



GENERAL COUNSEL  
TREASURY DEPARTMENT  
WASHINGTON 25

*Revised*

Dear Dr. Dixon:

With further reference to your request of March 20, I am enclosing draft legislative language to handle the problem called to your attention by Mr. Kinard involving the use of municipal tax-exempt bonds for financing the construction or acquisition of industrial facilities for lease to private firms.

You will recall that operations of this kind typically involve the exploitation of three separate provisions of present law: the income tax exemption of interest on municipal bonds, the deductibility of rental payments in arriving at taxable income, and the income tax exemption of the activities of State and local governments. The enclosed legislative language would curb this practice by denying the availability of the first two of these provisions. An attempt to qualify the third of these provisions by denying income tax exemption to certain activities of State and local governments was discarded because of the difficulties encountered in drafting language which would strike at the abuse you apparently have in mind without interfering with the customary proprietary and investment activities for State and local governments. We deem it important to avoid interference with the regular operations of State and local governments. The enclosed draft would therefore add a new section 274 to the Revenue Code and amend the present section 103 relating to the exclusion from gross income of interest from certain government obligations.

The new section 274 is patterned on a somewhat similar section which appeared in the House version of H. R. 8300 (83rd Congress) and was deleted in the Senate before enactment of the bill which became the Revenue Code of 1954. This section would disallow as a business cost deduction the rental payments made by the taxpayer to a governmental authority for the use or occupancy of property acquired or improved out of certain indebtedness incurred after a given date (to be specified). The type of indebtedness involved is further described as any obligation issued to finance the acquisition or improvement of property for a nonpublic purpose and which does not carry the full faith and credit of the issuing authority. Public purpose is defined as not including the leasing of property for a commercial enterprise or for rendering services, except where such operations are under the supervision of publicly appointed governmental officials.

The requirement that the property be used for a public purpose in combination with the requirement that if the activity is commercial, it must be conducted under governmental supervision is designed to differentiate between the normal activities of governments and those conducted for private gain. It would, for example, leave unchanged present law with respect to the deductibility of rentals paid to municipal airports for such facilities as hangars, to seaport authorities for pier space, or to municipalities for parking meter concessions. It would, however, deny the deduction for the rental of a manufacturing plant allied to the aircraft industry, erected on the property of a municipal airport.

The draft language would leave unaffected also the system employed in some States for the construction of school facilities under which a group of private citizens organize a nonprofit corporation to finance the construction of the facility and to lease it to the public school authorities on terms adequate to finance the operation. In these cases the operation of the facility, the school, is under the direct supervision of government officials. By the same token, the definition of "public purpose" would deny the deduction of rental payments for facilities employed by private persons in commercial or industrial operations of the kind described by Mr. Kinard, as well as those financed through industrial development bonds in a few States since such enterprises are not operated under the supervision of public officials.

The proposed amendment of section 103 would deny the income tax exemption of interest on obligations issued after a time to be specified for the acquisition or improvement of property, rental with respect to which would not be allowed as a deduction under section 274. Of the two sections, section 103 would be the more effective but it is also likely to stir up the more opposition. A similar proposal was considered in the early stages of H. R. 8300 (83rd Congress) and was dropped under protests from municipalities which regarded the provision as the entering wedge to the termination of municipal bond exemption generally.

I believe that this draft legislation provides a basis for curbing the abuse you apparently have in mind without in any way interfering with the efficient functioning of State-local governments. Please feel free to call on us if we can be of further help to you.

Sincerely yours,

Jay W. Glasmann  
Assistant General Counsel

Honorable Henry Aldous Dixon  
House of Representatives  
Washington 25, D. C.

Enclosures

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E-R: *ft 4/24/57* CA *Guerin: erk 6-15-57*