968, Revenue and Expenditure Control Act of 1968, conference report to accompany H.R. 15414, House Report No. 1533, 90th Cong., 2nd sess. (Washington: GPO, 1968), p. 32.

The Tax Reform Act of 1986

The 1986 act, which rewrote the Internal Revenue Code of 1954, renewed most of the previously defined private activities identified in the 1968 act. Notably, TRA 1986 added one private activity, qualified hazardous waste facilities, and limited the exemption for some previously acceptable private activities, including construction of sports facilities and privately owned (as opposed to government owned) airports, docks, wharves, and mass-commuting facilities. In **Table 2**, the activities that must be government owned to qualify for tax-exempt financing are identified in italics. After enactment of TRA 1986, there were several other additions to the list of qualified private activities. The date of introduction for each qualified private activity is included in the last column of **Table 2**.

Empowerment Zones and New York Liberty Zones

In addition to the private activities listed in **Table 2**, Congress has at times created special zones where tax-exempt private activity bonds could be issued for qualified economic development projects in that zone. The Empowerment Zone/Enterprise Community (EZ) program was implemented in rounds and each round was subject to different debt rules. Round I EZ bonds were subject to the state volume cap, and each zone could have only $3 million of EZ bonds outstanding.[28] There were also limits on the amount of Round I EZ bonds any one borrower could have outstanding. An EZ borrower could have an aggregate of $20 million outstanding for all EZ projects throughout the country.

Round II EZs (and all EZs established after December 31, 2001) were subject to designation "lifetime" caps depending on the urban vs. rural designation and population for urban EZs. For the lifetime of the EZ designation, rural EZs could issue up to $60 million; urban EZs with population less than 100,000 could issue up to $130 million; and urban EZs with population greater than 100,000 could issue up to $230 million. In contrast to Round I EZs, there were no limits on the amount any one entity could borrow for Round II EZs.[29] Designation of Empowerment Zones and the authority to issue EZ bonds expired on December 31, 2016.

The New York Liberty Zone (NYLZ) was established in the wake of the September 11, 2001, terrorist attacks upon New York City.[30] The tax benefits created to foster economic revitalization within the NYLZ included a "Liberty Bond" program. The program allowed New York State (in conjunction and coordination with New York City) to issue up to $8 billion of tax-exempt, private activity bonds for qualified facilities in the NYLZ. Qualified facilities followed the exempt facility rules within Section 142 of the IRC. The initial deadline to issue these bonds was January 1, 2005, however, the deadline was extended three times until January 1, 2014. The most recent extension was made by P.L. 112-240.

The Safe, Accountable, Flexible, Efficient, Transportation Equity Act of 2005

This legislation created a new type of tax-exempt private activity bond for the construction of rail to highway (or highway to rail) transfer facilities. The national limit is $15 billion and the bonds

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[28] A special EZ for the District of Columbia allows up to $15 million of outstanding EZ bond debt.

[29] See the following publication for more details on the EZ programs: U.S. Department of Housing and Urban Development, *Tax Incentive Guide for Businesses in the Renewal Communities, Empowerment Zones, and Enterprise Communities: FY2003.* The report is available at the Department of Housing and Urban Development website: https://www.hudexchange.info/resources/documents/Tax-Incentive-Guide-Businesses-RCEZEC-FY-2003.pdf.

[30] Section 301 of the Job Creation and Worker Assistance Act of 2002, P.L. 107-147, created the various NYLZ tax benefits (26 U.S.C. 1400L). The tax-exempt bond component can be found in 26 U.S.C. 1400L(d).

are not subject to state volume caps for private activity bonds. The Secretary of Transportation allocates the bond authority on a project-by-project basis.

Gulf Opportunity Zone Act of 2005

The hurricanes that struck the gulf region in late summer 2005 prompted Congress to create a tax-advantaged economic development zone intended to encourage investment and rebuilding in the gulf region. The Gulf Opportunity Zone (GOZ) comprised the counties where the Federal Emergency Management Agency (FEMA) declared the inhabitants eligible for individual and public assistance. Based on proportion of state personal income, the Katrina-affected portion of the GOZ represented approximately 73% of Louisiana's economy, 69% of Mississippi's, and 18% of Alabama's.[31]

Specifically, the Gulf Opportunity Zone Act of 2005 (GOZA 2005; P.L. 109-35) contains two provisions that expanded the amount of private activity bonds outstanding and language to relax the eligibility rules for mortgage revenue bonds. The most significant is the provision to increase the volume cap (see **Table 2**) for private activity bonds issued for Hurricane Katrina recovery in Alabama, Louisiana, and Mississippi (identified as the Gulf Opportunity Zone, or "GO Zone"). GOZA 2005 added $2,500 per person in the federally declared Katrina disaster areas in which the residents qualified for individual and public assistance. The increased volume capacity added approximately $2.2 billion for Alabama, $7.8 billion for Louisiana, and $4.8 billion for Mississippi in aggregate over the next five years through 2010. The legislation defines "qualified project costs" that can be financed with the bond proceeds as (1) the cost of any qualified residential rental project (26 §142(d)) and (2) the cost of acquisition, construction, reconstruction, and renovation of (i) nonresidential real property (including fixed improvements associated with such property) and (ii) public utility property (26 §168(i)(10)) in the GOZ. The additional capacity originally had to be issued before January 1, 2011, but was extended to January 1, 2012, by P.L. 111-312. The original provision was estimated to cost $1.556 billion over the 2006-2015 budget window, while extending the issuance deadline by one year was estimated to cost $0.226 billion over the 2009-2020 budget window.[32]

The second provision allows for advance refunding of certain tax-exempt bonds. Under GOZA 2005, governmental bonds issued by Alabama, Louisiana, and Mississippi could be advance refunded an additional time and exempt facility private activity bonds for airports, docks, and wharves once. Private activity bonds are otherwise not eligible for advance refunding. Following is a brief description of advance refunding and how the GOZA 2005 provision conferred a significant tax benefit to the Gulf states.

Refunding is the practice of issuing new bonds to buy back outstanding bonds to potentially lower interest costs. *Advance* refunding is the practice of allowing the new bonds to be outstanding for longer than 90 days. Advance refunding, thus, allows for the existence of two sets of federally tax-exempt bond issues to be outstanding at the same time for a single project. P.L. 115-97, the 2017 tax revision, disallows the federal income exclusion of interest income earned from an advance refunding bond for bonds issued after December 31, 2017. GOZA 2005 allowed

[31] See archived CRS Report RL33154, *The Impact of Hurricane Katrina on the State Budgets of Alabama, Louisiana, and Mississippi*, by Steven Maguire (available for congressional clients upon request).

[32] The 10-year revenue loss estimates for GOZA 2005 are from the Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 4440, the 'Gulf Opportunity Tax Relief Act of 2005,'* as passed by the House of Representatives and the Senate on December 16, 2005, JCX-89-05, December 20, 2005. The 10-year revenue loss estimates for P.L. 111-312 are from the Joint Committee on Taxation, *General Explanation of Tax Legislation in the 111th Congress*, JCS-2-11.

the states of Alabama, Louisiana, and Mississippi to advance refund $1.125 billion, $4.5 billion, and $2.25 billion, respectively. This provision was estimated to cost $741 million over the 2006-2015 budget window.[33] For more on advance refunding, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*, by Grant A. Driessen.

The Housing and Economic Recovery Act of 2008

In response to the housing crisis of 2008, Congress included two provisions in the Housing and Economic Recovery Act of 2008 (HERA; P.L. 110-289) that are intended to assist the housing sector. First, HERA provided that interest on qualified private activity bonds issued for (1) qualified residential rental projects, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds would not be subject to the AMT. In addition, HERA also created an additional $11 billion of volume cap space for bonds issued for qualified mortgage bonds and qualified bonds for residential rental projects. The cap space was designated for 2008 but could be carried forward through 2010.

The American Recovery and Reinvestment Act of 2009

In response to the 2008 financial crisis and economic recession, Congress included several bond-related provisions in the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5). The following three provisions were intended to make bond financing less expensive for the designated facilities. One expanded the definition of qualified manufacturing facilities (under §144(a)(12)(C)) to include the creation and production of intangible property including patents, copyrights, formulae, etc. Before ARRA, only tangible property was eligible. The second created a new category of private activity bond called "recovery zone facility bonds." The bonds were to be used for investment in infrastructure, job training, education, and economic development in economically distressed areas. The bonds, which were subject to a separate national cap of $15 billion allocated to the states based on the decline in employment in 2008, were to be issued in 2009 and 2010.

A third provision provided $2 billion for tribal governments to issue tax-exempt bonds for economic development purposes. The tax code generally allows tribal governments to issue debt for "essential government functions" only. Many economic development projects would not qualify absent this ARRA provision.

The Infrastructure Investment and Jobs Act of 2021

The Infrastructure Investment and Jobs Act of 2021 (IIJA; P.L. 117-58) made a number of changes to federal incentives for infrastructure development, and included an expansion of the list of activities eligible for exempt facility bonds. Section 80401 of the IIJA added a category for qualified broadband projects, defined as projects that intend to provide high-speed broadband solely to census tracts with existing broadband connectivity speeds below certain thresholds. Section 80402 of the IIJA created a new category for qualified carbon capture facilities, which are facilities that recover and store carbon dioxide emissions otherwise produced from industrial production. Qualified broadband projects that are government owned are entirely excluded from the annual state volume cap; otherwise, only 25% of the issuance amounts for each new category are subject to the volume cap.

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[33] JCT, December 20, 2005.

IRS Review of Tax-Exempt Status

The IRS often reviews the tax-exempt status of outstanding bonds issued for *qualified* private activities. If the bonds that were originally issued as tax-exempt are found to no longer qualify (meaning that they pass both the security and use tests or fail the private loan financing test), the interest on the bonds becomes taxable. Technically, bond holders are the recipient of the tax benefit and are responsible for remitting forgone taxes to the Treasury when a tax-exempt bond fails to qualify. A *retroactive* taxability finding means all previous tax benefits to the bond holder would have to be returned to the Treasury. A *prospective* taxability finding means all future interest payments would be taxable to the bond holder. However, in most cases, the IRS will settle the apparent violation by requiring that the issuer, not the bond holders, pay a monetary penalty and that the issuer change the circumstances that led to the noncompliance finding.[34]

What Is the Private Activity Volume Cap?[35]

The federal government has limited the amount of private activity bonds that states can issue to a subset of the 30 activities listed in **Table 2** and to EZ bonds. The third column of **Table 2** identifies the 16 activities (of the 30) that are subject to an annual state volume cap. The annual cap is adjusted each year for inflation, and is the greater of $110 per capita or $335 million in 2022. For small states, the $335 million minimum provides a more generous volume cap than the per capita allocation. **Figure 1** lists the volume cap amount in 2022 relative to 2020 state personal income.

Of the 16 activities subject to an annual volume cap, 4 are treated differently than the others, and 4 others are subject to a separate cap. First, states are required to count only 25% of the bonds issued for high-speed intercity rail facilities (26 U.S.C. 142(i)), qualified broadband projects (26 U.S.C. 142(n)), and qualified carbon capture facilities (26 U.S.C. 142(o)) against the annual cap. If the high-speed intercity rail facility or broadband project is government owned and operated, no cap allocation is required. Second, bonds issued for solid waste disposal facilities (26 U.S.C. 142(a)(6)) are not subject to the cap if the facility is government owned and operated.

Table 2. Qualified Private Activities

Internal Revenue Code Section	Type of Private Activity (Italicized activities must be owned by the issuing government to qualify)	Subject to Volume Cap	Year Established
§142	**Exempt facility bonds**		
§142(c)	*Airports*	No	1968
§142(c)	*Docks and wharves*	No	1968
§142(c)	*Mass commuting facilities*	Yes	1981
§142(e)	Water furnishing facilities	Yes	1968
§142(a)(5)	Sewage facilities	Yes	1968
§142(a)(6)	Solid waste disposal facilities (government owned)	No	1968
§142(a)(6)	Solid waste disposal facilities (private owned)	Yes	1968
§142(d)	Qualified residential rental projects	Yes	1968
§142(f)	Local electric energy or gas furnishing facility	Yes	1968

[34] See the following IRS website for more information on tax-exempt bond rulings and findings: http://www.irs.gov/compliance/index.html.

[35] 26 U.S.C. 146.

Internal Revenue Code Section	Type of Private Activity (Italicized activities must be owned by the issuing government to qualify)	Subject to Volume Cap	Year Established
§142(g)	Local district heating and cooling facilities	Yes	1982
§142(h)	Qualified hazardous waste facilities	Yes	1986
§142(i)	High-speed intercity rail facilities (government)	No	1988
§142(i)	High-speed intercity rail facilities (private)	Yes[a]	1988
§142(j)	*Environmental enhancements of hydroelectric generating facilities*	No	1992
§142(k)	Qualified public educational facilities	No	2001
§142(l)	Qualified green building and sustainable design projects	No	2005
§142(m)	Qualified highway and surface freight transfer facilities	No	2005
§142(n)	Qualified broadband projects (government)	No	2021
§142(n)	Qualified broadband projects (private)	Yes[a]	2021
§142(o)	Qualified carbon capture facilities	Yes[a]	2021
§1400U-3	Recovery zone facility bonds	No	2009
§1394	New empowerment zone facilities	No	1994
§143	**Mortgage revenue bonds**		
§143(a)	Qualified mortgage bond	Yes	1968
§143(b)	Qualified veterans' mortgage bond	No	1968
§144(a)	**Qualified small issue bond**	Yes	1968
§144(b)	**Qualified student loan bond**	Yes	1976
§144(c)	**Qualified redevelopment bond**	Yes	1968
§145	**Qualified 501(c)(3) bond**	No	1968
§150	**Current refunding bonds not exceeding outstanding amount of refunding bonds**	No[b]	1968
§150	**Current refunding bonds exceeding outstanding amount of refunding bonds**	Yes	1968

Source: IRS Publication 4078 and Infrastructure Investment and Jobs Act of 2021 (P.L. 117-58).

a. 25% of the bond issue is included in the cap.

b. Maturity limitations apply for refundings of qualified mortgage revenue bonds and qualified student loan bonds.

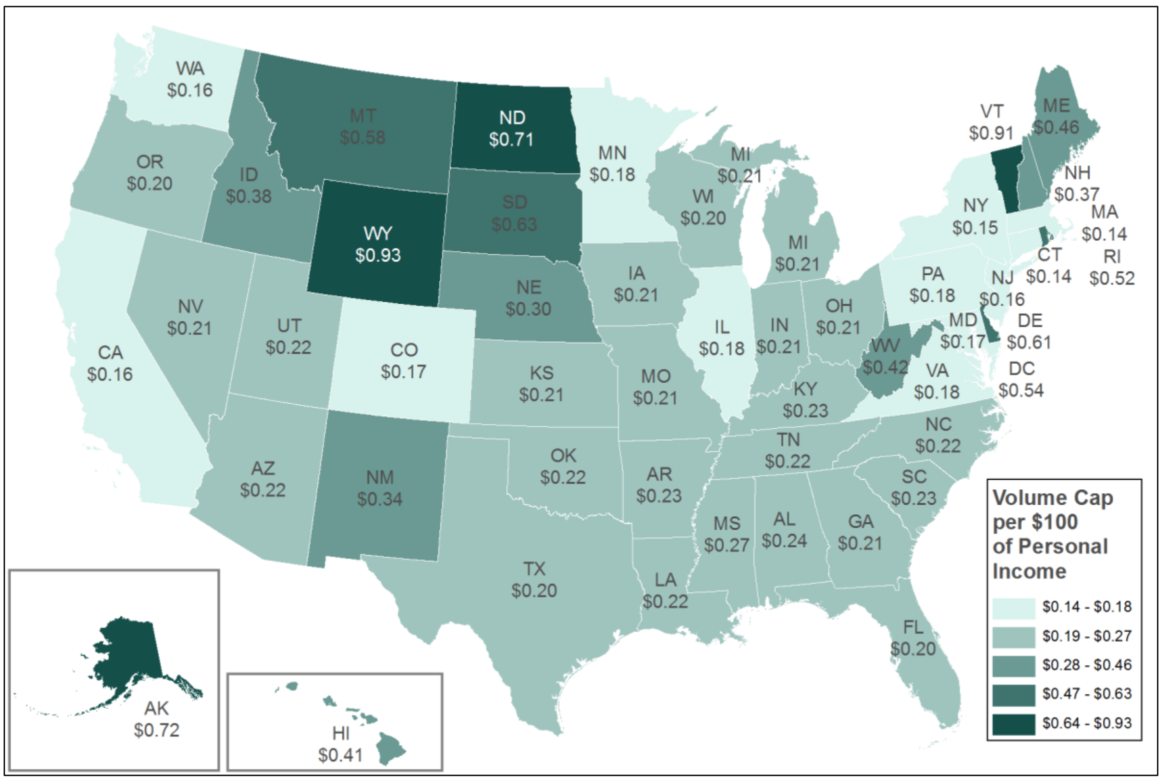
Qualified public educational facilities (26 U.S.C. 142(k)) are subject to a separate annual cap, which is the greater of $10 per capita or $5 million. Three activities—bonds for green buildings (26 U.S.C. 142(l)), highway-freight transfer facilities (26 U.S.C. 142(m)), and recovery zone facilities (26 U.S.C. 1400U-3)—are subject to a separate cap. Green buildings are subject to a $2 billion lifetime (not annual) cap, and transfer facilities are subject to a lifetime cap of $15 billion.[36] The $15 billion of recovery zone facility bonds were allocated to the states by formula

[36] For more on the transfer facility private activity bond program, see U.S. Department of Transportation, "Applications for Authority for Tax-Exempt Financing of Highway Projects and Rail-Truck Transfer Facilities," 71 *Federal Register* 642, January 5, 2006.

then further suballocated to local jurisdictions, also by formula. Generally, a jurisdiction received an allocation that matches its ratio of the total decrease in employment relative to the national decline in employment in 2008.[37]

The total 2022 private activity bond volume cap for all states and the District of Columbia is about $39.8 billion.[38] The cap for California is over one-tenth of total new volume in 2022, or $4.3 billion. However, as measured against total California personal income, the new volume cap is below the national average. For every $100 of 2020 personal income in California, approximately $0.16 of private activity debt can be issued in 2022, whereas the U.S. average is $0.20. In contrast, Wyoming could issue up to $0.93 of private activity debt for every $100 of personal income using its 2022 volume cap allocation. The less populous states are more likely not to use the entire annual cap amount for this reason.[39] See **Table A-1** for more details on 2022 state volume caps.

Figure 1. Annual State Private Activity Bond Volume Cap for 2022 and State Cap Per $100 of State Personal Income



Source: Personal income data are from 2020 measurements from the Bureau of Economic Analysis, State Annual Personal Income, available at http://www.bea.gov/. Graphic and analysis by CRS.

[37] The IRS has established the following website to report those allocations: http://www.irs.gov/pub/irs-tege/rzblocalreallocations.pdf.

[38] All 2022 volume cap estimates are calculated by CRS using 2021 Census population estimates published in December 2021. Federal statute requires state population estimates for the annual volume cap to draw from the most recent Census population estimates published before the beginning of the year.

[39] For more on state use of the volume cap, see archived CRS Report RL34159, *Private Activity Bonds: An Analysis of State Use, 2001 to 2006*, by Steven Maguire (available for congressional clients upon request).

This disparity arises from the two-part volume capacity calculation, which provides for a minimum of $335 million, regardless of state population. In addition, states that have total personal income below the national average would also have a relatively high debt allowance as measured against personal income. **Figure 1** provides a comparative measure of the state-by-state volume capacity based on 2020 state personal income.

Bond Use by Type of Activity

Each state independently determines the allocation of its volume capacity. **Table 3** identifies the total distribution for private activities for 2017, not just those bonds subject to the cap. The data roughly reflect the cap allocation preferences of the states and their subdivisions for those activities subject to the cap.

Roughly half of the available volume capacity in any given year is carried forward to the following year.[40] Unused volume capacity can be carried forward for up to three years, as long as the state identifies the project for which the cap space is dedicated. Bond capacity that has not been used after three years is then abandoned.

Table 3. Private Activity Bond Use, 2017

(figures are in millions of dollars)

Bond purpose	All Issues ($)	New Issues ($)	Refunding Issues ($)	% of All Issues
Total	142,407	69,924	72,483	
Airports	13,319	7,689	5,630	9.4%
Docks and wharves	1,296	632	664	0.9%
Water, sewage, and solid waste disposal facilities[a]	2,419	2,013	404	1.7%
Qualified residential rental facilities[a]	17,083	13,980	3,103	12.0%
Local electricity or gas furnishing facilities[a]	[b]	0	[b]	[b]
Tax Reform Act of 1986 transition properties	1,129	[b]	[b]	0.8%
Empowerment zone facilities	[b]	[b]	0	[b]
Qualified highway or surface freight transfer facilities	1,903	1,903	0	1.3%
Qualified Gulf Opportunity Zone facilities	1,456	0	1,456	1.0%
Qualified New York Liberty bonds	[b]	0	[b]	[b]
Mass commuting facilities	[b]	[b]	[b]	[b]
Local heating/cooling facilities[a]	[b]	[b]	[b]	[b]

[40] The Council of Development Finance Agencies (CDFA) independently compiles data on abandoned QPAB capacity by state in its annual *National Volume Cap Map & Report*, available at https://www.cdfa.net/cdfa/volumecap.nsf/search.html.

Hydro-electric environmental facilities	b	0	b	b
Qualified Midwestern disaster area exempt facilities	265	0	265	0.2%
Recovery zone exempt facilities	157	0	157	0.1%
Qualified mortgages[a]	8,151	5,695	2,456	5.7%
Qualified veterans' mortgages	b	b	b	b
Qualified small issues[a]	349	270	79	0.2%
Qualified student loans[a]	1,222	786	436	0.9%
Qualified redevelopment[a]	b	b	b	b
Qualified hospital facilities	37,880	13,126	24,754	26.6%
Qualified Section 501(c)(3) nonhospital	54,569	23,381	31,188	38.3%
Nongovernmental output properties	b	0	b	b
Other purposes	91	b	b	0.1%

Source: IRS Statistics of Income, Tax Exempt Bond Statistics, Table 07 *Long-Term Bonds – Number of Bonds Issued, Entire Issue Price.*

a. Activities subject to annual state cap.

b. Data deleted to avoid disclosure of information about specific bonds. However, the data are included in the appropriate totals.

Other Restrictions on Private Activity Bonds

The use of private activity bonds is also limited by other technical restrictions. In general, loosening the restrictions would allow issuers to reduce administrative and compliance costs. However, the relaxed restrictions would exacerbate the concerns (i.e., the economically inefficient allocation of capital) surrounding tax-exempt bonds that were discussed earlier in the report. Following is a list of the more technical rules along with the section in the tax code where the rule appears.

- The maturity of the bonds cannot be greater than 120% of the economic life of the asset purchased with the bonds (26 U.S.C. 147(b));
- less than 25% of the bond proceeds can be used to acquire land (except for qualified first-time farmers) (26 U.S.C. 147(c));
- proceeds of the bond issue cannot be used to purchase existing property unless greater than 15% of the cost of acquiring the property is spent on rehabilitating the property (26 U.S.C. 147(d));
- public approval of bonds, either through public hearing and notice or voter referendum, is required for private activity bonds (26 U.S.C. 147(f));

- issuance costs cannot be any greater than 2% of the bond proceeds (3.5% for mortgage bond issues of less than $20 million) (26 U.S.C. 147(g)); and
- private activity bonds cannot be advance refunded.[41]

[41] Current refunding is the practice of issuing bonds to replace existing bonds. Issuers typically do this to "lock-in" lower interest rates or more favorable borrowing terms. Current refunding is allowed as long as the "old" bonds are redeemed within 90 days of the issuance of the refunding bonds. Advance refunding is the practice of issuing new bonds to replace existing bonds, but not immediately (within 90 days) retiring the old bonds. Thus, two sets of tax-exempt bonds are outstanding for the same project.

Appendix. Annual State Private Activity Bond Volume Cap and Personal Income Data

Table A-1. Annual State Private Activity Bond Volume Cap and Personal Income Data

State	2022 Volume Cap ($ millions)	2020 Personal Income ($ billions)	2022 Cap per $100 of 2020 Personal Income
U.S. Total	39,754	19,607	$0.20
Alabama	554	228	$0.24
Alaska	335	46	$0.72
Arizona	800	368	$0.22
Arkansas	335	143	$0.23
California	4,316	2,763	$0.16
Colorado	639	370	$0.17
Connecticut	397	280	$0.14
Delaware	335	55	$0.61
District of Columbia	335	62	$0.54
Florida	2,396	1,210	$0.20
Georgia	1,188	555	$0.21
Hawaii	335	83	$0.41
Idaho	335	89	$0.38
Illinois	1,394	792	$0.18
Indiana	749	351	$0.21
Iowa	351	169	$0.21
Kansas	335	163	$0.21
Kentucky	496	212	$0.23
Louisiana	509	236	$0.22
Maine	335	73	$0.46
Maryland	678	405	$0.17
Massachusetts	768	541	$0.14
Michigan	1,106	531	$0.21
Minnesota	628	351	$0.18

Mississippi	335	125	$0.27
Missouri	679	318	$0.21
Montana	335	58	$0.58
Nebraska	335	112	$0.30
Nevada	346	169	$0.21
New Hampshire	335	92	$0.37
New Jersey	1,019	652	$0.16
New Mexico	335	98	$0.34
New York	2,182	1,440	$0.15
North Carolina	1,161	533	$0.22
North Dakota	335	47	$0.71
Ohio	1,296	627	$0.21
Oklahoma	439	199	$0.22
Oregon	467	239	$0.20
Pennsylvania	1,426	789	$0.18
Rhode Island	335	64	$0.52
South Carolina	571	251	$0.23
South Dakota	335	53	$0.63
Tennessee	767	352	$0.22
Texas	3,248	1,619	$0.20
Utah	367	170	$0.22
Vermont	335	37	$0.91
Virginia	951	532	$0.18
Washington	851	516	$0.16
West Virginia	335	80	$0.42
Wisconsin	649	324	$0.20
Wyoming	335	36	$0.93

Source: Personal income data are from the Bureau of Economic Analysis, State Annual Personal Income, available at http://www.bea.gov/. Bond volume cap information are CRS calculations using 2021 Census population data.

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