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Committee on General Tax Matters Comments on Final Regulations on the Private Activity Bond Tests Applicable to Tax-Exempt Bonds

Editor's Note: The following comments were submitted to the Internal Revenue Service on August 1, 1997, by the Committee on General Tax Matters on behalf of the Association. Perry E. Israel, Carol L. Lew, Jeremy A. Spector, and Committee Chair John J. Cross III were principally responsible for their preparation. Other contributors included Jeannette M. Bond, Walter R. Calvert, William H. Conner, Daniel C. Waugh, Howard J. Eichenbaum, Lucy A. Emison, Robert G. Goldman, Brenda S. Horn, Scott R. Lilienthal, Mitchell H. Rapaport, Sharon Stanton White, Milton S. Wakschlag, and Dean M. Weiner. The Committee complimented the IRS on the regulations, saying that "they significantly advance the state of the law in many respects with analytically sound and workable standards," but urged the Service "to provide needed technical amendments and certain substantive changes ... in a timely manner as part of your priority guidance project or the currently-reserved portions of these regulations."

General Introduction

This report contains comments prepared by members of the General Tax Matters Committee (the "Committee") of the National Association of Bond Lawyers ("NABL") on the final Treasury Regulations on the private activity bond tests applicable to tax-exempt bonds which were promulgated under T.D. 8712 and published in the Federal Register on January 16, 1997 (the "Final PAB Regulations"). These regulations made final, with amendments, parts of the December 1994 proposed private activity bond regulations ("Proposed PAB Regulations"). Unless noted, section references are to the Internal Revenue Code of 1986 and the Final PAB Regulations.[1]

NABL was incorporated as an Illinois nonprofit corporation on February 5, 1979 for the purposes of educating its members and others in the law relating to state and municipal bonds and other obligations and participating in national and local forums in order to advise and comment on legislative, regulatory, and judicial issues affecting said bonds and obligations. NABL currently has over 2,900 members.

First, we want to compliment Treasury and the IRS on the Final PAB Regulations. As a general matter, the Final PAB Regulations significantly advance the state of the law in a number of respects with analytically sound and workable standards. These comments focus mainly on technical issues and areas of ambiguity identified to date by various NABL members. In addition, we raise several substantive issues.

These comments do not purport to be comprehensive, but we hope they will be constructive. We expect that other issues may arise as bond counsel and issuers gain experience with applying the Final PAB Regulations in practice and we may make additional comments in the future to address any such issues.

Given that the Final PAB Regulations represent the first comprehensive final regulatory project on the private activity bond tests in over 20 years and that they were substantially re-written between the proposed and final versions without further opportunity for public comment, we urge you to provide needed technical clarifications and amendments to the Final PAB Regulations in a timely manner as part of or in conjunction with the anticipated priority guidance project on the currently-reserved portions of the Final PAB Regulations.

I. 1.141-1: Definitions and rules of general application.

A. '1.141-1(b): Amend public utility property definition to clarify that rate regulation is unnecessary.

1. Comment.

Section 1.141-1(b) defines "public utility property" by reference to the definition in '168(i)(10) of the Code.

Prop. Treas. Reg. '1.168-3(c)(10)(i) proposes to interpret the scope of the Code definition of public utility property under '168(i)(10) to property of a public utility that is "regulated." Prop. Treas. Reg. '1.168-3(c)(10)(i) further provides in relevant part, as follows:

"A taxpayer's rates are "regulated" if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where the taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not regulated' if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, insuring adequate security for loans, or charging reasonable' rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods or services. Rates are considered to be established or approved if a schedule of rates is filed with a regulatory body that has the power to approve such rates, even though the regulatory body takes no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer."

The IRS also has taken a similar position in certain private letter rulings. See, e.g., PLR 8624005.

The use of the '168(i)(10) definition of public utility property in the Final PAB Regulations appears mainly to provide a convenient list of types of public utility facilities. The potential incorporation of rate regulation, however, seems unintended but in any event is wholly inappropriate. Frequently, rates set by a State or local governmental utility are set on a cost plus debt service basis or some other basis. It is extremely rare for municipal utilities to set rates to include any kind of profit. In addition, given the range of state deregulation initiatives for different types of public utility facilities, particularly different approaches to electric generation, transmission, and distribution facilities, any linkage of the definition of public utility facility to any regulation could lead to inappropriately disparate results.

From a tax policy standpoint, the provisions in the Final PAB Regulations which employ the term "public utility property" focus on types of facilities which warrant longer-term private management contractual arrangements, presumably in recognition of the need for longer-term operating arrangements for these types of utilities. To take one example, in the case of jointly-owned nuclear power plants, it is common for one of the joint owners to manage the plant under a "life-of-the-plant" operating arrangement.

Specific affected provisions include '1.141-3(b)(4)(iii)(C) (long-term expense-sharing operating arrangements for public utility property), and Rev. Proc. 97-13's 20-year management contract safe harbors for public utility property with certain 80% or 95% fixed fee management contracts. In short, a governmental public utility ought not be required to be subject to regulation, much less rate regulation, in a rapidly-deregulating environment, in order to employ these longer-term management contract arrangements for public utility property under the Final PAB Regulations and Rev. Proc. 97-13. We also suggest that the regulations incorporate flexibility to add to the list of "public utilities."

2. Recommendation.

We recommend that the definition of public utility property under the Final PAB Regulations and Rev. Proc. 97-13 be amended to remove any regulation requirement. We specifically recommend that public utility property be defined without reference to '168 or any attendant regulation, as follows:

"Public utility property" means property used predominantly in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, (3) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), (4) transportation of gas or steam by pipeline, or (4) such other facilities as may be specified by revenue ruling or revenue procedure."

B. '1.141-1(b): clarify that governmental persons include "on-behalf-of" entities.

1. Comment.

Without explanation, the Final PAB Regulations deleted from the definition of "governmental person" entities which act "on behalf of" governmental units. The Proposed PAB Regulations had included such on-behalf-of entities in the definition of governmental persons. Section 1.141-3(d)(1) of the Final PAB Regulations appears to treat certain nongovernmental on-behalf-of entities as agents of governmental persons, based on the second sentence which states that "[f]or example, use by a nongovernmental person that issues obligations on behalf of a governmental person is not private business use to the extent the nongovernmental person's use of proceeds is in its capacity as an agent of the governmental person." Although we presume that no substantive change was intended, we believe that it should be clarified that no change was intended in the longstanding body of law on eligible tax-exempt bond issuers that act on behalf of governmental units, including, without limitation, governmentally constituted authorities who issue on behalf of governmental units under Treas. Reg. '1.103-1(b) and nonprofit corporations that issue on behalf of governmental units under Rev. Rul. 63-20, Rev. Rul. 57-128, and their progeny.

2. Recommendation.

Subject to our comment in the next paragraph, we generally recommend that the first sentence in the definition of governmental person in '1.141-1

(b) be amended to add back at the end of that sentence the following phrase which referenced on-behalf-of entities as it appeared in the Proposed PAB Regulations:

> "or any entity issuing obligations on behalf thereof"

If the intent of the change in approach was to test Rev. Rul. 63-20 issuers for their use activities (as contrasted with their issuing activities), under the principles of Section 145, it would seem appropriate to leave that narrow consideration for analysis under the agency principles of '1.141-3(d)(1). This limitation, however, would not make sense to apply to "on-behalf-of" corporations described in Rev. Rul. 57-128, which need not be 501(c)(3) organizations.

II. '1.141-2: Private activity bond tests.

A. '1.141-2(a): narrow the statement of purposes.

1. Comment.

While we recognize the need for broad statements of regulatory purposes, we believe that the statement of purposes under '1.141-2(a) is overly broad and inaccurate. This provision fails to recognize statutorily-permitted governmental financing arrangements (e.g., permissible private benefit when the general public use exception is met) or the narrowing effect of the private payment or security test (e.g., clearly permissible grants to private businesses when there are no private payments). A more narrow and accurate statement of purpose is needed. In a similarly broad provision, '1.148-10(a) of the arbitrage regulations contains a statement acknowledging permitted financing arrangements.

2. Recommendation.

We recommend that the second and third sentences of '1.141-2(a) be amended to read as follows:

> "The general purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finances the activities of nongovernmental persons or transfers benefits to nongovernmental persons, directly or indirectly, in circumstances that are inconsistent with governmental bond financing because they meet either (i) the two-part private business use test and private payment or security test, or (ii) the private loan test, in each case based on the standards set forth in section 141 and ''1.141-1 through 1.141-16 and after taking into account financing arrangements expressly permitted for governmental bonds thereunder."

B. ''1.141-2(d)(2)(ii) and 1.141-12(a)(1): address gap situation in which issuer has no specific reasonable expectations.

1. Comment.

In the current climate of governmental privatizations and 501(c)(3) hospital

dispositions to for-profit companies, an issuer may be unable in good faith to reach a specific reasonable expectation on the issue date that it will be able to maintain its governmental bond status throughout the term of a bond issue or that it will take some future deliberate action to cause the private activity bond tests to be met. '1.141-2(d)(2)(ii) (on special redemption provisions for future expected private activity bond status) and '1.141-12(a)(1) (on conditions to all change-of-use remedies) fail to cover this gap situation. As a result, in this situation, the issuer would appear to be ineligible technically to rely on the reasonable expectations test as of closing, the reasonable expectations test under the remedial action rule, or the reasonable expectations required for the mandatory redemption exception. There would appear to be no sound tax policy reason to preclude such an issuer with uncertain expectations from using the special mandatory redemption rule to the same extent as an issuer who specifically expects to meet the private activity bond tests at some point.

2. Recommendation.

We recommend that '1.141-2(d)(2)(ii) be amended to begin, as follows:

"An action that, if reasonably expected, as of the issue date, to occur after the issue date, would cause either the private activity business tests or the private loan financing test to be met may be disregarded for purposes of those tests ifC"

In addition, we recommend that the last sentence of '1.141-12(a)(1) be amended to read, as follows:

"For this purpose, if the issuer takes a deliberate action prior to the final maturity date of the issue that would cause either the private business tests or the private loan financing test to be met, the term of the bonds may be determined by taking into account a redemption provision if the provisions of '1.141-2(d)(2)(ii)(A) through (C) are met."

We also recommend appropriate conforming changes, including a conforming change to '1.141-3(g)(2)(iii) and to '1.141-12(a)(1).

C. '1.141-2(d)(2)(ii)(A): provide a safe harbor for the "substantial period requirement."

1. Comment.

While we understand that unquantified standards can provide useful flexibility, we nonetheless believe that the important undefined term "substantial period" under '1.141-2(d)(2)(ii)(A) causes undue uncertainty. We believe a safe harbor describing what constitutes a "substantial period" for this purpose is needed. Two obvious interpretative analogies are the five-year standard that was used in Revenue Procedure 93-17 and the 10% of the measurement period standard under '1.141-3(g)(7). We believe that the standard based on 10% of the measurement period is more appropriate because it incorporates some consideration of the maturity structure or type of financing.

2. Recommendation.

We recommend that '1.141-2(d)(2)(ii)(A) be amended to add a second sentence, as follows:

"For this purpose, 10 percent of the measurement period (described in '1.141-3(g)(2)) generally is a substantial period."

D. '1.141-2(d)(3)(ii)B): extend regulatory safe harbor to state or local governmental regulatory directives.

1. Comment.

The safe harbor against deliberate actions for actions taken in response to federal regulatory directives is helpful. It recognizes that states and local governmental entities do not always control their own destinies. We believe that this underlying policy applies equally to actions taken in response to state or local governmental directives that are beyond an issuer's control. We recommend extending this safe harbor to cover these state or local governmental actions. We also note that the "in response to" language and the safe harbor nature of the rule for federal regulatory directives suggest the possibility of a broader definition of the term "deliberate." This will be particularly useful in circumstances in which an issuer has a legal choice over its actions but no practical choice.

2. Recommendation.

We recommend that '1.141-2(d)(3)(ii)(B) be amended to add the phrase "or other unrelated state or local governmental entities" immediately after the phrase "federal government" at the end of the sentence.

E. '1.141-2(d)(4)(i): delete "established" program constraint from special rule on ordinary course dispositions of personal property.

1. Comment.

This helpful exception to deliberate action for ordinary course dispositions of personal property requires that a disposition be part of an "established" governmental program. This exception favors existing governmental programs over new governmental programs for no good tax policy reason. In addition, the word "established" is vague.

2. Recommendation.

We recommend that '1.141-2(d)(4)(i) be amended to delete the word "established."

F. '1.141-2(d)(4): extend special rule on ordinary course dispositions of personal property to 501(c)(3) bonds.

1. Comment.

Sections 141 and 145 generally treat qualified 501(c)(3) bonds the same as governmental bonds for purposes of the private activity bond tests, with three main modifications. First, financed property must be owned by a 501

(c)(3) organization or a governmental unit. Second, any property used by the 501(c)(3) organization in activities related to its exempt activities counts as qualified use. Third, the 10% private business test thresholds are reduced to 5%. Except to give effect to these modifications, the private activity bond rules should treat qualified 501(c)(3) bonds the same as governmental bonds to the fullest extent possible absent a good tax policy reason to distinguish these bonds.

Like governmental entities, 501(c)(3) organizations commonly purchase and dispose of personal property in the ordinary course. It would appear to be equally appropriate to apply the rule contained in '1.141-2(d)(4) to 501(c)(3) organizations. The ownership requirement for qualified 501(c)(3) bonds ought not preclude extension of this special rule. This special rule is a case in which narrowly-prescribed dispositions of personal property do not override reasonable expectations. As such, it should apply to reasonable expectations for both private business use and 501(c)(3) organization ownership. In addition, this special rule can be viewed as a limited change-of-use remedial action (i.e., all sale proceeds must be expected to be used to purchase new equipment). In this regard, a parallel change-of-use remedy under '1.141-12(e) permits a 501(c)(3) organization to cure a change of use by applying disposition proceeds to qualifying 501(c)(3) organization exempt purposes.

2. Recommendation.

We recommend that '1.145-2(c)(1) be amended to delete the reference to '1.141-2(d)(4).

G. '1.141-2(d)(5): amend GO bond safe harbor to make it more useful.

1. Comment.

While we appreciate the intent behind the safe harbor for large general obligation bond programs, we believe that the number of eligibility conditions unduly limit its practical usefulness. We recommend several changes to try to make this safe harbor more useful.

First, given that the purpose of this safe harbor is to relieve ongoing administrative tracking burdens for large governmental program issuers, the verification test directly undermines that purpose. The verification test is a vague awkward hybrid between a reasonable expectations test and an actual facts test. The verification test should be deleted and reasonable expectations should be determined based on all the facts and circumstances.

Second, the requirement for financing "predominantly" not fewer than four separate purposes introduces a vague new standard and seems unnecessary.

Third, the 100% capital expenditures expectation seems unduly tight regarding the nature of the expenditure. It should be loosened modestly to cover related working capital expenditures under the de minimis rule under '1.148-6(d)(3)(ii) of the arbitrage regulations that are included in the arbitrage definition of "capital project" under '1.148-1(b).

Fourth, it is unrealistic for large governmental program issuers to establish

reasonable expectations to spend all the proceeds of one general obligation bond issue before issuing another such bond issue. Numerous perfectly valid reasons (e.g., interest rates) influence the timing of bond issues for large governmental program issuers.

Fifth, the requirement that no proceeds be used to make private loans is unnecessarily restrictive. Large general obligation issues are already greatly limited to $5 million in private loans. This requirement should be deleted, and, instead, issuers should be required to track loan proceeds for deliberate actions.

2. Recommendations.

- We recommend that '1.141-2(d)(5) be amended in several respects to address the indicated concerns, as follows:
- In paragraph (i), delete the phrase "and does not predominantly finance fewer than four separate purposes."
- In paragraph (iii), after the beginning language which reads "The issuer reasonably expects on the issue date to allocate all of the net proceeds of the issue to capital expenditures within 6 months of the issue date," delete the balance of that paragraph.
- Delete paragraphs (iv) and (v).
- In paragraph (vi), change the term "capital expenditures" to "capital projects (as defined in '1.148-1(b))."

III. '1.141-3: definition of private business use.

A. '1.141-3(a)(1): clarify certain basic points.

1. Comment.

On balance, we believe that the private business use test portion of the Final PAB Regulations provides a strong analytic framework. We think it would be helpful to clarify specifically a couple of basic points in the general introductory provision in '1.141-3(a)(1). The fourth sentence of this section, which comes directly from Code '141(b)(6)(B), reads "[A]ny activity carried on by a person other than a natural person is treated as a trade or business." Although that sentence may be technically accurate and we understand the intent, it has caused some confusion about the treatment of activities of both governmental persons and natural persons.

We recommend an express statement that a governmental person's use can never be private business use. We understand that one of the more confusing examples in the Final PAB Regulations under '1.141-4(g), Example 9, was aimed in part to illustrate the point that a governmental person's use of property is not private business use. A direct statement of this point would be clearer.

We further recommend a clarifying statement on the effect of a natural

person's conduct of trade or business activities (e.g., a sole proprietor's business). In addition, in subsection B of this Section of our comments below, we further recommend an express exception to clarify the scope of coverage of trade or business activities of a natural person.

2. Recommendation.

We recommend that '1.141-3(a)(1) be amended to replace the existing fourth sentence with the following:

"A governmental person's activity is not private business use. A nongovernmental person's (including a natural person's) conduct of a trade or business activity is treated as private business use to the extent and under the principles set forth in this section."

B. '1.141-3(b)(2); '1.141-3(b)(3); and '1.141-3(b)(7): clarify when ownership, leasing, and other arrangements by natural persons cause private business use.

1. Comment.

In several provisions, including ''1.141-3(b)(2), 1.141-3(b)(3), and 1.141-3 (b)(7), the Final PAB Regulations provide that ownership, leasing, or other arrangements by any nongovernmental person cause private business use. Literally, these provisions treat a natural person who owns, leases, or has other arrangements with respect to property as automatically engaged in private business use. However, ownership, leasing, or other arrangements with respect to property by a natural person only cause private business use if the natural person conducts a trade or business activity with respect to that property.

2. Recommendation.

We recommend that a new exception to private business use be added as paragraph (d)(7) in '1.141-3 (with appropriate conforming cross-references in paragraphs (b)(2), (b)(3), and (b)(7) of '1.141-3) to clarify the limitations on private business use by natural persons, as follows:

"(d)(7) Natural persons. In the case of a natural person, ownership of property, leasing of property, or other arrangements that convey special legal entitlements or special economic benefits to use of property are private business use by the natural person only if the natural person conducts a trade or business activity with respect to that property."

C. '1.141-3(c)(1): clarify that "use on the same basis by natural persons" applies to the system as a whole.

1. Comment.

In applying the general public use exception to private business use in circumstances involving financing of an extension of the infrastructure grid (e.g., extension of a sewer line from the general sewer system to a factory), it should be clarified that general public use is determined based on the system as a whole. This is a very important point.

2. Recommendation.

We recommend that a system improvement provision comparable to '1.141-3(e)(4) of the Proposed PAB Regulations be added, but without treating roads differently than other system improvements.

D. '1.141-3(c)(3): clarify that only long-term arrangements that would otherwise constitute private use violate the 180-day rule; change 180 days to six months.

1. Comment.

'1.141-3(c)(3) generally provides that an arrangement is not general public use if the term of the use under the arrangement is more than 180 days. Many governmental entities are required to provide services for extended periods on the same basis to all persons without regard to any priority use. For example, a municipal utility may be required under a contract with the Rural Economic and Development Program to provide services on a non-priority basis for the term of any loan from the Program. The term of such a requirement may exceed 180 days. Such an arrangement should not be disqualified by '1.141-3(c)(3) so long as there otherwise is no priority use or special rate arrangement.

The exception for long-term arrangements under the general public use test introduces unnecessary complexity by using a period of 180 days instead of six months. Most contracts of this type will run on a number of months basis and will run afoul of the common perception that six months is the same as 180 days. Thus, for example, a contract that runs from January 1 to June 30 will exceed the 180-day rule.

2. Recommendation.

We recommend that the introductory clause of '1.141-3(c)(3) be amended to read as follows:

"An arrangement that would otherwise be treated as private business use is not treated as general public use..."

We also recommend that "six months" replace "180 days" in the first sentence of '1.141-3(c)(3).

E. '1.141-3(f), Example 6: modify or delete fish ladder example.

1. Comment.

The fish ladder example continues to cause confusion about its analytic basis. Although members of the general public will not physically use the fish ladders, it appears that the benefit of the fish preservation scheme benefits the entire general public. In addition, the hydroelectric facility is not physically using the fish ladders to any greater extent than any members of the general public. So long as the hydroelectric facility operator receives no special benefits from the use of the fish ladder (such as keeping the fish out of the hydroelectric facility), the fish preservation facilities should be treated as used by the general public.

2. Recommendation.

We recommend that Example 6 under '1.141-3(f) be amended to provide that the fish preservation facilities are used by the general public. So long as the facilities are not owned by K, K should be considered to have no special legal entitlement to the fish preservation facilities, and the facilities should be treated as having no private business use. It may be useful to state that general public benefit alone is insufficient to overcome private business use when a private business owns the facilities. For example, toxic waste cleanup on land owned by a private business or the satisfaction of mitigation requirements by purchasing marshlands owned by a private business will still result in special legal entitlements because of the private ownership of those facilities even though their use may be restricted. In the alternative, given the confusion generated by this example, we believe that it safely could be deleted.

F. '1.141-3(f), Example 8,(iii): clarify or delete residual basis lease constraint in airport runway example.

1. Comment.

It is unclear why the residual basis lease gives rise to a special legal entitlement rather than a special economic benefit. Moreover, many, if not most, airport use agreements provide that fees are determined on a cost-center basis. For example, an airport may take into account all "airfield" side costs, subtract out expected revenues from other operations (such as fueling), to determine an expected "net cost" for the cost-center. Landing fees will then be set for all aircraft (commercial or noncommercial) based upon net costs divided by expected landing weights. If revenues exceed costs (as will often be the case, particularly when bond documents impose debt service coverage requirements), the excess revenues typically will be taken into account in adjusting the landing fees for all airplanes during the succeeding period. If the fees are adjusted by reducing the fees for the signatory airlines (often the case to encourage airlines to become signatory airlines), the reduction in fees should be treated explicitly as a bulk use discount rather than as "special legal entitlement," so long as the resultant fees for the signatory airlines are not discriminatory in violation of FAA regulations.

Moreover, on a residual basis lease arrangement, where excess net revenues are used to reduce lease payments in future years, another issue is whether those arrangements give rise to special legal entitlements even though the airlines may not be lessees in the future years. Absent unusual facts suggesting an ownership-like arrangement (such as that described in Example 8, (ii)), it would appear that the more appropriate conclusion generally should be to find no private business use of the runways. The mere reduction in rental costs for airlines alone should be insufficient to constitute a special legal entitlement unless the airline also has some sort of control over the airport, such as under a management contract.

2. Recommendation.

We recommend that Example 8 (iii) under '1.141-3(f)(7) be revised to conclude that, notwithstanding that the leases with the private air carriers are determined on a residual basis, the leases do not convey special legal

entitlements to the runway and therefore the private business use test is not met with respect to the runway.

G. '1.141-3(g)(2)(i): consider determining reasonably expected economic life from the viewpoint of the issuer.

1. Comment.

Under the measurement period provision, it would seem that, for purposes of determining the reasonably expected economic life of the property as of the issue date, economic life properly should be determined from the viewpoint of the issuer. Thus, if an issuer reasonably expects to use financed property having a ten-year safe harbor economic life under section 147 for a shorter period of only five years, the issuer should take into account the shorter reasonably expected life. Thus, once property has exceeded its expected economic life to the issuer, the issuer should be able to sell it at its then fair market value without giving rise to private business use. Conversely, if an issuer reasonably expects to use property for a period longer than the Section 147(b) safe harbors, the issuer should take that longer life into account. To protect against inconsistent results, consideration could be given to imposing a specific consistency requirement on economic life determinations for purposes of all the related tax-exempt bond provisions (e.g., the 120% test under '1.148-1(c)(4)(i)(B) and Section 147 (b) for 501(c)(3) bonds).

On the other hand, and as a caveat to this recommendation, some of our members are concerned that the recommended approach may introduce undue subjectivity into the economic life determination. Economic life safe harbors may be simpler to apply.

In any event, given the importance of the economic life determination to compliance, we believe that it would be helpful to clarify how to apply this economic life test.

2. Recommendation.

Subject to consideration of the referenced caveat, we recommend that the definition of Aweighted average reasonably expected economic life under '1.141-1(b) be amended to read as follows:

"Weighted average reasonably expected economic life or reasonably expected economic life is determined under section 147(b) based upon the expected economic life to the issuer or conduit borrower. The reasonably expected economic life of property may be determined by reference to the class life of the property under section 168. The economic lives used for purposes of section 141 shall be consistent with those used for other purposes of sections 141 through 150."

We further recommend that a consistent term be used and defined for purposes of the 10-year and 15-year term management contract safe harbors under Sections 5.03(1) and (2) of Rev. Proc. 97-13. Those safe harbors currently limit these contract terms by reference to 80% of the "reasonably expected useful lives of the financed property." We recommend that these safe harbors incorporate a consistent defined "average economic

life" concept in lieu of useful life.

H. '1.141-3(g)(4)(i) and (ii): re-consider disregard of periods in which a facility is not actively used.

1. Comment.

In the case of actual government use and private business use at different times, '1.141-3(g)(4)(ii) disregards periods in which a facility is not in use. This provision is somewhat unclear in that it fails to address whether a governmental person's ownership suffices to count as governmental use in the absence of any countervailing private business use. Example 2 under '1.141-3(g)(8) suggests that governmental ownership fails to count as governmental use in this context. However, this approach is inconsistent with the general rules on ownership and leasing under '1.141-3(b)(2) and (3). We believe that a better way to address the isolated concern raised by stadium financings would be to apply the existing provision under '1.141-3 (g)(4)((v) which considers the effect of private business use having a significantly greater fair market value than government use.

More generally, however, we believe that it is both harsh and administratively burdensome to disregard for private business use measurement purposes those periods in which a governmental person owns or leases a financed facility, but during which, for whatever reason, the facility remains vacant or not actively used. To take several sympathetic examples, a facility may remain vacant while undergoing environmental remediation, during a real estate recession, or as a result of technological or policy changes regarding optimum way to delivery governmental services. Given that a governmental person bears the economic benefits and burdens of these legal possessory interests during these periods, these interests properly should count as governmental use. Moreover, the disregard of periods of nonuse in this circumstance also increases administrative burdens of tracking private business use because it causes a more frequently changing denominator in the private business use percentages.

2. Recommendation.

We recommend that '1.141-3(g)(4)(ii) be amended to delete the word "actual" in the two places it appears in the first sentence of that section and to delete the second sentence of that section in its entirety.

I. '1.141-3(g)(8), Example (1): allocations of private business use based on costs contributed may be inappropriate in certain circumstances.

1. Comment.

It is unclear from the example why the amount of private business use is properly determined from the dollar amount of contribution to the facility. The implication is that if 100% of the facility were financed by the governmental issuer, no private business use would arise. That appears to be erroneous.

2. Recommendation.

We recommend that Example 1 under '1.141-3(g)(8) be clarified or deleted in conjunction with the issuance of mixed use allocation rules. One possible clarification would be to state that a governmental person will finance 90% and nongovernmental persons will finance 10% based upon their reasonable expectations as to the anticipated use of the facility. This seems a more correct result even though it may not be "reasonably practicable" to estimate the relative revenues expected to result from the various uses of the facility.

IV. Section 1.141-4: private security or payment test.

A. '1.141-4(b)(2)(ii)(A): modify exclusions from debt service.

1. Comment.

This provision excludes from the private security or payment test calculation those payments of debt service made or to be made from sale or investment proceeds of a bond issue. This exclusion reduces the amount of permitted private security or payments. This exclusion seems too broad in certain circumstances and may cause this test to get out of balance inappropriately.

2. Recommendation.

We recommend that '1.141-4(b)(2)(ii)(A) be amended to convert the exclusion test to a reasonable expectations test. Short of that, we recommend that this section expressly carve out of the excluded payments any unexpected use of proceeds to retire bonds and any use of proceeds (including specifically investment proceeds) held in a reasonably required reserve or replacement fund to pay debt service on the bonds.

B. '1.141-4(b)(2)(iv): clarify timing of first fair market value allocation of property as private security.

1. Comment.

For purposes of the private security test, '1.141-4(b)(2)(iv) imposes a mark-to-market requirement on property as of "the first date on which the property secures bonds of the issue." This provision contains no express provision to limit the timing of the mark-to-market allocation to take into account when property is first used for a private business use.

2. Recommendation.

We recommend that '1.141-4(b)(2)(iv) be amended to change the clause beginning after the comma to read as follows:

"the property is valued at fair market value as of the first date on which the property both secures the bonds and is used for a private business use."

C. ''1.141-4(c)(2)(i)(A), 1.141-4(d)(5), and 1.141-4(g), Example 11: clarify that private payments include only payments that directly or indirectly pay debt service.

1. Comment.

The various restatements of the private payment test under '1.141-4 have caused a fair amount of concern about the intended breadth of this test. Although helpful (albeit unofficial) public statements by Treasury and IRS officials have alleviated much of that concern, we believe that express clarification is needed on an important limitation on the private payment test. Specifically, it should be made clear that private payments properly include only those payments that, directly or indirectly, provide for payment of debt service on an issue or otherwise directly benefit the issuer. In short, the private payments test should capture underlying arrangements to pay debt service on an issue, but not more.

2. Recommendation.

We recommend that '1.141-4 be amended in several respects as follows:

- In the first sentence of '1.141-4(c)(2)(i)(A), insert the phrase "of debt service on the issue" immediately after the word "payments" the first time it appears.

- In the third sentence of '1.141-4(c)(2)(i)(A), insert the following phrase at the end of that sentence:
  "if made for a period of time that property is used for a private business use and debt service on the issue is directly or indirectly derived from such payments."

- In '1.141-4(c)(2)(i)(A), add the following sentence after the third sentence:

  "Generally, only payments made to the actual issuer or a related party (within the meaning of Section 1.150-1) are considered private payments for purposes of the private payment test."

- In '1.141-4(d)(5), insert the following phrase at the end of the sentence:

  "and debt service on the issue is directly or indirectly derived from such payments."

- In '1.141-4(g), Example 11(i), insert the following phrase at the end of the third sentence:

  "and debt service on the issue will not be directly or indirectly derived from payments made to X by members of the general public or others for the period of time the stadium is used by X."

D. ''1.141-4(c)(2)(i)(A) and 1.141-4(g), Example 9: clarify that payments by a governmental person are never private payments.

1. Comment.

Consistent with our earlier comment on the private business use test, we

recommend an express statement that payments by a governmental person are never private payments.

2. Recommendation.

We recommend that '1.141-4(c)(2)(i)(A) be amended to add a new sentence after the third sentence thereof as follows:

"Payments made by a governmental person are not private payments for purposes of the private payment test."

We further recommend that '1.141-4(g), Example 9, be deleted. We understand that, in large measure, the intent of this example was to illustrate the point that payments made by a governmental person are not private payments. Beyond that, however, this example seems to be technically confusing in various respects.

E. '1.141-4(g), Example 4: clarify example on moving utility lines underground.

1. Comment.

Example 4 under '1.141-4(g) illustrates a case in which a city issues tax assessment bonds to finance the cost of a project which consists of moving existing electric utility lines underground. This example appears intended to illustrate the point that whether or not financed property is used for private business use controls its status under the private payment test. Although the utility lines are privately owned, the key to this example appears to be that the financed project (i.e., the relocation of the lines) fails to be used for a private business use because it does not benefit the private utility company. Also, we understand that an unstated, but apparently important, factor in finding no private benefit was the absence of an obligation on the part of the private utility company to bear the cost of moving the utility lines underground.

2. Recommendation.

We recommend that '1.141-4(g), Example 4, be clarified to add the phrase "privately used" before "financed" in the title and to amend the second to last sentence to read as follows:

"Since the utility company is under no obligation to pay for moving the utility lines underground and receives no special economic benefit therefrom, the undergrounding does not give rise to private business use and the assessments for the undergrounding do not give rise to private payments."

F. '1.141-4(d)(2) and 1.141-4(g), Example 9: Private security, security taken into account.

1. Comment.

In certain jurisdictions, State law limits the issuance of debt secured by generally applicable taxes. As a result, certain issuers must structure financings in the form of leases or installment sale transactions to avoid these debt limits. The remedies in the event of a default under these leases

or installment sale transactions vary depending on the law of the jurisdiction and the nature of the facility financed. In certain jurisdictions, the remedy of a trustee upon a default with respect to the "leased" property is limited. For example, a trustee may have limited right of reentry to lease the property to a third party but may not foreclose. Repossession of public facilities (e.g., city hall) may be impractical. These financing leases and installment sales are typically payable from the issuer's general fund or a special revenue fund (e.g., water or sewer). We believe that an exception to the private security test is needed to accommodate these transactions structured as financing leases or installment sales solely to comply with state law debt limitations in circumstances in which the "security" provided by the financed property is limited (e.g., a limited right of reentry), and is economically insignificant.

2. Recommendation.

We recommend that '1.141-4(d)(2) be amended to add a new sentence at the end to read as follows:

"Financed property, however, is not considered private security if: (i) the security is provided by a governmental person as security for a financing lease, installment sale, or other equivalent transaction; (ii) the security is provided solely because of state law debt limitations; (iii) the security is limited to a right of reentry upon default or comparable right and is economically insignificant; and (iv) the financed facility serves an essential governmental function within the meaning of '1.141-5(d)(4))."

V. '1.141-5: private loan financing test.

A. '1.141-5(c)(1): private loan definition should coincide with general federal tax definition of a loan.

1. Comment.

The first sentence of '1.141-5(c)(1) appropriately adopts the general federal tax law definition of a loan as the applicable private loan standard. This general definition is a broad standard which clearly encompasses the concepts addressed in the balance of '1.141-5(c)(1) regarding substance over form and economic equivalence to a loan. We are concerned that certain aspects of this section could be read to expand the definition of loan for private loan purposes beyond the general federal tax definition of a loan. The new second sentence of this section suggests such an expansion, particularly in its lead-in phrase. This second sentence provides that A[i]n addition (emphasis added), a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed." More properly, the legislative history suggests that the reference to economic equivalence to a loan is an illustration of substance over form. See 1986 Tax Act Conference Report, at II-692, 1986-3 C.B., Volume 4 ("Thus, the determination of whether a loan is made depends on the substance of a transaction, as opposed to its form.") (emphasis added) We agree that substance over form should control the determination of a loan for private loan purposes. In this regard, we agree that avoidance of the private loan financing test ought not be permitted formalistically, such as through failure to specify a principal or interest component on an obligation.

In addition, the fourth sentence of '1.141-5(c)(1) converts into an example what the legislative history clearly intended to be an express limitation on the private loan definition consistent with the general federal tax definition of a loan. See 1986 Tax Act Conference Report, at II-692, 1986-3 C.B., Volume 4 ("However, a lease or other deferred payment arrangement with respect to bond-financed property that is not in form a loan of bond proceeds generally is not treated as such unless the arrangement transfers tax ownership to a nongovernmental person.") (emphasis added)

Accordingly, to assure a reasonably administrable standard which has much existing general federal tax law precedent and to most clearly implement the legislative history, we strongly suggest that generally a loan should only exist for purposes of Section 141 if the transaction constitutes a loan in economic substance for federal income tax purposes.

2. Recommendation.

We recommend that the second sentence of '1.141-5(c)(1) be amended to delete the introductory phrase "In addition,".

We further recommend that '1.141-5(c)(1) be amended to add a new sentence at the end of that section to read as follows:

"A loan will not exist, however, unless the arrangement transfers tax ownership of the bond-financed property to a person other than a governmental person."

B. '1.141-5(d)(3): modify required law of general application under tax assessment loan exception.

1. Comment.

Section 1.141-5(d)(3) provides in part that, for purposes of the tax assessment loan exception to private loans, a prescribed tax or assessment must be imposed pursuant to a "state law of general application." (emphasis added) We understand that this requirement is inconsistent with certain state enabling laws (e.g., Maryland). For example, an enabling law for a special improvements tax may be a state law, may be of general application within a particular local jurisdiction, and may provide for collection and administration of the tax pursuant to statewide procedures for real property taxes, but technically may fail to be of general application throughout the state. The legislative history suggests some recognition of state law variations. See 1986 Tax Act House Report, at 525, 1986-3 C.B., Volume 2 ("The committee understands that the method of assessing residents for these improvements varies from State to State."). In addition, the 1986 Tax Act Bluebook indicated that the relevant distinction was between "mandatory taxes or other assessments of general application" and "fees for services." See 1986 Tax Act Bluebook, at 1166-1167.

2. Recommendation.

We recommend that '1.141-5(d)(3) be amended to delete the word "state" from the third sentence thereof.

C. '1.141-5(d)(4): clarify "custom" concept under tax assessment loan exception.

1. Comment.

Section 1.141-5(d)(4) includes within covered essential governmental functions eligible for the tax assessment loan exception certain governmentally-owned utility system improvements and certain other facilities based on a standard under which a primary factor is the extent to which the service provided by the facility is customarily performed and financed with governmental bonds by governments with general taxing powers. The role of governments, technology, and facilities financed evolves over time. The definition of "essential governmental functions" should be sufficiently flexible to take evolving customs into account so that important essential services may continue to be provided by governments in a cost effective and efficient manner.

2. Recommendation.

We recommend that '1.141-5(d)(4)(ii) be amended to add the following sentence after the second sentence to read as follows:

"For purposes of determining essential governmental functions, the changing role of government, changes in technology, and the changing nature of facilities financed by governmental persons are taken into account in determining customs."

D. '1.141-5(d) and (e): consider providing a Mello-Roos example under tax assessment loan exception.

1. Comment.

Overall, it appears that Treasury and the IRS have been responsive to public concerns regarding the impact of certain provisions of the Proposed PAB Regulations on common tax assessment bond financing techniques, most notably so-called "Mello-Roos" financings in California. However, there continues to be some ambiguity in this area. It is unclear exactly what the requirement that a tax be imposed pursuant to a state law that "can be applied equally" to natural persons and private businesses means under '1.141-5(d)(3). It is also unclear exactly what the requirement that the terms of payment be the same under '1.141-5(d)(4) means.

2. Recommendation.

We recommend that '1.141-5(e) be amended to add a favorable example for a Mello-Roos financing. The facts should show that residential and commercial property are taxed at different rates and that some properties are exempt (in whole and in part) from taxation.

VI. '1.141-12: remedial actions.

A. Introduction.

Although the final change-of-use remedies include several more workable and notable

advances over existing principles, particularly in the area of reduced emphasis on unwieldy tender offers, nonetheless we believe it is fair to say that this area in the Final PAB Regulations continues to generate more comments from our members and more concerns from issuers than any other area of the Final PAB Regulations.

B. '1.141-12(a): permit combinations of remedies.

1. Comment.

An action that causes an issue to meet the private business tests or the private loan financing test is not treated as a deliberate action if the issuer takes a remedial action under paragraph (d), (e) or (f) of '1.141-12 with respect to nonqualified bonds if certain requirements are met. This provision appears on its face to only allow alternative remedial actions. There is no specific allowance of combined remedial actions. Thus, it is unclear whether the redemption or defeasance remedial action could be combined with the alternative use of disposition proceeds or alternative use of facility remedial actions. We believe that there is no sound tax policy reason to limit issuers from employing a combination of otherwise permitted change-of-use remedies.

2. Recommendation.

We recommend that '1.141-12(a) be amended to add the following sentence at the end of that section and that conforming changes be made to the individual change-of-use remedies:

"For this purpose, an issuer may employ any combination of the remedial actions otherwise permitted under paragraphs (d), (e), (f), and (h) of this section, provided that in the aggregate, the issuer takes remedial action for all the nonqualified bonds."

C. '1.141-12(a)(1): clarify consistent reasonable expectations test.

1. Comment.

Section 1.141-12(a)(1) provides that an issuer must have "reasonably expected" on the issue date that the bonds would be governmental use bonds for the entire term of the bonds. This provision could be read to add a reexamination requirement to the reasonable expectations test under '1.141-2(d) due to the phrasing of the reasonable expectations test in the past tense. If the reasonable expectations test was met on the date of issuance, it is unclear what this provision adds unless the Service intends that subsequent actions of the issuer be taken into account to determine whether the issuer's expectations on the issue date were reasonable. We believe that a single coordinated reasonable expectations test is the proper approach and that this reading should be made clear. In addition, to the extent that the remedial action rules apply to pre-May 16, 1997 bonds, this limitation may leave issuers without a remedial action. Since there was no corresponding provision under prior regulations, there is no assurance that every issuer had this expectation or that they stated this expectation. For these pre-effective date bonds, it should be sufficient if the issuer lacked an expectation to violate the private activity bond restrictions.

2. Recommendation.

To provide a consistent reasonable expectations test, we recommend that '1.141-12(a)(1) be amended to read as follows:

"(1) Reasonable expectations test met. The issuer satisfied the reasonable expectations test under '1.141-2(d). For this purpose, the term of the bonds may take into account a special mandatory redemption provision that satisfies the provisions of '1.141-2(d)(ii)."

D. '1.141-12(a)(5): modify all-proceeds-spent condition.

1. Comment.

Section 1.141-12(a)(5) appears to limit an issuer to the bond redemption or defeasance remedy if any bond proceeds remain unspent. This seems unduly harsh. Affected circumstances could include a case in which an issuer has unspent bond proceeds in a reasonably required reserve or replacement fund or has a modest amount of unspent bond proceeds in a construction fund.

2. Recommendation.

Consistent with our earlier recommendation to permit combinations of remedies, we recommend here that '1.141-12(a)(5) be amended to read as follows:

"Any unspent proceeds of an issue affected by a deliberate action must be applied in the manner described in paragraph (d) or (e) of '1.141-12 to the extent otherwise permitted by the pertinent issue documents."

E. '1.141-12(b)(1): permit remedial action for the private security or payment test.

1. Comment.

Since the private business tests represent a two-pronged standard, each of which must be satisfied to cause a private activity bond, it seems inappropriate as a tax policy matter to permit remedial action to cure the private business use test, but not to permit remedial action to cure the private security or payment test. This approach requires issuers to consider burdensome bond redemption or other provisions in bond documents to try to address in different ways the alternative approaches taken towards the private business use test and the private security or payment test under the Final PAB Regulations.

2. Recommendation.

We recommend that '1.141-12(b)(1) be amended to delete the second sentence thereof and to modify the first sentence to read as follows:

"The effect of a remedial action to cure use of proceeds that causes the private business tests or the private loan financing test to be met."

F. '1.141-12(d)(1): Redemption or defeasance of nonqualified bonds: In general.

1. Comment.

The bond redemption or defeasance remedy under '1.141-12(d)(1) literally appears to prohibit an issuer from using any unspent tax-exempt bond proceeds of the affected issue (e.g., an unspent bond-funded reserve fund) to redeem or defease nonqualified bonds. This seems unduly harsh. Here, the issuer will no longer benefit from the use of all or a portion of the tax-exempt bond proceeds and will take the bonds off the market as soon as possible. In addition, this treatment is harsher on governmental bonds than for exempt facility bonds which are permitted to so use such unspent proceeds under '1.142-2(c)(1).

2. Recommendation.

We recommend that the second sentence in '1.141-12(d)(1) be amended to read as follows:

"Except for unspent proceeds of the affected issue and for proceeds of newly-issued bonds that are qualified bonds taking into account the use of the facility after giving effect to the deliberate action, proceeds of tax-exempt bonds may not be used to effect this redemption."

G. '1.141-12(d)(4): modify call requirement to address noncallable bonds and to address certain 11-year calls.

1. Comment.

It is unclear how noncallable bonds impact the availability of the bond defeasance remedy under the 102-year first call date condition. Presumably, serial bonds which are technically noncallable but which mature within the 102-year period are eligible for the bond defeasance remedy. In addition, it would seem that callable bonds (versus a bond issue) ought to be eligible for the bond defeasance remedy even if the bond issue has other bonds which are noncallable and mature beyond the 102-year period, provided that the issuer employs another remedy for those bonds (e.g., the Rev. Proc. 97-15 payment remedy).

In addition, we understand that under certain traditional governmental bond financing practices, the first call date runs 10 years from the first scheduled principal payment date which is scheduled to coincide with tax receipts. Thus, it is not unusual in such situations for the first call date to be more than 102-years but not later than 11 years from the issue date.

Finally, and importantly, for pre-May 16, 1997 bonds, there was no reason for issuers to that a 102 year call would be required. For these issuers, the only remedies would appear to be the Rev. Proc. 97-15 payment procedure or a 100% successful tender offer. This seems to be an unfair result.

2. Recommendation.

We recommend that '1.141-12(d)(4) be amended to read as follows:

"In order for bonds (as contrasted with a bond issue) to be eligible for the defeasance escrow remedy, the bonds must either mature or be callable not later than 11 years after the issue date. This paragraph (d)(4) does not apply to bonds issued before May 16, 1997."

H. '1.141-12(e)(1)(iii) and '1.141-12(f)(2): clarify that future remedial actions can be taken.

1. Comment.

'1.141-12(e)(iii) and '1.141-12(f) could be interpreted to mean that a future deliberate action by the issuer could cause the tax-exempt bonds to be taxable, whether or not remediated. An issuer who employs one of these change-of-use remedies ought not be foreclosed from employing a change-of-use remedy for a future deliberate action. Such a result seems unduly punitive to issuers who may have little control over future events.

2. Recommendation.

We recommend that '1.141-12(e)(iii) and '1.141-12(f) each be clarified to either expressly permit future remedial actions or convert the future qualified use standard to a reasonable expectations standard.

I. '1.141-12(g): rules for deemed reissuance.

1. Comment.

The deemed reissuance rules under ''1.141-12(e)(2) and 1.141-12(f)(2) each appear to require compliance for the reissued bonds effective on the date of the deliberate action. The eligibility rules for these types of bonds, however, require that certain actions be taken (e.g., TEFRA approvals) before the issue date. Rev. Proc. 93-17 appropriately permitted an issuer a 90-day grace period after a change-in-use to obtain a TEFRA approval. Due to inadvertence, an issuer may fail to satisfy these requirements prior to the reissuance date. An issuer should be permitted a 90-day grace period after a deliberate action to comply with the rules for the deemed reissued bonds.

2. Recommendation.

We recommend that '1.141-12(g) be amended to add a new third paragraph to read as follows:

"(3) An issuer shall have a 90-day cure period after the date of a deliberate action to satisfy the applicable requirements for the issuance of the deemed reissued bonds."

J. '1.141-12(j)(1): strongly recommend a more analytically sound, less punitive, proportionate measure of nonqualified bonds.

1. Comment.

Our single most significant substantive comment is that the measure of unqualified bonds under '1.141-12(j) based on the highest percentage of

private use in any one-year period commencing with a deliberate action is unduly punitive, analytically unsound, a radical departure from existing change-of-use principles, and unworkable. The problems with this nonqualified bonds measure are particularly acute with large-scale financings involving numerous projects. We strongly urge reconsideration of this principle. This nonqualified bonds measure is inconsistent with the entire approach to the measure of private business use under the Final PAB Regulations. In addition, for purposes of curing violations of the private loan test, this provision wrongly bases the measure of nonqualified bonds on the highest annual private business use percentage.

2. Recommendation.

The tax policy aim of the change-of-use remedies should be to bring an issue into compliance going forward. To that end, we strongly recommend that the amount of nonqualified bonds be determined under the analytically sound proportionate approach of Rev. Proc. 79-5, Rev. Proc. 81-22, and '1.142-2(e) of the Final PAB Regulations. Specifically, the nonqualified bonds are a portion of the outstanding bonds in an amount such that, if the remaining bonds were issued on the date of the deliberate action, the applicable percentage (90% or 95%) of the proceeds of the remaining bonds would be used for a qualified governmental use. For bonds meeting the private loan test, we recommend that the amount of nonqualified bonds be determined under the same analytic approach.

K. Clarify applicable change-of-use remedies for bonds issued before May 16, 1997.

1. Comment.

The Final PAB Regulations generally apply prospectively to bonds issued on or after May 16, 1997. For bonds issued before this general effective date, however, the scope of application of the change-of-use remedies under the Final PAB Regulations seems both ambiguous and inappropriate in certain respects. The Final PAB Regulations appropriately permit issuers to elect to apply the new change-of-use remedies under '1.141-12 of the Final PAB Regulations retroactively to cure changes of use of pre-effective date bonds. The Final PAB Regulations further make the existing change-of-use safe harbors under Rev. Proc. 93-17 "obsolete" for actions that occur on or after May 16, 1997. It would appear that the goals here were to curtail private letter rulings on change of use and to encourage issuers to elect to use the new change-of-use remedies under the Final PAB Regulations as most representative of current tax policy.

In certain respects, however, it seems inappropriate to expect issuers of pre-effective date bonds to have structured their bond issues to satisfy these new change-of-use remedies or otherwise to leave these bond issues with the restrictive new payment option under Rev. Proc. 97-15 as their exclusive change-of-use remedy. To take one identified problem area as an illustrative example, an issuer with outstanding noncallable bonds issued say in 1986 cannot satisfy the 102-year first call requirement under '1.141-12, but it seems unfair to leave that issuer with the restrictive new payment option under Rev. Proc. 97-15 as their exclusive change-of-use remedy. An issuer in such circumstances ought to be able to do a bond redemption or defeasance to cure a change of use under existing law, by analogy to the

principles under Rev. Proc. 93-17 or otherwise. Further in this regard, it is unclear generally whether an issuer that does not elect to apply the new change-of-use remedies under '1.141-12 of the Final PAB Regulations for a pre-effective date bond issue reasonably can look to any existing law or standards in effect before the Final PAB Regulations for change-of-use remedies.

2. Recommendation.

We believe that, if our recommendations herein on amendments to the change-of-use remedies, particularly those on the measure of nonqualified bonds and combinations of remedies, are largely incorporated into the Final PAB Regulations, Treasury and the IRS could fairly adopt the change-of-use remedies under the Final PAB Regulations for future changes of use on outstanding pre-effective date bonds.

We further recommend specifically that the first call condition under '1.141-12(d)(4) be amended to make it inapplicable to bonds issued before May 16, 1997.

Finally, we recommend that, in any event, some express clarification be made regarding the applicable change-of-use remedy standards for outstanding pre-effective date bonds.

L. Amend Example 8 under '1.141-12(k) to reconcile it with the cash sale at a loss limitation on bond redemption.

1. Comment.

Example 8 under '1.141-12(k) involves an all-cash sale of a portion of a bond-financed facility. Example 8 suggests that the amount of bonds that must be redeemed is the full amount of the nonqualified bonds. This measure is greater than and inconsistent with the limited pro rata amount of bonds required to be redeemed from disposition proceeds received in an all-cash sale at a loss under '1.141-12(d)(2) and Example 1 under '1.141-12 (k). The only way to reconcile Example 8 is to assume that the sale does not occur at a loss.

2. Recommendation.

We recommend that the fourth sentence of Example 8 under '1.141-12(k) be amended to read as follows:

"G later sells one-half of the courthouse property to a nongovernmental person for cash at a sale price equal to or greater than the amount of outstanding bonds allocable to the financing of that portion of the courthouse property."

VII. Miscellaneous provisions.

A. '1.145-2(c)(2): costs of issuance on qualified 501(c)(3) bonds.

1. Comment.

Section 1.145-2(c)(2) treats costs of issuance as bad costs for purposes of Section 145(a)(2). While we recognize that this treatment is consistent with the legislative history to the 1986 Tax Act, we nonetheless believe that this is the wrong answer, based on a misunderstanding of how issuance costs are capitalized. Issuance costs properly are capitalized to the attendant debt. Thus, for an exempt facility in which 95% of the net proceeds must be used for capital costs of qualified exempt facilities, the issuance costs appropriately are bad costs. However, for qualified 501(c)(3) bonds under Section 145, 95% of the net proceeds need only be used for exempt purposes, not necessarily capital costs of facilities. Accordingly, consistent with the Proposed PAB Regulations and '1.141-3(g)(6) of the Final PAB Regulations, the proper answer should be that issuance costs for qualified 501(c)(3) bonds are neutral costs allocable proportionately between exempt and nonexempt uses of proceeds.

2. Recommendation.

We recommend that '1.145-2(c)(2) be deleted.

B. '1.148-6: clarify accounting timing and effective date.

1. Comment.

The relationship between the accounting timing rules in the first two sentences of '1.148-6(d)(1)(iii) needs clarification. Specifically, it is unclear which of the following two accounting timing rules for expenditures controls: (1) 18 months after the later of the date the expenditure is paid or the project is placed in service; or (2) "in any event" by 60 days after the earlier of the fifth anniversary of the issue date or the date of retirement of the issue. The second such rule implicitly seems to recognize that accounting within that latter five-year period should suffice. We believe that result is a better and more flexible approach. While we can understand the IRS's concern with retroactive re-allocations for accounting purposes, the first 18-month rule seems too tight for initial allocations. We can envision reasonable circumstances in which an issuer routinely uses governmental bond proceeds for governmental projects and for whatever reason may fail to focus on initial accounting before some necessary accounting review (e.g., five-year rebate calculations).

In addition, we believe that this prospectively-applicable provision should tag along to apply to earlier issues to which '1.141-6(a) applies as a result of an election to apply the Final PAB Regulations to a pre-effective date issue.

2. Recommendation.

We recommend that '1.148-6(d)(1)(iii) be amended to delete the requirement of the first sentence thereof. In any event, we recommend that the requisite accounting timing requirement be clarified.

We further recommend that '1.148-6(a)(3) and '1.148-6(d)(1)(iii) each be amended to add immediately after the date "May 16, 1997" the phrase "and to any other issue to which '1.141-6(a) applies."

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