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Preliminary Data on Tax-Exempt Bonds Used to Finance Housing for the Elderly

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The Honorable Lloyd Bentsen
Chairman, Joint Committee on Taxation

The Honorable Dan Rostenkowski
Vice Chairman, Joint Committee on Taxation
Congress of the United States

In August 1988, you asked us to provide information on our ongoing review of how tax-exempt organizations have used tax-exempt bonds to finance housing for the elderly. This information may be useful in congressional deliberations on technical corrections to the Tax Reform Act of 1986. While the House bill (H.R. 4333) requires housing provided by tax-exempt organizations to include some low-income tenants, the Senate bill (S. 2238) does not. The proposed rules in the House bill are the same as those that now apply to residential rental housing financed by private activity bonds, as opposed to governmental bonds. This report discusses the availability of data on tax-exempt bonds issued by tax-exempt organizations to finance housing for the elderly.

Results in Brief

The Internal Revenue Service (IRS) cannot identify the volume of tax-exempt bonds issued on behalf of certain tax-exempt organizations (501[c][3] organizations) to finance housing for the elderly. Also, IRS does not link specific bond issues to these organizations. Thus, IRS cannot easily administer section 145 of the Internal Revenue Code. This provision, enacted in the Tax Reform Act of 1986, places a $150 million volume limit on outstanding bonds issued on behalf of individual 501(c)(3) organizations.

Objectives, Scope, and Methodology

The objectives of this report are to provide

- information on the requirements for obtaining tax-exempt status and on rules governing tax-exempt bonds,
- information on what IRS receives on tax-exempt organizations and tax-exempt bonds,
- data on retirement housing financed with tax-exempt bonds, and
- data on defaults of these types of bonds.

To collect this information, we interviewed IRS officials and reviewed tax forms and related instructions as well as pertinent IRS regulations and not explicitly defined "low income" in determining whether an organization should be recognized as tax-exempt. Rev. Rul. 70-585, 1970-2 C.B. 115 refers to the inability of the persons served by the organizations to afford housing in the community and their eligibility for other types of federal assistance as indications that the organization serves low-income individuals. The ruling further says that "(t)he determination of what constitutes low income is a factual question based on all of the surrounding circumstances."[4]

Tax-Exempt Bonds

The Tax Reform Act of 1986 changed certain provisions governing tax-exempt bonds and extended others. Private activity bonds and 501(c)(3) bonds are two types of tax-exempt bonds. The act continued to require that multi-family residential rental projects financed by tax-exempt private activity bonds house a percentage of tenants with low or moderate incomes. For the first time, the act placed these bonds under a state volume cap for private activity bonds. This new unified annual volume cap covers various types of private activity bonds, such as student loan bonds and redevelopment bonds, that are issued by state agencies and local governments within each state.

Qualified 501(c)(3) bonds are not covered by the unified annual state volume cap. Instead, the act imposed a separate volume limit on these bonds (with the exception of hospital bonds) and tightened the qualification standards. Bonds used to finance housing for the elderly are qualified if (1) 95 percent of the net proceeds are used by the 501(c)(3) organization or a governmental unit; (2) no more than 5 percent of the net proceeds are used for an unrelated trade or business activity; and (3) the total of outstanding qualified 501(c)(3) bonds does not exceed $150 million for the organization using the proceeds.

IRS Information

IRS receives information on the activities of 501(c)(3) organizations and bonds issued on behalf of these organizations on three forms—IRS Forms 1023, 990, and 8038.

When organizations apply for tax-exempt status, they file a Form 1023. On Form 1023, 501(c)(3) organizations check the activity codes that most closely match the activities they plan on undertaking. Separate codes identify low-income housing and housing for the elderly. If an organization plans on providing housing for the elderly, it must answer

[4] Id. at 115.

Data on Retirement Housing Financed With Tax-Exempt Bonds

In researching information on retirement housing financed with tax-exempt bonds, we also looked at private data bases to see whether they could shed light on this issue. Several private sector data bases record the nature of the various activities financed by tax-exempt bond issues, such as retirement communities, but we found none that identified categories within each activity by the type of bond, i.e., governmental bonds, private activity bonds, or qualified 501(c)(3) bonds.

The Public Securities Association collects data on the use of proceeds of long-term municipal bond sales, including retirement housing financed with municipal bonds. These data do not differentiate between government bonds, private activity bonds, and qualified 501(c)(3) bonds. The data show that 1986 was a low point for new issues in both dollar volume and number. If the pace established during the first half of 1988 were to continue, the dollar volume of new issues in 1988 would grow almost 200 percent over 1987.

Table 1: Long-Term Retirement Housing Financings

(Dollars in Millions)

	Amount of new capital	Number of issues	Amount of refunding[b]	Number of issues	Total amount	Total number of issues
1984[a]	$269.4	20	$60.1	4	$329.5	24
1985[a]	367.0	25	94.2	6	461.2	31
1986	160.7	8	140.3	8	301.0	16
1987	214.7	20	314.0	20	528.7	40
1/01/88 - 6/30/88	318.7	14	102.7	7	421.4	21

Note: Such financing includes both taxable and various types of tax-exempt securities (general obligation, traditional revenue, 501[c][3], and private activity bonds).

[a]The dollar amounts and number of issues for 1984 and 1985 reflect only issues that are greater than $5 million in size.

[b]Refundings are bonds issued to retire outstanding bonds.

Source: Public Securities Association.

Data on Bond Defaults

Since municipal bonds are not registered with the SEC, that agency lacks data on defaults of tax-exempt bonds used to finance housing for the elderly. Data from the Bond Investors Association, a private organization that tracks defaults of municipal bonds, indicate that 145 retirement community projects, representing over 1,000 tax-exempt bond issues, have defaulted since the early 1980s. These bonds had an aggregate dollar value of $1.265 billion.

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As arranged with you, we are sending copies of this report to the Commissioner of Internal Revenue and other interested parties.

Richard L. Fogel
Assistant Comptroller General

several questions regarding admission requirements, entrance and periodic fees charged residents, and whether the home will have a policy concerning residents who become unable to pay. These questions are based on the requirements for tax-exempt status in the revenue rulings. If an existing 501(c)(3) organization begins to provide housing for the elderly, it is to inform IRS of the new activity on its annual return, Form 990.

When state and local governments issue private activity tax-exempt bonds, the governmental unit must file an information return (Form 8038) with IRS. The filer indicates on the form whether a private activity bond is a qualified 501(c)(3) bond. The current form does not, however, identify the 501(c)(3) organization that will use the proceeds of the issue. On previous versions of Form 8038, the principal user of the proceeds of all private activity bonds was identified by employer identification number. However, IRS found that because the principal user was, in many instances, a governmental unit, the information was of limited use. IRS decided to eliminate the need to report the principal user of the proceeds before the Tax Reform Act of 1986 was enacted.

Since IRS cannot link particular bond issues with individual 501(c)(3) organizations, it cannot easily enforce the $150 million limit on the outstanding bonds of an individual 501(c)(3) organization. IRS officials said that they rely on bond counsels to check the volume limit when counsels certify that a new issue meets the requirements for tax exemption; however, IRS does not know if the bond counsels do so.

Recommendation

We recommend that the Commissioner of Internal Revenue require that the employer identification number of the users of qualified 501(c)(3) bonds be reported on Form 8038. With such data, IRS can make computer checks by organization to ensure they comply with the Code.

Agency Comments

IRS officials are in the process of revising the form. They said that they agreed with our report and its recommendation, and that they would incorporate the recommended change during the current revision process.

revenue rulings. We also interviewed Securities and Exchange Commission (SEC) officials and representatives of several private organizations, such as the Public Securities Association and the Bond Investors Association, to determine if data bases exist that identify tax-exempt bonds issued on behalf of certain exempt organizations. We obtained aggregate statistical data on certain types of bonds from the Public Securities Association and the Bond Investors Association. We did not verify the data because it was impractical to contact every local and state government that issues bonds.

Obtaining Tax-Exempt Status and Tax-Exempt Bonds

Private organizations that provide housing for the elderly or low-income individuals can be recognized as tax-exempt organizations under Internal Revenue Code section 501(c)(3). While 501(c)(3) organizations cannot issue tax-exempt bonds to finance their operations, state and local governments can issue tax-exempt bonds on behalf of 501(c)(3) organizations if the bonds meet certain requirements.

Obtaining Tax-Exempt Status

According to IRS officials, as of June 1988, about 18,000 tax-exempt organizations listed housing for the elderly as a primary charitable activity when they applied for tax-exempt status.[1] In order to be recognized as a tax-exempt provider of housing for the elderly, an organization must meet several requirements set forth in regulations and rulings. For example, the home must meet the elderly's special needs, such as health care, financial security, and residential facilities designed to meet their specific physical, social, and recreational requirements.[2] The organization must also commit itself to operate such housing at the lowest possible cost and to maintain in residence those tenants who become unable to pay its monthly fees.[3] Thus, according to IRS officials, while 501(c)(3) organizations do not have to admit low-income elderly as residents to qualify for tax-exempt status, they do have to have a policy to retain tenants who become unable to pay.

IRS officials also said that as of June 1988, about 2,400 501(c)(3) organizations had reported low-income housing as a primary activity. IRS has

[1] IRS officials said that although these data were not complete and may not be accurate, they are the most recent and best available.

[2] Rev. Rul. 79-18, 1972-1 C.B. 194.

[3] Rev. Rul. 72-124, 1972-1 C.B. 145.