



The Essentials

# Avoiding Private Activity (Basic)

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## Common Private Activity Questions...With Answers\*!



\*Quite probably leading to more questions

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### What are the private activity tests?

- General 2-Prong Test
  - Private Use. More than 10% (or 5% if unrelated/disproportionate) of bond proceeds are to be used in the trade or business of a person other than a state or local government unit

**AND**

- Private Security/Payments. The payment of the principal of, or the interest on, more than 10% (or 5% if unrelated/disproportionate) of the proceeds of a bond issue is (A) secured by an interest in property used or to be used for a private business use or payments in respect of such property or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use

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### What are the private activity tests?

- \$15 Million Limitation on "nonqualified" amount unless the issuer allocates volume cap to the excess.
- Private Loan Financing. More than the lesser of 5% or \$5M of the bond proceeds are used to make or finance loans to a person other than a state or local government unit.

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### Who are private business users?

- **Private business users include all of the following:**
  - Corporations, partnerships or any other entity engaged in business
  - Exempt organizations (but I.R.C. § 145 permits Private Activity Bonds for 501(c)(3) orgs for facilities used in their exempt purposes)
  - Federal government and federal government agencies
  - Natural persons engaged in a trade or business
- **Special rule for partnerships between governments and nongovernmental persons**

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### What types of arrangements create private use?

**Defined in 1.141-3(b) of the Regulations:**

- Private ownership of the financed facility
- Lease of the facility to a private business user
- Nonqualified management contract (Rev. Proc. 2017-13)
- Nonqualified "output contract"
- Nonqualified research contract (Rev. Proc. 2007-47)
- Joint Ventures
- Any other comparable "special legal entitlement"
- Special economic benefit (in some cases)

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**If an issuer rents out facilities to private users is there a need to worry?**

There are “short term use” exceptions for:

- Arrangements for fewer than 200 days of use, if available to general public on the same basis (e.g., parking permits) for generally applicable and uniformly applied rates
- Arrangements for up to 50 days of use, if negotiated at arm’s-length for FMV rate and not financed specifically for that user (e.g., performing arts center rental)
- Arrangements for up to 100 days of use, even if not qualifying as general public use, if the facility is not available to natural persons and was not financed specifically for that user (e.g., prison)

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**Does having outside help to manage a facility create a private business use problem?**

Contract is “qualified” if it meets certain requirements:

- Eligible expense reimbursement
- Financial requirements
  - Reasonable compensation
  - No net profits
  - No bearing of net losses
- Term no greater than the lesser of 30 years or 80% of weighted average reasonably expected economic life
- Qualified user exercises significant control
- Qualified user bears risk of loss
- No inconsistent tax position
- No circumstances substantially limiting exercise of rights

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**If there is nonqualifying management contract that covers an entire facility, are any related bonds taxable?**

Relax and remember:

- Measured on an issue-by-issue, not facility-by-facility basis.
- The measurement is of average annual use over the life of the issue, so excessive use in one year may be balanced out by low use in another year.
- It’s not just private use that matters – also have to meet the private payments test.

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**An issuer would like name a performing arts facility after a company in exchange for money – any issues?**

- Not all naming rights are problematic
- When coupled with conditions regarding display of name, IRS concluded that a naming rights contract would give rise to private business use (PLR 200323006)
- IRS has applied a measurement approach that compares the fair market value of the naming rights contract to the fair market value of the bond-financed facility.
  - FMV of use may equal payments made for naming rights
  - IRS has suggest FMV of facility may be measured by:
    - Revenues generated by the facility during its reasonably expected economic life
    - Cost of constructing the facility

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**If tax revenues are used to pay debt service on the bonds, can payments from private parties be ignored?**

- **Payments from “underlying arrangements” are indirect private payments and must be taken into account.**
- **There are certain measuring rules that soften the impact**
  - Private Payments are measured on a present value basis
  - Private Payments not taken into account to the extent that they:
    - Exceed the present value of the debt service on those proceeds
    - Are allocable to the FMV of other property
    - May be offset by operating expenses (but not general overhead)

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**How do tax assessments fit into the private business analysis?**

- **Special assessments imposed are not generally applicable taxes of the limited scope of application**
- **Section 1.141-5(d)(3)-(5) provides for a “tax assessment loan” exception to the private loan test:**
  - Mandatory
    - Enforced contribution imposed under a state law of general application
    - Applied equally to natural persons and entities in trade or business
  - Essential Governmental Function
  - “Equal Basis”
    - Terms of payment must be the same for all persons
    - Guarantees of collections by a “borrower” violates “equal basis” requirement if there is a reasonable expectation that payments will be made under guarantee

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**If the bonds are refunded, does the issuer get a “do over” and start measuring private activity fresh?**

- **General rule**
  - Look at the average use over the life of the facility (or life of the bonds, if shorter)
- **Special rules for refunding bonds**
  - Combined Treatment
    - Measurement period spans the life of both the prior and refunding bonds
    - Blended yield for purposes of private payment/security test
  - Separate Treatment
    - Can start over only if prior issue complies with private business use limitation

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**Thanks to written post-issuance compliance procedures, some excess private business use was discovered. What can be done?**

- Reallocation (within 18 month limit)
- Contract renegotiation
- Remedial action
  - Prerequisites include, but are not limited to:
    - No reasonable expectation at closing that would meet private activity tests
    - Receipt of FMV consideration and treatment of disposition proceeds as gross proceeds
  - Options for remedial action generally include:
    - Redemption or defeasance of nonqualified bonds
    - Alternative use of disposition proceeds
    - Alternative use of facility
- Voluntary Closing Agreement Program (Notice 2008-31 and I.R.M. 7.2.3)

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