

## TAX TREATMENT OF INTEREST ON FARMERS HOME ADMINISTRATION INSURED LOANS

DECEMBER 16 (legislative day, DECEMBER 15), 1970.—Ordered to be printed

Mr. LONG, from the Committee on Finance,  
submitted the following

### REPORT

[To accompany H.R. 15979]

The Committee on Finance, to which was referred the bill (H.R. 15979) to provide that the interest on certain insured loans sold out of the Agricultural Credit Insurance Fund shall be included in gross income, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

#### I. SUMMARY

The Consolidated Farmers Home Administration Act of 1961 authorizes the Farmers Home Administration to make loans both to local governmental units and to private bodies for such purposes as conservation, land use, water, etc., and to resell this debt to private parties as federally insured loans. The Internal Revenue Service has ruled that in those cases where the security originates with a local governmental unit the interest or other income paid on it continues to be exempt from Federal tax even after it is resold as a loan insured by the Federal Government. Because the Federal Government has concluded that the exemption of interest on these loans is costly and has inequitable results, it in recent years has been reluctant to make and then resell these loans on an insured basis to provide credit assistance to local governmental units. H.R. 15979 overcomes this problem by providing (in an amendment to the Consolidated Farmers Home Administration Act) that interest or other income paid to an insured holder on an insured loan sold out of the Agricultural Credit Insurance Fund is for income tax purposes to be included in gross income of the recipient of the interest. This is to be effective with respect to sales of insured loans by the Federal Government after the date of enactment of this bill.

This bill is favored by the Treasury Department and the Department of Agriculture.

## II. GENERAL STATEMENT

Under present law (sec. 306(a)(1) of the Consolidated Farmers Home Administration Act of 1961 (7 U.S.C. 1926(a)(1))), the Secretary of Agriculture is authorized to make conservation, land use, water, waste disposal, and recreational loans both to governmental units and to private bodies. These loans may be made either directly to the governmental unit or private body or may be made by providing insurance for these loans. Where the insured approach is used, the Farmers Home Administration makes a loan to the unit or body and receives in return a note or bond bearing an interest rate which by law cannot exceed 5 percent. The FHA then resells the note to private lenders, insuring the bond's principal and interest, and pays out of its own funds the cost of any differential between the interest rate at which the insured securities are sold and the 5 percent or lower interest rate specified by the securities which were acquired by FHA.

Direct lending, of course, has an immediate impact, to the full extent of the loan, on Federal budget outlays. Therefore, the volume of loans which could be made directly under the Consolidated Farmers Home Administration Act has been limited. At one time FHA supplemented these direct loans by reselling packages of these loans on an insured basis to private institutional investors. However, it has been held by the Internal Revenue Service that bonds of local governmental units which are acquired by the Farmers Home Administration and then resold on an insured basis continue to be tax exempt in the hands of the lender (Rev. Rul. 58-452). The result of this has been that in recent years FHA has greatly curtailed its program of insuring and reselling loans to local governmental units. This action was taken because the Federal Government concluded that federally guaranteed tax-exempt obligations involve a needlessly costly and inequitable method of financing. Studies by the Treasury Department and the Bureau of the Budget have indicated that it is costly to the Federal Government to use federally insured tax-exempt obligations to finance loans to local governmental units. The studies indicate that while the tax exemption makes it possible to resell the insured loans at a lower interest rate than would otherwise be possible, the loss of tax revenue resulting from the exemption more than offsets the benefits of the lower interest payments.

Additionally, it was concluded that the sale of bonds which are both tax exempt and insured by the Federal Government would give these bonds a competitive advantage over both State and local securities which are tax exempt but not federally insured, and also Federal securities which are subject to Federal income tax. As a result, the sale of such bonds could well have increased interest rates on other bonds, particularly those issued by States and localities and hampered their ability to finance other vital public needs.

H.R. 15979 eliminates these problems by providing that interest on federally insured loans sold out of the Agricultural Credit Insurance Fund after the date of enactment of the bill is for tax purposes to be included in the gross income of the holder of the debt. The interest on these loans is to be taxable for the following reasons. First, the

purchase of the bond from the FHA is viewed to be the equivalent of a contract between the FHA and the bond purchaser to report the interest for Federal income tax purposes. Second, the interest on these loans is interest paid by a Federal agency and not by a State or local governmental unit (even though a portion of the interest payment is, in effect, reimbursed by interest received by the agency on tax-exempt municipal bonds). In view of these factors this does not represent a precedent for the Federal taxation of interest on State or local bonds.

The effect of this action is to make it practical to use federally insured loans to finance credit assistance to local governmental units for the purposes specified in the Consolidated Farmers Home Administration Act. This will be beneficial to the local governments since it should increase substantially the volume of these local governmental loans which the Federal Government will be able to acquire and to resell on an insured basis. At the same time the bill also will reduce the need for appropriations for direct Federal loans for the purposes specified in the Consolidated Farmers Home Administration Act since greater dependence can be placed on loans which are resold to private holders on an insured basis.

The proposed legislation will not increase interest rates to the local communities involved in the federally insured loans since these communities can continue to obtain loans at present low interest rates of not over 5 percent, which are below the current market rates on good quality, long-term, tax-exempt bonds. Moreover, the bill does not in any way interfere with the right of local governments to issue tax-exempt obligations.

### III. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

#### SECTION 306(a)(1) OF THE CONSOLIDATED FARMERS HOME ADMINISTRATION ACT OF 1961

Sec. 306. (a)(1) The Secretary is also authorized to make or insure loans to associations, including corporations not operated for profit, and public and quasi-public agencies to provide for the application or establishment of soil conservation practices, shifts in land use, the conservation, development, use, and control of water, and the installation or improvement of drainage or waste disposal facilities, and recreational developments, all primarily serving farmers, ranchers, farm tenants, farm laborers, and other rural residents, and to furnish financial assistance or other aid in planning projects for such purposes. *When any loan made for a purpose specified in this paragraph is sold out of the Agricultural Credit Insurance Fund as an insured loan, the interest or other income thereon paid to an insured holder shall be included in gross income for purposes of chapter 1 of the Internal Revenue Code of 1954.*