Attention Carbon Auditors: There's Low-Hanging Fruit in the PAB Regs
By Darien Shanske

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A. Introduction

The federal government is looking for ways to limit the production of greenhouse gases, and its search includes the code. Carbon auditors will find much of the production of greenhouse gases, and its search in-...
California, which often requires a supermajority. However, if there is only one landowner or a handful of landowners, usually who own unimproved land, the process is much simpler, and this much smaller group can vote to encumber the land, with the plan being that the bulk of the new assessments will be paid by new residents once the land is improved (in part thanks to the money raised by the promise of these assessments). It is a question of state law whether it should be made easier to finance new developments on unimproved land rather than encourage new infill pattern development.6 Federal tax law is involved because the bonds issued in this scenario are tax exempt — that is, the interest on the bonds is excluded from the income of the bondholders under section 103, meaning that the bonds pay a lower interest rate than they would otherwise at the U.S. taxpayer’s expense.7


And there is still more of a subsidy from the federal government if the residents deduct the assessments used to secure the tax-exempt bonds. Pragmatically, one supposes that it is likely that most people deduct all of these taxes (if they deduct at all). The taxes should not be deducted if they are “taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.” 26 U.S.C. section 164(c)(1). The idea is that if the taxes are like a private expense that one will recoup later, they are no more deductible than any other home improvement. But if this is true, why should these bonds be tax exempt to the buyer? In any event, the interest portion is deductible, but the principal portion is not to the extent that the benefits tend to increase the value of the property. See also California Franchise Tax Board, “Are Mello-Roos [a form of assessment-type financing] taxes deductible on your personal income tax return?” available at http://www.fbt.ca.gov/individuals/faq/net/909.html (California warning that principal on Mello-Roos taxes not likely deductible). Again, it is hard to understand why it is appropriate for the same bonds that principal on Mello-Roos taxes not likely deductible). Again, it is hard to understand why it is appropriate for the same bonds that was to be improved, were PABs and thus not eligible for the tax exemption under section 103(b)(1). The prima facie case that they are PABs is strong: They are issued on behalf of a private party (the developer) who then shares (or does not) the federal subsidy with other private parties (namely the new home buyers). Treasury apparently reached the same conclusion that these bonds were PABs when it first proposed PAB regulations in 1994.9

However, in response to widespread criticism, especially from California,10 Treasury backed down and allowed the kind of land-secured financing described above to retain its tax exemption. However, now, with our knowing far more about the externalities generated by this kind of development, the time has come for Treasury (perhaps prod by the carbon auditors) to revisit its PAB regulations and go forward by going back to its original 1994 proposal (at least in modified form).

It is important that the contours of my argument be clear. First, as a matter of construction of the statute, Treasury had the analysis correct in 1994 and should return to the original regulations. Second, as a matter of policy, Treasury got it right in 1994, and is only more right today.

Finally, the opponents of the 1994 regulations often wrote as if denying land-secured projects the section 103 federal tax exemption would destroy this kind of financing. There is no reason to believe this is true. The heyday of land-secured financing occurred before there even was a federal income tax. This is because, as is still manifestly the case, the logic of land-secured financings is sound: If a property is going to benefit from a public improvement (most especially though having its value increase), it makes sense for that property to pay for that improvement (at least to the extent its property value increases). The only question here is whether the federal government should generally be subsidizing such financings, and the answer is that it should not.

B. Theory and History of Private Activity Bonds

Traditional public finance theory suggests that the section 103 federal tax exemption is appropriately used when there has been some kind of market failure, most especially a situation in which the local government or


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B. Theory and History of Private Activity Bonds

Traditional public finance theory suggests that the section 103 federal tax exemption is appropriately used when there has been some kind of market failure, most especially a situation in which the local government or


market might otherwise provide too little of a regional public good. One example of this would be subsidizing the building of a superior waste treatment plant. The local community that uses the plant and will fund its construction could survive with a lesser plant because the harms generated by the inferior plant are suffered by the community downstream. In that situation a subsidy from a higher level of government to fund the better plant (and perhaps a regulation to forbid not so doing) is appropriate as a means of advancing the general public good through the building of a regional improvement.

Congress became concerned that the tax exemption was being used to sponsor private endeavors that did not need it and perhaps were not even viable. Perhaps still worse, this dubious subsidy was to some extent being used to fund a race to the bottom as different states competed to attract the same private industries. And perhaps worst of all, at least some of the subsidy was being used simply to generate positive arbitrage for local governments that were borrowing on the tax-exempt market and investing in the taxable market. In that situation, the federal tax exemption was functioning like a free-floating grant to whichever local government showed the initiative to take advantage of it. Also, with each additional bond issued, the cost of the exemption to the federal government increased, while the benefit to the local entity decreased. This inverse relationship between the cost and benefit of the subsidy happens because the more tax-exempt bonds are issued, the lower the marginal tax bracket of the marginal tax-exempt bond buyer and so the greater the gap between how much money the federal government loses in the tax exemption relative to how much localities gain. This watering down of the exemption also meant that the subsidy for theoretically appropriate projects was lessened.

Congress acted on the arbitrage concerns first in 1969. The primary rules were passed as part of the Tax Reform Act of 1986. Congress acted on the specific issue of private activity in 1968, with rules governing “industrial development bonds”; these rules also take their current form from the 1986 act and the new term of art is that bonds to fund a private enterprise is a “private activity bond.” The statutes and regulations governing PABs are summarized below.

At this point, as a matter of constitutional law, the federal tax exemption is not a given but a gift. As to this gift, it is one that theory and practice suggest should be used with care and that Congress has tried to tailor in various ways.

C. The Basics of the PAB Statute

The statutory scheme that Congress eventually used was not simple, but a summary will have to suffice here. If a bond issue is found to be a PAB, the interest income earned by investors on the bond is not exempt from federal income tax under section 103. There are two ways that a bond issue can become a PAB. Again, in trying to decipher the tests we have to keep in mind that Congress does not want to subsidize private businesses that do not need a subsidy, nor does it seek to overburden the tax-exempt market.

The first way a bond can become a PAB is by passing the private loan financing test. The rationale of this test is simple enough. Congress does not want a state or local government borrowing at a tax-exempt rate and then relending that money to private parties. Passing this test is sufficient on its own to render an issue of bonds PABs. This law does not forbid state or localities from issuing such bonds; it only denies the bonds a federal subsidy. Furthermore, the statute permits some PABs to retain their tax exemption if they are deemed “qualified private activity bonds.” Examples of such bonds include student loan bonds and mortgage bonds.

The kind of bonds that are our focus, assessment bonds secured by private land, would pass the private loan financing test and therefore the interest on them would not be tax exempt. This is because an assessment is conceptualized as a loan to a private party, usually a homeowner, to improve a parcel of real estate. Since the tax-exempt market might otherwise provide too little of a regional public good, the assessment bond is a necessary part of the general public good. But if the property owner defaults on the assessment bond, the government has the property to sell in order to pay off the bondholders. The government can thus achieve the primary public policy goal of the project while being able to choose the localities that are willing to bear the financial risk of the project.
homeowner. For example, in the typical case homeowners do not have the money upfront to pay for a needed improvement (say undergrounding utility lines), and so the assessment enables the homeowners to borrow cheaply now and pay for the improvement slowly over time. However, the statute explicitly excepts such tax assessment bonds from its reach. This exception makes some sense under our traditional theory. An improvement is wanted by the community and the community is willing to pay for it and yet there is an absence of a market mechanism to enable this transaction. Thus some government intervention is warranted — whether a federal subsidy is warranted is a further question but given the variety and complexity of the kinds of improvements financed, the federal government could determine that it is in our national interest to incentivize every community to invest in itself. We will return to the private loan financing test in Part E.1 because it arguably suggests that all assessment bonds should retain their tax exemption under the PAB statute.

There is a second way that a bond issue can become a PAB, and this so-called “private business test” is conjunctive. The first, and key, prong of the test is whether the bonds pass the private business use test. This test is passed by any bond: “if more than 10 percent of the proceeds of the issue are to be used for any private business use.” Congress did not want tax-exempt bond proceeds to be used for private business. The second prong, the private security test is passed “if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is guaranteed by any interest in...property used or to be used for a private business use.” The general sense of this prong is that tax-exempt bonds are not to be secured by property that is used for private business use (if that property is also used for private business). For our purposes then, if an assessment-type financing counts as private business use, it will “pass” both prongs of the private business use test because assessment bonds would be used for improvements that inure to the benefit of private persons and these improvements are secured by private property. If the bonds are therefore found to be PABs, the interest earned on them is not tax exempt.

D. The 1994 Proposed PAB Regulations

In 1994 Treasury promulgated regulations that affected land-secured financings in multiple ways. Importantly, the regulations defined “business use” as triggered by the “discharge of a primary legal obligation.” These regulations had it right. The discharge of a legal obligation can result in income and should also result in use. If a developer would have to build an improvement (say a sewer line) anyway, but another party pays for it (in this case, the government entity using assessment bond proceeds), the developer is better off than she would have been had she just funded the project herself. This analysis is not really challenged by the opponents of the 1994 proposed regulations, as far as I can tell, but it is dismissed as “formalistic.”

I will therefore repeat the analysis more concretely. When tax-exempt bonds are used as an intermediate financing tool for a land development project, they are essentially a means for a private developer to finance a private project that will lead to a private profit. If the project were truly viable, the developer would just use private funding. Thus, using tax-exempt bonds for these kinds of projects subsidizes private projects that were in no need of subsidy or allows projects to be completed for a profit that would otherwise not be viable.

The proposed regulation offered the following example on what it meant for bond proceeds to discharge a primary legal obligation and therefore trigger private business use:

Example. As a condition to obtaining a permit to construct an industrial development, Developer N unconditionally agrees that it will construct governmentally owned streets and sidewalks in its development. N and several other developers undertake to create District, a political subdivision. District issues its tax assessment bonds, the proceeds of which are used, in part, to construct the street and sidewalk improvements that N is obligated to construct. N’s obligation to construct the improvements is unconditional and, therefore, the discharge of that obligation results in private business use of the proceeds used to construct those improvements.

The objectors to the proposed 1994 regulations were therefore correct that bonds used to finance required infrastructure in new developments would likely be categorized as PABs because the bonds would pass both the private security test and the private business use tests.

E. Objections to the 1994 Proposed Regulations

The many commentators who objected to the 1994 proposed regulations raised several plausible arguments, which I place in three groups. As a matter of legislative history, Treasury went too far in making this traditional form of financing more difficult. This was especially clear given that there had been a long-standing use of land-secured tax-exempt bonds that Congress did not seem interested in affecting with the PAB rules. Furthermore,
and most interestingly, Congress did not want to interfere with such financings for a very good reason, namely that they forced development to pay for itself.\textsuperscript{30} I will discuss each objection in turn.

1. Legislative history. There are passages in the legislative history that indicate that traditional assessment financings were not intended to be affected by the PAB rules. For example, the blue book contains the following:

To the extent possible, Congress desired to restrict tax-exempt financing for private activities without affecting the ability of state and local governments to issue bonds for traditional governmental purposes.\textsuperscript{31}

Most powerfully, there is this passage:

Many States provide for the creation of tax or utility districts that may themselves be qualified governmental units to provide essential governmental functions to an area within a larger governmental unit for which development is planned. During an initial development period, the land in such a district may be owned by a single developer (e.g., a redevelopment agency), or a limited group of developers, who are proceeding with all reasonable speed to develop and sell the land to members of the general public for residential or commercial use. Congress intended that bond proceeds used in such situations to finance facilities for essential governmental functions such as extensions of municipal water systems; street paving, curbing (including storm water collection), and sidewalk and street-light installation; and sewage disposal generally not be treated as used in the trade or business of the developers. Rather, the tax status of the bonds generally will be determined by reference to the ultimate (i.e., after the initial development period) use of the facilities.\textsuperscript{32}

There are several reasons, however, why these passages should not be dispositive — even leaving aside objections that one may have about the use of legislative history. This is not to say that legislative action, if possible, would not be superior to administrative action.

As for why the 1994 proposed regulations were sound despite the legislative history, first, though the legislative history acknowledges the traditional public use of tax-exempt bonds and would like the new statute not to impact these, it is not certain where Congress wanted to draw the line. Indeed, as various commentators grudgingly note, there was already agency precedent for the 1994 interpretation of what would soon become the PAB statute before the 1986 changes, suggesting (although hardly proving) that Congress approved of the agency's approach.\textsuperscript{34} Second, and perhaps most crucially, this initial interpretation of the statute was technically sound and would seem therefore to reflect its plain meaning and Congress's manifest overriding intent, which was to deny the section 103 exemption to private business use. Again, because of the role of the developer as intermediary, there is no reason to believe that the developer is not pocketing the lion's share of the subsidy.

Third, regarding the argument from plain meaning, it must be conceded that the statute on its face exempts assessment-type financings from the private loan financing test and the second passage from the legislative history cited above seems to confirm that Congress intended to preserve the section 103 exemption for assessment-type districts. This suggests that Treasury should not have found these financings problematic under the initial private business test regulations because this undermines the purpose of the tax-exempt financing exception.

Yet these facts might go the other way. There is a kind of assessment financing that would fail Treasury's proposed business use test (and therefore retain its tax exemption), but pass the private loan financing test if not for this exception (and therefore still retain its tax exemption). This distinction between projects makes good sense.

\textsuperscript{30}See generally National Association of Bond Lawyers, supra note 10; Lew, supra note 4; Belisle and Seed, supra note 10.

\textsuperscript{31}JCT staff, supra note 12.

\textsuperscript{32}Id. at 1160-1161; see also House Report No. 99-426, p. 523.


\textsuperscript{34}Most importantly, there was Rev. Rul. 85-120 (1985), the “fish ladder” ruling. In this ruling, the IRS reasoned that it was business use if company “Q,” a provider of hydroelectric power, used bond proceeds to discharge an environmental obligation imposed by law:

In this case, although the fish preservation and recreational facilities will not increase electrical output of the hydroelectric project, they are such facilities which would not be built but for the hydroelectric project. Just as the dam and other facilities for the generation of electricity are properties used in the private utility’s trade or business these facilities that Q is required to build and maintain under the license are so closely associated with the hydroelectric project as to be considered a part of the hydroelectric project used in Q’s trade or business. Rev Rul. 85-120. The IRS applied this “but for” principle to a road that a private developer was required to build in LTR 8704049 (Oct. 28, 1986). Or, as other (critical) commentators (Belisle and Seed, supra note 10) put the situation:

At the outset, let us give the drafters of the regulations their due. They have attempted to rationalize into a coherent set of rules an area of the law that does not readily lend itself to such an effort.... Under the banner of ‘principles of prior law,’ the IRS can take the high road and assert that though the results may at times seem absurd, they are results compelled by prior law and the need for bright-line rules.

However, as noted by the National Association of Bond Lawyers, supra note 10, the legislative history bears no explicit trace of these administrative rulings. That said, the blue book states that “Congress was aware that, under Treasury Department rules, limited use of facilities by nongovernmental persons on a basis unlike that of the general public was disregarded in certain cases....” Neither these rules, nor the Treasury Department’s general authority to determine what constitutes (or does not constitute) a use of bond proceeds, is modified by the Act.” (Internal citations omitted.) JCT staff, blue book, supra note 12, at 1159-1160 n. 54.
on policy grounds and also mostly explains those portions of the legislative history that look benignly on assessment-type financings.

Consider a project driven not by developers, but by a local government or residents looking to improve their community. We can consider a locality wishing to move its utility lines underground or finance a new overpass or even finance energy-efficient improvements to people’s homes.35 In such a scenario, even if the locality hires private contractors, these bonds will not constitute private business use because there would have been no “discharge of a legal obligation.”

This distinction is sensible from the federal government’s perspective. These are projects in which existing communities of residents seek to improve themselves beyond the floor set by law. The federal government may well wish to subsidize this kind of (limited) activity.36 The case of installing more energy-efficient improvements could be a textbook example of a positive externality — individuals may not realize enough gain to make it worthwhile, but as a country we stand to gain enormously through such improvements.

As for the details in the existing regulations that support this approach to different assessment-type financings (and thus making it even easier to adopt the recommendation herein), the first step is to observe that the regulations specifically say that the tax assessment exception applies only to the private loan financing test but not the private business test.37 This indicates that Treasury still believes (correctly) that the exception under the private loan financing test does not automatically carry over to the private business test.

Furthermore, the regulations for the private business test offer an example of an assessment arrangement that would fail the private security test prong of the private business test, therefore allowing the financing to be tax exempt. This example seems to involve a community-initiated assessment financing:

**Example 4. Payments not in respect of financed property.** In order to further public safety, City Y issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by City Y on the customers of the utility. Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Y by the utility company for the undergrounding are, however, taken into account as private payments.38

The private business use test is part of a conjunction with the private security test. Therefore, if a project fails the security test because there is no private use, it is tax exempt. This example illustrates that using the assessment method for improvements to an existing community retains the section 103 tax exemption, as distinct from using assessment-type financing for unimproved land, which under the 1994 proposed regulations would not have retained the tax exemption. This example also underscores the conceptual overlap between the two private business test prongs and suggests that projects that fail the private security test would fail the private business use test, too.39

This approach to the regulations and the underlying issues is confirmed and elaborated by a private letter ruling about burying utility lines:

Section 1.141-4(g), Example 4 [reproduced above] concerns application of the private security or payment test and does not directly address application of the private business use test. The example implies, however, that relocation of existing utility lines for governmental reasons, such as public safety, is not necessarily properly analyzed for purposes of the private business tests as an improvement to those utility lines. The example does not indicate that bond proceeds used to underground utility lines are never treated as used in a trade or business by a nongovernmental person under the private business tests.

In the case at hand, the facts and circumstances indicate that the relocation of the existing utility lines is properly treated as distinct from the utility lines themselves. Thus, the utility companies are

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36Of course, the federal government already subsidizes this kind of activity through all kinds of tax incentives in the code; given the inefficiency of the tax-exempt bond subsidy and the ease with which these transactions can involve an assessment bond structure or payments by private taxpayers who are then eligible for various tax breaks, an additional question is whether it makes sense to make the subsidy available in two generally fungible ways.

37At least to the use of assessment bond proceeds. Reg. section 1.141-3(e).
not treated as private business users of the proceeds used for relocation. This conclusion is possible only because the utility companies are under no contractual or other legal obligation to relocate the lines, will make no direct or indirect payments for the relocation, and will not benefit from any increased capacity of the lines.

The upshot of this subsection is that neither the plain meaning of the statute nor its legislative history dictates that there was anything problematic with Treasury’s initial interpretation in 1994. We have dwelt on the seeming difficult issue of the tax assessment bond exception of section 141(c)(2) and demonstrated that it does not necessarily imply that Congress wanted all possible permutations of assessment bonds to retain their tax exemption. There is a sensible way to interpret the kinds of projects Congress wanted to encourage (for example, using land-secured finance to improve a locality) as opposed to projects that overburden the tax-exempt market for little gain (for example, using tax-exempt bonds to subsidize private provision of infrastructure that had to be provided anyway). Furthermore, the regulations already make this distinction, though it could be drawn more clearly.

2. The history of assessment financing. Many commentators who objected to the proposed 1994 regulations dwelled on the long history of assessment-type financing, often blending this discussion with the legislative history to conclude that Congress could not have wanted to limit the use of these “traditional financings.” However, the admittedly long history of assessment financing is more problematic for their position than the various commentators acknowledge (much like the sparse and qualified legislative history). Assessment-type financing was a central component to the building of our infrastructure without the federal tax exemption, and this widespread use was because the argument for land-value-type financing was and is strong without the subsidy. If an improvement is going to raise the values of the land nearby, it is sound policy for the benefiting landowners to pay for that improvement in the first place.

As for the wisdom of the federal subsidy, the long history of assessment financing ought to give pause. Even without the tax exemption, local speculators tended at the margins to use land-secured financing aggressively; undermining whole communities if the economy turned south. By definition the subsidy encourages even more inframarginal projects of this type. Given the cyclical risk inherent to this kind of financing structure, it is hard to see why the federal tax system should encourage a structure that can already be sensibly used and already can have a destabilizing effect in case of economic downturn. There would seem to be at least as good an economic argument for the federal government to attempt to discourage overly aggressive use of land-secured financing.

The objects might respond that existing residents had their infrastructure subsidized by the federal government, why should future residents be denied this benefit? Even if the original subsidy was misplaced, they might say, why stop extending it now? Note that this argument is based on arguments of horizontal equity, and not on any tax policy argument that the subsidy made sense in the first place. Yet even this equity argument is weak. To see why this is so, we must

41See, e.g., Lew, supra note 4; National Association of Bond Lawyers, supra note 10 (“the legislative history to the 1986 Tax Act provided assurance to state and local governments that issuers should clearly be able to finance traditional government activities”).
42Diamond, “The Death and Transfiguration of Benefit Taxation: Special Assessments in Nineteenth-Century America,” 22 J. Legal Stud. 201, 202 (1983) (“in the United States, the special assessment developed simultaneously with the general property tax as one of the twin financial pillars of state and local government”). For 1890 the percentage of revenue from special assessments for select locations is shown in the appendix at the end of this article.
43Especially interesting is the use of special assessments in the 19th century speculatively to pay for the infrastructure for a new community to come, with severe consequences when the expected residents did not materialize. Rosewater, supra note 40, at 72. (“Elizabeth [N.J.], for example, had miles upon miles of streets opened and laid with wooden pavements, through the supposed suburban districts, which as yet comprised nothing more than unbroken meadows or worthless woodland.”)
44Many special assessment districts failed during the Great Depression. In 1930 special assessment revenue made up 6.7 percent of all revenue collected by U.S. cities. Tax Foundation Inc., Special Assessments and Service Charges in Municipal Finance, 1970, p. 10. But there was a 90 percent drop in assessment revenue between 1930 and 1940 in cities with a population exceeding 500,000. Shoup, “Financing Public Investment by Deferred Special Assessment,” 33 National Tax Journal 413 (1980). During the Great Depression, the California Legislature, for instance, intervened to soften the effects of defaults (e.g., through lessening penalties), resulting in litigation by bondholders and confused outcomes. Compare Islais Company v. Matheson, 35 P.2d, 1051, 1054-1055 (Cal. Ct. App. 1934) (allowing the Legislature to retroactively lessen penalties) with Islais Company v. Matheson, 45 P.2d 326 (Cal. 1935) (finding it unconstitutional for the Legislature to retroactively lessen penalties). For the state of the modern doctrine, see Amdursky and Gillette, supra note 11, at section 5.10. So far, there does not seem to have been a dramatic increase in the number of failures of assessment-type districts during the current so-called Great Recession, but there are worrying signs that it is only a matter of time. See California Debt and Investment Advisory Commission, “California Mello-Roos Community Facilities Districts Yearly Fiscal Status Reports and Reports on Draw on Reserves and Defaults,” CDIAC Publication No. 08-09, Aug. 2008, pp. 10-11, available at http://www.treasurer.ca.gov/cdiac/reports/M-Roos/2007.pdf (no signs of surge of defaults so far in California); Adam Ashton, “Behind on Mello-Roos Bill: Nearly One-Fifth of Fairview Village Owners Delinquent,” The Sacramento Bee, June 10, 2009; see also http://www.floridacddreport.com (reporting 100 out of 600 of these Florida assessment-type districts have defaulted as of early 2010). From the perspective of the federal government, the policy question is why it is subsidizing such a volatile market.
45See, e.g., National Association of Bond Lawyers, supra note 10.
consider further the history of state and local public finance over the last few decades.

The various objectors do not dwell on how much state and local finance has changed since the advent of California’s Proposition 13 (and many similar measures in other states). It is not at all obvious that owners of homes built before Proposition 13 had their infrastructure subsidized through the federal tax exemption. Before Proposition 13, it could be plausibly maintained in California that existing residents paid for their own infrastructure and were continuing to pay for it. This is because their property taxes, ultimately a more general form of land-secured finance, were sufficient to meet the local community’s costs. In a world of adequate property taxes, new development would pay for itself over the long term and so the existing community could pay for the infrastructure that would allow for new development because new development would eventually enrich everyone. In a state where the property tax is suddenly rendered inadequate, as it was in California, maintaining the section 103 exemption does not level the playing field between old and new residents so much as subsidize the decision of a state to apply a low property tax rate.

There is another way to make this point in terms of horizontal equity. The more appropriate comparison is not between the fictional old homeowner and the new, but between a developer trying to build a development in an existing community and one that is trying to develop unimproved land. Assessment bonds, and by extension the federal subsidy, are only pragmatically available to a developer who is working outside an existing community. It is hard to understand why the federal government should distinguish between the two when granting a subsidy.

3. Policy-based arguments. And now we get to the heart of the matter, which is the policy dispute. Various commentators correctly insist that in general, assessment bond financings are a way for a new community to pay for its own infrastructure. There are, however, several counters to this consideration. First, strictly speaking, limiting the tax exemption as proposed by Treasury had no impact on the principle that new development ought to pay for itself. All the existing community has to do is refuse to issue the necessary entitlements until the developer has proposed a satisfactory plan, the cost of which would presumably be passed on to the future home buyers just like development impact fees. The only question posed by the regulation is whether the federal government should subsidize this process.

Second, there is no good argument for such a subsidy. As discussed above, the traditional argument for the federal subsidy is that some local and regional projects generate positive externalities (or can limit negative externalities) beyond the jurisdiction of the entity undertaking the project and levying the necessary tax, fee, or assessment. There is no reason to believe that the development of unimproved land at issue in this article is beneficial in this way, especially given all the subsidies the federal government already gives to homeownership. On the contrary, there is reason to believe that the costs borne by these (typically new) communities are actually below the real costs generated by these developments in terms, for instance, of environmental degradation. The federal government should not encourage less energy-intensive development patterns with one hand, while encouraging such developments with tax-exempt financing with the other.

F. Treasury Nevertheless Backs Down

Treasury retreated in the final regulations it issued in 1997:

Commentators suggested that this rule be deleted from the final regulations. Many commentators indicated that this rule would interfere with traditional tax assessment bond financings for governmental projects such as roads and sidewalks. Some commentators also indicated that certain state and local governments may be required or encouraged under state law to enter into development agreements with private developers that could result in private business use of governmental projects under the discharge of a primary legal obligation rule. The final regulations adopt this comment by deleting the rule.

I have already addressed the bulk of these concerns, most especially the notion that somehow changing the rule would be disruptive. These comments also pick up on a policy point raised by commentators on the use of development agreements. This issue is in fact the same as the policy objection discussed above. Development agreements, like assessment financing, are a means for

Proposed Regulations is that state and local governments may not shift the costs of such improvements to benefited property owners.

See Lew, supra note 4, at discussion of California’s subdivision map act.


See, e.g., Lew, supra note 4.
development to pay for itself, and as a general proposition, this is a reasonable goal, but this is not the issue here. A developer enters into a development agreement in order to clarify her obligations vis-à-vis all the various local governments she must get approvals from and then to price her houses accordingly. Sometimes, developers choose to securitize the payments of future homeowners that will go toward these agreements and thus to issue tax-exempt bonds with the help of the local governments. This in effect marries an assessment-type financing to a development agreement. In that case, the federal subsidy likely helps the local governments and the developers arrive at a deal, but this does not explain why it is appropriate that the federal government provide this subsidy in the first place largely to developers of unimproved land. Nor does it explain why simple tax logic does not dictate that the developer is benefiting from the subsidized fulfillment of her legal obligation.52

G. Thirteen Years Later

It has become almost a commonplace that we as a society have poured too much money into homes.53 Also, and (somewhat) independently, all levels of government are scrambling to develop ways to lessen the environmental intensity of our way of life, including our development patterns. The carbon audit is a small part of this, as are myriad other incentives and programs. I have argued that even in 1997 it made good sense for Treasury to issue regulations under which many land-secured financings on unimproved land would be found to be PABs and therefore not eligible for a tax exemption. The case against the tax exemption has only gotten stronger now after a decade in which in California alone more than 90 percent of development in recent years may have been subsidized.54

I am not proposing that Treasury change the regulation without consultation or retroactively (even if it could).55 However, I am suggesting that Treasury has an opportunity to use sound tax logic to incentivize superior development patterns prospectively.56 Only allowing the section 103 exemption to be used in existing communities makes the subsidy more valuable (because less often used), better targeted to environmentally sustainable development, less likely to encourage destabilizing speculation, and more consistent with general tax policy principles. Treasury should take this opportunity. If it
does not, Congress should pass a statute making the proper interpretation of PABs even more explicit.

(Appendix table is on the following page.)

52Treasury may be returning to this way of thinking, at least in some situations. See Peter Schroeder, “Florida Community Development District Debt May Be Taxable,” The Bond Buyer, Feb. 19, 2009 (aggressive use of Florida assessment-bond structure may have resulted in private use, according to the IRS). 53''Briefing: Home Ownership, Shelter or Burden?'' The Economist, Apr. 18, 2009, pp. 76-78. 54Shanske, supra note 4, at 721-722. 55See section 7805(b). 56This is a good time for this change because there are so few ongoing projects that were depending on such tax-exempt financing. See, e.g., California Debt and Investment Advisory Commission, supra note 44, at p. 3 (number of Mello-Roos financings has plummeted).
### Appendix

<table>
<thead>
<tr>
<th>Location</th>
<th>Rank in Population in 1890</th>
<th>All Receipts</th>
<th>Tax Receipts</th>
<th>Assessment Receipts</th>
<th>Assessment Receipts as Percentage of Total</th>
<th>Assessment Receipts as Percentage of Total Tax Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>1</td>
<td>$86,838,344</td>
<td>$30,733,819</td>
<td>$2,541,856</td>
<td>2.93%</td>
<td>8.27%</td>
</tr>
<tr>
<td>Chicago</td>
<td>2</td>
<td>$30,247,317</td>
<td>$9,199,796</td>
<td>$6,407,394</td>
<td>21.18%</td>
<td>69.65%</td>
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<tr>
<td>Philadelphia</td>
<td>3</td>
<td>$23,400,496</td>
<td>$12,137,058</td>
<td>$1,063,332</td>
<td>4.54%</td>
<td>8.76%</td>
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<tr>
<td>Brooklyn</td>
<td>4</td>
<td>$23,061,699</td>
<td>$9,405,663</td>
<td>$284,217</td>
<td>4.54%</td>
<td>8.76%</td>
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<tr>
<td>St. Louis</td>
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<td>$10,014,607</td>
<td>$3,405,198</td>
<td>$339,010</td>
<td>3.39%</td>
<td>9.96%</td>
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<tr>
<td>Boston</td>
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<td>$9,653,073</td>
<td>$38,648</td>
<td>0.16%</td>
<td>0.40%</td>
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<tr>
<td>San Francisco</td>
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<td>$5,317,099</td>
<td>$2,517,504</td>
<td>$1,348,877</td>
<td>25.37%</td>
<td>53.58%</td>
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<tr>
<td>Cleveland</td>
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<td>$1,412,850</td>
<td>$499,363</td>
<td>11.00%</td>
<td>35.34%</td>
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<tr>
<td>Minneapolis</td>
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<td>$1,305,801</td>
<td>$699,168</td>
<td>14.60%</td>
<td>51.25%</td>
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<td>Omaha</td>
<td>19</td>
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<td>$461,795</td>
<td>38.66%</td>
<td>60.67%</td>
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<tr>
<td>Denver</td>
<td>23</td>
<td>$1,630,230</td>
<td>$617,546</td>
<td>$75,225</td>
<td>4.61%</td>
<td>12.18%</td>
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