

Tax Lines

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The Internal Revenue Service (the “Service”) and Treasury Department were able to push through two more important pieces of guidance on provisions in the American Recovery and Reinvestment Act (“ARRA”) this past quarter. With these two notices covering Recovery Zone Bonds and Tribal Economic Development Bonds, issuers have the information needed to make allocations and get bonds issued. The tax credit stripping regulations represent the more complex task related to the ARRA provisions, and those are apparently still in the works.

The Service also released solid waste disposal regulations. These were issued as proposed regulations, so the Service will not yet be able to take this guidance project off the business plan just yet. There were a handful of private letter rulings over the past several months, including rulings on change in use and management contract safe harbors.

American Recovery and Reinvestment Act Notices

Recovery Zone Bonds

On June 12, 2009, the Service released the last of the many separate volume allocations from ARRA. Notice 2009-50 (the “Recovery Zone Notice”) provides the allocations of the maximum face amount of Recovery Zone Economic Development Bonds (“RZEDBs”) and Recovery Zone Facility Bonds (“RZFBs” and together with RZEDBs, “RZBs”). As with the prior notices on ARRA allocations, the Recovery Zone Notice also provides interim guidance for RZBs.

Allocations of Volume Cap for Recovery Zone Bonds. The Recovery Zone Notice lists the allocations of the nationwide bond volume limitations of \$10 billion for RZEDBs and \$15 billion for RZFBs for bonds issued through December 31, 2010. Within the text of the Recovery Zone Notice are the allocations to the States, which are based on the relative decline in the number of individuals employed in the State determined in December 2007 compared to December 2008. Section 1400U-1 further provided that no State was to receive less than 0.9% of the respective national volume caps. To get a sense of how this formula worked, 31 of the 56 States (including the District of Columbia and 5 possessions) received the minimum allocation, and 4 States (California, Michigan, Illinois and Florida) received 28% of the total allocation. In some ways, the State allocations are likely to be less relevant to issuers because the statute requires that a State sub-allocate its entire allocation down to counties and large municipalities (those with population over 100,000). Thus, the State will have no volume cap to allocate unless a county or municipality waives its allocation and gives it to the State.

Thankfully, the Service took on the task of providing the sub-allocations to the counties and large municipalities. While the legislative history to this section of ARRA included a website address for determining employment decline, the whole allocation scheme was complicated enough to cause issuers to err on the side of caution and wait for the Service. The allocations produced some rather surprising results, with some large municipalities receiving no

allocation at all. The surprises are likely a result of the specific time period for comparison of decline in employment dictated by Section 1400U-1 (December 2007-2008), the use of the number of people employed rather than a percentage of unemployment and also the fact that individuals may be employed in one jurisdiction and live in another.

ARRA does not take into account the various geographical and political relationships between counties and large cities, relationships that will likely come into play in the actual use of allocations. The Recovery Zone Notice discusses who can use amounts that have been allocated under the statutory requirements. The general requirement for counties and large municipalities with regard to the use of their allocations is that the allocation be used to finance a project within the “jurisdiction” of the entity with the original allocation. The entity receiving the allocation can permit another entity to issue the bonds, but again the project must be within the jurisdictions of both the entity with original allocation and the entity issuing the bonds. Jurisdiction in this case appears to mean geographical jurisdiction rather than political jurisdiction or control. By way of example, a county that receives an allocation under the Recovery Zone Notice would be permitted to do the following: (i) issue the bonds itself or have an on-behalf-of issuer issue the bonds for a project within county boundaries, or (ii) have the State issue pooled bonds and lend the portion of the bonds represented by the county allocation to a borrower to finance a project located within the boundaries of the county in order to achieve economies of scale for issuance costs in a pooled bond issue, or (iii) waive its allocation and allow the allocation to be used anywhere in the State at the State’s discretion, as might happen if the amount is too small to warrant a bond issue or the county cannot meet the issuance deadline of December 31, 2010. The Recovery Zone Notice is helpful in that it contemplates that there could be various permutations in using the volume cap, though there will probably still be many questions that arise as to implementation in any given circumstance.

Good faith designation by issuers of Recovery Zones. RZBs must generally be used for projects located within “Recovery Zones” that are, for the most part, designated by the issuer of the bonds in conformity with general guidelines contained in ARRA. Thus, the issuer, not the federal government, can designate as a “Recovery Zone” any area having significant poverty, unemployment, rate of home foreclosures or general distress, or any area economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990. Section 1400U(b) itself automatically designates any of the 80 federal Empowerment Zones and Renewal Communities in effect as of February 17, 2009 as Recovery Zones, apparently without further action required of the issuer.

Prior to the release of the Recovery Zone Notice, there had been a great deal of debate about the extent to which the Service would place additional or more specific requirements on the issuer’s ability to make a Recovery Zone designation. On this matter, the Recovery Zone Notice is particularly helpful by providing that any State, county or large municipality that receives a volume cap allocation for RZBs may “make the designations of recovery zones in any reasonable manner as it shall determine in good faith in its discretion.” This approach gives the issuer a great deal of leeway in targeting this economic incentive to a jurisdiction’s particular needs.

Issuers appear to have taken several different approaches. For example, a county may designate the entire county as a Recovery Zone in order to capture areas where development is

feasible or where economic activity and jobs are concentrated, even though potential employees may live in other parts of the county. In the case of a large city, designations may be targeted to certain sub-areas of the city because the areas where people live and work are more concentrated. Given the “good faith” requirement, either approach would appear to be appropriate, though it would be important to document the rationale for designation should the Service review it to determine if good faith was exercised. Issuers have also developed different procedures for designating the area. In some cases it may be done by a resolution of a legislative body and in other cases the designation occurs by mayoral declaration.

In most cases, jurisdictions waited for guidance from the Service prior to making a designation and are now struggling with the extent to which projects that began construction before designation can be financed with RZFBs. Section 1400U-3(c) requires that 95% of the proceeds of RZFBs be used to finance “Recovery Zone Property,” defined as property constructed, reconstructed, renovated or acquired by purchase by the taxpayer after the date on which the Recovery Zone designation “took effect.” The question is whether an issuer can take the position that its Recovery Zone designation “took effect” on the effective date of ARRA (February 17, 2009), regardless of the fact that an issuer may have waited to make the actual designation of the Recovery Zone after the release of the Recovery Zone Notice. Hopefully, the Service will be able to clarify this.

RZEDBs Guidance. The Recovery Zone Notice does not provide a great deal of new guidance on RZEDBs, and cross-references Notice 2009-26 for rules relating to matters such as Form 8038-G filings, the ability to reimburse expenditures, reserve fund sizing and yield calculation for arbitrage and rebate purposes.

The Recovery Zone Notice reiterates that proceeds of RZEDBs can be used to fund both capital expenditures and working capital expenditures, including (1) capital expenditures paid or incurred with respect to property located in the Recovery Zone; (2) expenditures for public infrastructure and construction of public facilities; and (3) expenditures for job training and educational programs. Normally a State or local government would not use long-term bonds to finance working capital, but in these tight budgetary times this might be an attractive proposition. The RZEDBs must meet the general arbitrage rules applicable to governmental bonds, so any bonds that finance working capital for job training would still be subject to the rule that the bonds cannot be outstanding longer than necessary. Presumably the issuer would be able to take advantage of the safe harbor maturity rules for working capital financings or would be able to establish that there are no other available amounts to pay the expenditures under the gross-proceeds-spent-last rules of Treas. Reg. § 1.148-6. The issuer would need to evaluate the value of the 45% subsidy available for RZEDBs if the maturity of the bonds is very short.

The Recovery Zone Notice does not shed any light on whether public infrastructure or public facilities constructed with proceeds of RZEDBs must be located within the Recovery Zone or must simply promote development or other economic activity in the Recovery Zone. Section 1400U-2 requires that capital expenditures be paid or incurred with respect to property located in a Recovery Zone, but the separate prong of qualified purposes dealing with public infrastructure and facilities does not include the same limitation. The legislative history included language saying that the public facilities were to be located within the Recovery Zone. In the case of public infrastructure, particularly a system such as roads or conduit pipes, it may well be

that expenditures would be used for property outside of the Recovery Zone. Presumably, bond proceeds used to finance job training activities at a facility outside of the Recovery Zone could still be financed with RZEDBs.

The Recovery Zone Notice deals only briefly with the mechanics for obtaining the 45% subsidy payment, citing the IRS' prior Notice 2009-26 on Build America Bonds ("BABs"), which contained details on how to file for payments. Thus, under current procedures, an issuer of RZEDBs must claim the credits on Form 8038-CP, which it must file with the Service either semiannually or quarterly depending on the nature of the interest payment on the bond issue.

The Recovery Zone Notice does not discuss the requirement of Section 1601 of ARRA that the issuer pay prevailing wages (so-called Davis Bacon rules) for a project financed with proceeds of RZEDBs. This is a non-Code provision, and tax lawyers may take the view that this is a matter governed by the Department of Labor rather than the Service. Questions also arise as to what constitutes a "project financed with proceeds of RZEDBs" when the bonds are only one source of funds in a larger financing. Perhaps the Service will be able to clarify this provision and the impact of Davis Bacon compliance on the tax status of RZEDBs.

RZFBs Guidance. The Recovery Zone Notice summarizes the statutory provisions related to Recovery Zone Property, qualified businesses, substantial renovation and sale-leasebacks, but does not add any detail beyond what is in ARRA. In general, issuers are directed to the general rules for exempt facility bonds under Section 142. Interim guidance on RZFBs relates only to how the Form 8038 should be revised to report issuance of the RZFBs.

Tribal Economic Development Bond Notice and Initial Award Announcement

On June 23, 2009, the Service released Notice 2009-51 (the "TEDB Notice") to solicit applications for allocations of the \$2 billion national bond volume limitation for issuance of Tribal Economic Development Bonds ("TEDBs") pursuant to Section 7871(f). On its website the Service had previously solicited comments on the method it should apply in allocating the \$2 billion nationwide volume cap, and the TEDB Notice reflects the Service's decision to allocate based on application. The majority of the Notice provides detailed instructions on eligibility requirements that a project must meet to be considered for an allocation, application requirements, deadlines and forms for requests for allocations. The TEDB Notice also contained some interim guidance.

Allocation Application. The Notice states that the Service will allocate the TEDB volume cap in two \$1 billion tranches. Applications for the first allocation of \$1 billion were due by August 15, 2009, and applicants must expect to issue the bonds under this tranche by December 31, 2010. As discussed below, the Service made announcements of the allocations on September 15, 2009. Applications for the second allocation must be submitted before January 1, 2010.

The form of application for a TEDB allocation is included in the TEDB Notice. The application must be submitted by an Indian tribal government that appears on the most recent list published by the Department of the Interior in the *Federal Register*. If not listed, the tribe must

submit a letter from the Department of the Interior that states it has been acknowledged as a federally recognized tribe.

The tribe is required to provide a project description, the project's location, expected date the project will be acquired or the expected date the project will be placed in service, a plan of financing, the allocation amount requested and a certification of the tribe that, if it is awarded an allocation, the tribe is ready to issue the TEDBs on or before December 31, 2010, or December 31, 2011, depending on the tranche from which the allocation is made. Many of the items required for the application appear to be designed to assure the bonds can be issued within the required timeframe. For example, the tribe must provide the status on all necessary federal, state and local regulatory approvals for the project and must provide a reasonably detailed description of the plan of financing, including named underwriters or named investors in a private placement and the status of all other financing sources for the project, including the names and addresses of all entities expected to provide any financing.

If an award is made, the Service will permit only insubstantial deviations from the application submitted, and even those deviations must be approved by the Service. This is certainly an incentive to a tribe to assure that its project is well-defined and its application is well-documented to avoid having to request changes if it receives an allocation.

The application must be submitted in hard copy (2 copies) and on a compact disc. The address provided evidently does not use the screening procedures that melted the discs in the initial CREBs application process.

Interim Guidance. TEDBs are not limited to financing projects that constitute an "essential government function" as had been the case under Section 7871 prior to ARRA. TEDBs may be issued to finance generally any activity for which a state or local government could issue tax-exempt bonds, including private activity bonds for 501(c)(3) organizations, airports, private water or sewer companies, low-income rental housing, and certain manufacturing facilities, so long as the financed facilities were located on an Indian reservation.

Even though ARRA broadened the category of activities that a tribe could finance on a tax-exempt basis, TEDBs may not be used for gaming facilities, or any portion of a building in which gaming is conducted or housed. The TEDB Notice also expressly states that TEDBs may be issued to finance golf courses, convention centers and hotels, subject to the same limitations as state and local governments that historically had also including gaming facilities, and then goes on to provide a fairly bright line test that will be applied to make a determination of what facilities could be financed. Under the TEDB Notice, a structure, such as a hotel, will be treated as a separate building from a gaming structure, and therefore eligible for financing, if the hotel has an independent foundation, independent outer walls and an independent roof. Connections between two adjacent walls of separate buildings, for example doorways, covered walkways or other enclosed common area connections, would not prevent the qualifying building, such as a hotel, from being treated as a separate building as long as the connections do not affect the structural independence of either wall. With the focus on the physical structure of a building, apparently TEDBs could not be used to finance the hotel portion of a mixed use facility if the gaming facility was on one or more floors of the facility.

It is especially helpful that the Notice specifically states that golf courses can be financed, as the Service had challenged on audit whether resort-type golf courses met the “essential government function” requirement that limited the issuance of traditional tax-exempt tribal bonds.

The Service took an expansive view of TEDBs, permitting the use of TEDBs to refund prior bonds or taxable debt in the same manner as other state and local governments, including an advance refunding of prior governmental bonds, subject to meeting all of the applicable requirements of TEDBs. Because TEDBs are subject to the volume limit, refunding of prior tax-exempt bonds may be a less desirable use of TEDBs because the bonds already have the benefit of exemption.

The Treasury Department issued a press release on September 15, 2009 (TG-287), suggesting that tribes would be able to issue the TEDBs either as traditional tax-exempt bonds or as BABs. It appears that this particular expansion of tribal bond authority may have been too expansive, so we should expect clarification on this.

Allocation Awards. The TEDB Notice stated that if the total amount of allocations applied for in the first allocation tranche exceeded \$1 billion, each qualified project would be allocated an amount reduced pro rata such that the total allocation does not exceed \$1 billion. In its announcement of the awards on September 15, 2009 (IR-2009-81), the Service stated that they had received requests for \$1,329,487,364.88 (interesting that they got to the pennies). Therefore, the amounts requested by the 58 project applications were each reduced to bring the aggregate allocation down to \$1 billion.

The maximum allocation any tribe may request during the first round of applications is \$30 million. The awards ranged from \$902,603.54 to several allocations of \$22,565,088.46 (an original request of \$30 million reduced pro rata). The announcement provides information on the type of financing for all entities consenting to public disclosure. Interestingly, approximately half of the applicants consenting to disclosure applied to finance tourism facilities, perhaps reflecting the fact that those types of financings had been challenged by the Service under the previous “essential governmental function” limitation.

Second Round of Applications. The second round applications may be submitted after August 15, 2009, and before January 1, 2010. Tribes receiving a second round allocation must issue the TEDBs by December 31, 2011. The TEDB Notice stated that the Service expected the maximum allocation request to be limited to \$30 million for the second application round as well, but reserved the right to increase, decrease or eliminate this limit. To date, the Service has not indicated that it would change the \$30 million limit.

For the second allocation, a tribe must inform the Service if it has previously received an allocation of TEDBs for the same project or a “related” project. The Notice provides that a project is related if it is (1) owned by the same entity, (2) located at or near the same site and (3) is integrated, interconnected or dependent on the initial project receiving an allocation based on all the facts and circumstances. The Service has left open the possibility that a tribe could receive a TEDB allocation in excess of \$30 million for the same project by applying during both application rounds.

The TEDB Notice states that if TEDBs are not issued by December 31, 2010 or December 31, 2011, as applicable, then the TEDB allocation is forfeited. Any allocation amounts forfeited may be available for allocation by the Service as part of an allocation process to be announced by the Service at some future date.

Proposed Regulations on Solid Waste Disposal Facilities

On September 15, 2009, the Service released proposed regulations (the “Proposed Regulations”) to provide rules for determining whether a facility is a solid waste disposal facility under section 142(a)(6). These Proposed Regulations come more than five years after the Service issued proposed regulations that substantially revised the existing test for determining whether material is solid waste (the “2004 Proposed Regulations”). The 2004 Proposed Regulations caused a firestorm of comments, prompting the Service to withdraw the 2004 Proposed Regulations as of September 16, 2009, and to re-propose a substantially different definition of solid waste disposal facilities than that described in the 2004 Proposed Regulations.

Existing Regulations. The existing regulations under Treas. Reg. §§ 1.103-8(f) and 17.1, in place since 1972, define solid waste disposal facilities to mean any property or portion thereof used for the collection, storage treatment, utilization, processing or final disposal of solid waste. Generally, solid waste is defined as property that is useless, unused, unwanted or discarded solid material that has no market or other value at the place where the property is located on the date of issue of the bonds (the “No Value-Test”). The existing regulations provide that a facility that disposes of solid waste by recycling it into material that is not waste also qualifies as a solid waste disposal facility if solid waste constitutes at least 65 percent by weight or volume of the total material introduced into the recycling process. The No Value Test had been the source of many audits pursuant to which the bonds were declared taxable, giving rise to the need for new regulations.

2004 Proposed Regulations. The 2004 Proposed Regulations eliminated the No Value Test used to determine whether material is solid waste and created an entirely new test that focused on the process rather than the material being processed. The 2004 Proposed Regulations would have defined a solid waste disposal function as the processing of solid waste in (1) a final disposal process, (2) a conversion process, (3) a recovery process or (4) a transformation process. The 2004 Proposed Regulations did not attempt to define the conversion process, leaving a gap in the guidance.

Although not defining solid waste, the 2004 Proposed Regulations would nonetheless have eliminated financing of a facility that disposed of (1) fossil fuels or other materials created for the principal purpose of converting the materials to heat, hot water, steam or other useful energy introduced into a conversion process; (2) precious metals introduced into a recovery process; (3) hazardous materials subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on October 22, 1986, the date of enactment of the Tax Reform Act of 1986); and (4) radioactive materials.

With respect to recycling facilities, the entire facility qualified if at least 80 percent of the material introduced was solid waste. If less than 80 percent was solid waste, a portion of the facility could be financed based on the lowest percentage of solid waste processed in any year.

Proposed Regulations. The Proposed Regulations do not bring back the No-Value Test, but do they revive the approach of defining “solid waste” in addition to what is a solid waste disposal process.

The Proposed Regulations define the term solid waste in much the same manner as the existing regulations. Solid waste is garbage, refuse and other solid material derived from any agricultural, commercial, consumer or industrial operation or activity if the material meets two additional requirements: (1) it is either “used material” or “residual material,” and (2) the material is reasonably expected by the person who purchases or otherwise acquires the material to be introduced within a reasonable time after purchase or acquisition in a solid waste disposal process.

Used material is defined as any material that has been used previously as an agricultural, commercial, consumer or industrial product or as a component of any such product. Residual material is defined as any residual byproduct or excess unused raw material that remains from the production of any agricultural, commercial, consumer or industrial product provided that material that qualifies as residual material only to the extent that it constitutes less than five percent of the total material introduced into the production process and it has a fair market value that is reasonably expected to be lower than that of any of any product made in that production process. This latter criteria may look a little like the No Value Test and introduces a small cushion for material that is not solid waste. The prong dealing with an expectation that the material will be introduced into a solid waste disposal process within a reasonable time would seem to relieve some of the controversy that arose under the requirement of the existing regulations that the No Value Test be determined on the date of issue.

The Proposed Regulations exclude from the definition of solid waste (1) virgin materials; (2) solids within liquids and liquid waste; (3) precious metals; (4) hazardous material; and (5) radioactive material. The definition of virgin material includes all raw materials except to the extent such material becomes residual material. The prohibition on fossil fuels in the 2004 Regulations is dropped, and two examples in the Proposed Regulations dealing with waste coal and residual material from refining of crude oil indicate that the general definition of solid waste would dictate the extent to which fossil fuel material would qualify.

The Proposed Regulations state that the term solid waste disposal facility means a facility to the extent that the facility (1) processes solid waste in a qualified solid waste disposal process; (2) performs a preliminary function; or (3) is functionally related and subordinate (within the meaning of § 1.103-8(a)(3)) to a facility which either processes solid waste in a qualified solid waste disposal process or performs a preliminary function. This is similar to the 2004 Proposed Regulations, which basically just rearranged and restated the existing regulations.

The Proposed Regulations provide for three types of solid waste disposal processes: a final disposal process, an energy conversion process and a recycling process. The fourth category (transformation process) included in the 2004 Proposed regulations, which had been reserved, is dropped. The remaining three are similar to those included in the 2004 Proposed Regulations.

Final Disposal Process. A final disposal process includes the placement of solid waste in a landfill, the incineration of solid waste without capturing any useful energy, or the containment of solid waste with the reasonable expectation that the containment will continue indefinitely and that the solid waste has no current or future beneficial use. The containment definition was added in these Proposed Regulations.

Energy Conversion Process. The “conversion process” definition of the 2004 Proposed Regulations is refined to focus on energy. An energy conversion process is defined to include a thermal, chemical and other process that is applied to solid waste and used to create and capture useful energy. Under the Proposed Regulations, an energy conversion process begins at the point of the first application of a process to create and capture useful energy and ends at the point at which the useful energy is first created or captured in the form of a first useful product. The Proposed Regulations bring back the first useful product rule that is derived from the existing regulations and was dropped in the 2004 Proposed Regulations. First useful product means the first product produced from solid waste that is useful for consumption in agricultural, consumer, commercial or industrial operation or activity and that could be sold for such use, whether or not actually sold.

Recycling Process. The “recovery process” category of the 2004 Proposed Regulations has morphed into a “recycling process.” The recycling process definition picks up on the concepts of the existing regulations, defining it as a process for disposing of solid waste that reconstitutes, transforms or otherwise processes the solid waste into a useful product. The recycling process begins at the point of the first application of a process to reconstitute or transform the solid waste into a useful product, such as a decontamination, melting or re-pulping, shredding or other processing of the solid waste to accomplish this purpose, and ends at the point of completion of production of the first useful product from the solid waste. As with the 2004 Proposed Regulations, the term recycling process does not include refurbishment, repair, or similar activities, but the Proposed Regulations put parameters on this concept. Refurbishment is defined as the breakdown and reassembly of a product whereby the finished product contains more than 30 percent of its original components.

The Proposed Regulations also restore the prior 65 percent rule for determining whether an entire facility will be treated as a solid waste disposal facility even if it processes “mixed-inputs” (solid waste and non-solid waste materials). The 2004 Proposed Regulations required that 80 percent or more of material introduced each year into an energy conversion process or a recycling process be solid waste. The Proposed Regulations also drop the rule of the 2004 Proposed Regulations which would have required an allocation between qualifying costs and nonqualifying costs based on the lowest percentage of solid waste rather than the average percentage of solid waste if the 80 percent (now 65 percent) test was not met.

Finally, the Proposed Regulations contain an increased number of examples that further illustrate the application of the rules. The examples are more up-to-date than the processes described in the private letter rulings practitioners previously had to parse through.

The Proposed Regulations will apply to bonds that are sold on or after the date that is 60 days after the date of publication of the final regulations, though issuers may elect to apply the Proposed Regulations before that time. The ability to elect to apply the Proposed Regulations

retroactively should be helpful in filing gaps or eliminating confusion as to the extent the existing regulations could be used in the face of audit challenges by the Service. A public hearing is scheduled for January 5, 2010, with comments due by December 15, 2009. NABL expects to submit comments.

Private Letter Rulings

Change in Use. The Service released two private letter rulings dealing with change in use, although in one case the change was a temporary one during repair of damage.

In PLR 200928018 (dated April 7, 2009, released July 10, 2009), the Service concluded that the demolition of pollution control facilities financed with pre-1986 bonds did not result in a change in use of facilities. This ruling differs from a prior letter ruling (PLR 9838006, dated June 11, 1998), where the Service determined that the abandonment of a financed facility was not a change in use to the extent the property had been kept in a condition such that it could be reactivated, but a change in use did occur later upon demolition and the sale of some component parts as scrap. A remedial action was required in that case because of the cash received from sale as scrap value.

In the current ruling, the Service looked only to the change in use regulations under Treas. Reg. § 1.142-4, though noting that the bonds, as refundings of bonds originally issued before the Tax Reform Act of 1986, were not subject to Treas. Reg. § 1.142-4 and that Rev. Proc. 93-17 had been made obsolete with the adoption of the change in use regulations. Nonetheless, both the regulations and Rev. Proc. 93-17 were deemed useful in analyzing as a threshold matter whether the proceeds would be put to a use different from that for which the bonds were issued.

Under the facts of the ruling, the project consisted of pollution control facilities (the “Project”) which had been sold to a new entity (the “Purchaser”), though the bonds remained the obligation of the original borrower and had apparently not been assumed by the Purchaser. As a result of a consent decree with the State, the Purchaser would have been required to incur substantial costs to bring the Project into compliance. Initially the Purchaser decided to discontinue operations, but later decided it was more economical to demolish the Project rather than pay costs associated with mothballing the Project. The facts as recited state that upon demolition, the Project would not be susceptible of any use, except perhaps as scrap materials for recycling. However, the demolition contract provided that there was no net scrap value.

The Service takes the practical approach to the issue, concluding that while demolition is an “action” that might fall within the concept of a deliberate action, the change from an unexpected, nonfunctional use as a mothballed facility to no use even as scrap material for recycling is not a change in use requiring a remedial action. Therefore, the bonds could remain outstanding as tax-exempt bonds and the interest deduction penalties of Section 150(b) of the Code do not apply.

In PLR 200923008 (dated January 26, 2009, released June 5, 2009), the Service addressed whether a residential rental project continued to be available for rent during a period of repair of the facilities substantial enough to require vacating residents. The ruling is not

technically a change in use ruling, and the Service specifically states that it is not addressing the interest deduction penalties of Section 150(b) of the Code resulting from a change in use.

The Service concluded that the project met the requirement that the project be continuously rented, based on the rental agreements the project owner entered into with respect to tenants that were required to vacate units while the extensive damage was repaired. The project owner terminated all existing leases with qualified tenants, entered into replacement leases allowing qualified tenants to move back into their previously occupied units when renovations were complete and compensated tenants for rent paid for temporary housing in the interim. The owner represented that it would not rent any unit previously occupied by a qualified tenant prior to the vacating of the tenants to any other tenant, unless the unit was vacant immediately prior to terminating the leases to repair damage or the qualified tenant decided not to return to the previously-occupied unit. If the income of the returning tenant exceeded 170% of the applicable income limit (the over-income rule for a deep rent skewed project), the owner agreed to rent the next available unit to a qualifying tenant.

The Service applied the regulations promulgated under Section 103(b)(4) of the 1954 Code because no regulations have been promulgated under Section 142(d) of the 1986 Code. In particular, the Service analyzed Treas. Reg. § 1.103-8(b)(6)(i) relating to the cure of noncompliance within a reasonable time after noncompliance is discovered. The Service cites the fact that the owner discovered the noncompliance and acted to repair the damage soon after discovery. Because the owner entered into the replacement leases, the owner was effectively prohibited from leasing qualifying units to other prospective tenants. The units would be occupied by qualifying tenants when it was safe to do so. Based on these facts, the Service concluded that the owner was correcting any noncompliance within a reasonable period within the meaning of Treas. Reg. § 1.103-8(b)(6).

This ruling is helpful in expanding the application of the noncompliance correction regulations. Treas. Reg. § 1.103-8(b)(6)(ii) states that a “reasonable period” for correction is at least 60 days after the error is discovered or would have been discovered by the exercise of due diligence. A 60-day period would seem reasonable in light of the example of noncompliance cited in the regulation, that of an unauthorized lease. While the ruling does not state the time period between discovery of the damage and the date tenants were able to reoccupy units, presumably it was longer than 60 days given that the damage was extensive enough to require tenants to vacate. The ruling puts more gloss on the “at least 60 days” language of the noncompliance correction regulations.

The ruling states that no opinion is expressed regarding the application of the disallowance of interest deductions for a change in use of facilities under Section 150(b) of the Code. Section 150(b)(2) disallows an interest expense deduction during the time period that the requirements of section 142(d) are not met. Presumably no ruling was necessary because the primary ruling was that the project was still in compliance with the continuous rental requirement

Management and Service Contracts. The Service was again called upon to interpret whether a service agreement would result in private business use under a facts and circumstances approach because it did not fit within the safe harbors of Rev. Proc. 97-13. Hopefully in the

somewhat near future the Service will have some breathing room to update Rev. Proc. 97-13 to give issuers and 501(c)(3) conduit borrowers the comfort from expanded safe harbors rather than the less certain facts and circumstances world. The need is more pressing in light of the new IRS Form 990 reporting requirements for 501(c)(3) organizations regarding the status of management contracts.

In PLR 200926005 (dated March 17, 2009, released June 26, 2009), a hospital had entered into professional services contracts with physicians for services to be provided in a bond-financed property. The contracts are described as being chiefly for specialty care and designed to overcome prior difficulties in recruiting and retaining qualified physicians outside of the largest metropolitan areas of the State.

The contracts were essentially based on a percentage of “Net Professional Patient Billings” (“NPPB”), with the applicable percentage changing for different bands of NPPB (because of redacting, the percentages cannot be determined). NPPB is defined as gross patient billings for the professional component of physician care services including capitation fees (but not the technical component of any ancillary services). The gross patient billings are net of contractual write-offs, usual and customary reductions by private insurers, physician discretionary discounts and managed care discounts. NPPB is not reduced by charitable expenses (uninsured, indigent patients) and bad debt, unless the bad debt is attributable to physician lack of medical records and improper coding. Thus, NPPB is not “net” of operating expenses (other than certain license fees and educational expenses), which would be the typical concept of “net” profits which give rise to private business use.

Additional compensation is based on NPPB, including compensation for serving as a supervising physician of “physician extenders” (apparently a new term for nurse practitioners and physician assistants) and the incentive portion of a deferred compensation plan (the “Plan”). Although the incentive portion of the Plan is calculated as a percentage of NPPB, it is based on the extent to which the physician meets individually-established goals related to the categories of quality, learning and customer goals. The Plan also takes into account the physician’s duration of service with the hospital.

The Base Compensation is required to be reviewed by the hospital if it exceeds a stated percentage of the most current version of a specified survey of compensation for physicians in the same medical specialty in the same or comparable region of the U.S. Apparently this review does not necessarily directly result in a reduction of Base Compensation, but leads to a review of the practice area and billing to determine if it is fair market value.

The proposed contracts are deemed by the Service to most closely resemble the percentage of gross revenues contract described in Section 5.03(6) of Rev. Proc. 97-13. The term of the contract is redacted but apparently it did not conform to the two-year term permitted for percentage-based contracts. The Service concludes that the various reviews of compensation as to fair market value and the use of factors other than the productivity of the hospital or net profits to determine compensation (length of service and performance goals), combined with a term tailored to attract and retain physicians under the circumstances described, resulted in reasonable compensation. Thus, under all the facts and circumstances, the contracts do not result in private business use.

While it would be helpful to have some idea of term of the contract that was permitted in this case., the focus on what compensation is reasonable even if based on a percentage of revenues is favorable.

ACT Report on Record Retention

The Advisory Committee for Tax-exempt Entities ("ACT") released its annual report on June 12, 2009 (the "Report"). This year's report picked up on the work and recommendations of prior ACT members on the topic of record retention and produced what I would call "shovel ready" guidance.

The working group for this Report consisted of Michael Bailey (an attorney in private practice formerly with the Service), Joan DiMarco (a rebate analyst) and John Pasicznyk (an issuer), thus providing a nice mixture of viewpoints and experience with respect to record retention. The report includes an Executive Summary, a technical discussion of record retention requirements (Appendix A), an issues memorandum in the form of questions and answers (Q & A) (Appendix B) and a proposed revenue procedure (Appendix C).

The Report summarizes the history, such as it is, of record retention. The ACT Report released in 2005 framed the issue and outlined six general principles for record retention. The 2005 Report led to the release by the Service of Notice 2006-63, which acknowledged the difficulty of fitting the square peg requirements associated with long-term bond issues in the round hole of recordkeeping requirements of general tax provisions under Section 6001. The Report puts responses to the Notice from various groups, including NABL, into context within the Q&A and the proposed revenue procedure. The Report also incorporates the recommendations from the 2007 Report, which had advocated putting written policies and procedures in place to assure post issuance compliance.

In general, the Report takes the approach that an issuer should be able to reduce its recordkeeping burden through safe harbor summary documentation if the issuer has adopted and implemented reasonable procedures intended to ensure compliance with the rules for the tax-exempt and tax credit bonds (including Build America Bonds). The basic safe harbor for reasonable procedures has six elements:

1. Reasonable procedures to assign compliance responsibilities to appropriate departments, employees, or other functions;
2. Reasonable procedures for the establishment and maintenance of books and records files for each issue;
3. Reasonable procedures for compliant investment of gross proceeds for each bond issue;
4. Reasonable procedures for the review and allocation of expenditures of bond proceeds for each issue;
5. Reasonable procedures for periodic monitoring of use of proceeds and financed property; and

6. Susceptibility to audit to verify adherence to the procedures.

Each of these elements is discussed in more detail, particularly in the proposed revenue procedure, with examples of procedures and how an issuer might approach a procedure. Many of the items in the example pick up on the areas included in the 501(c)(3) and governmental compliance surveys sent out by TEB over the past year. For example, reasonable procedures might include procedures for periodic training of employees responsible for monitoring policies, devoting sufficient resources to implementing remedial actions and elements of detailed records of expenditures.

The Report recommends safe harbors for a shorter period than the term of the bonds for retaining detailed records if the issuer has prepared certain summary documents, a so-called “Minimum Detailed Record Retention Period.” The minimum period in the proposed revenue procedure is the shorter of six years or the term of the bonds plus three years. If TEB is to accept this type of recommendation, they would be foregoing a detailed review of invoices if an audit were initiated after the minimum retention period.

The Report is a very thoughtful piece, and will hopefully be the document that pushes us to the finish line on record retentions obligations. In the recent NABL teleconference, Cliff Gannett, Director of TEB, indicated that they are reviewing the Report carefully and expect to make some changes, though he was not able to discuss the extent of the changes or the timing of any guidance.

Qualified School Construction Bonds Addendum

In the last column I indicated that unused Qualified School Construction Bond volume cap allocated to a State was required to be used in the following calendar year. I understand that the Service has interpreted Section 54F(e) to mean that the unused State amount can be carried over to succeeding calendar years until it is exhausted. That is good news.

Federal Securities Law

Paul S. Maco

Summer doldrums did not becalm municipal securities regulators, who mid-summer launched a variety of rulemaking initiatives affecting the municipal securities markets. Here is an overview:

SEC

The Securities and Exchange Commission proposed amendments to Rule 15c2-12 that would: (1) increase the categories of events for which notice would be required under continuing disclosure agreements from eleven to fourteen, add tender offers to the bond calls category, and expand the scope of tax-related events triggering notice; (2) remove the “materiality” qualification from many such events; (3) provide a time-frame within which notices must be filed; and (4) remove the exemption in Rule 15c2-12(d)(1)(iii) for securities sold in denominations of \$100,000 or more and which, at the option of the holder thereof, may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months.¹ In addition, the Commission revisits and “further expounds” upon its prior interpretation of underwriters’ responsibilities previously articulated in earlier rulemaking releases with respect to Rule 15c2-12.² The window for comments officially closed September 8, 2009, however SEC staff has indicated in informal conversations that tardy comments will not be ignored.

The proposals have already drawn supporting comments as well as comments advocating either more stringent modifications or a relaxation of the proposals. Without speaking for or against them, a few aspects of the proposals are worthy of note.

Tender Offers. At the outset, note that the term “tender offer” is not defined in federal securities law statutes, rules, or regulations. The term has been defined in the courts.³ Among the proposed modifications is the addition of tender offers to the list of events requiring notice in subparagraph (b)(5)(i)(C)(8) of the Rule. In footnote 102 to the proposing release, the Commission points out that “[g]enerally, municipal securities are not subject to Commission rules governing tender offers, including Rule 13e-4 under the Exchange Act, 17 CFR 240.13e-4, which sets forth disclosure, time periods, and other requirements governing tender offers by

¹ Proposed Amendments to Municipal Securities Disclosure, 17 CFR Parts 240 and 241, Release No. 34-60332 (Jul. 17, 2009).

² Securities Exchange Act Release No. 26100 (September 22, 1988), 53 FR at 37787-91 (September 28, 1988); Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR at 28811-12; and Securities Exchange Act Release No. 34961 (November 10, 1994) 59 FR at 12757-58.

³ Courts have developed various tests, of which an eight factor test is most generally applied. *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979). But the Second Circuit also asks if sellers (or bondholders) need protections of tender offer rules. *Hanson Trust plc v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985).

issuers.” The proposal would modify existing event notice item 8 “Bond calls”⁴ to read: “Bond calls, if material, and tender offers.” Comment is requested as to what additional details, if any, should be included as required elements of the notification, in addition to comments on other aspects of the proposed modification.

Tax Events. The proposal expands the existing 6th event requiring notification, if material, from “Adverse tax opinions or events affecting the tax-exempt status of the security” to “Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax-exempt status of the securities, or other events affecting the tax-exempt status of the security.” Note that this is one of several events for which the qualifier “if material” will be dropped if the modifications are adopted as proposed.

Variable Rate Demand Obligations. The proposal to remove the Rule’s existing exemption for Variable Rate Demand Obligations appears to contain a gap that will create confusion among municipal securities dealers attempting to comply with the Rule, if adopted as proposed. Under the proposal, “the Participating Underwriter of a primary offering of VRDOs would need to reasonably determine that the issuer or obligated person has entered into a continuing disclosure agreement with respect to the submission to the MSRB of continuing disclosure documents.”

What sort of continuing disclosure documents? The proposal does not say, presumably because the answer is “those generated by the requirements found in paragraph (b)(5).” Here is where the trouble appears to begin. Paragraph (b)(5)(i)(A) requires that the contract for continuing disclosure include “Annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria.” The term *annual financial information*, as defined in paragraph (f)(9), means “financial information or operating data, provided at least annually, *of the type included in the final official statement* with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis.”

This structure reflects the “footprint” concept added in the release adopting the 1994 amendments to the Rule. During the comment period on the proposed 1994 amendments to the Rule, some market participants were concerned that an articulation of a required contractual baseline in the Rule would have the effect of mandating disclosure in the final official statement that was not material to the offering. The solution, as explained in the release adopting the 1994 amendments under the heading “a. The Starting Point -- Definition of Final Official Statement” where the Commission says “The definition [of Final Official Statement] does not set its own form and content requirements on the financial information and operating data to be included...

⁴ 15c2-12(b)(5)(i)(C)(8).

Instead it provides the flexibility that many commenters asserted is necessary in determining the content and scope of the disclosed financial information and operating data, given the diversity among types of issuers, types of issues, and sources of repayment. The fact that the amendments rely on the final official statement to set the standard for ongoing disclosure ..."

Here's the trouble: after amendment of the Rule as proposed, when a Participating Underwriter checks the continuing disclosure agreement for a VRDO, what annual financial information should the continuing disclosure agreement provide? As pointed out above, the definition of annual financial information in paragraph (f)(9) directly references the final official statement. But what final official statement? Under Rule 15c2-12, final official statements are generated by paragraph (b)(3), from which VRDOs are exempt. The sensible answer to this question is the same answer arrived at and adopted by the Commission in 1994, namely deferring to the wisdom of what the working group considers to be material in their assessment of the antifraud provisions as they prepare the offering document or final official statement used at the time of issuance of the VRDOs. This can be fixed by a footnote.

Exchange Act § 3(f) Analysis. As the proposal points out under "VII. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation," Exchange Act § 3(f) "requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation." § 23(a)(2) of the Exchange Act also requires that the Commission consider the impact proposed rules would have on competition and "prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act." The discussion and statistics under this heading, as well as the discussion under the headings "V. Paperwork Reduction Act" and "VI. Costs and Benefits of Proposed Amendment to Rule 15c2-12" may have the ring of bureaucratic tedium, but are worth reading as they reflect the Commission's statement for the record of the effects of, and rationale and support for its proposed rulemaking under these statutory tests.

The statistics raise provocative questions. For example, the Commission believes the time required to for an issuer to prepare and submit an annual filing to the MSRB in an electronic format would require approximately 45 minutes.⁵ The time required for an issuer to prepare and submit an event notice is likewise estimated at 45 minutes.⁶ The cost to an Issuer of preparation and submission of an event notice is approximately \$47.⁷ What is and is not included in such time and cost estimates is worthy of consideration. The Commission has previously held issuers and issuer officials responsible for misleading disclosure that violates the antifraud provisions, as illustrated long ago by the Orange County and Miami cases. Do the estimates reflect purely the ministerial effort of making a filing and exclude the time for preparation and review necessary to avoid liability for violation of the antifraud provisions enforced by the Commission or do the estimates take it into account? If the statistics exclude the time for preparation and review necessary to avoid antifraud liability, do they accurately reflect the cost and economic burden placed upon issuers? If they include such time, do they create a benchmark measure of the level

⁵ See the Proposed Amendments at footnote 170.

⁶ Id, at footnote 174.

⁷ Id, at footnote 262.

of care necessary in order to avoid negligent conduct in the preparation of such disclosures? Can the Commission have it both ways? As stated at the beginning of this paragraph, these are provocative questions.

MSRB

The MSRB launched three proposals affecting municipal securities dealers.

First, the MSRB submitted to the SEC proposed mandatory additions to the information submitted on form G-32 by municipal dealers to and voluntary submission to EMMA by issuers of “preliminary official statements and other related pre-sale documents, official statements and advance refunding documents (“primary market documents”), as well as information relating to the preparation and submission of audited financial statements and/or annual financial information and hyperlinks to other disclosure information available from the issuer’s website.”⁸

Second, the MSRB proposed for comment amendments to Rule G-34(c), under which municipal dealers would be required to submit: (1) certain documents to EMMA in addition to the information currently collected and publicly disseminated that define auction procedures and interest rate setting mechanisms for ARS and liquidity facilities for VRDOs, (2) ARS bidding information, and (3) additional VRDO information to the SHORT System. This proposal for comment precedes by one step a filing of a proposed rule change with the SEC in the administrative rulemaking process.⁹

Third, the MSRB also filed with the SEC an interpretation of existing regulations on “disclosure and other sales practice obligations of brokers, dealers and municipal securities dealers to individual and other retail investors in municipal securities,” under MSRB Rules G-17, G-18, G-19, and G-30 (the “Interpretation”), by its nature effective upon filing.¹⁰

The Interpretation is worth reading carefully, as it contains numerous statements of the Board’s views on disclosure obligations of municipal securities dealers. Here are ten of them:

- The Interpretation describes MSRB Rule G-17 as “the core of the MSRB’s investor protection rules” and “requires a dealer effecting a municipal securities transaction to

⁸ MSRB Notice 2009-44 (July 15, 2009), MSRB Files Proposals to Provide for Additional Primary Market and Continuing Disclosure Information to be Made Available Through the MSRB’s Electronic Municipal Market Access System (“EMMA”). Available at: www.msrb.org/msrb1/whatsnew/2009-44.asp. The SEC has separately posted the proposals for comment under SR-MSRB-2009-09, available at: www.sec.gov/rules/sro/msrb/2009/34-60314.pdf, and SR-MSRB-2009-10, available at: www.sec.gov/rules/sro/msrb/2009/34-60315.pdf

⁹ MSRB Notice 2009-43 (July 14, 2009) Request for Comment on Additional Increases in Transparency of Municipal Auction Rate Securities and Variable Rate Demand Obligations. Available at: www.msrb.org/msrb1/whatsnew/2009-43.asp

¹⁰ MSRB Notice 2009-42 (Jul. 14, 2009), posted for comment by the SEC on July 21, 2009 at: www.sec.gov/rules/sro/msrb/2009/34-60359.pdf and text available at: www.msrb.org/msrb1/whatsnew/2009-42.asp.

disclose to its customer all material information about the transaction known by the dealer, as well as material information about the security that is reasonably accessible to the market,” including information available from established industry sources.

- Disclosure under G-17 is to be provided to the investor “at the time of trade.”
- The Interpretation states the “disclosure duty applies to any municipal securities transaction, regardless of whether the dealer is acting as a so-called “order-taker” (as when the trade is “unsolicited”), whether the transaction is recommended, or whether the transaction is a primary or secondary market trade.”
- A municipal dealer’s disclosure duty extends to “material information they know about the securities even if such information is not then available from established industry sources.”
- The MSRB states: “it is essential that dealers establish procedures reasonably designed to ensure that information known to the dealer is communicated internally or otherwise made available to relevant personnel in a manner reasonably designed to ensure compliance with this disclosure obligation.”
- On VRDO’s the Interpretation states: “The role of the remarketing agent also may be material to investors. If the remarketing agent for a VRDO has customarily or from time-to-time taken tendered bonds into inventory to make it unnecessary to draw on the liquidity facility for unremarketed bonds (thereby in effect providing liquidity support), the fact that the remarketing agent is not contractually obligated to maintain such practice will generally be material information required to be disclosed to customers to which VRDOs are sold.”
- The Interpretation also states: “the following information will generally be material information required to be disclosed to investors in credit/liquidity enhanced securities, including but not limited to VRDOs, if known to the dealer or if reasonably available from established industry sources: (i) the credit rating of the issue or lack thereof; (ii) the underlying credit rating or lack thereof, (iii) the identity of any credit enhancer or liquidity provider; and (iv) the credit rating of the credit provider and liquidity provider, including potential rating actions (*e.g.*, downgrade). Additionally, material terms of the credit facility or liquidity facility should be disclosed (*e.g.*, any circumstances under which an SBPA would terminate without a mandatory tender). This list is not exhaustive. Other information may also be material to investors in credit/liquidity enhanced securities.”
- The suitability determination under MSRB Rule G-17 “requires a meaningful analysis” and such determinations “are required regardless of the apparent safety of a particular security or issuer or the apparent wealth or sophistication of a particular investor.”
- Pointing to the systems and procedures requirement of Rule 15c2-12(c), the Interpretation states municipal dealers “would be expected to have reviewed any applicable continuing

disclosures made available through EMMA or other established industry sources and to have taken such disclosures into account in undertaking its suitability determination.”

- MSRB Rule G-30 requires “the aggregate transaction price to the customer must be fair and reasonable, taking into consideration all relevant factors;” in determining fair and reasonable, “among other things, dealers would be expected to have reviewed any applicable continuing disclosures made available through EMMA or other established industry sources and to have taken such disclosures into account.”

The Courts

The Court of Appeals for the District of Columbia has been tough on Commission rulemaking in recent years.¹¹ That pattern continued this summer in an opinion that is well worth reading dated July 21, 2009, *American Equity Investment Life Insurance Company, et al v. Securities and Exchange Commission*, (No. 09-1021) in which the Court of Appeals remanded rulemaking with respect to Rule 151A to the Commission “to address the deficiencies with its § 2(b) analysis.” § 2(b) of the Securities Act of 1933, similar to § 3(f) of the Exchange Act discussed above, provides: “Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” The court reviewed the Commission’s analysis under § 706 of the Administrative Procedure Act, which “requires the court to set aside agency action that is ‘arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law’” and in tough language held “the Commission’s consideration of the effect of Rule 141A on efficiency, competition, and capital formation was arbitrary and capricious.”

Paul S. Maco
Washington D.C.
September 18, 2009

¹¹ See *Chamber of Commerce v. SEC*, 412 F. 3d 133 (D.C. Cir. 2005), holding the Commission violated the Administrative Procedure Act by failing adequately to consider the costs mutual funds would incur in order to comply with the conditions imposed in rulemaking under the Investment Company Act of 1940 and by failing adequately to consider a proposed alternative to one of the conditions, and remanding to address deficiencies in the rulemaking.

Municipal Law

State Law Perspective on Public Private Partnerships for Transportation Projects

Lesly Murray and Elizabeth Thomas

Public-Private Partnerships, P3, PPP. No matter the name or acronym used, this funding mechanism is a method of increasing the availability and sources of funds needed for transportation projects throughout the country. Moreover, while the United States Department of Transportation is promoting P3s as a means for transportation agencies to supplement public funding of infrastructure and reducing traffic congestion, there are many federal and state legal requirements, as well as public policy concerns, to be considered by public agencies in using P3s to deliver projects. This article focuses only on a few state law requirements common to many states.

A. Lack of State Legislation

Currently, only 23 states¹ have legislation authorizing various forms of P3 arrangements, which are in addition to design-build authority given for contracting for transportation projects. A number of states, such as New York, Michigan and Massachusetts, do not have any such authority. For the states that have adopted legislation there is no uniformity and the legislation varies widely.

Some states' legislation is project specific², while others impose restrictions on the ability to engage in P3 arrangements, such as containment to certain geographic areas.³ Other states' legislation only applies to a limited number of "pilot" projects, such as Arizona's legislation that authorizes programs involving up to two solicited and two unsolicited proposals.⁴ There are only a few states, such as Virginia⁵ that have very comprehensive legislation for P3 projects.

The state legislative authority usually will restrict which governmental entities may enter into a contract for a P3 project. Most states delegate the authority to the state department of transportation or to a turnpike or toll road authority and not to any other type of governmental entity.⁶ The restriction on which governmental entity may enter into a P3 contract usually takes this financing method out of the hands of local governments, who then may have to tackle and handle congestion and traffic problems using only limited public resources. Even when local governments are given the ability to use P3 arrangements, the state department of transportation must still be involved in reviewing proposals and awarding any such contract.⁷

¹ See http://apta.com/about/committees/public_private/documents/legis_model.pdf for a map of the United States and territories with P3 legislation.

² See ALASKA STAT. §§ 1905, *et seq.*

³ See N.C. GEN. STAT. §§ 136-89.180 to 136.89.197.

⁴ ARIZ. REV. STAT. §§ 28-7701 to 28-7758.

⁵ Public-Private Transportation Act of 1995, VA. CODE ANN. §56.566-575 (1995).

⁶ For example, see Tenn. CODE ANN. §§ 54-3-101 to 54-3-133.

⁷ See MISS. CODE ANN. § 65-43-3.

B. Other Restrictions on Use of P3 Structures

There are numerous other restrictions on the use of P3 structures, such as only allowing tolling of new roads and bridges, providing that tolls must be rescinded once project debt is paid and providing a maximum term with respect to the contract. Tolling of only new transportation projects is more amenable to the public, as the project became a reality only through the use of tolling and the P3 structure. The new transportation project is delivered and the relief of traffic congestion is accomplished. However, this “new transportation project” restriction can present financial feasibility issues as well as many practical hurdles. Can the new transportation project be built in phases, with phases coming on line and subject to tolling at different periods? Can a lane be added to the “new transportation project” after it is open to traffic and subject to tolls? Can a “new lane” be added to an existing road, with only this “new addition” being tolled? If the answer to any of these questions is no, then the ability of using the P3 structure to supplement funding and reduce traffic congestion is hampered.⁸

The P3 legislative authority in several states requires the removal of tolls *after* the complete repayment and retirement of all project debt.⁹ While this approach no doubt is popular with the users of any tolled road, it limits an otherwise viable funding source for the state transportation agency. If tolling is allowed to continue after the repayment of the project debt, this toll revenue could be used by the state transportation agency for maintenance on the toll road, maintenance on other non-toll roads, or for general use by the state transportation agency to fulfill their statutory purposes.¹⁰

The term or length of the P3 contract also is another restriction that can hamper the use of P3 structures and varies among the states.¹¹ It is generally believed that in order for a P3 structure to be viable it must contain at least a 50-year term, and some states allow 75 years or as long as 99 years. While 50 years is a substantial length of time, it may not be long enough depending upon when the term begins. If the term begins when the P3 contract is executed, the 50-year term is reduced by the construction period. During the construction period, no tolls are being collected and thus the private operator’s time to collect such revenues is reduced, which effectively shortens the tolling period to less than the term allowed by the state legislation.

C. State Law Procurement Issues

Many state transportation agencies do not engage in performance-based procurements and instead award based on “lowest responsive price.” Additionally, P3 procurements should

⁸ See Diana Burbules, *Tx. DOT Considers Hwy 6 Toll Roads*, THE BATTALION, Sept. 12, 2006, available at <http://media.www.thebatt.com/media/storage/paper657/news/2006/09/12/News/College.Stations.Txdot.Consider.Hwy.6.Toll.Roads-2267292.shtml?sourcedomain=www.thebatt.com?MIHHost=media.colelgepublisehr.com>.

⁹ See Footnote 3.

¹⁰ See Florida Turnpike Enterprise, FLA. STAT. ANN. §§338.22 to 338.251. The Florida Turnpike Enterprise does not contain such restriction and tolls have been used by Florida Department of Transportation to deliver additional highway projects.

¹¹ The Chicago Skyway P3 is for an operation and maintenance term for 99 years, while the Florida Turnpike’s restriction is for 50 years, with the ability of the Florida Secretary of Transportation to increase it to 75 years.

offer bidders an opportunity to bid on a uniform bid package so as to promote transparency and fairness. This approach, however, does not allow for the consideration of other factors, such as assumption of risk or other public policy considerations, which are important in a performance-based competition. The United States Department of Transportation has model legislation¹² that attempts to cure this potential impediment by providing procurement provision samples for states to consider when adopting P3 legislation or amending their current P3 legislation. The model legislation provides for sealed bidding, selection of proposals (with or without negotiation) based on qualifications, best value or both or any competitive selection process deemed appropriate or reasonable.¹³ Additionally, there is a list of factors that may be used in the evaluation process, which include general reputation, qualifications, industry experience and financial capacity of the private entity; proposed design, operation and feasibility of the project; the ability of the proposal to improve safety, reduce congestion and increase capacity; and the benefits to the public.¹⁴

Because of the complex nature and performance-based method of approval of P3 procurements, the model legislation exempts the P3 project from a state's existing procurement legislation. It is important, however, that the legislation adopted by any state not be perceived as unfair, lack transparency or cause uncertainty in the process. As such, a state's legislation may provide for when and in what instances a state's current procurement legislation applies.

D. Confidentiality of Proposals

Another state law issue relating to P3 procurements is the confidentiality of any proposals or other bid and negotiation materials. Here the interest of transparency should be balanced with the interest of protecting the bidder's trade secrets or other proprietary information. Most states have open records or freedom of information acts that govern the release of procurement information to the public, unless such information falls within an exemption to such publication. Generally, there are exemptions for trade secrets, balance sheets, financial information and other commercially sensitive information that private entities may or are required to submit as part of the P3 procurement process. Confidentiality is important during negotiations and this is particularly true where the negotiation is between a public entity and a private party. As such, a state's legislation authorizing P3 projects should take this into account in the procurement process. It is also important that all of the participants in a P3 process understand and appreciate the applicability of a state's open records act, and the confidentiality expectations of the various participants.

E. State Taxation

There are state property tax implications of a long-term lease or other contract arrangements that gives the private party possession, use and control over the transportation facility. Generally, such leases and other arrangements are exempt from state and local property taxes when owned and controlled by a public entity. However, the conveyance of the possession, use and/or control over the transportation may cause such exemption not to be

¹² USDOT Model Legislation available at http://www.apta.com/about/committees/public_private/documents/legis_model.pdf.

¹³ See Footnote 12.

¹⁴ See Footnote 12.

