

National Rural Water Association

101 Constitution Ave., NW Suite 900
Washington, DC 20001
[p] 202-742-4416
[f] 202-742-4422
[e] s157@ruralwater.org

July 15, 2005

The Honorable Chuck Grassley
Chairman
U.S. Senate Committee on Finance
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
U.S. Senate Committee on Finance
Washington, DC 20510

Dear Chairman Grassley and Ranking Senator Baucus,

The National Rural Water Association (NRWA), a nonprofit, community-based rural water development organization of 22,147 rural and small communities, urges your support and cosponsorship of S. 157, to amend the Internal Revenue Code of 1986 to permit interest on federally guaranteed water, wastewater, and essential community facilities' loans to be tax exempt.

On behalf of NRWA's membership, we support Senator Kohl's legislation and encourage its passage as expeditiously as possible.

Many rural communities can't afford to provide water service to all residents—leaving thousands of U.S. families to haul water, rely on shallow wells, or use unsafe supplies. More than 93% of the country's 54,000 community water systems serve fewer than 10,000 homes. These communities have the greatest difficulty providing safe and affordable public drinking water and sewer services because of their economies of scale and lack of technical expertise. To overcome the lack of density in rural areas, rural communities have turned to the USDA rural water & wastewater loan and grant program to build or extend water systems and repay the loans at affordable rates and terms. Without this financial assistance, these small towns and rural water and wastewater districts could not construct new systems, expand existing utilities, or comply with EPA mandates. Unlike other environmental funding programs, USDA targets its funds to the smallest, most economically disadvantaged communities.

There is an extreme shortfall in USDA water funding available to meet rural water communities' demonstrated needs. Presently, hundreds of communities are on the long waiting list for funding, which includes a backlog of over \$2 billion in eligible grants. The average wait for available funding is now more than three years. The multibillion-dollar backlog in the USDA program is the most accurate indicator of need, because all systems on backlog have applied for funding and have met the USDA strict needs requirement (including lack of commercial funding availability and high ratios of median household income to water rates). In addition to this present need, the EPA is proposing more federal water and sewer regulations that will force small towns to come up with millions in financing. Many systems will be stressed to comply with the following rules: arsenic, ground water, disinfection byproduct, radon, TMDLs, and the ever-changing and tightening of wastewater permits, etc.

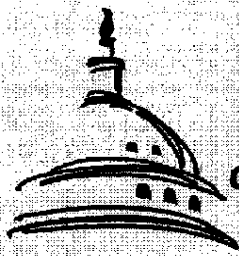
Without cost to the U.S. Treasury, S. 157 would allow for additional subsidized funding to be available to small and rural water supplies that are in need. The funding is only available to a limited group of small communities that have no chance of obtaining commercial funding, are economically disadvantaged, and have documented environmental or public health needs. No other federal funding effort meets these rigorous requirements to ensure that funding is targeted to the communities most in need. If enacted, there is no cost to the Treasury with this legislation, because it only provides loans to communities that cannot obtain commercial loans. Therefore, it would not replace any potential commercial loans that generate federal tax revenue to the Treasury.

Thank you, Mr. Chairman, for your continued support and assistance. If enacted, S. 157 would have a very positive impact on improving the lives of numerous rural families and enhancing rural community development. Please contact us with any questions, and we look forward to using our grassroots network of over 22,000 small and rural communities to advance the legislation in the Congress.

Sincerely,

A handwritten signature in blue ink that reads "John Montgomery". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

John Montgomery & Mike Keegan



**Congressional
Research
Service**

Memorandum

June 22, 2005

TO: Senator Herb Kohl
Attention: Phil Karsting

FROM: Steven Maguire
Analyst in Public Finance
Government and Finance Division

SUBJECT: Federal Guarantee of Tax-Exempt Bonds

This memorandum responds to your question about the federal guarantee of tax-exempt bonds. As I noted in our telephone conversation, under current law, a “federally guaranteed bond is not tax-exempt.”¹ Congress, however, has made some exceptions to the rule. You asked CRS to briefly summarize the exceptions to the rule.

The guarantees by the following federal entities, private companies, and publicly held government sponsored enterprises (GSEs) are not considered federal guarantees. Thus, debt guaranteed by these entities could be tax-exempt (if the bond would otherwise qualify):²

- (1) the Federal Housing Administration (FHA),
- (2) the Veteran’s Administration (VA),³
- (3) the Federal National Mortgage Association (FNMA),
- (4) the Federal Home Loan Mortgage Corporation (FHLMC),
- (5) the Government National Mortgage Association (GNMA),
- (6) the Student Loan Marketing Association (SLMA), and
- (7) the Bonneville Power Authority (BPA).

Four of the above entities are, without question, part of the federal government: FHA, VA, GNMA, and BPA. Tax-exempt bonds guaranteed by these four would be the true exceptions to the rule that federally guaranteed bonds cannot be tax-exempt. Generally, these entities do not issue and make payment on tax-exempt bonds. However, CRS did not investigate how much tax-exempt debt the BPA assumed when it acquired non-federal nuclear power authorities. The BPA would seem unlikely to issue new tax-exempt debt

¹ 26 U.S.C. § 149(b).

² 26 U.S.C. § 149(b)(3)(A)

³ The VA is now called the Department of Veterans Affairs.

given its access to the U.S. Treasury. The BPA has the following information on its website describing its borrowing relationship with the federal government through the U.S. Treasury:

While BPA is part of the Department of Energy, it is not tax-supported through government appropriations. Instead, BPA recovers all of its costs through sales of electricity and transmission and repays the U.S. Treasury in full with interest for any money it borrows.⁴

The U.S. Department of Energy does not have an entry for the subsidy cost of any loan guarantees in the *2006 Federal Credit Supplement*.⁵

Two entities, FNMA and FHLMC, are publicly held government sponsored enterprises and are subject to federal oversight through the Office of Federal Housing Enterprise Oversight (OFHEO).⁶ Legally, they are not part of the federal government and a guarantee by these entities does not constitute a *federal* guarantee. Nevertheless, some observers claim that guarantees by these entities *are* a federal guarantee because they believe the federal government will not let these entities fail.

SLMA is a private entity that is not subject to explicit federal oversight. Bonds guaranteed by SLMA, thus, would not have a federal guarantee. On the agency's website, the following statement is made:

The company was created by Congress in 1972 as a government-sponsored enterprise (GSE). SLM Corporation, commonly known as Sallie Mae, began privatizing its operations in 1997, a process it completed at the end of 2004 when it terminated its GSE charter, ending its ties to the federal government.⁷

In addition to the above entities, the qualified bonds issued (by non-federal entities) for the following purposes are also exceptions to the rule. These qualified tax-exempt bonds can receive a federal guarantee:⁸

- (1) a private activity bond for a qualified residential rental project or a housing program obligation under section 11(b) of the United States Housing Act of 1937,
- (2) a qualified mortgage bond,
- (3) a qualified veteran's mortgage bond.

The allowance for tax-exempt interest on bonds generates a benefit for the issuers and to the bond buyer. Issuers can offer the bonds at a lower interest rate than would otherwise be the case, reducing the issuer's interest cost. In addition, bond buyers in marginal tax rates

⁴ See the introductory text on the agency website: [http://www.bpa.gov/corporate/About_BPA/].

⁵ The *Federal Credit Supplement* is included as a supporting document in the FY2006 Budget submitted by the president.

⁶ See CRS Report RS21663, *Government-Sponsored Enterprises (GSEs): An Institutional Overview*, by Kevin Kosar.

⁷ See the introductory text on the company's website: [<http://www2.salliemae.com/about/>].

⁸ 26 U.S.C. § 149(b)(3)(C)(i).

above a threshold, where the return on tax-exempt and taxable securities generate the same after-tax return, receive a supra-marginal gain.⁹ Congress limits the use of tax-exempt debt to state and local government projects and to a list of qualified activities.¹⁰

The addition of a federal guarantee to tax-exempt bonds further increases the interest rate subsidy to the issuer and buyer. The potential federal revenue loss would also increase because the federal government would bear the risk of possible default on the bonds. The proponents of these programs argue that the intrinsic benefit of the subsidized activity justifies these additional costs to the federal government.

The legislation introduced by your office, S. 157, would extend the federal guarantee to tax-exempt bonds issued "...pursuant to section 306(a)(1) of the Consolidated Farm and Rural Development Act (7 U.S.C 1926(a)(1)) to finance water, wastewater, and essential community facilities." This treatment would deepen the federal commitment to these projects. The federal government would be responsible for default on the bonds if the community issuing bonds were unable to repay the debt. Because the tax-exemption would be coupled with the guarantee, the revenue cost to the federal government could exceed the benefit conferred on the community. Observers note that in these cases a more efficient means of delivering a federal subsidy would be through loans or grants directly from the Treasury.

If you have any questions about this memorandum or the tax treatment of bonds generally, please call me on extension 7-7841.

⁹ See CRS Report RL30638, *Tax-Exempt Bonds: An Description of State and Local Government Debt*, by Steven Maguire.

¹⁰ See CRS Report RL31457, *Private Activity Bonds: An Introduction*, by Steven Maguire.

AUG 21 2002

THE CITY OF JEROME

City Hall
152 East Avenue A
Jerome, Idaho 83338
(208) 324-8189

August 20, 2002

The Honorable United States Senator Larry Craig
Twin Falls Field Office
1292 Addison Avenue East
Twin Falls, Idaho 83301

Dear US Senator Craig:

Over the course of the last few weeks, the city of Jerome has been working to secure funding sources. During this time, the city has been working with the Idaho Department of Environmental Quality (I-DEQ), the United States Department of Agriculture (USDA) Rural Development Division and commercial bank lending sources.

The total project cost is estimated at \$8.5 million. The solutions embodied in the projects will significantly reduce odor problems, increase the plant's current treatment capacity, reduce nutrient loading sent into the Snake River via the North Side Canal in accordance with the city's NPDES permit, and, more importantly, provide greater protection of the health and safety for those residing in the greater Jerome Community.

The City of Jerome through its agencies has contributed over \$715,000 to this effort to date. I-DEQ has reserved \$2.8 million for this project. The balance was to come from the USDA in the form of a guaranteed loan.

Yesterday I had the opportunity to meet with Mr. Terry Stigile, a rural development specialist with USDA located in their Twin Falls, Idaho office. During this meeting, Mr. Stigile informed me that Congress recently passed legislation allowing for this type of activity. I have also enclosed a copy of a "fact sheet" distributed by Mr. Stigile that describes the applicable uses of the USDA loan.

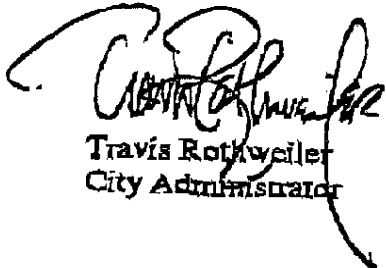
The fact sheet states, "The USDA, Rural Development (RD) is authorized to guarantee loans made by eligible lenders to borrowers in rural areas and towns of up to 10,000 population, for developing water and waste disposal facilities for public use." Additionally, the city of Jerome meets the minimum collection of criteria used by the USDA in its evaluation process.

If this was the end of the story, all would be well and city would begin to take the required, subsequent steps to complete this project as we have at least one local lender that is extremely interested in participating in this project utilizing the guaranteed program. Also if it were the end of the story, I would not have to write to you and members of your staff for assistance.

It is my understanding that the Internal Revenue Service (IRS) will not allow (through its rule making authority) tax-exempt organizations, like the city of Jerome, to use the funds at a tax exempt rate. Simply, in order to use the USDA guaranteed loan program with funding from a commercial bank, the city of Jerome will have to. Comparing interest rates available through commercial lenders, if the lender is not able to write the guaranteed loan on a tax-exempt basis, the cost difference is approximately \$11,000 per month to the City of Jerome. Over the twenty year term, the added interest rate increases the project cost by \$2.64 million. The increased cost associated with the higher interest rates would hamper the city's ability to fully fund the necessary project.

Thank you for looking into this matter. If you have any questions, comments, or suggestions, please do not hesitate to contact my office at (208) 324-8189.

Sincerely,



Travis Rothweiler
City Administrator

Enclosure

cc: Mayor Correll and Members of the Jerome City Council
Scott Bybee, City Engineer
Mr. Terry Stigile, USDA RD - Twin Falls Idaho Office
Erik Steigers, DL Evans Bank

Support Rural Communities

Cosponsor S. 157

A bill to help rural communities finance water, wastewater and other essential community facility projects.

How does it work?

Rural communities often finance essential community projects (water, sewer, fire stations, health clinics, assisted living facilities etc.) by issuing tax-exempt bonds. Project financing costs are thereby reduced because investors are willing to accept a lower rate of return (knowing that the interest income generated by the bonds is not subject to taxation.)

Alternatively, some rural communities utilize USDA loan guarantees to finance these projects. Loan guarantees also confer lower financing costs because investors' risk is limited. In practice, these guarantees result in interest rates that are 1 to 1.5% lower than non-guaranteed loans.

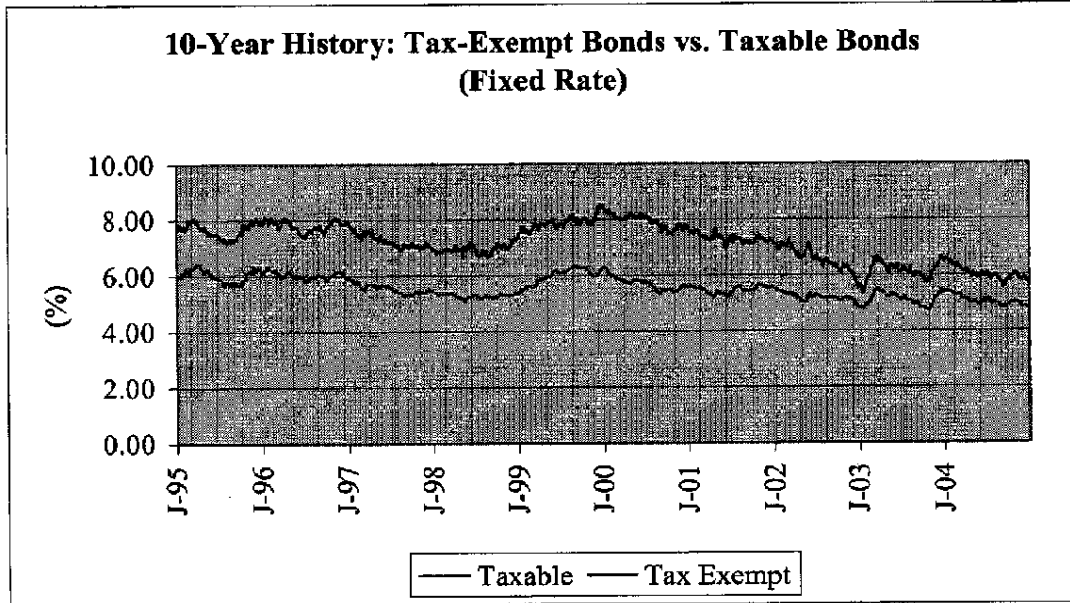
Under current law, however, rural communities are not allowed to combine these two mechanisms (tax exempt bonds and loan guarantees) to further reduce financing costs. *In other words*, local communities have to choose between USDA loan guarantees or tax exempt bonds.

The change proposed in S. 157 would allow local project sponsors to utilize both USDA loan guarantees *and* tax-exempt bonds to achieve lower financing costs.

What are the benefits of S. 157?

- lower end-user fees or reduced tax burdens on local residents,
- improved viability of rural lenders (USDA guarantees help preserve lending authority of rural banks, allow for longer-loan terms, reduce interest rates and improve the marketability of loans on secondary markets.)
- help in reducing the backlog of loans for small communities to build or improve water, wastewater, and essential community facilities. USDA Rural Development currently has an application backlog of over a billion dollars in water and wastewater project applications.
- improvements to critical infrastructure (water, sewer, medical facilities and public safety) help rural communities become more attractive to business and industry, thereby enhancing local economic activity.

**What has been the historical difference between
Taxable Bonds and Tax-Exempt Bonds?**



**How much difference does tax exempt
financing make for Individual projects?**

Illustrative Tax-Exempt Interest Savings			
Project Size	\$ 1,000,000	\$ 5,000,000	\$ 10,000,000
Annual Payments on Taxable Bonds	\$ 71,449	\$ 357,243	\$ 714,485
Annual Payments on Tax-Exempt Bonds	\$ 55,384	\$ 276,920	\$ 553,841
Annual Savings	\$ 16,064	\$ 80,322	\$ 160,644
Total Savings over 25 Years	\$ 401,610	\$ 2,008,052	\$ 4,016,104

Exceptions to the General Rule

Introduction

The bonds described below are still tax exempt, even though they are federally guaranteed.

Exceptions for Certain Federal Programs

Guarantees by the following federal programs are permitted by IRC section 149(b)(3)(A):

- Federal Housing Administration,
- Veterans Administration,
- Federal National Mortgage Association,
- Federal Home Loan Mortgage Corporation,
- Government National Mortgage Association,
- any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans, AND
- Bonneville Power Authority, pursuant to Northwest Power Act, as in effect as of the date of enactment of the Tax Reform Act of 1984.

Exceptions for Certain Investments of Bond Proceeds

IRC section 149(b)(3)(B) provides that certain bond proceeds may be invested (and federally guaranteed) as follows:

- proceeds invested during the initial temporary period,
- investments of a bona fide debt service fund,
- investments of a reserve which meets the requirements of IRC section 148(d), OR
- investments in US Treasury bonds.

In addition, the regulations provide that the following investments may be federally guaranteed:

- investments in a refunding escrow (Treas. Reg. Section 1.149(b)-1(b)(2), OR
- investments in obligations issued pursuant to Section 21 B(d)(3) of the Federal Home Loan Bank Act, as amended by Section 511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision (Treas. Reg. Section 1.149(b)-1(b)(1))

Continued on next page

General Rules

Legislative History

Congress became concerned about instances where bond proceeds were deposited into Federally insured accounts in financial institutions, and Federal agencies provided additional security for tax-exempt bonds through various methods.

It believed that the Federal government was indirectly providing a double subsidy for certain activities. Without IRC section 149(b), a federally guaranteed state or local bond is more attractive than either taxable federal securities or other state and local bonds lacking federal guarantees, because the bonds will have the backing and safety of a federal obligation plus the federal tax exemption of a state or local obligation.

The Deficit Reduction Act of 1984 eliminated the tax exemption for interest on bonds where a substantial portion of the issue was deposited in Federally insured deposits or accounts, or where the bonds were guaranteed directly or indirectly by the Federal government. They did, of course, provide for some exceptions. (House Rep. No. 98-432, Part 2, March 5, 1984, pages 1689 and 1690.)

When Are Bonds Federally Guaranteed?

IRC section 149(b)(2) provides that bonds are federally guaranteed if:


- the payment of the principal or interest is guaranteed, in whole or in part by the United States, or any of its agencies or instrumentalities, or
- the payment of the principal or interest is otherwise indirectly guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
- five percent or more of the bond proceeds are either:
 - used to make loans, and the principal and interest payments on the loans are guaranteed, in whole or in part, by the United States, or any of its agencies or instrumentalities, or
 - invested directly or indirectly in federally insured deposits or accounts.

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If you have any further questions, please call me or David White. My direct dial number is (202) 622-3449 and David's is (202) 622-3049.

Sincerely yours,

**Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
Government Entities)**

By: 

Rebecca L. Hartgal
Chief, Tax Exempt Bond Branch