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Connecticut may have found a way of transforming the baser elements into gold. At least, that seems to be the effect of a bill that the State Treasurer has prepared for introduction in the 1973 session of the General Assembly. The bill, which is designed to ease the financial plight of the Connecticut Commission on the Arts, offers the possibility of a novel funding mechanism for other activities including legal services for those who cannot otherwise afford them. This article will describe the Connecticut plan, explore possible difficulties with it in the light of the Internal Revenue Code, and propose a model statute for the plan's application to legal services.

Background

The Connecticut State Commission on the Arts was created in 1965, and consists of twenty-five members "broadly representative of all fields of the performing and fine arts," appointed by the President Pro Tempore of the Senate, the Speaker of the House, and the Governor. Its duties are primarily to "encourage, within the state, participation in, and promotion, development, acceptance and appreciation of, artistic and cultural activities." The Commission was designed to be the state agency for disbursement of funds within its jurisdiction, and thus be the recipient of federal, state and private monies for that purpose.[1]

Since its creation, the Commission has been hampered in it's work by a severe lack of funds. While there have been some state appropriations, which have been matched with federal funds, the amount of private contributions has been disappointing. The Commission has therefore been anxious for the state to provide more funding, something the state thus far has been loath to do.

Connecticut Foundation for the Arts

In response to the requests of the Commission, the State Treasurer, Robert Berdon, has drafted a bill establishing the Connecticut Foundation for the Arts, a nonprofit corporation, whose function will be to provide supplementary funds for the Commission. The Foundation is Berdon's brainchild. He perceived both the necessity of increased funds for the Commission if it were to operate effectively, and the likely disinclination of the Governor to request, and the Legislature to grant, more aid to the arts. The statutory mechanism is designed to get around both
303 obstacles.

The Foundation is to be governed by a board of directors selected by the Commission, with the exception of the Treasurer and Executive Director of the Commission, who are members ex officio. The board has the power to grant or loan money for programs and activities that have been approved by the Commission. The other major power of the Foundation is to "accept, hold, and administer" the property and monies of the Commission.

The bill provides that any corporation, association, or person may make tax-deductible contributions to the corporation, with such contributions being allowed as double deductions for the first five years of the Commission's life. Although Connecticut does not have a personal income tax, there are corporation, franchise, and insurance taxes that may be reduced under this provision. The corporation is made tax-exempt, as well.

The heart of the bill is an authorization for the treasurer to loan to the Foundation up to ten million dollars, for periods of up to one year, at the net interest rate that the state would have to pay for its short-term borrowings. The treasurer may make such loans from the General Fund, a combined investment pool established by the state, or by the issuance of state bonds.

The treasurer has expressed the hope that loans from the state will fill the temporary needs of the Commission, and thereby encourage private contributions, particularly from corporations. It is anticipated that the amount of state loans will gradually decrease from the ten million dollar authorization. In fact, the bill makes provision for legislative termination of the corporation when need for it no longer exists.

A quick overview of the bill would suggest that the Commission is merely getting short-term loans which it has to repay at the same rate of interest that the state must pay to get its money. The Commission would still appear unable to make extensive grants to the arts, since the money must be repaid. However, the Commission does, in fact, get a healthy income from these transactions, **without any cost to the state.** The source of income lies in the spread between the interest the state must pay to borrow short-term money and the return the treasurer can get by investing the money borrowed.[2]

The bill actually provides that the Foundation must pay interest as described, but never at more than three per cent. This is a realistic figure for the interest the state currently must pay on its short-term borrowing. (Connecticut can now borrow at approximately 2.8 per cent.) The reason for such a favorable rate for state borrowing is, of course, the tax considerations: interest earned on state obligations is not included in gross income for federal income tax purposes. The state lends the ten million dollars it has obtained at 2.8 per cent interest to the Foundation, which in return pays 2.8 per cent to reimburse the state. Once it receives these loans, the Foundation, through the treasurer, can place the money in the investments specified for the treasurer. Treasurer Berdon estimates the spread between the return earned on the investment and the 2.8 rate of interest to be, conservatively, 3.8 per cent, making available $380,000 each year for the Commission to use in fulfillment of its goals.

Where does that money really come from? The state comes out even, since it receives from the Foundation all the money it has loaned, together with the interest it has paid. The Commission is ahead $380,000. It is the federal treasury that foots the bill, in the form of tax revenue forgone through the exclusion from income of interest earned on state obligations. The exclusion represents an indirect federal subsidy to the states, the scope of which is determined by the states. (The total federal tax loss from the municipal bond interest exemption has been estimated at $2 billion.[3])

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1 C.S.G.A. § § 10-369, 370, 373.

2 This analysis and the figures used are based on interviews with Mr. Robert Berdon, the State Treasurer.

3 Comment: *Intergovernmental Tax Immunities: An Analysis and Suggested Approach to the Doctrine and Its Application to State and Municipal Bond Interest,* 15 Villanova L. R. 414, 439 (Winter, 1970).

Tax Considerations

An observer may wonder why the state does not employ this mechanism more frequently, as a way of raising revenue for all kinds of purposes. The explanation suggests a possible Achilles' heel of the entire proposal: § 103 of the Internal Revenue Code, which defines the scope of the state and municipal bond exemption. Section 103 raises enough questions about the proposal to merit reproducing the relevant parts completely:

a Gross income does not include interest on
  1 the obligations of a state . . . or any political subdivision of any of the foregoing . . .

d 1 Except as provided in this subsection, any arbitrage bond shall be treated as an obligation not described in subsection a 1 .
  2 For purposes of this subsection, the term "arbitrage bond" means any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly–
    A to acquire securities . . . or obligations (other than obligations described in subsection a 1 which may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue which is materially higher (taking into account any discount or premium) than the yield on obligations of such issue, or
    B to replace funds which were used directly or indirectly to acquire securities or obligations described in subparagraph A . . .
  4 For purposes of paragraph 1 , an obligation shall not be treated as an arbitrage bond solely by reason of the fact that–
    A the proceeds of the issue of which such obligation is a part may be invested for a temporary period in securities or other obligations until such proceeds are needed for the purpose for which such issue was issued

§ 103 d is of recent vintage, and the Internal Revenue Service has not yet had much to say in the way of interpretation. Temporary regulations have been issued. But these do not really speak to our questions, except to make clear that the yield anticipated by the treasurer is indeed "materially higher" under d 2 A .[4]

Treasurer Berdon believes that his proposal is safe from loss under § 103 d of the state and municipal bond interest exemption. He reasons that it is not the state that is reinvesting the proceeds in higher yield securities and obligations, but rather a private corporation. The state, he claims, has no control over what that corporation does with the money that is loaned to it by the state. It is this reasoning that required the creation of the corporation, since if the loans were made directly to the Commission the reinvestment would be made by a state agency.

The treasurer's reasoning is not entirely convincing. In the first place, the definition of arbitrage bonds, which do not qualify for the state and municipal bond interest exemption, includes those whose proceeds are to be used "indirectly" to acquire higher yield securities. Although the Service has not yet proferred a definition of "indirectly" for the purposes of this section, it would seem that the proceeds of the Connecticut bond issue would, at the very least, be used "indirectly" to purchase higher yield securities.

Whether Connecticut can get around this problem by making the loan to a separate entity is also unclear. The Service, and subsequently a court, could chose to ignore, as a sham, the attempt to attach a private body to a state agency merely to avoid the arbitrage definition. Furthermore, the section does not specify that it is the state which must make the investment in order for the bonds to be included in d 2 A . The section is framed in terms of the investment and not the investor. It is thus possible that a loan to, and investment by, an unquestionably private, independent entity would fall under d 2 A and not qualify for the a 1 exemption. It may be noted that a proposal to fund *legal services* by such a scheme may fare better in the courts than the present Connecticut proposal, as loans could be made directly to private legal services organizations without the necessity of setting up a clearly sham private corporation.

There may be a safer way around the d 2 A exclusion from favorable treatment. The treasurer does not actually anticipate that a bond issue is necessary to raise the Foundation's ten million dollars. Instead, this relatively small amount is already available from prior, much larger bond issues, and is sitting in the General Fund and other sources that the treasurer is authorized to tap for loans to the Foundation. This particular fact situation may allow the Connecticut proposal to escape the definition of "arbitrage bond" of d 2 , which requires the investment of "all or a major portion of the proceeds."

These facts, and the short term nature of the loans to the Foundation, may get the scheme within the bounds of d 4 A , since the investment will be somewhat temporary in character. Whether this approach is allowed will depend on the Service's interpretation of "temporary." The present temporary regulations, however, also indicate that some limit may be set on the yield from temporary investment, which (although greater than .125%) may cause re-evaluation of the soundness of the proposal.

Clearly, these speculations are of limited use without an indication of how the Internal Revenue Service will view the proposal. Such an indication is probably not far off, as new regulations in this area have been promised for quite some time. However, it is unlikely that the question will be finally resolved with their issuance. Even if the new regulations impose no new obstacles in the way of the proposal there are already sufficient obstacles in the section for the Service to move against the practice if it wishes. Even if the Service does not rule against this proposal, it is clear by the promulgation of subsection (d) and regulations under it, that this is an area of concern to the Internal Revenue Service. It seems inevitable that there will eventually be a clash between the states and the Service over the reinvestment of funds raised by tax-free state bonds. Such a conflict would, of course, be of constitutional proportions.

Although the history of Treasury attempts to change or eliminate the municipal bond immunity of § 103 (a) is some fifty years old, the existence of the exemption in the law has by and large, kept the constitutional debate out of the courts.[5] Absent the statutory exemption, the question of whether the federal government may tax the income from municipal obligations will revolve around the constitutional doctrine of "reciprocal" or "intergovernmental" immunity, said to be a cornerstone of our federalist system.

The Supreme Court affirmed the municipal bond immunity on constitutional grounds in such cases as *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429, aff'd on rehearing, 158 U.S. 601 (1895); and *National Life Insurance Co. v. United States*, 277 U.S. 508 (1928). However, later cases have apparently narrowed the immunity by asking the question in particular instances of whether the alleged federal encroachments on the immunity threaten functions that are essential to the continued existence of the states. These cases have also repudiated the doctrine that a tax on income is the equivalent of a tax on the income's source (the municipal government). *Helvering v. Gerhardt*, 304 U.S. 405 (1938); *Graves v. New York*, ex rel. *O'Keefe* 306 U.S. 466 (1939). Thus, whether there is a constitutional exemption of income from municipal bonds from federal taxation is still considered to be an open question.

The State's Power to Borrow

By statute, the State treasurer may issue bonds–either with the Governor's approval for temporary borrowing, or as the state bond commission deems necessary, even in the case of bond issues authorized by statute. The treasurer is authorized by the proposed new bill to issue bonds to finance the loans to the Foundation. There exists presently a statutory limitation on the amount of bonds that may be issued by the treasurer. He is limited to bonds, notes, etc., in a total amount up to four and a half times the tax receipts of the previous fiscal year. The treasurer estimates that of the 4.4 billion dollar limitation on bonds by this section, some two billion dollars worth have been issued. Of course, this limitation is not constitutional in nature, and may be changed by statute at any time.

Funding Legal Services

There appears to be no reason why a similar proposal could not be used to fund legal services organizations. Certainly from a tax point of view, there is no greater disability on a legal services proposal than on the one for the Foundation on the Arts. Indeed, as mentioned above, there would be no temptation for IRS to "pierce the corporate veil" of a "private" corporation, because there is no need to set up an intermediate corporation to fund legal service organizations.

There may, of course, be some political obstacles to the passage of such a proposal. There is the suspicion that this "money machine" is, in fact, costing the state money, which must be assuaged. One of Treasurer Berdon's selling points for the Foundation is that it is merely a temporary measure to get the Commission going so that it may then attract private contributions. At least in public the treasurer is hopeful that the state's monetary role in the scheme will expire within the five year double deduction period of the bill. The same argument could probably not be made for a legal services loan proposal.

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4 Regulation § 13.4 (a)(3) provides that the yield will be considered "materially higher" if the difference between the yield on the acquired obligations and the yield produced by the governmental obligations is greater than one-eighth of one percent.

5 Martori and Bliss, *Taxation of Municipal Bond Interest–Interesting Speculation and One Step Forward*, 44 Notre Dame Lawyer 191, 192 (Dec., 1968).

6 See C.G.S.A. 3-16 through 3-31 for the treasurer's powers of borrowing and investment.

Despite the fact that it would not cost the state anything, any such bill would raise all of the questions about legal services and state support that are currently being debated. A discussion of these political battles is beyond the scope of this short article, except to note that this debate is likely to continue, despite the present lack of state financial support.

It should also be noted that the sum of money involved in a legal services proposal might well be considerably more than the sum involved in the fine arts plan, although this would depend on whether a particular bill was designed to cover funding for all legal service programs in the state, or just a specific one, and on the size of the programs covered. The state, in theory, may be authorized to borrow more than enough money to finance legal services in the manner suggested. Thus, in Connecticut, up to 2.4 billion dollars more may be borrowed under the current borrowing limitation of the state. However, if the necessary state loan was raised to one hundred million dollars, for example, the public outcry would probably be intense. And in that case it would also be necessary, in the present Connecticut context, to have a separate bond issue, which would entail risks under the "arbitrage" definition.

Model Act

There follows a model act, which is patterned after Treasurer Berdon's proposal, and is designed to effectuate the scheme outlined above for the financing of legal services programs.

Several preliminary points should be made. First, there is no necessity, as discussed above, for the creation of a new entity to receive loans from the state. The only reason such an entity was felt to be necessary in Berdon's bill was that reinvestment by an obvious agency of the state, the Connecticut State Commission on the Arts, would bring the related state bond issue within the definition of "arbitrage Bond." Here, however, the reinvestment would be made by private legal service programs.

On the other hand, in some situations the creation of an intermediate corporation entity would be desirable, for instance if a state-wide corporation is desired to disburse funds to all of the legal service programs in the state and to retain the investment function under perhaps closer scrutiny than is provided in the bill set out below. Of course, if scrutiny becomes too close, it may be that the advantages to be gained by having a separate entity are lost by the risk of the IRS "piercing the corporate veil." In any case, it was felt that such a separate entity was not a necessity, and no provision is made for it in the model act.

Second, although the discussion and the model act are framed in the context of state loans, there appears to be no reason why the proposal could not be utilized on a municipal or county level. The provisions of § 103 are equally applicable, and at most, an addition to the proposed enabling act might be necessary. A loan program on the local level might well be preferable to such a program on a state level because it would eliminate separate requests from each legal services program for funds, and fights between legal services programs over the allocation of funds.

All these considerations should be kept in mind in the consideration of the act for any given jurisdiction.

One further note: Certain terms, such as "combined investment pool," have been retained from the Connecticut proposal to give as broad a view of the proposal as possible. Appropriate language should, of course, be substituted in any other jurisdiction.

Section 1
Loan of State moneys.
Issue of note obligations.

(a) The state treasurer is hereby authorized to loan to (X Legal Services Organization) from time to time amounts not to exceed Y million dollars outstanding at any one time, for such periods of time as he may determine but not to exceed one year, at a rate of interest as determined in subsection (b) of this section, such loans to be made under such other terms and conditions as he may determine. The state treasurer may make such loans from any one or a combination of the following: (i) the General Fund; (ii) the combined investment pool; (iii) the proceeds of notes of the state issued and sold pursuant to subparagraph (c) of this section.

(b) The loans to said (Legal Services Organization) shall provide for interest payable to the combined investment pool to the extent that the loans are made from that pool, or to the General Fund to the extent they are made from other sources. The net interest rate shall be the current rate the state would have to pay for its short-term borrowings as may be determined and estimated by the state treasurer but in no event shall said interest rate exceed 3% per annum.

(c) The notes issued and sold by the state treasurer pursuant to (iii) of subsection (a) of this section shall be general obligations of the state and the full faith and credit of the State of Z are pledged for the payment of the principal of and interest on said notes as the same become due, and accordingly and as parts of the contract of the state with the holder of said notes, appropriation of all amounts necessary for punctual payments of such principal and interest is hereby made, and the treasurer shall pay from the general fund such principal and interest as the same become due. All of said notes shall be payable at such place or places as may be determined by the treasurer and shall bear such date or dates, mature at such time or times, not exceeding one year from their respective dates, bear interest at such rate and payable at such time or times, be in such denominations, and be payable in such medium of
307 payment as may be determined by the treasurer. Any premium and accrued interest received on the sale of said notes shall go first to pay the cost of the sale and issuance of the notes and then the balance is credited to the General Fund.

Section 2
Establishment and operation of State Loan Fund.

(a) The (X Legal Services Organization) shall establish and maintain a separate fund entitled the "State Loan Fund."
(b) All loans made to (X) from the state shall be credited to the State Loan Fund of (X). The net asset value of said fund as determined by the treasurer shall always be equal to the outstanding loan balance due to the state at any given time. In determining the net asset value of such fund, the state treasurer may, at his discretion, take into consideration and value investments in the fund at the cost of (X), if in his opinion the market value is higher or lower than the cost because of fluctuating interest rates which are of a short-term nature. The treasurer may invest this fund in any other fixed income, bond, and mortgage funds established pursuant to law, or in any other prudent source of investment, subject to the approval of the board of directors of X. The net income of the fund and surplus assets, over and above the net asset value equal to the amount of the outstanding balance of the state loans, may from time to time be transferred by the board of directors to any other fund of X to be used for the purposes of such fund. If at any time there exists a deficit in this fund, after valuating the assets as aforesaid, the treasurer shall report the same to the Governor.

Section 3
Accounting audit and reports.

The accounts and books of the State Loan Fund of X shall be maintained by the treasurer and the facilities of his office shall be used for this purpose without charge to or contributions from X. The accounts of this fund shall be subject to annual audit by the State Auditors of Public Accounts. The board of directors may cause the accounts of the State Loan Fund to also be audited on an annual or other basis by a Certified Public Accountant. The treasurer shall annually report to the Governor the financial condition of the State Loan of X.

Section 4

The notes issued pursuant to this act are made and declared to be (a) legal investments for savings banks and trustees unless otherwise provided in the instrument creating the trust, (b) securities in which all public officers and bodies, all insurance companies and associations and persons carrying on an insurance business, all banks, bankers, trust companies, savings banks and savings associations, including savings and loan associations, building and loan associations, investment companies and persons carrying on a banking or investment business, all administrators, guardians, executors trustees and other fiduciaries and all persons whatsoever who are or may be authorized to invest in notes of the state, may properly and legally invest funds including capital in their control or belonging to them, and (c) securities which may be deposited with and shall be received by all public officers and bodies for any purpose for which the deposit of notes of the state is or may be authorized. All such notes, their transfer and the income therefrom including any profit on the sale or transfer thereof, shall at all times be exempt from all taxation by the state or under its authority.

Section 5

This act shall take effect from its passage.