

**PRESENT LAW AND BACKGROUND INFORMATION RELATED
TO STATE AND LOCAL GOVERNMENT FINANCE**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on April 25, 2012

Prepared by the Staff
of the
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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on “Tax Reform: What it Means for State and Local Tax and Fiscal Policy” for April 25, 2012. This document,¹ prepared by the staff of the Joint Committee on Taxation, summarizes tax-exempt and tax-credit bond provisions, the provisions allowing a deduction for certain State and local taxes, and provides select background data relating to State and local bonds and revenues.

Tax-exempt and tax-credit bonds

Present law generally involves three different structures to deliver Federal borrowing subsidies on State and local governmental bonds:

- 1) tax-exempt bonds (in which the State and local governmental borrowing cost is lower because the interest income is tax-exempt to the investor and thus the investor is willing to accept a lower interest rate);
- 2) tax-credit bonds (in which the State and local governmental borrowing cost is lower because investors receive Federal tax credits to replace a prescribed portion of the interest cost on the taxable bonds); and
- 3) tax-credit bonds issued as “direct-pay bonds” (in which the State or local governmental borrowing cost is lower because the Federal Government makes direct payments to issuers to cover a prescribed portion of the interest cost on the taxable bonds, for example the now expired Build America Bonds program and certain specified tax-credit bonds).

Over the period 2002 through 2011, State and local governments have issued on average \$384 billion in tax-exempt bonds.² Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Because the income is excludible, investors generally are willing to accept a lower rate of interest on tax-exempt bonds than they might otherwise accept on a taxable investment. This lower rate of interest, in turn, lowers the borrowing cost for the beneficiaries of such financing.

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current or recently expired tax-credit bonds include qualified tax

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Information Related to State and Local Government Finance* (JCX-36-12), April 23, 2012. This document can also be found on our website at www.jct.gov.

² Securities Industry and Financial Markets Association, U.S. Municipal Issuance, available at <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Municipal-US-Municipal-Issuance-SIFMA.xls>.

credit bonds, recovery zone economic development bonds, and Build America bonds.³ Qualified tax credit bonds, which have certain common general requirements, include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy (“QZABs”), and qualified school construction bonds.

The Federal subsidy for tax-credit bonds is economically equivalent to the Federal government directly paying the interest on a taxable bond issue on behalf of the State or local government benefiting from the bond proceeds. The Code⁴ provides that an issuer may opt to issue certain tax credit bonds as “direct-pay bonds.” Instead of a credit to the holder, with a “direct-pay bond” the Federal government pays the issuer a percentage of the interest on the bonds.

For tax-credit bonds and direct-pay bonds, the depth or extent of the Federal borrowing subsidy has varied among programs. For example, for qualified school construction bonds and QZABs, the Federal borrowing subsidy is 100 percent of the interest cost. For qualified energy conservation bonds and new clean renewable energy bonds the Federal borrowing subsidy is 70 percent of the interest cost. The Federal subsidy is 35 percent of the interest cost for Build America Bonds (45 percent in the case of recovery zone economic development bonds).

Federal deductions for State and local taxes

A U.S. citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income. Taxable income equals the taxpayer’s total gross income less certain exclusions, exemptions, and deductions, including the applicable standard deduction. A taxpayer may elect to itemize deductions in lieu of the applicable standard deduction. Generally only about one-third of taxpayers elect to itemize deduction in lieu of taking the standard deduction because for most taxpayers, the applicable standard deduction is greater.

For purposes of determining taxable income, taxpayers are permitted an itemized deduction for the taxable year in which such taxes are paid or accrued for any (1) State and local real property taxes; (2) State and local personal property taxes; and (3) State and local income taxes. For taxable years beginning in 2004 through 2011, at the election of the taxpayer, an itemized deduction is allowed for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes.

For 2012, the staff of the Joint Committee on Taxation estimates that 44.8 million returns will itemize deductions for \$174.0 billion of real property taxes, 42.5 million returns will itemize deductions for \$291.5 billion of State and local income taxes, 22.4 million returns will itemize deductions for \$9.5 billion of personal property taxes, and 2.8 million returns will itemized deductions for \$1.9 billion of other taxes.

³ The authority to issue Build America bonds and recovery zone economic development bonds expired December 31, 2010.

⁴ Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

I. TAX-EXEMPT BONDS

A. Overview

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes.⁵ Because the income is excludible, investors generally are willing to accept a lower rate of interest on tax-exempt bonds than they might otherwise accept on a taxable investment. This lower rate of interest, in turn, lowers the borrowing cost for the beneficiaries of such financing. The direct cost to the Federal government of the interest exclusion for State and local bonds is the forgone income tax revenue.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds generally are bonds for which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income of interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) and other Code requirements are met.

⁵ In order to be tax-exempt, such bonds also must satisfy any applicable State and local laws.

B. Tax-Exempt Governmental Bonds and Private Activity Bonds

In general

Present law does not limit the types of facilities that can be financed with governmental bonds. Thus, State and local governments can issue tax-exempt, governmental bonds to finance a broad range of projects. However, while the types of projects eligible for governmental bond financing are not circumscribed, present law imposes restrictions on the parties that may benefit from such financing. For example, present law limits the amount of governmental bond proceeds that can be used by nongovernmental persons. Use of bond proceeds by nongovernmental persons in excess of amounts permitted by present law may result in such bonds being treated as taxable private activity bonds, rather than tax-exempt governmental bonds. The Code does not expressly define a governmental bond. Instead it defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test (“the private business test”); or (2) the private loan financing test.⁶ Generally, private activity bonds are taxable unless issued as qualified private activity bonds.

Generally, governmental bonds are not subject to restrictions that apply to bonds used to finance private activities. For example, governmental bonds are not subject to issuance cost, maturity, and annual volume limitations that generally apply to qualified private activity bonds.

Private business test

Under the private business test, a bond is a private activity bond if it is part of an issue in which:

- 1) more than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit (“private business use”); and
- 2) more than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use (“private payment test”).⁷

A bond is not a private activity bond unless both parts of the private business test (*i.e.*, the private business use test and the private payment test) are met. Thus, a facility that is 100 percent privately used does not cause the bonds financing such facility to be private activity bonds if the bonds are not secured by or paid with private payments. For example, land improvements that benefit a privately-owned factory may be financed with governmental bonds if the debt service on such bonds is not paid by the factory owner or other private parties.

⁶ Sec. 141.

⁷ The 10 percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.

In general, private business use arises when a private business owns or leases tax-exempt bond financed facilities or otherwise has legal rights to the beneficial use of such facilities. A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use depending on the terms of the contract.⁸ In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits.⁹ For example, a management contract with respect to a commuter rail facility that compensates the management company based on the profits of such facility would result in private use. Contracts for service incidental to the facility's primary functions, such as janitorial, office equipment repair and similar services, are not considered management contracts.

For purposes of the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.¹⁰

Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of \$5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons. Private loans include both business and other (*e.g.*, personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

⁸ Treas. Reg. sec. 1.141-3(b)(4).

⁹ In addition to net profits, there are other indices of private business use involving management contracts. A management agreement for a tax-exempt bond financed facility that does not meet the safe harbor provisions of Rev. Proc. 97-13 generally causes there to be private business use of the facility by the manager. 1997-1 C.B. 632.

¹⁰ Treas. Reg. sec. 1.141-4(c)(3).

C. Qualified Private Activity Bonds

In general

Qualified private activity bonds are tax-exempt bonds issued to provide financing for specified privately used facilities. “Qualified private activity bond” means an exempt facility bond, or qualified mortgage, veterans’ mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.¹¹

Exempt facility bonds

To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance an eligible facility.¹² Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, high-speed intercity rail facilities, and qualified highway or surface freight transfer facilities), privately owned and/or operated public works facilities and certain other facilities specifically identified in the Code.

Airports

Exempt facility bonds may be issued to finance airports. Exempt facility bonds for airports are not subject to the State volume cap. However, all tax-exempt bond financed airport property must be governmentally owned. Property eligible for this financing includes land, terminals, runways, and related equipment. Airplanes are not eligible for tax-exempt financing. Additionally, certain real property facilities (and related equipment) are excluded from this financing.

Port facilities

Exempt-facility bonds may be issued to finance port (“dock and wharf”) facilities and related storage and training facilities. Facilities that are specifically ineligible for financing with airport bonds may not be financed with port bonds. Further, ships and other vessels are not eligible for private activity tax-exempt bond financing. All property financed with these bonds must be governmentally owned. Exempt facility bonds issued for ports are not subject to the State volume cap described below.

Mass commuting facilities

Exempt facility bond financing for mass commuting facilities is subject to similar restrictions as those which apply to such bonds for airports and ports. All property financed with these bonds must be governmentally owned. Further, “rolling stock” (e.g., buses and rail cars) are not eligible for financing with exempt facility bonds.

¹¹ Sec. 141(e).

¹² Sec. 142(a).

High-speed intercity rail facilities

The definition of an exempt facility bond includes bonds issued to finance high-speed intercity rail facilities.¹³ A facility qualifies as a high-speed intercity rail facility if it is a facility (other than rolling stock) for fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas.¹⁴ The facilities must use vehicles that are reasonably expected to be capable of attaining a maximum speed in excess of 150 miles per hour between scheduled stops, and the facilities must be made available to members of the general public as passengers.

Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned. However, if the bonds are to be issued for a nongovernmental owner of the facility, such owner must irrevocably elect not to claim depreciation or credits with respect to the property financed by the net proceeds of the issue.¹⁵

The Code imposes a special redemption requirement for these types of bonds. Any proceeds not used within three years of the date of issuance of the bonds must be used within the following six months to redeem such bonds.¹⁶

Seventy-five percent of the principal amount of the bonds issued for high-speed rail facilities is exempt from the volume limit.¹⁷ If all the property to be financed by the net proceeds of the issue is to be owned by a governmental unit, then such bonds are completely exempt from the volume limit.

Qualified highway or surface freight transfer facility bonds

Present law authorizes the issuance of tax-exempt private activity bonds to finance qualified highway or surface freight transfer facilities. A qualified highway facility or surface freight transfer facility is any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code or any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Qualified highway or surface freight transfer facility bonds are not subject to the State volume limitations. Rather, the Secretary of Transportation is authorized to allocate a total of

¹³ Sec. 142(a)(11) and sec. 142(i).

¹⁴ A metropolitan statistical area for this purpose is defined by reference to section 143(k)(2)(B). Under that provision, the term metropolitan statistical area includes the area defined as such by the Secretary of Commerce.

¹⁵ Sec. 142(i)(2).

¹⁶ Sec. 142(i)(3).

¹⁷ Sec. 146(g)(4).

\$15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate.¹⁸

Similar to the requirement for high-speed intercity rail facilities, the Code imposes a special redemption requirement for qualified highway or surface freight transfer facility bonds. Under present law, the proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds.

Sewage facilities

The Code permits the issuance of exempt facility bonds for sewage facilities. This includes property used for certain levels of treatment of wastewater and property used for collection, storage, use, processing, or final disposal of wastewater, sewage, septage.

¹⁸ As of May 2011, from the \$15 billion in qualified highway or surface freight transfer facility bond authority, the Department of Transportation had made the following allocations (bonds issued where indicated):

Project	PAB Allocation
Bonds issued	
Capital Beltway HOT Lanes, Virginia	\$589,000,000
North Tarrant Express, Texas	\$400,000,000
IH 635 (LBJ Freeway), Texas	\$615,000,000
Denver RTD Eagle Project (East Corridor and Gold Line), Colorado	\$397,835,000
CenterPoint Intermodal Center, Joliet, Illinois	\$150,000,000
Subtotal	\$2,151,835,000
Allocations	
Knik Arm Crossing, Alaska	\$600,000,000
CenterPoint Intermodal Center, Joliet, Illinois	\$1,190,000,000
I-80 RailPort, Seneca, Illinois	\$576,000,000
Subtotal	\$2,386,000,000
Total PAB allocations and issuance	\$4,517,835,000

Source: Federal Highway Administration [http://www.fhwa.dot.gov/ipd/fact_sheets/pabs.htm].

Water facilities

The Code permits the issuance of exempt facility bonds for water facilities. This provision covers facilities furnishing water that is made available to the general public, including electric utility, industrial, agricultural, or other commercial users. Such facilities must be operated by a governmental unit or the rates for sale of water must be approved by a governmental unit.

Facilities for the local furnishing of electric energy or gas

The Code permits the issuance of exempt facility bonds for facilities for the local furnishing of electric energy or gas. This generally includes a facility furnishing electric energy or gas serving an area not to exceed two contiguous counties or a city and one contiguous county.

Local district heating or cooling facilities

The Code permits the issuance of exempt facility bonds for local district heating and cooling facilities. Such a facility provides hot water, chilled water, or steam to two or more users for residential, commercial, or industrial heating or cooling, or process steam. The use of this financing is limited to financing a facility for the local furnishing of gas or electricity only if (1) the facility will be used by a person who is engaged in the local furnishing of that energy source on January 1, 1997, and be used to provide service within the area served by such person on January 1, 1997 (or with a county or city any portion of which is within such area) or (2) the facility will be used by a successor in interest to such person for the same use and within the same service area as described in (1).

Hazardous waste disposal facilities

Facilities for the incineration or permanent entombment of hazardous waste are permitted to be financed by exempt facility bonds if certain requirements are met.

Other exempt facility bonds

In addition to exempt facility bonds for transportation and privately owned and/or operated public works facilities discussed above, tax-exempt exempt facility bonds may be used for privately-owned and/or operated residential rental housing, qualified public educational facilities, and qualified green building and sustainable design projects. Environmental enhancements of hydro-electric generating facilities also may qualify for exempt facility bonds.

Other qualified private activity bonds

Qualified mortgage bonds

Owner-occupied housing may be financed with qualified mortgage bonds. Qualified mortgage bonds are bonds issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers

and purchase price limitations for the home financed with bond proceeds. In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement). Special income and purchase price limitations and first-time homebuyer waivers apply to targeted area residences and in certain disaster areas. Also, the Code provides an exception from the first-time homebuyer requirement for certain veterans provided that the veteran has not previously received financing under any State’s qualified mortgage bond program.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Generally, qualified home-improvement loans may not exceed \$15,000, however special rules apply for certain disaster areas, including increasing the loan maximum.

Qualified veterans’ mortgage bonds

Qualified veterans’ mortgage bonds are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences of qualified veterans located within the jurisdiction of the issuer of the bonds. A qualified veterans’ mortgage bond may be issued only by those States that issued such bonds before June 22, 1984. These States are Alaska, California, Oregon, Texas, and Wisconsin. Annual issuance of qualified veterans’ mortgage bonds is subject to a separate State limit, but not to the unified State volume cap applicable to most other private activity bonds.

Persons receiving qualified veterans’ mortgage bond loans must be veterans who served on active duty, and who applied for the financing before the date 25 years after the last date on which the borrower left active service. There are no restrictions on purchase price or borrower income, and there is no first-time homebuyer requirement for qualified veterans’ mortgage bond loans.

Small issue bonds

Qualified small issue bonds are tax-exempt bonds issued by State and local governments to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate.¹⁹

¹⁹ The authority to issue small issue bonds for the creation and production of intangibles property (described in sec. 197(d)(1)(C)(iii)) expired December 31, 2010.

Redevelopment bonds

Qualified redevelopment bonds are bonds issued as part of an issue 95 percent or more of the net proceeds of which is to be used for one or more redevelopment purposes in a designated blighted area. A blighted area is an area designated as such by the local governing body of such area based on the substantial presence of factors such as excessive vacant, abandoned or vacant buildings, substandard structures, vacancies, and delinquencies in payment of real property taxes.

Qualified 501(c)(3) bonds

State and local governments may issue tax-exempt bonds to finance the activities of charitable organizations described in section 501(c)(3) (“qualified 501(c)(3) bonds”). The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) may be financed with qualified 501(c)(3) bonds. Qualified 501(c)(3) bonds are not subject to the State volume cap.

Student loan bonds

Qualified student loan bonds are bonds issued to finance eligible student loans. Interest on qualified student loan bonds is tax-exempt. Eligible student loans include Federally guaranteed loans under the Higher Education Act of 1965 and other loans financed as part of a program of general application approved by the State.²⁰

Temporary disaster relief and targeted area bonds

The Code contains several temporary and targeted tax-exempt bond provisions to assist in the rebuilding and recovery of certain areas that have experienced a major disaster. The authority to issue New York Liberty Zone bonds and Gulf Zone bonds expired December 31, 2011. The authority to issue enterprise zone facility bonds and DC Zone bonds also expired December 31, 2011 with the expiration of the underlying programs on the same date. The authority to issue special bonds for areas damaged by the 2008 storms and tornados in the Midwest and for areas damaged by Hurricane Ike expires December 31, 2012.

Additional qualified private activity bonds requirements

State volume cap

Unlike governmental bonds, the aggregate volume of most qualified private activity bonds is restricted by the annual volume cap imposed on issuers within each State.²¹ The per-

²⁰ Sec. 144(b)(1). The Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152) eliminated Federally-guaranteed student loans and terminated the program that allowed the private sector to make loans under the Higher Education Act of 1965. Specifically, the legislation prohibited the origination of new Federal Family Education Loan Program (“FFELP”) loans after June 30, 2010, and required that all new Federal student loans be originated under the William D. Ford Federal Direct Loan Program.

²¹ Sec. 146.

State volume cap rules reflect Congress' intent to control the total volume of tax-exempt bonds issued for private activities. For calendar year 2012, the amount for calculating the volume cap is the greater of \$95 multiplied by the State population, or \$284,560,000 (the "small population State minimum").

Exceptions from the volume cap are provided for bonds for certain governmentally owned facilities (*e.g.*, airports, ports, high-speed intercity rail, and solid waste disposal) and bonds issued to finance the activities of certain charitable organizations. In addition, bonds for which the Code provides a separate local, State, or national volume limit are not subject to the volume cap (*e.g.*, public/private educational facility bonds, enterprise zone facility bonds, qualified green building bonds, and qualified highway or surface freight transfer facility bonds).

If an issuer's volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority may elect to treat all (or any portion) of the excess as a carryforward for one or more specified "carryforward purposes." The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean one of four purposes: issuing exempt facility bonds; issuing qualified mortgage bonds or mortgage credit certificates; issuing qualified student loan bonds; and issuing qualified redevelopment bonds.²² Carryforwards of unused volume cap are valid for three years.

Maturity limitations

Most qualified private activity bonds are subject to a term to maturity rule which limits the period of time such bonds may remain outstanding. Generally, this rule provides that the average maturity of a qualified private activity bond cannot exceed 120 percent of the economic life of the property being financed.²³ The term to maturity rule does not apply to qualified mortgage or student loan bonds.²⁴

Issuance costs

Generally, the amount of costs of issuance (*e.g.*, bond counsel and underwriter fees) that may be paid from qualified private activity bond proceeds is limited to two percent. In addition,

²² Sec. 146(f)(5). Qualified governmental units can elect to exchange all or any portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs"). Sec. 25. MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue \$200 million of qualified mortgage bonds, and that elected to exchange \$100 million of that bond authority, could distribute an aggregate amount of MCCs equal to \$25 million.

²³ Sec. 147(b).

²⁴ Sec. 147(h).

amounts paid for costs of issuance are not treated as spent for the exempt purpose of the borrowing (*i.e.*, are not “good costs”).

Public approval

To be a qualified private activity bond, a bond must satisfy a public approval requirement including providing reasonable public notice for a hearing. Regardless of State and local law, reasonable public notice must include notice “published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or television broadcast to those residents.”²⁵

Prohibited facilities

Qualified private activity bonds generally are subject to restrictions on the use of proceeds for the acquisition of land and existing property, and use of proceeds to finance certain specified facilities (*e.g.*, airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores). Small-issue and redevelopment bonds also are subject to additional restrictions on the use of proceeds for certain facilities (*e.g.*, golf courses and massage parlors).

²⁵ Treas. Reg. sec. 5f.103-2(g)(3).

D. Rules Applicable to All Tax-Exempt Bonds

Arbitrage restrictions

In general, the purpose of the arbitrage restrictions is to control arbitrage investment incentives such as issuing greater amounts of tax-exempt bonds than necessary, issuing tax-exempt bonds earlier, or leaving tax-exempt bonds outstanding longer than is reasonably necessary to carry out the purposes of the bonds. To prevent the issuance of Federally subsidized tax-exempt bonds that do not directly support governmental projects or specified activities, the tax exemption for State and local bonds does not apply to any arbitrage bond.²⁶ An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. For example, a tax-exempt issuer might be able to borrow money at six percent and invest the funds in taxable securities that yield eight percent. The tax-exempt issuer would earn a profit of two percent. This two-percent profit is, in effect, a subsidy from the Federal government to the tax-exempt issuer. The arbitrage restrictions are necessary to control this subsidy.

In general, arbitrage profits may be earned only during specified periods (*e.g.*, defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (*e.g.*, “reasonably required reserve or replacement funds”). Subject to certain exceptions for prompt spending of the bond proceeds, small issuers, and limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal government (“arbitrage rebate”).

Advance refundings

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for “current” as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond (thus, two or more issues of tax-exempt bonds are outstanding simultaneously).²⁷ An advance refunding often takes place when interest rates fall and the issuer, in an effort to save money, seeks to redeem an existing issue with new funds borrowed at a lower rate. If the existing issue has “call protection,” that is, provisions of the bonds that prohibit redemption by the issuer for a period of years in order to protect the holders, the issuer cannot immediately redeem the existing bond issue with the proceeds of the advance refunding bond issue. For that reason, proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

²⁶ Secs. 103(a) and (b)(2).

²⁷ Sec. 149(d)(5).

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.²⁸ Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.²⁹

Federal guarantees

Generally, interest on State and local bonds that are Federally guaranteed does not qualify for tax exemption. A bond is Federally guaranteed if: (1) the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof); (2) such bond is issued as part of an issue and five percent or more of the proceeds of such issue is to be (a) used in making loans the payment of principal or interest with respect to which is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or (b) invested directly or indirectly in Federally insured deposits or accounts; or (3) the payment of principal or interest on such bond is otherwise indirectly guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof).

The Federal guarantee restriction was enacted in 1984 with certain exceptions for certain guarantee programs in existence at that time.³⁰

Information returns

An issuer of bonds must file with the Internal Revenue Service (“IRS”) certain information in order for the interest on such bond to be tax-exempt.³¹ Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

²⁸ Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

²⁹ Sec. 149(d)(2). Special rules apply for certain advance refundings in the New York Liberty Zone and the Gulf Opportunity Zone.

³⁰ The exceptions include guarantees by: the Federal Housing Administration, the Department of Veterans’ Affairs, the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, the Government National Mortgage Association; the Student Loan Marketing Association; and the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d). The exception also includes guarantees for certain housing programs. These are: (a) private activity bonds for a qualified residential rental project or a housing program obligation under section 11(b) of the United States Housing Act of 1937; (b) a qualified mortgage bond; or (c) a qualified veterans’ mortgage bond. In addition, if certain requirements are met, the Federal guarantee prohibition does not apply to any guarantee by a Federal Home Loan Bank made in connection with the original issuance of a bond during the period July 30, 2008 through December 31, 2010.

³¹ Sec. 149(e).

II. TAX-CREDIT BONDS

In general

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current or recently expired tax-credit bonds include qualified tax credit bonds, recovery zone economic development bonds, and Build America Bonds. Qualified tax credit bonds which have certain common general requirements include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy (“QZABs”), and qualified school construction bonds.

Qualified tax-credit bonds

General rules applicable to qualified tax-credit bonds³²

Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer.³³ The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Qualified tax-credit bonds are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a qualified tax-credit bond being equal to 50 percent of the face amount of such bond. The discount rate used to determine the present value amount is the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the qualified tax-credit bonds are issued.

For qualified tax-credit bonds, 100 percent of the available project proceeds must be used within the three-year period that begins on the date of issuance. Available project proceeds are proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period,

³² Separate rules apply in the case of tax-credit bonds which are not qualified tax-credit bonds (*e.g.*, “recovery zone economic development bonds,” and “Build America Bonds”).

³³ However, for new clean renewable energy bonds and qualified energy conservation bonds, the applicable credit rate is 70 percent of the otherwise applicable rate.

bonds will continue to qualify as qualified tax-credit bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified tax-credit bonds also are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to qualified tax-credit bonds. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (*i.e.*, yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified tax-credit bonds are issued.

Issuers of qualified tax-credit bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. In addition, issuers of qualified tax-credit bonds are required to certify that applicable State and local law requirements governing conflicts of interest are satisfied with respect to such issue, and if the Secretary prescribes additional conflicts of interest rules governing the appropriate Members of Congress, Federal, State, and local officials, and their spouses, such additional rules are satisfied with respect to such issue.

New Clean Renewable Energy Bonds

New clean renewable energy bonds ("New CREBs") may be issued by qualified issuers to finance qualified renewable energy facilities.³⁴ Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.

The term "qualified issuers" includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. The term "public power provider" means a State utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act (as in effect on the date of the enactment of New CREBs). A "governmental body" means any State or Indian tribal government, or any political subdivision thereof. The term "cooperative electric company" means a mutual or cooperative electric company (described in section 501(c)(12) or section

³⁴ Sec. 54C.

1381(a)(2)(C)). A clean renewable energy bond lender means a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002 (including any affiliated entity which is controlled by such lender).

There was originally a national limitation for New CREBs of \$800 million. The national limitation was then increased by an additional \$1.6 billion in 2009. No more than one third of the national limit may be allocated to projects of public power providers, governmental bodies, or cooperative electric companies. Allocations to governmental bodies and cooperative electric companies may be made in the manner the Secretary determines appropriate. Allocations to projects of public power providers shall be made, to the extent practicable, in such manner that the amount allocated to each such project bears the same ratio to the cost of such project as the maximum allocation limitation to projects of public power providers bears to the cost of all such projects.

As with other tax credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.³⁵ The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings.³⁶

Qualified Energy Conservation Bonds

Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term “qualified conservation purpose” means:

- 1) capital expenditures incurred for purposes of reducing energy consumption in publicly owned buildings by at least 20 percent; implementing green community programs;³⁷ rural development involving the production of electricity from renewable energy resources; or any facility eligible for the production tax credit under section 45 (other than Indian coal and refined coal production facilities);

³⁵ Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

³⁶ See Notice 2009-15, 2009-6 I.R.B. 449 (January 22, 2009).

³⁷ Capital expenditures to implement green community programs include grants, loans and other repayment mechanisms to implement such programs. For example, States may issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures.

- 2) expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (c) increasing the efficiency of existing technologies for producing nonfossil fuels; (d) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (e) technologies to reduce energy use in buildings;
- 3) mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;
- 4) demonstration projects designed to promote the commercialization of: (a) green building technology; (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak-use of electricity; and (e) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and
- 5) public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There was originally a national limitation on qualified energy conservation bonds of \$800 million. The national limitation was then increased by an additional \$2.4 billion in 2009. Allocations of qualified energy conservation bonds are made to the States with sub-allocations to large local governments. Allocations are made to the States according to their respective populations, reduced by any sub-allocations to large local governments (defined below) within the States. Sub-allocations to large local governments are an amount of the national qualified energy conservation bond limitation that bears the same ratio to the amount of such limitation that otherwise would be allocated to the State in which such large local government is located as the population of such large local government bears to the population of such State. The term “large local government” means any municipality or county if such municipality or county has a population of 100,000 or more. Indian tribal governments also are treated as large local governments for these purposes (without regard to population).

Each State or large local government receiving an allocation of qualified energy conservation bonds may further allocate issuance authority to issuers within such State or large local government. In general, any allocations to issuers within the State or large local government shall be made in a manner that results in not less than 70 percent of the allocation of qualified energy conservation bonds to such State or large local government being used to designate bonds that are not private activity bonds (*i.e.*, the bond cannot meet the private business tests or the private loan test of section 141). However, any bond used for the purpose of providing grants, loans or other repayment mechanisms for capital expenditures to implement green community programs is not treated as a private activity bond for these purposes.

Qualified energy conservation bonds are a type of qualified tax credit bond for purposes of section 54A of the Code. As a result, 100 percent of the available project proceeds of qualified energy conservation bonds must be used for qualified conservation purposes. In the case of qualified conservation bonds issued as private activity bonds, 100 percent of the available

project proceeds must be used for capital expenditures. In addition, qualified energy conservation bonds only may be issued by Indian tribal governments to the extent such bonds are issued for purposes that satisfy the present law requirements for tax-exempt bonds issued by Indian tribal governments (*i.e.*, essential governmental functions and certain manufacturing purposes).

The maturity of qualified energy conservation bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

As with other qualified tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.³⁸ The Secretary determines credit rates for tax credit bonds based on general assumptions about credit quality of the class of potential eligible issuers and such other factors as the Secretary deems appropriate. The Secretary may determine credit rates based on general credit market yield indexes and credit ratings.³⁹

Qualified Zone Academy Bonds

QZABs are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy,” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

A total of \$400 million of QZABs has been authorized to be issued annually in calendar years 1998 through 2008. The authorization was increased to \$1.4 billion in 2009 and 2010,

³⁸ Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

³⁹ See Notice 2009-15, 2009-6 I.R.B. 449 (January 22, 2009).

respectively. Most recently the authorization for 2011 was set at \$400 million.⁴⁰ The annual aggregate bond cap is allocated to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Qualified School Construction Bonds

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond is issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

There is a national limitation on qualified school construction bonds of \$11 billion for calendar years 2009 and 2010, and zero after 2010. If an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years.

The national limitation is tentatively allocated among the States in proportion to respective amounts each such State is eligible to receive under section 1124 of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year ending before such calendar year. The amount each State is allocated under the above formula is then reduced by the amount received by any local large educational agency within the State.

For allocation purposes, a State includes the District of Columbia and any possession of the United States. The provision provides a special allocation for possessions of the United States other than Puerto Rico under the national limitation for States. Under this special rule an allocation to a possession other than Puerto Rico is made on the basis of the respective populations of individuals below the poverty line (as defined by the Office of Management and Budget) rather than respective populations of children aged five through seventeen. This special allocation reduces the State allocation share of the national limitation otherwise available for allocation among the States. Under another special rule, the Secretary of the Interior may allocate \$200 million of school construction bonds for 2009 and 2010, respectively, to Indian schools. This special allocation for Indian schools is to be used for purposes of the construction, rehabilitation, and repair of schools funded by the Bureau of Indian Affairs. For purposes of such allocations Indian tribal governments are qualified issuers. The special allocation for Indian schools does not reduce the State allocation share of the national limitation otherwise available for allocation among the States.

Forty percent of the national limitation is allocated among large local educational agencies in proportion to the respective amounts each agency received under section 1124 of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year ending before such calendar year. With respect to a calendar year, the term large local educational agency means any local educational agency if such agency is: (1) among the 100 local educational agencies with the largest numbers of children aged 5 through 17 from families living below the

⁴⁰ There has been no legislation enacted addressing calendar year 2012.

poverty level, or (2) one of not more than 25 local educational agencies (other than in (1), immediately above) that the Secretary of Education determines are in particular need of assistance, based on a low level of resources for school construction, a high level of enrollment growth, or other such factors as the Secretary of Education deems appropriate. If any amount allocated to large local educational agency is unused for a calendar year the agency may reallocate such amount to the State in which the agency is located.

Direct-pay bonds and expired tax-credit bond provisions

The Code provides that an issuer may elect to issue certain tax credit bonds as “direct-pay bonds.” Instead of a credit to the holder, with a “direct-pay bond” the Federal government pays the issuer a percentage of the interest on the bonds. The following tax credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. Qualified zone academy bonds may be issued as direct-pay but such an election is not available regarding any allocation of the national zone academy bond allocation for 2011 or any carryforward of such election. The ability to issue Build America Bonds and Recovery Zone bonds (discussed below), which have direct-pay features, has expired.

Build America Bonds

Section 54AA, added to the Code by the American Recovery and Reinvestment Act of 2009 (“ARRA”),⁴¹ permits an issuer to elect to have an otherwise tax-exempt bond, issued prior to January 1, 2011, treated as a “Build America Bond.”⁴² In general, Build America Bonds are taxable governmental bonds, the interest on which is subsidized by the Federal government by means of a tax credit to the holder (“tax-credit Build America Bonds”) or, in the case of certain qualified bonds, a direct payment to the issuer (“direct-pay Build America Bonds”).⁴³

A Build America Bond is any State or local governmental obligation (other than a private activity bond) if the interest on such obligation would be (but for section 54AA) excludable from gross income under section 103, and the issuer makes an irrevocable election to have the rules in section 54AA apply.⁴⁴ In determining if an obligation would be tax-exempt under section 103, the credit (or the payment discussed below for direct-pay Build America Bonds) is not treated as a Federal guarantee.⁴⁵ Further, for purposes of the restrictions on arbitrage in section 148, the

⁴¹ Pub. L. No. 111-5.

⁴² Sec. 54AA.

⁴³ For background and analysis of Build America Bonds in comparison to tax-exempt bonds, see U.S. Treasury Department, *Treasury Analysis of Build America Bond Issuance and Savings* (May 16, 2011), which is available at <http://www.treasury.gov/initiatives/recovery/Documents/BABs%20Report.pdf>.

⁴⁴ Sec. 54AA(d). Subject to updated IRS reporting forms or procedures, an issuer of Build America Bonds makes the election required by 54AA on its books and records on or before the issue date of such bonds. IRS Notice 2009-26, 2009-16 I.R.B. 833 (April 20, 2009).

⁴⁵ Sec. 54AA(d)(2)(A). Section 149(b) provides that section 103(a) shall not apply to any State or local bond if such bond is federally guaranteed.

yield on a tax-credit Build America Bond is determined without regard to the credit,⁴⁶ the yield on a direct-pay Build America Bond is reduced by the payment made pursuant to section 6431.⁴⁷ A Build America Bond does not include any bond if the issue price has more than a de minimis amount of premium over the stated principal amount of the bond.⁴⁸

The holder of a tax-credit Build America Bond accrues a tax credit in the amount of 35 percent of the interest paid on the interest payment dates of the bond during the calendar year.⁴⁹ The interest payment date is any date on which the holder of record of the Build America Bond is entitled to a payment of interest under such bond.⁵⁰ The sum of the accrued credits is allowed against regular and alternative minimum tax; unused credit may be carried forward to succeeding taxable years.⁵¹ The credit, as well as the interest paid by the issuer, is included in gross income, and the credit may be stripped under rules similar to those provided in section 54A regarding qualified tax credit bonds.⁵² Rules similar to those that apply for S corporations, partnerships and regulated investment companies with respect to qualified tax credit bonds also apply to the credit.⁵³

Under the special rule for qualified bonds, in lieu of the tax credit to the holder, the issuer is allowed a credit equal to 35 percent of each interest payment made under such bond.⁵⁴ A “qualified bond,” that is, a direct-pay Build America Bond, is any Build America Bond issued as part of an issue if 100 percent of the excess of available project proceeds of such issue over the amounts in a reasonably required reserve with respect to such issue are to be used for capital expenditures.⁵⁵ Direct-pay Build America Bonds may not be issued to refinance capital expenditures in “refunding issues”⁵⁶ Direct-pay Build America Bonds also must be issued

⁴⁶ Sec. 54AA(d)(2)(B).

⁴⁷ Sec. 6431(c).

⁴⁸ Sec. 54AA(d)(2)(C).

⁴⁹ Sec. 54AA(a) and (b). Original issue discount (“OID”) is not treated as a payment of interest for purposes of determining the credit under the provision. OID is the excess of an obligation’s stated redemption price at maturity over the obligation’s issue price (sec. 1273(a)).

⁵⁰ Sec. 54AA(e).

⁵¹ Sec. 54AA(c).

⁵² Sec. 54AA(f). See IRS Notice 2010-28, *Stripping Transactions for Qualified Tax Credit Bonds*, 2010-15 I.R.B. 541 (April 12, 2010).

⁵³ *Ibid.*

⁵⁴ Sec. 54AA(g)(1). OID is not treated as a payment of interest for purposes of calculating the refundable credit under the provision.

⁵⁵ Sec. 54AA(g).

⁵⁶ IRS Notice 2009-26. In contrast, tax-credit Build America Bonds “may be issued to finance the same kinds of expenditures (*e.g.*, capital expenditures and working capital expenditures) and may involve the same kinds

before January 1, 2011. The issuer must make an irrevocable election to have the special rule for qualified bonds apply.⁵⁷

The payment by the Secretary is to be made contemporaneously with the interest payment made by the issuer, and may be made either in advance or as reimbursement.⁵⁸ In lieu of payment to the issuer, the payment may be made to a person making interest payments on behalf of the issuer.⁵⁹

Recovery Zone Economic Development Bonds

The provision permits an issuer to designate one or more areas as recovery zones. The area must: (1) have significant poverty, unemployment, general distress, or home foreclosures; (2) be an area for which a designation as an empowerment zone or renewal community is in effect or; (3) be an area designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990. Issuers may issue recovery zone economic development bonds and recovery zone facility bonds with respect to these zones.

There is a national recovery zone economic development bond limitation of \$10 billion. The bond limitation is allocated among the States in the proportion that each State's employment decline bears to the national decline in employment (the aggregate 2008 State employment declines for all States).⁶⁰ The Secretary is to adjust each State's allocation for a calendar year such that no State receives less than 0.9 percent of the national recovery zone economic development bond limitation. A county or large municipality may waive all or part of its allocation of the State bond limitations to allow further allocation within that State. In calculating the local employment decline with respect to a county, the portion of such decline attributable to a large municipality is disregarded for purposes of determining the county's portion of the State employment decline and is attributable to the large municipality only.

For purposes of the provision "2008 State employment decline" means, with respect to any State, the excess (if any) of (i) the number of individuals employed in such State as determined for December 2007, over (ii) the number of individuals employed in such State as

of financings (e.g., original new money financings, current refundings, and one advance refunding) as tax-exempt governmental bonds." *Ibid.* Refunding issues is defined in Treas. Reg. sec. 1.150-1.

⁵⁷ Sec. 54AA(g)(2)(B). Subject to updated IRS reporting forms or procedures, an issuer of direct-pay Build America Bonds makes the election required by 54AA(g)(2)(B) on its books and records on or before the issue date of such bonds. IRS Notice 2009-26, 2009-16 I.R.B. 833.

⁵⁸ Sec. 6431.

⁵⁹ Sec. 6431(b).

⁶⁰ The Bureau of Labor Statistics prepares data on regional and State employment and unemployment. *See, e.g.*, Bureau of Labor Statistics, USDL 09-0093, *Regional and State Employment and Unemployment: December 2008* (January 27, 2009), <<http://www.bls.gov/news.release/laus.nr0.htm>>.

determined for December 2008. The term “large municipality” means a municipality with a population of more than 100,000.

Section 54AA(h) of the Code creates a special rule for qualified bonds (a type of taxable governmental bond) issued before January 1, 2011, that entitles the issuer of such bonds to receive an advance tax credit equal to 45 percent of the interest payable on an interest payment date. For taxable governmental bonds that are designated recovery zone economic development bonds, the applicable percentage is 55 percent.

A recovery zone economic development bond is a taxable governmental bond issued as part of an issue if 100 percent of the available project proceeds of such issue are to be used for one or more qualified economic development purposes and the issuer designates such bond for purposes of this section. However a reasonably required reserve fund may be funded from the proceeds of a recovery zone economic development bond. A qualified economic development purpose means expenditures for purposes of promoting development or other economic activity in a recovery zone, including (1) capital expenditures paid or incurred with respect to property located in such zone, (2) expenditures for public infrastructure and construction of public facilities located in a recovery zone.

The aggregate face amount of bonds which may be designated by any issuer cannot exceed the amount of the recovery zone economic development bond limitation allocated to such issuer.

III. BENEFITS AND COSTS OF TAX-EXEMPT BOND AND TAX-CREDIT BOND FINANCING

A. Tax-Exempt Bonds

Benefits and costs of the subsidy

Issuer benefit

Tax-exempt financing provides an implicit Federal subsidy to the borrower (*i.e.*, either the qualified governmental unit or the conduit borrower) but, in practice some of the subsidy redounds to the bond investor (the lender). Because interest income on the bonds is excluded from gross income, the bond investor is willing to accept a lower interest rate on the bonds than he might otherwise accept on an identical taxable investment. Thus, the borrower receives an implicit Federal subsidy equal to the difference between the tax-exempt interest rate paid and the taxable rate that otherwise would be paid. In this way, the income exclusion lowers the cost of capital for the State and local governments (or private parties in the case of private activity bonds).

The following example illustrates the Federal subsidy measured as a percentage of the otherwise applicable taxable rate. Assume a school district may borrow either at a taxable rate of 6.25 percent or a tax-exempt rate of 4.5 percent. The yield spread in this example is 1.75 percentage points and the ratio of tax-exempt to taxable rates is 0.72, or 72 percent, and the subsidy is equal to 28 percent of the otherwise applicable taxable rate.⁶¹ To illustrate the benefit of the subsidy in dollar terms, if the school district borrows \$1 million at the taxable rate of 6.25 percent and \$1 million at the tax-exempt rate of 4.5 percent, the school district's annual interest payments would be \$62,500 on the taxable debt, but \$45,000 on the tax-exempt debt, a \$17,500 savings.

Finally, as the ratio of tax-exempt rates to taxable rates moves closer to one (*i.e.*, the spread between tax-exempt and taxable interest rates narrows), the value of the subsidy to the borrower also diminishes. Among other reasons, this may occur as the volume of tax-exempt bond issuances increases and tax-exempt borrowers respond by offering higher interest rates to attract bond investors. (See Figure 1.a., below, comparing the average tax-exempt interest rate on high-grade municipal bonds and the average taxable interest rate on corporate bonds for the period 1986-2007. Figure 1.b., below separately reports the yield spread between the interest rates on tax-exempt and taxable bonds).

⁶¹ Column 5 of Table 1, on page 30, may be used to illustrate the measure of the subsidy measured as a percentage of the otherwise applicable taxable rate for the period 1986-2011.

Figure 1.a.—Comparison of Municipal Bond Interest Rates and Corporate Bond Interest Rates, 1986-2011

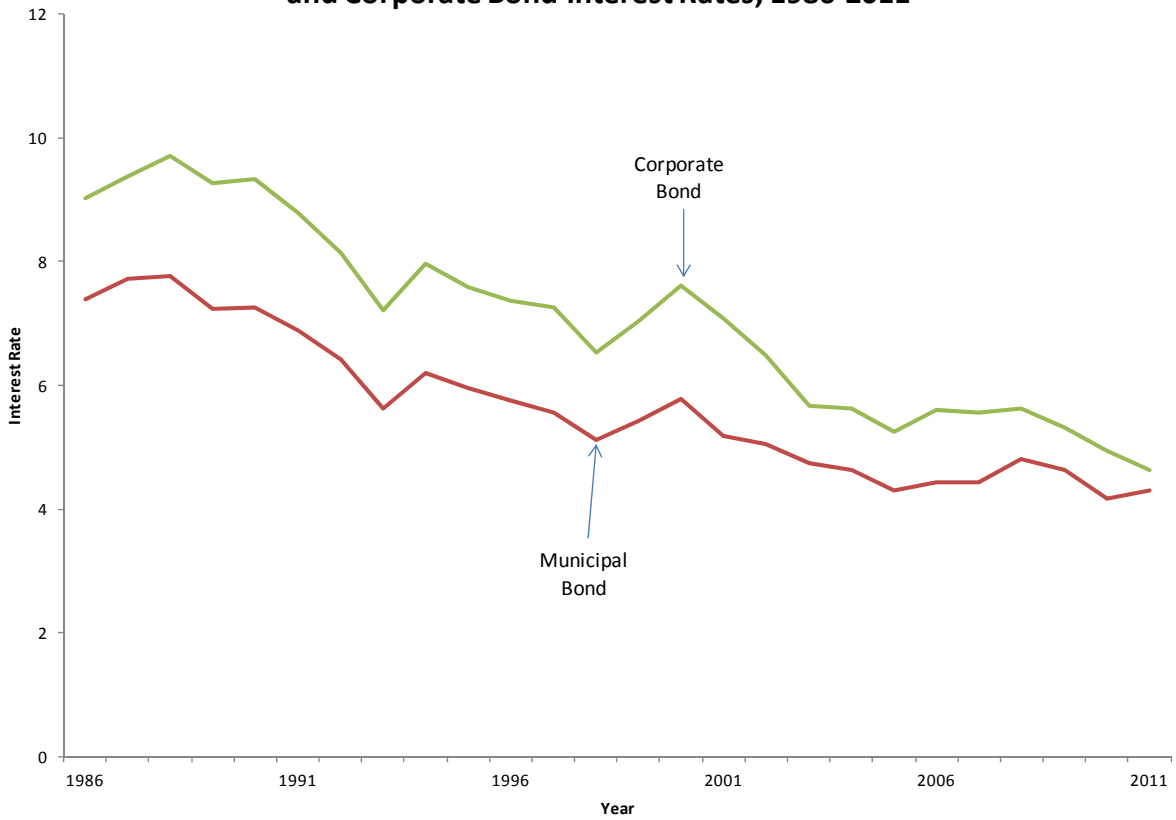
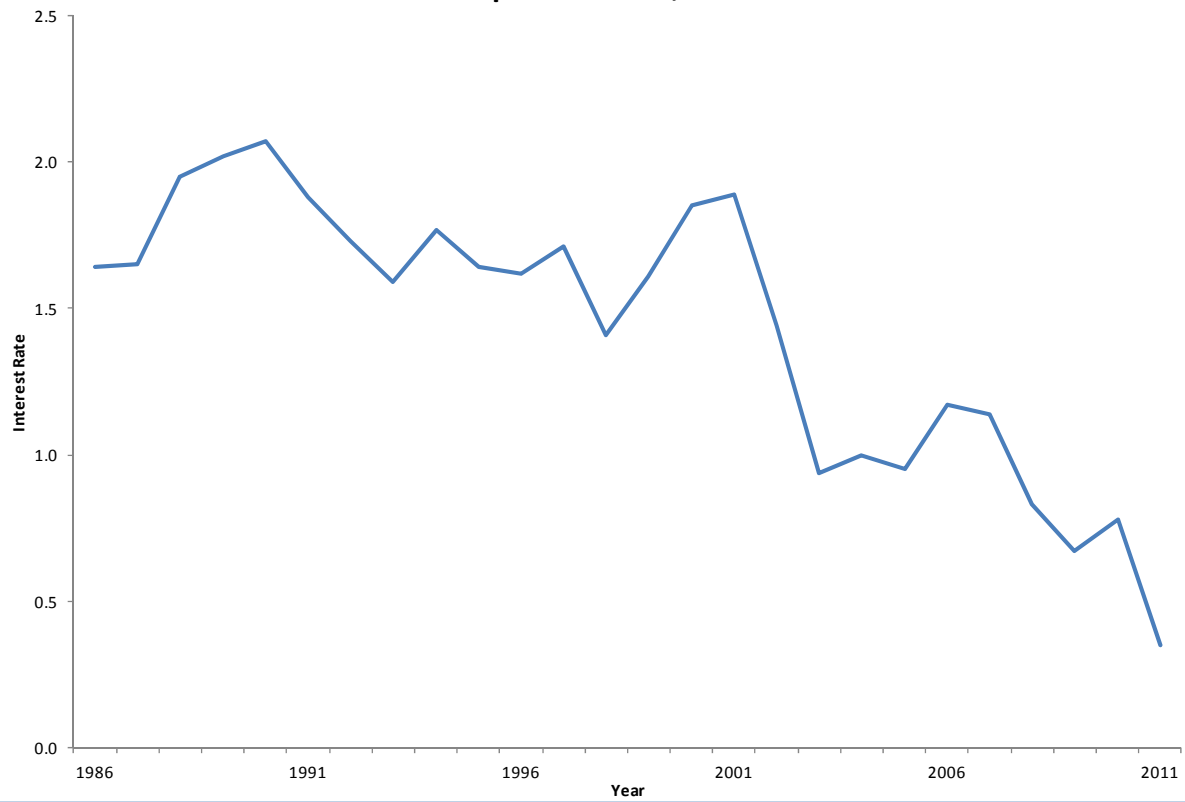


Figure 1.b.—Yield Spread Between Municipal Bonds and Corporate Bonds, 1986-2011



Bond investor benefit

The bond investor also receives a Federal subsidy from tax-exempt financing equal to the difference between the tax-exempt interest rate and the after-tax yield on a taxable investment. The bond investor's willingness to purchase tax-exempt bonds also depends on the bond investor's marginal tax rate. Generally, all other things being equal (such as credit worthiness), a bond investor is indifferent between a tax-exempt bond and a taxable bond with an equivalent after-tax yield.⁶² To illustrate using the example from above, if a bond investor with a 28-percent marginal tax rate purchased a \$1 million taxable bond at a 6.25-percent rate, as an alternative to the tax-exempt bond, the investor would receive \$62,500 in interest income and pay \$17,500 in income tax for a net return of \$45,000 and an after-tax yield of 4.5 percent. This is the same net return the bond investor receives if he were to purchase the \$1 million tax-exempt bond. Thus, this bond investor generally would be indifferent to a taxable investment with a 6.25-percent rate and a tax-exempt investment with a 4.5-percent rate.

With many bond investors in different tax brackets, bond investors in higher marginal tax-brackets receive a larger tax benefit than those in lower brackets. For example, if a bond investor with a 33-percent marginal tax rate purchased the alternative \$1 million taxable bond at a 6.25-percent rate, the investor would receive \$62,500 in interest income and pay \$20,625 in income tax for a net return of \$41,875 and an after-tax yield of 4.19 percent. However, this bond investor would receive a 4.5 percent net return on the school district's tax-exempt bond. Thus, unlike the bond investor in the 28-percent marginal tax rate who is indifferent to investment in taxable or tax-exempt bonds, the bond investor in the 33-percent marginal tax rate receives a greater benefit by purchasing the tax-exempt bond. In contrast, a bond investor with a 15-percent marginal tax rate receives no benefit from purchasing the tax-exempt bond.

Costs associated with tax-exempt bonds

Revenue loss associated with tax-exempt bonds

The direct cost to the Federal government of the interest exclusion for State and local bonds is the income tax revenue forgone. Under our example, if the bond investor with a 28-percent marginal tax rate purchases the school district's \$1 million tax-exempt bond with a 4.5-percent interest rate, the bond investor receives \$45,000 of tax-exempt interest income for each year the bond is outstanding. However, assuming the bond investor's preferred alternative investment is a taxable bond, the actual revenue loss to the Federal government is based upon the taxable yield the bond investor forgoes. For example, if the bond investor purchased the taxable bond at a 6.25-percent rate, rather than the tax-exempt bond, the bond investor would have received \$62,500 in interest income and paid \$17,500 in income tax. In this case, the revenue forgone to the Federal government equals the interest savings of the school district.

⁶² This may be represented as $r_e = (1-t)r$, where r_e is the tax-exempt yield, t is the investor's marginal tax rate, and r is the taxable bond yield.

However, using the second part of the example from above, if the bond investor in the 33-percent bracket purchases the school district's tax-exempt bond, it costs the Federal government \$20,625 (\$62,500 of interest income taxed at a 33-percent rate). Due to the existence of multiple tax brackets, the loss of Federal receipts is greater than the reduction in the tax-exempt issuer's interest cost. In this case, the \$17,500 interest subsidy realized by the school district costs the Federal government \$20,625. The difference accrues to bond investors in tax brackets higher than those that would be implied by the yield spread between taxable and tax-exempt bonds. Thus, if a bond investor in the 28-percent bracket finds it profitable to hold a tax-exempt security, a bond investor in the 33-percent bracket will find it even more profitable. This implies that the Federal government will lose more in revenue than the tax-exempt issuer gains in reduced interest payments.⁶³ This is one source of inefficiency to the subsidy provided by the tax exemption.

Table 1, below, reports the data used for Figures 1.a. and 1.b. It also calculates the implied marginal tax rate at which the bond investor would be indifferent between holding the average corporate bond and the average municipal bond.⁶⁴ The table shows that generally over the past 25 years any holdings of tax-exempt bonds by bond investors in a 25-percent marginal tax bracket and above would have led to the inefficiency described above.

The implied tax rate of the marginal investor for 2011 is low by historical standards. Data suggest at least two factors that may have contributed to the decrease in the yield spread between corporate and municipal bonds. First, primary market issuance of municipal bonds dropped in 2011 to its lowest level in 10 years.⁶⁵ Second, reports at the end of 2010 and high profile defaults by certain issuers raised concerns about an increased risk of default by municipalities.⁶⁶ The lack of new supply and the increased concerns about credit quality may have contributed to an increase in municipal bond yields relative to corporate bonds. It remains to be seen whether this relationship persists or represents an historical anomaly.

⁶³ To the extent that bond investors in lower tax brackets purchase tax-exempt bonds for nontax reasons, such as to help support the local schools, the revenue forgone would be less than the issuer's interest savings.

⁶⁴ Some analysts suggest that consideration of other financial assets beyond a comparison of taxable and tax-exempt bonds determine the yield spread between taxable and tax-exempt interest rates. In particular, these analysts suggest that the yield spread increases (decreases) as the dividend yield on corporate stocks increases (decreases). N. Gregory Mankiw and James M. Poterba, "Stock Market Yields and the Pricing of Municipal Bonds," National Bureau of Economic Research Working Paper #5607, June 1996. However, such an augmented analysis of the yield spread does not alter the conclusion that the Federal Government loses more in revenue from State and local issuance of tax-exempt bonds, than the borrower gains in reduced interest costs.

⁶⁵ Securities Industry and Financial Markets Association, *U.S. Municipal Issuance*, available at <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Municipal-US-Municipal-Issuance-SIFMA.xls>.

⁶⁶ Invesco, "Investment Insights Municipal Bond Market Update," Fourth Quarter, 2011.

Table 1.—Comparison of Taxable Interest Rates and Tax-Exempt Interest Rates

Year	Corporate Bonds (Percent)	High-Grade Municipal Bonds (Percent)	Yield Spread (Percent)	Implied Tax Rate of Marginal Investor (Percent)
1986	9.02	7.38	1.64	18.2
1987	9.38	7.73	1.65	17.6
1988	9.71	7.76	1.95	20.1
1989	9.26	7.24	2.02	21.8
1990	9.32	7.25	2.07	22.2
1991	8.77	6.89	1.88	21.4
1992	8.14	6.41	1.73	21.3
1993	7.22	5.63	1.59	22.0
1994	7.96	6.19	1.77	22.2
1995	7.59	5.95	1.64	21.6
1996	7.37	5.75	1.62	22.0
1997	7.26	5.55	1.71	23.6
1998	6.53	5.12	1.41	21.6
1999	7.04	5.43	1.61	22.9
2000	7.62	5.77	1.85	24.3
2001	7.08	5.19	1.89	26.7
2002	6.49	5.05	1.44	22.2
2003	5.67	4.73	0.94	16.6
2004	5.63	4.63	1.00	17.8
2005	5.24	4.29	0.95	18.1
2006	5.59	4.42	1.17	20.9
2007	5.56	4.42	1.14	20.5
2008	5.63	4.80	0.83	14.7
2009	5.31	4.64	0.67	12.6
2010	4.94	4.16	0.78	15.8
2011	4.64	4.29	0.35	7.5

Source: Economic Report of the President, February 2012, Moody's Investors Services Aaa Corporate bonds, Standard and Poor's high-grade municipal bonds, JCT staff calculations.

Issuance costs

Borrowers always incur transactions costs in attaining loanable funds. Generally, issuing tax-exempt bonds to finance capital costs is a complex and expensive process. In addition to the borrower and bond investor, there are a number of parties employed to facilitate a bond issuance (e.g., service providers such as investment bankers and bond counsel attorneys to provide opinion letters regarding the satisfaction of the requirements necessary for tax-exemption). The requirements for tax exemption may result in higher incremental costs of issuance for tax-exempt bonds than those associated with issuing taxable bonds. Because a portion of the benefits of tax

exemption flows to these service providers in the way of fees, such fees are a second potential source of inefficiency resulting from tax-exempt financing.

Arbitrage potential

As described in Part II.D, above, present law generally restricts the ability of qualified governmental units and other parties to earn and retain arbitrage profits. Without these rules, the reduced cost of funds obtained through tax-exempt bonds provides issuers the opportunity to earn arbitrage profits by investing tax-exempt bond proceeds in higher yielding investments. For example, the average yield spread between taxable and tax-exempt debt for the period 1986-2007, as reported in Table 1, above, was approximately 1.6 percentage points. Consider a simple arbitrage transaction of the type available to borrowers using tax-exempt debt prior to restrictions adopted by the Congress in 1969. Assume a local government planned to construct a \$10 million building. Further assume the local government issued \$10 million in tax-exempt bonds with the knowledge that the construction schedule was such that the local government could invest a five-year average of \$5 million of the \$10 million in bond proceeds in taxable securities yielding interest at 1.00 percentage point greater than the interest the issuer would owe on its tax-exempt bonds. This investment would generate \$50,000 in profit to the local governmental issuer annually net of interest payments to the owners of the local government's bonds.⁶⁷ Over the five-year period, the quarter of million dollar profit equals 2.5 percent of principal value of the bond issue. The ability to earn arbitrage profits means that project costs are lowered beyond the benefit reflected in a comparison of taxable and tax-exempt interest rates. One could say that, if the yield spread reflects the implicit Federal subsidy to a State or local issuer's borrowing costs, potential arbitrage profits reflect an implicit Federal subsidy to the payment of the principal amount of the State or local issuer's borrowing.

Arbitrage transactions have no economic substance, as the issuance of one financial instrument (the tax-exempt bond) is offset by the purchase of another financial instrument (typically another debt instrument). The transaction is made profitable solely through the ability to borrow at tax-exempt rates in reliance on a Federal subsidy of borrowing costs. If permitted to earn and retain arbitrage profits, borrowers would have a substantial incentive to issue more bonds, to issue them earlier, and to leave them outstanding longer than necessary. From the Federal government's standpoint, allowing arbitrage profits to be earned from the issuance of tax-exempt bonds is an inefficient alternative to additional borrowing, because it is more costly to the Federal government in terms of forgone tax revenue than the additional borrowing that would be necessary to produce the same amount of proceeds.

⁶⁷ For simple examples and explanations of arbitrage transactions, see, Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds*, (Washington, D.C.: The Urban Institute Press), 1991, pp. 158-162.

B. Tax-Credit Bonds

Benefits and costs of the subsidy⁶⁸

One hundred percent interest credit

As described above, tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. The amount of the credit is determined by multiplying the bond's credit rate by the face amount⁶⁹ on the holder's bond. For the present law categories of tax-credit bonds, the credit rate on the bonds is determined by the Secretary of the Treasury and is an estimate of the rate that permits issuance of such bonds without discount and interest cost to the qualified issuer. That is, the tax credit is chosen to approximate an interest rate subsidy of 100 percent (70 percent for New CREBs and qualified energy conservation bonds). The credit is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

Under present law, the Federal subsidy provided to issuers by tax-credit bonds is deeper than the subsidy for tax-exempt bonds. This is because the issuer of tax-credit bonds pays no interest, only principal.⁷⁰ The "interest" is paid by the Federal government in the form of tax credits. Thus, the issuer theoretically has an interest-free loan. In comparison, issuers of tax-exempt bonds pay interest on such obligations, albeit at a lower interest rate than if the debt were taxable. As noted above, the Federal subsidy provided to borrowers using tax-exempt bonds is limited to the difference between the tax-exempt interest rate paid and the taxable bond rate that otherwise would be paid.⁷¹

The Federal subsidy for tax-credit bonds is economically equivalent to the Federal government directly paying the interest on a taxable bond issue on behalf of the State or local

⁶⁸ Congressional Budget Office, *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures*, July 2004, offers an analysis of the economics of tax-credit bonds and alternatives.

⁶⁹ The "face amount" (or par value) represents the value of a bond at maturity as stated on the bond certificate.

⁷⁰ This conclusion assumes the bonds are not issued at discount. If tax-credit bonds are issued at discount, *i.e.*, less than par value, the issuer incurs interest cost to the extent its debt service payments will exceed the amount of proceeds received from the sale of the bonds. This may occur because the rate on a prospective issue of tax-credit bonds is set lower than what investors are willing to accept to purchase the bonds at par value. To illustrate, assume the credit rate on tax-credit bonds with a face amount of \$100 is set at five percent. If investors do not view the five percent credit rate as an acceptable return given the riskiness of the investment, they will purchase the bonds for something less than \$100, *e.g.*, \$90. Because the credit is determined by reference to the face amount of bonds (\$100), the investor purchasing tax-credit bonds at a discount (\$90) receives a higher yield than the stated credit rate. However, the issuer must repay the full face value of the bonds, \$100 in this example, even though it received less than \$100 in proceeds.

⁷¹ This discussion ignores any potential for permitted arbitrage earnings.

government benefiting from the bond proceeds.⁷² To see this, consider any taxable bond that bears an interest rate of 10 percent. A thousand dollar bond would thus produce an interest payment of \$100 annually. The owner of the bond that receives this payment would receive a net payment of \$100 less the taxes owed on that interest. If the taxpayer were in the 28-percent Federal tax bracket, such taxpayer would receive \$72 after Federal taxes. Regardless of whether the State government or the Federal government pays the interest, the taxpayer receives the same net-of-tax return of \$72. In the case of tax-credit bonds, no cash interest is paid by the Federal government. Rather, a tax credit of \$100 is allowed to be taken by the holder of the bond. In general, a \$100 tax credit would be worth \$100 to a taxpayer, provided that the taxpayer had at least \$100 in tax liability. However, for tax-credit bonds, the \$100 credit also has to be claimed as income. Claiming an additional \$100 in income costs a taxpayer in the 28-percent tax bracket an additional \$28 in income taxes, payable to the Federal government. With the \$100 tax credit that is ultimately claimed, the taxpayer nets \$72 of interest income by holding the bond. The Federal government loses \$100 on the credit, but recoups \$28 of that by the requirement that it be included in income, for a net cost of \$72, which is exactly the net return to the taxpayer. If the Federal government had simply agreed to pay the interest on behalf of the State or local government, both the Federal government and the bondholder/taxpayer would be in the same situation. The Federal government would make outlays of \$100 in interest payments, but would recoup \$28 of that in tax receipts, for a net budgetary cost of \$72, as before. Similarly, the bondholder/taxpayer would receive a taxable \$100 in interest, and would owe \$28 in taxes, for a net gain of \$72, as before. The State or local government also would be in the same situation in both cases.

In addition to the deeper subsidy provided by 100-percent tax credit bonds, tax-credit bonds do not generate the same revenue loss inefficiency as do tax-exempt bonds. As explained in Part III.A., above, in the case of a tax-exempt bond, the loss of Federal receipts is greater than the reduction in the tax-exempt issuer's interest cost. This is due to the existence of multiple tax brackets since the bond investor's tax saving is dependent upon the bond investor's marginal tax rate. With a tax-credit bond, the bond investor's tax saving is independent of the bond investor's marginal tax rate. As a consequence, with a tax-credit bond, the loss in Federal receipts from the tax credit equals the reduction in the tax-credit bond issuer's interest cost.

Issuance costs and arbitrage potential

Issuance costs

At present, issuance costs for tax-credit bonds likely exceed those of tax-exempt bonds. Because tax-credit bonds are relatively new financial instruments, fewer potential borrowers are familiar with the applicable rules. Also, present law limits the total dollar value of issuance of these instruments. This, too, would likely discourage participation by some service providers (i.e., investment bankers, financial advisors, and bond counsel). These factors generally would result in fewer service providers competing for the business of helping borrowers issue tax-credit

⁷² This is true provided that the taxpayer faces tax liability of at least the amount of the credit. Without sufficient tax liability, the proposed tax-credit arrangement would not be as advantageous. Presumably, only taxpayers who anticipate having sufficient tax liability to be offset by the proposed credit would hold these bonds.

debt, with the result being higher prices for such services. Because a portion of the benefit of the tax credit flows to these service providers in the way of fees, such fees are a second potential source of inefficiency resulting from tax-exempt financing. Over time more service providers would be expected to become familiar with these financial instruments, reducing current disparities in the issuance costs of tax-exempt and tax-credit bonds. If the Congress were to continue to permit the issuance of tax-credit bonds, their increased share in the financial market also would be expected to reduce current disparities in the issuance costs of tax-exempt and tax-credit bonds. Nevertheless, as is the case with tax-exempt bonds, the additional requirements for tax-credit bonds may result in higher incremental costs of issuance for tax-credit bonds than those associated with issuing taxable bonds.

Arbitrage potential

In general, tax-credit bonds are subject to the same arbitrage and rebate requirements, as detailed in section 148 of the Code (discussed above in Part I.D.), applicable to tax-exempt State and local bonds. However, issuers of QZABs, new CREBs, qualified energy conservation bonds, and forestry conservation bonds are allowed to take advantage of special arbitrage rules that provide a limited ability for borrowers to invest bond proceeds and use the earnings from such investments to make additional qualified expenditures. This ability to invest bond proceeds and retain the earnings increases the magnitude of the tax expenditure available for qualified expenditure purposes beyond the interest cost saving achieved through having the borrower's interest costs paid in full, or in part, by the Federal tax credit. If as a general matter issuers of tax-credit bonds had the ability to earn and retain arbitrage profits, issuers would have an incentive to issue more tax-credit bonds and to issue the bonds earlier than necessary to fund a qualified project. As a result, there may be increased delays in the expenditure of bond proceeds for approved purposes to earn greater arbitrage profits.

IV. DEDUCTIONS FOR STATE AND LOCAL TAXES

A. Summary of Present-Law Federal Income Tax Treatment of Certain State and Local Taxes

Basic structure of the individual income tax

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income.⁷³ Taxable income equals the taxpayer's total gross income less certain exclusions, exemptions, and deductions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may face additional liability if the alternative minimum tax applies. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions.⁷⁴ In lieu of taking the applicable standard deduction, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes.⁷⁵

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

⁷³ Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

⁷⁴ The basic standard deduction varies depending upon a taxpayer's filing status. For 2012, the amount of the standard deduction is \$5,950 for single individuals and married individuals filing separate returns, \$8,500 for heads of households, and \$11,900 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind. The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

⁷⁵ Other itemized deductions include the deductions for home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of \$100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI).

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax.

Deduction for State and local real property taxes

For purposes of determining taxable income, taxpayers are permitted an itemized deduction for any State or local real property taxes for the taxable year in which such taxes are paid or accrued, even if such taxes are not incurred in a taxpayer's trade or business.⁷⁶ The itemized deduction for State and local real property taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.⁷⁷ In the event of the sale of real property, the Code and Treasury Regulations provide rules under which the seller and buyer are required to apportion the itemized deductions taken on their respective returns for the real property taxes owed for the tax year.⁷⁸

For Federal income tax purposes, a real property tax is a tax imposed on interests in real property and levied for the general public welfare.⁷⁹ Taxes paid for local benefits such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the tax is levied, are not deductible as taxes.⁸⁰ A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited by the proceeds of the assessment. Such taxes are not deductible, even though an incidental benefit may inure to the public welfare.⁸¹

The IRS has ruled that payments in lieu of taxes ("PILOTs") are deductible when such payments are made pursuant to a state statute, are calculated through a rate based on the valuation of an ownership interest in real property, and are used for public or governmental purposes.⁸²

Deduction for State and local personal property taxes

For purposes of determining taxable income, taxpayers are permitted an itemized deduction for State and local personal property taxes.⁸³ The itemized deduction for State and

⁷⁶ Sec. 164(a)(1).

⁷⁷ Sec. 56(b)(1)(A)(ii).

⁷⁸ Sec. 164(d); Treas. Reg. sec. 1.164-6.

⁷⁹ Treas. Reg. sec. 1.164-3(b).

⁸⁰ Treas. Reg. sec. 1.164-4. Such taxes are often referred to as "assessments."

⁸¹ *Ibid.*

⁸² Private Letter Ruling 8919002. However, a private letter ruling can be relied on only by the taxpayer to whom it was issued.

⁸³ Sec. 164(a)(2).

local personal property taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.⁸⁴

For a tax to qualify as a personal property tax for Federal income tax purposes, it must meet three criteria.⁸⁵ First, the tax must be *ad valorem*, meaning that the tax must be substantially in proportion to the value of the personal property.⁸⁶ A tax which is based on criteria other than value does not qualify as *ad valorem*. For example, a motor vehicle tax based on weight, model year, or horsepower is not an *ad valorem* tax for Federal income tax purposes.⁸⁷ However, in the case of a tax which is partially based on value, and partially based on other criteria, that portion of the tax that corresponds to the value-based levy qualifies as an *ad valorem* tax, and the remainder does not.⁸⁸

Second, the tax must be imposed on an annual basis, even if collected more or less frequently.⁸⁹

Third, the tax must be imposed in respect of personal property.⁹⁰ A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege.⁹¹ For instance, State and local taxes on the registration or licensing of highway motor vehicles are deductible as personal property taxes even if such taxes are denominated as a "registration fee," provided that such fees meet the first and second requirement described above (*i.e.*, they are *ad valorem* in nature and they are imposed on an annual basis).⁹²

Deduction for State and local income taxes

For purposes of determining taxable income, taxpayers are permitted an itemized deduction for any State or local income taxes for the taxable year in which such taxes are paid or accrued, even if such taxes are not incurred in a taxpayer's trade or business.⁹³ The itemized

⁸⁴ Sec. 56(b)(1)(A)(ii).

⁸⁵ Treas. Reg. sec. 1.164-3(c).

⁸⁶ Treas. Reg. sec. 1.164-3(c)(1).

⁸⁷ *Ibid.*

⁸⁸ *Ibid.*

⁸⁹ Treas. Reg. sec. 1.164-3(c)(2).

⁹⁰ Treas. Reg. sec. 1.164-3(c)(3).

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ Sec. 164(a)(3).

deduction for State and local income taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.⁹⁴ A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.⁹⁵ In determining whether a payment constitutes a tax, the IRS generally takes the position that a tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes and not as payment for some privilege granted or service rendered.⁹⁶ That tax must be paid to a government levying the tax, to certain public benefit corporations created by that government for a public purpose, or to their agents.⁹⁷

The IRS has ruled that a tax is considered to be a State or local income tax for purposes of section 164(a) if that tax is imposed on "net gain."⁹⁸ Thus, in the case of a tax imposed upon the transfer of land, if the taxpayer cannot reduce taxable gain from sales or exchanges of land during the taxable year by any losses from other sales or exchanges of land during that year, such a tax is not considered an income tax for purposes of section 164(a).⁹⁹

Additionally, the IRS has ruled employees may deduct amounts paid to state unemployment compensation funds and disability benefit funds as state income taxes.¹⁰⁰

Deduction for State and local sales taxes

For taxable years beginning in 2004-2011, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes.¹⁰¹ As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.¹⁰² Taxpayers have two options with respect to the determination of the sales tax deduction amount.¹⁰³ Taxpayers

⁹⁴ Sec. 56(b)(1)(A)(ii).

⁹⁵ Sec. 164(b)(2).

⁹⁶ See Rev. Rul. 81-193, 1981-2 C.B. 52.

⁹⁷ *Ibid.*

⁹⁸ Rev. Rul. 80-121, 1980-1 C.B. 43.

⁹⁹ *Ibid.*

¹⁰⁰ See, e.g., Rev. Rul. 81-194, 1981-2 C.B. 54; Rev. Rul. 81-191, 1981-2 C.B. 49; Rev. Rul. 81-193, 1981-2 C.B. 52.

¹⁰¹ Sec. 164(a)(5).

¹⁰² Sec. 56(b)(1)(A)(ii).

¹⁰³ See Notice 2005-31, 2005-1 C.B. 830.

may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income, and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

A general sales tax is a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.¹⁰⁴ No deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the above rules are relaxed in two ways. First, if the tax does not apply with respect to some or all of such items, a tax that applies to other such items can still be considered a general sales tax. Second, the rate of tax applicable with respect to some or all of these items may be lower than the general rate. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess is disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.¹⁰⁵

Utilization

For 2009, a total of 140.5 million returns were filed. Of these, only 45.7 million claimed itemized deductions totaling \$1.2 trillion in aggregate. Of returns claiming itemized deductions, nearly 40 million returns claimed a deduction for \$167.8 billion of real property taxes paid.¹⁰⁶ A temporary provision permitted nonitemizers to increase their standard deduction by a portion of real property taxes paid. An additional 19.5 million returns took advantage of this provision.¹⁰⁷ This suggests that perhaps as many as one-third¹⁰⁸ of returns filed by homeowners are unable to claim the itemized deduction for real property taxes paid.

¹⁰⁴ Sec. 164(b)(5)(B).

¹⁰⁵ Sec. 164(b)(5)(E).

¹⁰⁶ Internal Revenue Service, *Individual Income Tax Returns 2009*, Publication 1304, Rev. 07-2011, Tables 1.1 and 2.1.

¹⁰⁷ Internal Revenue Service, *2009 Estimated Data Line Counts, Individual Income Tax Returns*, Rev. 08-2011.

¹⁰⁸ The fraction of returns with some form of a deduction for real property taxes paid that claimed the above-the-line deduction is 19.5 million/59.5 million (19.5 million plus 40 million), or 32.7 percent.

Approximately 16.2 million returns claimed a deduction for \$6.1 billion of personal property taxes paid. Deductions for \$236.1 billion of State and local income taxes were claimed on 33.8 million returns, while 10.3 million returns took advantage of the temporary provision to claim \$15.6 billion of deductions for general sales taxes in lieu of income taxes.¹⁰⁹

Table 2 reports the distribution of tax expenditures for the real property tax deduction by income class in 2010. Table 3 reports the distribution of tax expenditures for State and local income, sales, and personal property tax deduction. The largest tax expenditures for each deduction accrue to those households with the highest incomes as they are more likely to own homes, are more likely to itemize deductions, and face higher Federal, State, and local tax rates.

Table 2.—Distribution by Income Class of the Tax Expenditure for the Real Property Tax Deduction at 2010 Rates and 2010 Income Levels¹

Income Class ²	Tax Expenditure for Real Property Tax Deduction		
	Returns (thousands)	Amount (\$ millions)	Average Per Return in Dollars
Below \$10,000	-----	-----	-----
\$10,000 to \$20,000	142	22	155
\$20,000 to \$30,000	382	73	191
\$30,000 to \$40,000	970	220	227
\$40,000 to \$50,000	1,864	464	249
\$50,000 to \$75,000	6,002	2,281	380
\$75,000 to \$100,000	6,452	3,092	479
\$100,000 to \$200,000	14,228	11,873	834
\$200,000 and over	2,815	4,946	1,757
Total	32,853	22,971	699

¹ Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

² The income concept used to place tax returns into classes is adjusted gross income (“AGI”) plus:

(a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers’ compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

¹⁰⁹ Internal Revenue Service, *Individual Income Tax Returns 2009*, Publication 1304, Rev. 07-2011, Table 2.1.

Table 3.—Distribution by Income Class of the Tax Expenditure for State and Local Income, Sales, and Personal Property Tax Deduction at 2010 Rates and 2010 Income Levels¹

Income Class ²	Tax Expenditure for State and Local Income, Sales, and Personal Property Tax Deduction		
	Returns (thousands)	Amount (\$ millions)	Average Per Return in Dollars
Below \$10,000	6	(3)	-----
\$10,000 to \$20,000	181	7	39
\$20,000 to \$30,000	667	41	61
\$30,000 to \$40,000	1,434	147	103
\$40,000 to \$50,000	2,397	340	142
\$50,000 to \$75,000	7,694	2,042	265
\$75,000 to \$100,000	7,698	3,093	402
\$100,000 to \$200,000	15,945	14,316	898
\$200,000 and over	3,745	19,409	5,183
Total	39,766	39,395	991

¹ Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

² The income concept used to place tax returns into classes is adjusted gross income (“AGI”) plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers’ compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

³ Positive tax expenditure of less than \$500,000.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

For 2012, the staff of the Joint Committee on Taxation estimates that 44.8 million returns will itemize deductions for \$174.0 billion of real property taxes, 42.5 million returns will itemize deductions for \$291.5 billion of State and local income taxes, 22.4 million returns will itemize deductions for \$9.5 billion of personal property taxes, and 2.8 million returns will itemized deductions for \$1.9 billion of other taxes.

B. Data on State and Local Government Revenue

Total general fund revenue

The U.S. Census Bureau conducts an annual survey of State and local government finances. The most recent data available are for fiscal year 2009.¹¹⁰ For purposes of the Census reports, government financial data is divided into four broad categories: general government, utilities, liquor stores, and insurance trust activities. General revenue includes general revenue from own sources, such as taxes and charges for services, and intergovernmental revenue transferred from the Federal, State, or local government. The data in this document focus on general revenue.

For fiscal year 2009, general revenue for State and local governments totaled \$2.413 trillion, of which \$536.8 billion (22.2 percent) represents transfers from the Federal government and \$1.877 trillion (77.8 percent) represents general revenue from own sources. States relied on Federal transfers for 31.8 percent of their general revenue, while localities received only 4.3 percent of their general revenue from the Federal government. Approximately one-third of local government revenue represents transfers from State governments.

General fund revenue from State and local sources

Of the revenue that States and localities combined generate from their own sources, the largest component is taxes (67.7 percent), followed by current charges¹¹¹ (20.7 percent) and miscellaneous general revenue (11.5 percent). States rely on taxes more than local governments (71.5 percent vs. 63.4 percent) while local governments rely on current charges more than States (26.0 percent vs. 16.1 percent).

The composition of revenue differs significantly between States and local governments, as shown in Figures 2 and 3. The largest sources of revenue for States are general and selective sales taxes (34.5 percent combined) and individual income taxes (24.6 percent). Local governments' largest source of revenue is the property tax, accounting for 46.9 percent of general own source revenue and 73.9 percent of all local government tax revenue.

¹¹⁰ All references to years in this section refer to fiscal years. Forty-six of the 50 state governments have a fiscal year that runs from July 1 until June 30. Alabama and Michigan have fiscal years that end September 30, New York, March 31, and Texas, August 31.

¹¹¹ Current charges include revenue from entities such as higher education institutions, hospitals, and parking facilities, and charges for sewer and solid waste management.

Figure 2.-Sources of General Revenue, 2009: States

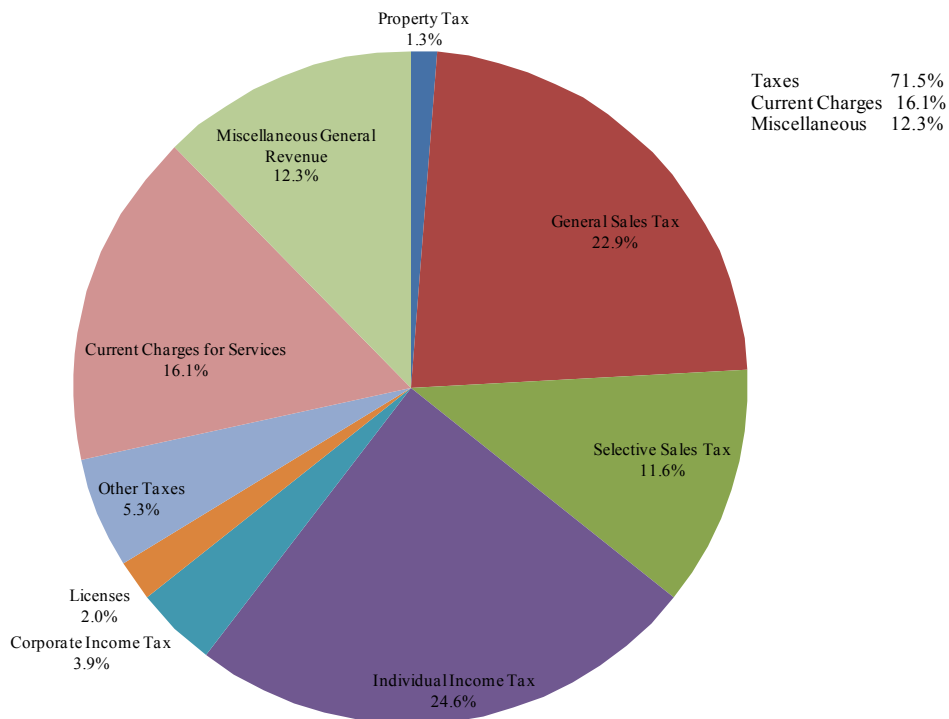
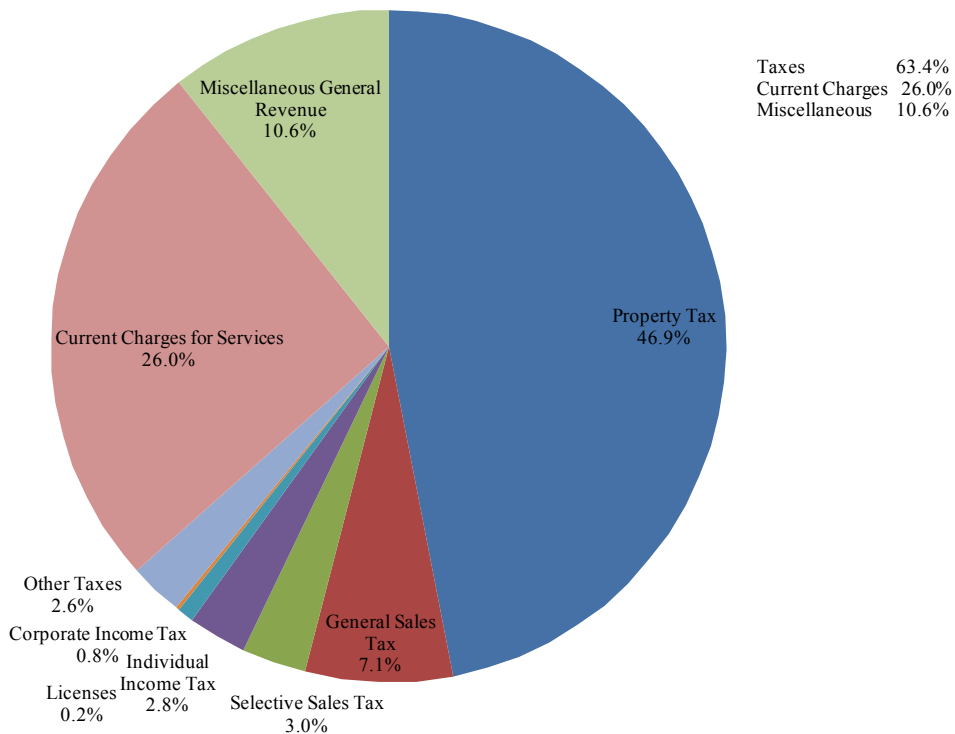


Figure 3.-Sources of General Revenue, 2009: Localities



Source: U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances.

State and local tax revenue

States

While States as a whole rely on sales and individual income taxes, there is variation among States in their reliance on major tax sources. For example, five States levy no general sales and gross receipts tax,¹¹² seven levy no individual income tax,¹¹³ four of which also levy no corporate income tax,¹¹⁴ and 14 collect no State property tax revenue.¹¹⁵ Thirty States rely on one category of tax for more than half of their tax revenue: 21 rely on general and selective sales taxes, eight on individual and corporate income taxes, and one on severance tax.¹¹⁶ Table 4 shows the percentage of total tax revenue States collect from each of selected major sources.

Localities

There is also wide diversity in tax burdens among local jurisdictions. Table 5 reports estimated combined State and local tax burdens for the largest city in each State and the District of Columbia. The four major taxes used in the comparisons are the individual income tax, the real property tax on residential property, the general sales and use tax, and automobile taxes, including the gasoline tax, registration fees, excise tax, and the personal property tax. Tax burdens are compared for a hypothetical family consisting of two wage-earning spouses and one school-aged child.¹¹⁷ Cities in States that rely heavily on sales taxes tend to have less progressive local tax structures than those in States that rely more heavily on income taxes. Variation in tax burdens also arise from variation in property tax rates and housing values in different jurisdictions.

¹¹² Alaska, Delaware, Montana, New Hampshire, and Oregon levy no general sales tax.

¹¹³ Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming levy no individual income tax.

¹¹⁴ Nevada, Texas, Washington, and Wyoming levy no corporate income tax.

¹¹⁵ Colorado, Connecticut, Delaware, Hawaii, Idaho, Iowa, New York, North Carolina, Ohio, Oklahoma, South Dakota, Tennessee, Texas, and Utah collect no State property tax revenue.

¹¹⁶ Severance tax paid by oil and gas companies that operate within Alaska accounted for 77.3 percent of all tax revenue in fiscal year 2009. Fifteen States collected no revenue from severance taxes in 2009. The Census Bureau defines severance taxes as “taxes imposed on removal (severance) of natural resources (*e.g.*, oil, gas, coal, other minerals, timber, fish, etc.) from land or water and measured by the value or quantity of products removed or sold. U.S. Bureau of the Census, Government Finance and Employment Classification Manual, October 2006, p. 4-16.

¹¹⁷ For details about the methodology used to estimate tax burdens in each jurisdiction, see Government of the District of Columbia, Office of the Chief Financial Officer, *Tax Rates and Tax Burdens in the District of Columbia - A Nationwide Comparison, 2010*, September 2011. This report is prepared annually pursuant to the District of Columbia Real Property Tax Revision Act of 1974, Pub. L. No. 93-407, secs. 415-416.

Table 4.—Major Sources of Tax Revenue by State, 2009

State	General Sales and			Selective Sales and	Licenses	Individual and Corporation			Other
	Property	Gross Receipts	Gross Receipts			Net Income	Individual Income	Corporation Net Income	
United States	1.8%	48.2%	32.0%	16.2%	6.9%	39.9%	34.4%	5.5%	3.3%
Alabama	3.8%	50.6%	24.9%	25.7%	5.8%	38.0%	32.1%	5.9%	1.8%
Alaska	2.2%	5.0%	0.0%	5.0%	2.7%	12.8%	0.0%	12.8%	77.3%
Arizona	7.5%	60.3%	43.8%	16.5%	3.6%	28.5%	23.1%	5.3%	0.2%
Arkansas	9.8%	50.2%	37.0%	13.2%	4.4%	34.6%	30.0%	4.6%	0.9%
California	2.3%	36.0%	28.7%	7.3%	8.3%	53.4%	43.9%	9.4%	0.0%
Colorado	0.0%	38.0%	24.5%	13.5%	4.2%	54.5%	50.7%	3.8%	3.3%
Connecticut	0.0%	44.6%	27.1%	17.6%	3.0%	49.8%	46.1%	3.7%	2.6%
Delaware	0.0%	16.9%	0.0%	16.9%	41.2%	39.9%	32.5%	7.4%	2.0%
Florida	0.0%	84.1%	60.0%	24.2%	5.7%	5.7%	0.0%	5.7%	4.4%
Georgia	0.5%	43.5%	33.0%	10.5%	3.0%	52.8%	48.5%	4.3%	0.1%
Hawaii	0.0%	66.3%	52.2%	14.1%	3.1%	30.1%	28.4%	1.7%	0.5%
Idaho	0.0%	49.6%	38.0%	11.6%	8.5%	41.5%	37.1%	4.5%	0.4%
Illinois	0.2%	53.7%	31.9%	21.9%	7.7%	37.2%	31.4%	5.8%	1.1%
Indiana	0.1%	59.4%	41.6%	17.8%	4.7%	34.6%	28.9%	5.6%	1.3%
Iowa	0.0%	46.8%	31.5%	15.3%	9.4%	42.5%	38.7%	3.8%	1.2%
Kansas	1.2%	45.5%	33.3%	12.2%	4.5%	46.3%	40.8%	5.5%	2.5%
Kentucky	5.3%	47.9%	29.3%	18.5%	4.7%	38.0%	34.0%	4.0%	4.1%
Louisiana	0.6%	51.0%	29.1%	21.9%	4.6%	34.8%	28.8%	6.0%	9.0%
Maine	1.2%	47.0%	29.0%	18.0%	7.0%	43.4%	39.3%	4.1%	1.4%
Maryland	4.5%	40.7%	25.2%	15.5%	5.0%	47.3%	42.4%	4.9%	2.5%
Massachusetts	0.0%	31.0%	19.7%	11.3%	3.8%	62.9%	53.8%	9.1%	2.2%
Michigan	9.5%	54.9%	39.5%	15.4%	5.9%	28.8%	25.7%	3.1%	0.8%
Minnesota	4.2%	42.9%	25.5%	17.4%	6.0%	45.0%	40.5%	4.5%	2.0%
Mississippi	0.1%	63.9%	46.8%	17.2%	6.2%	28.0%	23.0%	5.0%	1.8%
Missouri	0.3%	44.6%	29.4%	15.2%	5.8%	49.0%	46.3%	2.7%	0.2%
Montana	9.8%	22.0%	0.0%	22.0%	12.4%	41.2%	34.4%	6.8%	14.7%
Nebraska	0.0%	50.4%	37.6%	12.8%	4.2%	45.0%	40.0%	5.0%	0.4%
Nevada	4.1%	77.6%	47.8%	29.8%	9.5%	0.0%	0.0%	0.0%	8.8%
New Hampshire	18.5%	39.0%	0.0%	39.0%	10.7%	27.8%	4.6%	23.2%	4.0%
New Jersey	0.0%	43.1%	30.1%	13.0%	5.2%	48.0%	39.2%	8.8%	3.7%
New Mexico	1.3%	51.5%	39.0%	12.5%	4.4%	23.2%	19.8%	3.4%	19.5%
New York	0.0%	31.3%	17.1%	14.2%	1.9%	63.7%	56.9%	6.8%	3.1%
North Carolina	0.0%	41.1%	24.2%	16.9%	7.2%	51.0%	46.6%	4.4%	0.8%
North Dakota	0.1%	39.1%	25.1%	14.0%	5.8%	20.7%	15.3%	5.4%	34.3%
Ohio	0.0%	50.7%	30.6%	20.1%	12.0%	36.9%	34.8%	2.2%	0.3%
Oklahoma	0.0%	38.6%	26.4%	12.2%	12.5%	35.3%	31.1%	4.2%	13.7%
Oregon	0.3%	12.4%	0.0%	12.4%	9.7%	76.0%	72.6%	3.4%	1.6%
Pennsylvania	0.2%	50.2%	28.3%	21.9%	8.3%	37.5%	31.8%	5.8%	3.7%
Rhode Island	0.1%	53.5%	31.5%	22.0%	3.7%	41.3%	37.2%	4.2%	1.3%
South Carolina	0.1%	53.4%	38.1%	15.3%	5.9%	40.1%	36.8%	3.3%	0.5%
South Dakota	0.0%	81.2%	56.7%	24.5%	14.4%	3.7%	0.0%	3.7%	0.7%
Tennessee	0.0%	76.7%	60.9%	15.8%	10.8%	9.9%	2.1%	7.8%	2.6%
Texas	0.0%	78.1%	50.4%	27.7%	16.4%	0.0%	0.0%	0.0%	5.5%
Utah	0.0%	44.2%	32.2%	12.1%	6.6%	47.3%	42.8%	4.5%	1.9%
Vermont	36.4%	32.8%	12.8%	20.0%	3.9%	24.7%	21.3%	3.5%	2.1%
Virginia	0.2%	34.0%	20.3%	13.6%	4.0%	59.2%	55.4%	3.8%	2.6%
Washington	10.9%	79.9%	61.2%	18.7%	5.7%	0.0%	0.0%	0.0%	3.6%
West Virginia	0.1%	46.5%	23.2%	23.3%	4.0%	41.3%	32.5%	8.8%	8.0%
Wisconsin	0.9%	46.0%	28.3%	17.7%	6.6%	45.9%	41.3%	4.5%	0.5%
Wyoming	10.4%	40.5%	35.8%	4.7%	5.5%	0.0%	0.0%	0.0%	43.6%

Source: Bureau of the Census, State Government Tax Collections, 2009.

Table 5.—Estimated Tax Burdens for a Hypothetical Family of Three, 2010

City	Total taxes paid by income					Total taxes paid as percent of income				
	\$25,000	\$50,000	\$75,000	\$100,000	\$150,000	\$25,000	\$50,000	\$75,000	\$100,000	\$150,000
Average	2,727	4,414	6,471	8,402	12,244	10.9	8.8	8.6	8.4	8.2
Birmingham, AL	4,096	4,777	6,903	8,959	12,467	16.4	9.6	9.2	9.0	8.3
Anchorage, AK	2,236	2,438	2,971	3,343	4,133	8.9	4.9	4.0	3.3	2.8
Phoenix, AZ	3,327	3,683	5,143	6,857	9,748	13.3	7.4	6.9	6.9	6.5
Little Rock, AR	3,003	3,748	6,171	8,475	13,168	12.0	7.5	8.2	8.5	8.8
Los Angeles, CA	2,788	5,409	7,704	9,740	15,539	11.2	10.8	10.3	9.7	10.4
Denver, CO	2,770	3,603	5,447	7,175	10,693	11.1	7.2	7.3	7.2	7.1
Bridgeport, CT	3,200	10,708	14,667	17,702	23,655	12.8	21.4	19.6	17.7	15.8
Wilmington, DE	2,314	4,526	6,557	8,648	12,947	9.3	9.1	8.7	8.6	8.6
Jacksonville, FL	2,627	2,751	3,693	4,466	5,797	10.5	5.5	4.9	4.5	3.9
Atlanta, GA	3,391	4,962	7,607	10,077	14,861	13.6	9.9	10.1	10.1	9.9
Honolulu, HI	3,160	3,184	5,211	7,341	11,506	12.6	6.4	6.9	7.3	7.7
Boise, ID	2,236	3,524	5,917	8,408	13,262	8.9	7.0	7.9	8.4	8.8
Chicago, IL	3,154	5,068	6,830	8,402	11,152	12.6	10.1	9.1	8.4	7.4
Indianapolis, IN	3,258	4,749	6,833	8,913	12,787	13.0	9.5	9.1	8.9	8.5
Des Moines, IA	2,590	4,709	7,212	9,925	15,499	10.4	9.4	9.6	9.9	10.3
Wichita, KS	2,471	3,595	6,071	8,562	13,115	9.9	7.2	8.1	8.6	8.7
Louisville, KY	3,274	6,308	9,054	11,941	17,458	13.1	12.6	12.1	11.9	11.6
New Orleans, LA	2,684	3,272	4,910	6,507	9,338	10.7	6.5	6.5	6.5	6.2
Portland, ME	2,373	4,929	7,858	10,677	16,297	9.5	9.9	10.5	10.7	10.9
Baltimore, MD	2,148	4,890	7,471	10,083	15,180	8.6	9.8	10.0	10.1	10.1
Boston, MA	3,009	5,266	7,233	8,919	12,426	12.0	10.5	9.6	8.9	8.3
Detroit, MI	2,869	5,960	8,502	11,354	16,109	11.5	11.9	11.3	11.4	10.7
Minneapolis, MN	2,789	4,889	7,289	9,485	14,258	11.2	9.8	9.7	9.5	9.5
Jackson, MS	2,803	4,504	7,028	9,141	13,506	11.2	9.0	9.4	9.1	9.0
Kansas City, MO	3,246	5,067	7,906	10,037	14,741	13.0	10.1	10.5	10.0	9.8
Billings, MT	1,813	2,951	5,114	7,022	10,877	7.3	5.9	6.8	7.0	7.3
Omaha, NE	2,406	4,484	6,766	9,396	14,267	9.6	9.0	9.0	9.4	9.5
Las Vegas, NV	2,421	3,229	4,066	4,796	5,836	9.7	6.5	5.4	4.8	3.9
Manchester, NH	2,104	3,968	4,663	5,104	6,159	8.4	7.9	6.2	5.1	4.1
Newark, NJ	2,551	5,957	7,463	8,586	11,921	10.2	11.9	10.0	8.6	7.9
Albuquerque, NM	2,521	4,090	6,079	7,980	11,386	10.1	8.2	8.1	8.0	7.6
New York City, NY	2,909	4,857	7,833	10,984	18,077	11.6	9.7	10.4	11.0	12.1
Charlotte, NC	3,134	4,767	7,455	10,031	15,002	12.5	9.5	9.9	10.0	10.0
Fargo, ND	1,969	2,931	4,152	5,536	7,990	7.9	5.9	5.5	5.5	5.3
Columbus, OH	2,968	5,793	8,222	10,838	15,928	11.9	11.6	11.0	10.8	10.6
Oklahoma City, OK	2,496	3,722	5,787	7,748	11,419	10.0	7.4	7.7	7.7	7.6
Portland, OR	2,497	4,385	6,806	9,117	14,100	10.0	8.8	9.1	9.1	9.4
Philadelphia, PA	4,112	6,928	9,378	11,749	16,302	16.4	13.9	12.5	11.7	10.9
Providence, RI	2,693	5,669	7,520	9,615	14,604	10.8	11.3	10.0	9.6	9.7
Columbia, SC	2,533	3,712	6,782	8,929	13,848	10.1	7.4	9.0	8.9	9.2
Sioux Falls, SD	2,440	2,773	3,732	4,467	5,647	9.8	5.5	5.0	4.5	3.8
Memphis, TN	2,725	3,054	4,206	4,945	6,092	10.9	6.1	5.6	4.9	4.1
Houston, TX	2,451	3,051	4,188	5,028	6,310	9.8	6.1	5.6	5.0	4.2
Salt Lake City, UT	2,799	4,941	7,258	9,422	13,168	11.2	9.9	9.7	9.4	8.8
Burlington, VT	2,290	4,626	6,515	8,373	12,947	9.2	9.3	8.7	8.4	8.6
Virginia Beach, VA	2,427	3,684	5,782	7,637	11,205	9.7	7.4	7.7	7.6	7.5
Seattle, WA	2,825	4,020	5,173	5,651	6,502	11.3	8.0	6.9	5.7	4.3
Charleston, WV	2,942	3,876	6,326	8,439	12,644	11.8	7.8	8.4	8.4	8.4
Milwaukee, WI	2,470	5,407	7,686	10,207	14,698	9.9	10.8	10.2	10.2	9.8
Cheyenne, WY	2,211	2,085	2,808	3,403	4,560	8.8	4.2	3.7	3.4	3.0
Washington, DC	2,549	3,647	6,055	8,345	13,330	10.2	7.3	8.1	8.3	8.9

Source: District of Columbia, Chief Financial Officer.

Tax rates

Tax rates vary across jurisdictions. Table 6 reports effective property tax rates for the same cities shown in Table 5. State and average local sales tax rates as of January 1, 2012, are shown in Table 7. Table 8 reports State individual income tax rates as of January 1, 2012.

Table 6.—Residential Property Tax Rates in the Largest City in Each State, 2010

City	State	Effective Rate per \$100	City	State	Effective Rate per \$100
Indianapolis	IN	2.75	Atlanta	GA	1.35
Bridgeport	CT	2.71	Sioux Falls	SD	1.27
Philadelphia	PA	2.64	Louisville	KY	1.26
Milwaukee	WI	2.56	Oklahoma City	OK	1.25
Houston	TX	2.52	Minneapolis	MN	1.24
Baltimore	MD	2.38	Salt Lake City	UT	1.15
Providence	RI	2.37	Las Vegas	NV	1.15
Des Moines	IA	2.29	Portland	OR	1.15
Detroit	MI	2.11	Los Angeles	CA	1.11
Omaha	NE	2.05	Charlotte	NC	1.08
Burlington	VT	2.00	Boston	MA	1.06
Memphis	TE	1.80	Columbia	SC	1.00
Portland	ME	1.79	Phoenix	AR	0.89
Columbus	OH	1.75	Charleston	WV	0.86
Manchester	NH	1.74	Washington	DC	0.85
Jacksonville	FL	1.73	Birmingham	AL	0.80
Jackson	MS	1.70	Seattle	WA	0.79
Fargo	ND	1.70	Billings	MT	0.78
Newark	NJ	1.63	Virginia Beach	VA	0.75
Boise	ID	1.60	Cheyenne	WY	0.67
Anchorage	AK	1.55	New York City	NY	0.62
Wilmington	DE	1.54	Denver	CO	0.53
Kansas City	MO	1.49	Chicago	IL	0.52
Albuquerque	NM	1.44	Honolulu	HI	0.34
Little Rock	AR	1.41			
New Orleans	LA	1.40	Unweighted average		1.46
Wichita	KS	1.38	Median		1.40

Source: District of Columbia, Chief Financial Officer.

Table 7.—State and Local General Sales and Use Tax Rates, 2012

State	Average			State	Average		
	State Tax Rate	Local Tax Rate ¹	Combined Tax Rate		State Tax Rate	Local Tax Rate	Combined Tax Rate
Alabama	4.00%	4.33%	8.33%	Nebraska	5.50%	1.27%	6.77%
Alaska	0.00%	1.77%	1.77%	Nevada	6.85%	1.08%	7.93%
Arizona	6.60%	2.52%	9.12%	New Hampshire	0.00%	0.00%	0.00%
Arkansas	6.00%	2.58%	8.58%	New Jersey ⁵	7.00%	-0.03%	6.97%
California ²	7.25%	0.86%	8.11%	New Mexico ³	5.13%	2.12%	7.24%
Colorado	2.90%	4.54%	7.44%	New York	4.00%	4.48%	8.48%
Connecticut	6.35%	0.00%	6.35%	North Carolina	4.75%	2.10%	6.85%
Delaware	0.00%	0.00%	0.00%	North Dakota	5.00%	1.39%	6.39%
Florida	6.00%	0.62%	6.62%	Ohio	5.50%	1.25%	6.75%
Georgia	4.00%	2.84%	6.84%	Oklahoma	4.50%	4.16%	8.66%
Hawaii ³	4.00%	0.35%	4.35%	Oregon	0.00%	0.00%	0.00%
Idaho	6.00%	0.02%	6.02%	Pennsylvania	6.00%	0.34%	6.34%
Illinois	6.25%	1.95%	8.20%	Rhode Island	7.00%	0.00%	7.00%
Indiana	7.00%	0.00%	7.00%	South Carolina	6.00%	1.13%	7.13%
Iowa	6.00%	0.81%	6.81%	South Dakota ³	4.00%	1.39%	5.39%
Kansas	6.30%	1.96%	8.26%	Tennessee	7.00%	2.45%	9.45%
Kentucky	6.00%	0.00%	6.00%	Texas	6.25%	1.89%	8.14%
Louisiana	4.00%	4.85%	8.85%	Utah ²	5.95%	0.73%	6.68%
Maine	5.00%	0.00%	5.00%	Vermont	6.00%	0.14%	6.14%
Maryland	6.00%	0.00%	6.00%	Virginia ²	5.00%	0.00%	5.00%
Massachusetts	6.25%	0.00%	6.25%	Washington	6.50%	2.30%	8.80%
Michigan	6.00%	0.00%	6.00%	West Virginia	6.00%	0.00%	6.00%
Minnesota	6.88%	0.30%	7.18%	Wisconsin	5.00%	0.43%	5.43%
Mississippi	7.00%	0.00%	7.00%	Wyoming	4.00%	1.34%	5.34%
Missouri	4.23%	3.26%	7.49%	Washington, DC	6.00%	-	6.00%
Montana ⁴	0.00%	0.00%	0.00%				

Source: Tax Foundation; Sales Tax Clearinghouse.

¹ City, county, and municipal rates vary. These rates are weighted by population to compute an average local tax rate.

² Three States collect a separate, uniform “local” add-on sales tax that is included in the State sales tax rate in the table: California (1%), Utah (1.25%), Virginia (1%).

³ The sales taxes in Hawaii, New Mexico, and South Dakota have broad bases that include many services, so their rates are not strictly comparable to other States.

⁴ Due to data limitations, the table does not include sales taxes in local resort areas in Montana.

⁵ Some counties in New Jersey are not subject to the statewide sales tax rate and collect a local rate of 3.5%. Their average local score is represented as a negative.

Table 8.—State Individual Income Tax Rates, 2012

State	Rates	Brackets	State	Rates	Brackets
Alabama ^{1, 2}	2%	> \$0	Georgia	1%	> \$0
	4%	> \$500		2%	> \$750
	5%	> \$3,000		3%	> \$2,250
Arizona	2.59%	> \$0		4%	> \$3,750
	2.88%	> \$10,000		5%	> \$5,250
	3.36%	> \$25,000		6%	> \$7,000
	4.24%	> \$50,000	Hawaii	1.40%	> \$0
	4.54%	> \$150,000		3.20%	> \$2,400
Arkansas ^{2, 3, 4, 5}	1.0%	> \$0		5.50%	> \$4,800
	2.5%	> \$4,000		6.40%	> \$9,600
	3.5%	> \$8,000		6.80%	> \$14,400
	4.5%	> \$11,900		7.20%	> \$19,200
	6.0%	> \$19,900		7.60%	> \$24,000
	7.0%	> \$33,200		7.90%	> \$36,000
	California ^{3, 5}	1.0%		> \$0	8.25%
2.0%		> \$7,124		9.00%	> \$150,000
4.0%		> \$17,346		10.00%	> \$175,000
6.0%		> \$27,377	11.00%	> \$200,000	
8.0%		> \$38,004	Idaho ^{3, 5}	1.6%	> \$0
9.3%		> \$48,029		3.6%	> \$1,338
10.3%		> \$1,000,000		4.1%	> \$2,676
Colorado	4.63% of Federal taxable income	5.1%		> \$4,014	
		6.1%		> \$5,352	
Connecticut	3.0%	> \$0		7.1%	> \$6,690
	5.0%	> \$10,000		7.4%	> \$10,035
	5.5%	> \$50,000		7.8%	> \$26,760
	6.0%	> \$100,000	Illinois	5% of Federal adjusted gross income with modification	
	6.5%	> \$200,000			
	6.7%	> \$250,000	Indiana ²	3.4% of Federal adjusted gross income with modification	
Delaware ²	2.20%	> \$2,000			
	3.90%	> \$5,000			
	4.80%	> \$10,000			
	5.20%	> \$20,000			
	5.55%	> \$25,000			
	6.75%	> \$60,000			

Footnotes appear at end of the table.

Table 8.—State Individual Income Tax Rates, 2012 (continued)

State	Rates	Brackets	State	Rates	Brackets			
Iowa ^{1, 2, 5}	0.36%	>	\$0	Minnesota ⁵	5.35%	>	\$0	
	0.72%	>	\$1,469		7.05%	>	\$23,670	
	2.43%	>	\$2,938		7.85%	>	\$77,730	
		4.50%	>	\$5,876	Mississippi	3%	>	\$0
		6.12%	>	\$13,221		4%	>	\$5,000
		6.48%	>	\$22,035		5%	>	\$10,000
		6.80%	>	\$29,380	Missouri ^{1, 2}	1.5%	>	\$0
		7.92%	>	\$44,070		2.0%	>	\$1,000
		8.98%	>	\$66,105		2.5%	>	\$2,000
Kansas	3.50%	>	\$0	3.0%		>	\$3,000	
	6.25%	>	\$15,000	3.5%		>	\$4,000	
	6.45%	>	\$30,000	4.0%		>	\$5,000	
Kentucky ²	2.0%	>	\$0	4.5%	>	\$6,000		
	3.0%	>	\$3,000	5.0%	>	\$7,000		
	4.0%	>	\$4,000	5.5%	>	\$8,000		
	5.0%	>	\$5,000	6.0%	>	\$9,000		
	5.8%	>	\$8,000	Montana ^{1, 3, 5}	1.0%	>	\$0	
	6.0%	>	\$75,000		2.0%	>	\$2,700	
Louisiana ¹	2%	>	\$0		3.0%	>	\$4,700	
	4%	>	\$12,500		4.0%	>	\$7,200	
	6%	>	\$50,000		5.0%	>	\$9,700	
Maine ⁵	2.0%	>	\$0		6.0%	>	\$12,500	
	4.5%	>	\$5,100	6.9%	>	\$16,000		
	7.0%	>	\$10,150	Nebraska	2.56%	>	\$0	
	8.5%	>	\$20,350		3.57%	>	\$2,400	
Maryland ²	2.00%	>	\$0	5.12%	>	\$17,500		
	3.00%	>	\$1,000	6.84%	>	\$27,000		
	4.00%	>	\$2,000	New Hampshire ⁶	5%	>	\$0	
	4.75%	>	\$3,000		New Jersey ²	1.40%	>	\$0
	5.00%	>	\$150,000	1.75%		>	\$20,000	
	5.25%	>	\$300,000	3.50%		>	\$35,000	
5.50%	>	\$500,000	5.53%	>		\$40,000		
Massachusetts	5.3%	>	\$0	6.37%		>	\$75,000	
Michigan ²	4.35% of Federal adjusted gross income with modification			8.97%	>	\$500,000		
				continued				

Footnotes appear at end of table.

Table 8.—State Individual Income Tax Rates, 2012 (continued)

State	Rates	Brackets	State	Rates	Brackets	
New Mexico	1.7%	> \$0	Oregon ^{1, 2, 5}	5.00%	> \$0	
	3.2%	> \$5,500		7.00%	> \$2,000	
	4.7%	> \$11,000		9.00%	> \$5,000	
	4.9%	> \$16,000		9.90%	> \$125,000	
New York ²	4.00%	> \$0	Pennsylvania ²	3.07%	> \$0	
	4.50%	> \$8,000	Rhode Island ⁵	3.75%	> \$0	
	5.25%	> \$11,000		4.75%	> \$57,150	
	5.90%	> \$13,000		5.99%	> \$129,900	
	6.45%	\$20,000	South Carolina ^{3, 5}	3%	> \$2,800	
	6.65%	> \$75,000			4%	> \$5,600
	6.85%	> \$200,000			5%	> \$8,400
	8.82%	> \$1,000,000			6%	> \$11,200
North Carolina	6.00%	> \$0		7%	> \$14,000	
	7.00%	> \$12,750	Tennessee ²	6%	> \$0	
	7.75%	> \$60,000	Utah	5%	> \$0	
North Dakota ⁵	1.51%	> \$0	Vermont ^{3, 5}	3.55%	> \$0	
	2.82%	> \$35,350		6.80%	> \$34,500	
	3.13%	> \$85,650		7.80%	> \$83,600	
	3.63%	> \$178,650		8.80%	> \$174,400	
	3.99%	> \$388,350		8.95%	> \$379,150	
Ohio ^{2, 3, 5}	0.587%	> \$0	Virginia	2.00%	> \$0	
	1.174%	> \$5,100			3.00%	> \$3,000
	2.348%	> \$10,200			5.00%	> \$5,000
	2.935%	> \$15,350			5.75%	> \$17,000
	3.521%	> \$20,450	West Virginia	3.0%	> \$0	
	4.109%	> \$40,850			4.0%	> \$10,000
	4.695%	> \$81,650			4.5%	> \$25,000
	5.451%	> \$102,100			6.0%	> \$40,000
	5.925%	> \$204,200			6.5%	> \$60,000
Oklahoma	0.50%	> \$0	Wisconsin ^{3, 5}	4.60%	> \$0	
	1.00%	> \$1,000			6.15%	> \$10,180
	2.00%	> \$2,500			6.50%	> \$20,360
	3.00%	> \$3,750			6.75%	> \$152,740
	4.00%	> \$4,900		7.75%	> \$224,210	
	5.00%	> \$7,200	D.C.	4.00%	> \$0	
	5.25%	> \$8,700			6.00%	> \$10,000
				8.50%	> \$40,000	
				8.95%	> \$350,000	

Footnotes appear on following page.

Footnotes to Table 8.

Source: Tax Foundation, State tax forms and instructions.

Note: Brackets are for single taxpayers. Different rates and brackets may apply for taxpayers with a different filing status. Some States double bracket widths for joint filers (AL, AZ, CT, HI, ID, KS, LA, ME, NE, and OR). NY doubles all except the 6.85% bracket, which is effective at \$300,000. CA doubles all but the top bracket. Some states increase but do not double brackets for joint filers (GA, MN, NM, NC, ND, OK, RI, VT, and WI). MD decreases some and increases others. NJ adds a 2.45% rate and doubles some bracket widths.

¹ State allows some or all of Federal income tax paid to be deducted from State taxable income.

² Local income taxes are excluded. Fourteen States have county- or city-level income taxes. The average rate, weighted by total personal income within each jurisdiction is: 0.08% in AL; 0.16% in DE.; 0.64% in IN.; 0.08% in IA; 0.74% in KY; 1.57% in MD; 0.13% in MI; 0.14% in MO; 0.85% in NY; 1.06% in OH; 0.01% in OR; and 0.78% in PA (weighted local rates are from Tax Foundation, *2012 State Business Tax Climate Index*).

³ 2012 rates but 2011 brackets. 2012 brackets were not available from the source.

⁴ Rates apply to regular tax table. A special tax table is available for low-income taxpayers that reduces their tax payments.

⁵ Bracket levels adjusted for inflation each year.

⁶ Tax applies to interest and dividend income only.