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RE: Comments Regarding Final Regulations on Allocation and Accounting and Certain Other Matters

Ladies and Gentlemen:

The National Association of Bond Lawyers (NABL) respectfully submits the enclosed comments to the Department of the Treasury regarding final regulations published on October 27, 2015, in the Federal Register relating to the definition "private activity bonds" (the "Final Regulations").

The enclosed comments were prepared by a NABL Working Group, comprising the individuals listed in Exhibit B and approved by the NABL Board of Directors.

NABL exists to promote the integrity of the municipal securities market by advancing the understanding of and compliance with the law affecting public finance. We respectfully provide this submission in furtherance of that mission.

If NABL can provide further assistance, please do not hesitate to contact Jessica Giroux in our Washington, D.C. office at (202) 503-3290.

Thank you in advance for your consideration of these comments.

Sincerely,

Alexandra M. MacLennan

Alexandra M. MacLennan
Enclosure

COMMENTS BY THE NATIONAL ASSOCIATION OF BOND LAWYERS TO THE INTERNAL REVENUE SERVICE REGARDING FINAL REGULATIONS ON ALLOCATION AND ACCOUNTING AND CERTAIN OTHER MATTERS

On October 27, 2015, the Department of the Treasury published final regulations in the *Federal Register* relating to the definition of "private activity bonds" (the "Final Regulations").[1] The Final Regulations address four areas: (i) allocating and accounting for projects financed with tax-advantaged bonds,[2] especially focused on projects financed both with proceeds of bonds and with moneys not derived from tax-advantaged borrowings; (ii) the treatment of certain partnerships; (iii) remedial actions, including "anticipatory remedial actions," and (iv) qualification for multipurpose issue allocations under Treas. Reg. § 1.141-13(d). In large part, the Final Regulations represent the Treasury Department's response to comments received in response to an advance notice of proposed rulemaking,[3] published in the *Federal Register* on September 26, 2006.[4] The Final Regulations are generally applicable to bonds sold on or after January 25, 2016, and to deliberate actions taken on or after that date with respect to previously issued bonds.

NABL believes that the Final Regulations in general provide a workable framework for applying the private activity bond rules of Section 141 of the Code and Treas. Reg. §§ 1.141-1 through 1.141-16. Indeed, much of that framework is consistent with prevailing practice among bond and tax lawyers, allowing, for example, projects that are financed in part with bond proceeds and in part with other funds ("qualified equity," under the Final Regulations) to generally have private business use allocated first to the qualified equity before any private business use is allocated to the bonds. We have reviewed the Final Regulations and have been applying them for more nearly three years now and believe that there is room for clarification or confirmation of our interpretations in a few areas. These comments are submitted to point out some areas of concern and to suggest interpretations or clarifications that might go into a revenue procedure, notice, or similar guidance project to provide a clarification of some aspects of the Final Regulations. In furtherance of these comments, we have attached proposed examples in Exhibit A hereto that might be used to clarify some parts of the Final Regulations. In addition, NABL believes that one technical change or transition rule may be advisable with respect to the period over which private business use may be allocated to qualified equity and the period during which non-bond proceeds may be applied to a project and be treated as "qualified equity."

I. Allocation and Accounting Regulations

A. Definition of Project

In general, Treas. Reg. § 1.141-6(a)(2) as modified by the Final Regulations states that if two or more sources of funding are allocated to capital expenditures *for a project*, those sources

[1] TD 9741, published at 80 FR 65637.

[2] For simplicity, we will refer to tax-advantaged bonds as "bonds" without the qualifier. From time to time we may also refer to "taxable bonds," meaning governmental debt that is not tax-advantaged, and to "qualified private activity bonds," meaning bonds that are private activity bonds under Section 103 of the Internal Revenue Code of 1986 (the "Code") but that meet the requirements that allow them to bear interest that is excluded from federal gross income under Section 103 of the Code.

[3] REG-142599-02.

[4] 71 FR 56072.

are allocated to the governmental use and private business use of the project on a pro rata basis. Treas. Reg. § 1.141-6(b)(1) modifies this rule by stating that sources of funding allocated to capital expenditures for an *eligible mixed-use project* are allocated to undivided portions of the project, and that the private business use of the project in each year during the measurement period is allocated first to any qualified equity that financed the project. Thus, as a threshold matter, it is necessary to determine the "project" that is financed at least in part by the bonds.

5-Year Limit. Treas. Reg. § 1.141-6(a)(3)(i) states that "project" means one or more facilities or capital projects, including land, buildings, equipment, or other property financed in whole or in part with proceeds of the issue. In addition, Treas. Reg. § 1.141-6(a)(1) provides that the allocations of proceeds and other sources of funds to expenditures under Treas. Reg. § 1.148-6(d) apply for purposes of Treas. Reg. §§ 1.141-1 through 1.141-15. We read this language to mean that an issuer may use any reasonable accounting method to allocate proceeds to expenditures, provided that the current outlay of cash rule is met and that the accounting for expenditures takes place within the appropriate time period. We also note that Treas. Reg. § 1.148-6(d)(1)(iii) includes a 5-year limit designed to assure that expenditures are allocated to a bond issue no later than the date that rebate on the issue must first be computed (and, if appropriate, paid to the federal government).

In most cases, the 5-year limit does not cause any problem. However, NABL notes that in many situations the proceeds of the bonds are not all spent within the 5-year time limit and it is unclear exactly how proceeds are allocated to expenditures after the end of the 5 years. We believe that it would be appropriate to clarify that allocations are permitted both for private activity bond analysis and for arbitrage analysis after the 5-year time limit for expenditures that take place after the end of the fifth anniversary of the issue date.[5]

Project Identification. There is no further regulatory language relating to the definition of "project." However, the Preamble to the Final Regulations specifically states that "issuers may identify specific properties or portions of properties regardless of the properties' locations or placed-in-service dates." This rule gives issuers broad latitude to identify the components of their project. This latitude is limited slightly by Example 3 in Treas. Reg. § 1.141-6(f), which provides that the financing of a hospital placed in service in 2001 is a separate project from an addition to the hospital financed with proceeds of bonds issued in 2017 and with qualified equity.

NABL applauds the broad flexibility given to issuers to define their own project or projects.[6] We note that an issuer may, under the regulations, define any contemporaneous activities as being part of the same project so long as bond proceeds are being spent on capital costs of at least one of those activities. We believe that, in general, most issuers will narrowly define their "project" to simplify their obligations relating to tracking expenditures of proceeds and qualified equity and to tracking governmental and private business use. They may also recognize, however, that there will be circumstances in which it may be desirable to treat wholly unrelated activities as part of the same "project," allowing qualified equity to float among those activities. In any case, we expect that best practices will develop, with issuers perhaps

[5] NABL recognizes that a technical correction to Treas. Reg. § 1.148-6(d) may be required to accomplish this purpose.

[6] We note that, by making an appropriate allocation under Treas. Reg. § 1.141-13(d), an issuer may treat a bond issue as financing more than one project for purposes of the Final Regulations.

preliminarily declaring the scope of the project or projects financed in whole or in part with proceeds of a bond issue in a tax certificate or similar document with a reservation of the final definition of the "project" to be identified no later than the issuer's final allocation of bond proceeds.

NABL has some concern about what happens when an issuer fails to specifically identify the project being financed. To provide guidance in that situation, we believe that it is important for the Treasury Department or the Internal Revenue Service to provide an example of a default rule that states that, in the absence of the issuer's defining the "project," the project will consist of all capital facilities financed in whole or in part with the proceeds of an issue of bonds, based either upon a written allocation of the issuer or based on tracing the proceeds of the bonds to the capital facilities. In this default situation, qualified equity that is spent on the capital facilities that bond proceeds are also spent on would also be treated as financing a portion of the project. *See example 1 through 3 on Exhibit A.*

B. Eligible Mixed-Use Projects

The Final Regulations generally provide that, in the case of an "eligible mixed-use project," private business use of the project *in each year* is first allocated to qualified equity that financed the project, and only private business use of the project in excess of the percentage of qualified equity is allocated to the bonds. Treas. Reg. § 1.141-6(b)(1) [emphasis added]. For this purpose, an eligible mixed-use project is a project that is financed both with governmental bonds and with qualified equity and is wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner. Treas. Reg. § 1.141-6(b)(2).

NABL believes that the tenor of this guidance is generally consistent both with prior published guidance and with private letter rulings, both of which support the rule relating to "floating" qualified equity being allocated first to private use. However, NABL believes that some consideration should be made to eliminating the annual testing component of the rule. We note, for example, that the annual testing approach is inconsistent with the general measurement rule of Treasury Regulations § 1.141-3(g), which measures the percentage of private business use over the "measurement period" rather than providing for more frequent testing. The ability to allocate equity on a temporal basis, rather than on a pro rata basis, over the measurement period could be beneficial in infrastructure developed on a public-private partnership basis, where there may be more private use during earlier years than in later years.

NABL knows that in the past some issuers have used an equity contribution designed to absorb private business use arising from a carryover tenant situation. For example, an issuer may in the past have purchased a building for $120x, using $100x of proceeds of bonds with a maturity of 10 years and $20x of equity, with the belief that the $20x of equity would allow a carryover tenant to continue using the building for 2 years without causing a private activity problem for the bonds.[7] NABL recognizes and appreciates that in Treasury Decision 9777 a transition rule was

[7] The analysis for this would be something like the following: there are 2 years of private business use of $120x and 8 years of governmental use of $120x. The private business use is 20% of the entire building over the measurement period; however, the equity constituted about 16.7% of the financing, so effectively only 3.3% of the private business use over the years is allocable to the bonds. Under the Final Regulations, there would be 100% private

added in Treasury Regulations 1.141-15 providing that the Final Regulations do not apply to certain refundings. However, NABL continues to believe that the annual testing rule should be eliminated and that the regulations be clear that the measurement period should be used in all cases.[8]

C. Qualified Equity

To constitute an eligible mixed-use project, a project must be financed with proceeds of bonds and with qualified equity "pursuant to the same plan of financing (within the meaning of Treas. Reg. § 1.150-1(c)(1)(ii))." Additionally, Treas. Reg. § 1.141-6(b)(4) (added by the Final Regulations) states that qualified equity finances a project under the same plan of financing if the qualified equity pays for capital expenditures of the project within a specified time period.[9]

The time period specified by the Final Regulations for expenditures of qualified equity begins on the date on which the capital expenditures would be eligible for reimbursement by proceeds of the bonds under Treas. Reg. § 1.150-2(d)(2). Under Treas. Reg. § 1.150-2(d)(2), the reimbursement period generally begins between 18 months and up to three years before the bonds are issued, depending on when the original expenditure is paid and when the related project is placed in service or abandoned. To do a reimbursement allocation under Treas. Reg. § 1.150-2 of an expenditure that is more than 60 days prior to issue date of the bonds, an issuer must generally adopt an official intent not more than 60 days after the expenditure to be reimbursed. However, Treas. Reg. § 1.141-6(b)(4) states that the determination of when the qualified equity period begins does not depend on whether the applicable bonds are actually issued as reimbursement bonds. Accordingly, we interpret the start of the permitted qualified equity expenditure period to begin at least 18 months, and in some cases up to three years, prior to the date the bonds are issued regardless of whether a declaration of intent to reimburse has been adopted.

NABL also notes that a single project can be partially financed by multiple tax-exempt bond issues. If bond issues partially financing the project have different issue dates, the expenditure and placed-in-service dates may have different permitted timing intervals for the different bond issues. Neither the text of the Final Regulations nor the Preamble explains how to make a determination of qualified equity where proceeds of more than one issue finance an eligible mixed-use project. Assume, for example, that a project placed in service in 2017 is financed with equity contributed in July 2013 and with the proceeds of bond issue "A" issued in June 2016 and bond issue "B" issued in 2017. Presumably all equity should count toward qualified equity with respect to the project because the equity is contributed within the reimbursement period of the bonds issued in 2016.[10] We request that the Treasury Department confirm that, in a case such as this, the equity need not simultaneously qualify within the reimbursement periods of both bond issues to be treated as qualified equity with respect to the project. *See example 4 in Exhibit A.*

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business use assigned to the bonds in each of the first two years, meaning that the proceeds of the bonds that would be treated as privately used over the 10-year measurement period would be 20% rather than 3.3%.

[8] NABL recognizes that such a change may require a technical change to the Final Regulations.

[9] We note that the language of the Final Regulations appears to provide a bright-line test for determining whether an expenditure of qualified equity is made pursuant to the same plan of financing.

[10] A variant might involve first spending proceeds from bond issue A, then using equity, then using proceeds of bond issue B.

Treas. Reg. § 1.141-6(b)(4) also provides that, except for a reasonable retainage, qualified equity must be contributed no later than the date on which the measurement period begins. This raises two particular issues. First, as explained in the Preamble to the Final Regulations, "issuers may identify specific properties or portions of properties" as part of a project, "regardless of the properties' locations or placed in service dates." Multiple placed-in-service dates create some confusion as to what the last date is for contributing qualified equity, because under Treas. Reg. § 1.141-3(g), the measurement period of property financed by an issue begins not later than the date the property is placed in service. Qualified equity contributions to a project generally apply to the entire project. Accordingly, we believe that the reference to "measurement period" as applied to the contribution of qualified equity in the case of multiple facilities with different placed-in-service dates should refer to the last of the placed-in-service dates.

Second, NABL notes that equity that constitutes a "reasonable retainage" is, under an exception in Treas. Reg. § 1.141-6(b)(4), eligible to be included as qualified equity even if contributed after the measurement period begins. Reasonable retainage is defined with reference to Treas. Reg. § 1.148-7(h) as an amount that does not exceed 5% of the available construction proceeds of an issue that is retained for reasonable business purposes. We believe that a further exception is needed for expenditures that are paid after the placed-in-service date and that are not included in the definition of reasonable retainage. For example, it should be possible for an issuer to pay costs of construction of a project component from qualified equity even after the project component is placed in service if the cost is customarily incurred in connection with comparable projects. Assume, for instance, that a building is placed in service in the winter and, the following summer, additional costs are incurred to complete the air conditioning installation. Or assume that after a project is placed in service, the issuer undertakes "punch list" improvements at its own expense. Alternatively, assume that an issuer does not receive construction invoices until after the related project is placed in service. These costs would not necessarily qualify for the reasonable retainage exception either because these costs are construction costs the payment of which was not withheld for retainage purposes or because the costs exceed the 5% threshold. The Treasury Department might provide for this exception by, for example, allowing issuers to count as qualified equity expenditures that occur not later than 18 months after the placed-in-service date of the project.[11] NABL believes that applying an 18-month rule to qualified equity would be consistent with the general allocation rule that allows bond proceeds to be allocated to a project no later than 18 months after it is placed in service.[12]

II. Partnerships Provisions

The Final Regulations provide, in § 1.141-1(e), that a partnership "is treated as an aggregate of its partners, rather than as an entity." This clarification is both helpful and responsive to previously submitted comments. States, local governments and 501(c)(3) organizations, to be effective, need flexible rules to facilitate private involvement with respect to facilities.[13] The Final Regulations provide flexibility to both state and local government and 501(c)(3) organizations to (in certain instances) finance such entity's "partner's share" of property owned by a partnership with tax-exempt obligations. Treas. Reg. § 1.141-3(g)(2)(v).

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[11] NABL recognizes that such a clarification may require a modification of the Final Regulations.
[12] Treas. Reg. § 1.148-6(d)(iii).
[13] NABL notes that in Revenue Procedure 2017-13 the Treasury Department has taken some steps in helping to provide such flexible rules.

We note that new Treas. Reg. §§ 1.141-1(e) and 1.141-3(g)(2)(v) provide helpful rules for purposes of determining the amount of private business use under Section 141 of the Code, and the Preamble indicates an intention to provide aggregate treatment for purposes of the ownership requirement of Section 145(a)(1). To facilitate the intent of these provisions with respect to partnerships and allow for the bond financing of a "partner's share," it would be helpful to have clarification that the aggregate treatment under the Final Regulations applies not only for purposes of the ownership requirement of Section 145(a)(1) of the Code but also for the ownership requirement of Section 142(b)(1).

III. Anticipatory Remedial Actions

The Final Regulations expand the remedial action rules to encourage the retirement of tax-exempt bonds before the occurrence of excessive nonqualified use. NABL strongly supports these changes, including the expansion of the remedial action rules to permit an issuer to redeem or defease bonds at any time in advance of a deliberate action that would cause the private business tests to be met. However, while the Final Regulations mark a significant improvement, further clarification would allow issuers to proactively address private business use concerns, as discussed below.

A. Declaration of Intent

To address the concern of issuers potentially treating ordinary bond amortization payments as "anticipatory remedial actions" and to prevent the addition of "pseudo-qualified equity" after the fact, the Final Regulations require an issuer to declare its intent to redeem or defease bonds in advance of a deliberate action in a manner similar to the declaration of intent for reimbursement contained in Treas. Reg. § 1.150-2(e). As part of these requirements, the issuer must "describe the deliberate action that potentially may result in the private business tests being met." We note that, in the context of declarations of official intent for reimbursement, Treas. Reg. § 1.150-2(e) provides that a general description is sufficient to describe the project for which the issuer is seeking reimbursement (*e.g.*, highway capital improvement program, hospital equipment acquisition). NABL observes that most practitioners have interpreted the declaration of intent rule for anticipatory remediation similarly and suggests that it may be best to have similar rule allowing generalization be used to describe a future deliberate action when undertaking anticipatory remedial action.

B. Alternative Use of Disposition Proceeds

The Final Regulations permit an issuer to take an anticipatory remedial action only in the form of a redemption or defeasance of nonqualified bonds. NABL sees no policy reason to prohibit the remedial action of alternative use of disposition proceeds if the issuer meets all other conditions in Treas. Reg. § 1.141-12 and declares its official intent in the manner prescribed for anticipatory redemptions in the Final Regulations.

By way of illustration, the Final Regulations give the example of a sale of bond-financed property that the buyer may then lease to a nongovernmental person. City, for example, may sell property to State University, who may (but has not yet taken action to) lease the property to a nongovernmental person. Thus, City in this example has not yet engaged in any private business use in respect of the sale of the land. The Final Regulations would allow City to declare its official intent to redeem or defease a portion of the bonds from the future nonqualified use. If the bonds are not callable for another five years, City would be forced to establish a defeasance escrow and, under current market conditions, incur the attendant negative arbitrage cost of such an escrow.

NABL believes that if City were instead allowed to take a remedial action of alternative use of disposition proceeds at the time of the sale, City could allocate the proceeds from the sale of the property to another governmental project, thus decreasing the amount of additional bonds required to be issued for capital projects in the current year. This decreases City's overall tax-exempt debt and decreases the overall burden on the tax-exempt market.

IV. Examples

Exhibit A hereto contains examples that we believe may be used to clarify certain of the aspects described above relating to general allocation and accounting matters, remedial actions and multipurpose issues.

EXHIBIT A
EXAMPLES

Allocation and Accounting Examples

Example 1: Default identification of project

A university (a governmental entity) issues bonds in 2016 to finance part of a new bookstore and all of a new dormitory. The university does not specifically identify a "project" for purposes of Treas. Reg. § 1.141-6(a). The portion of the bookstore financed with the bonds and the dormitory are part of the same "project" under Treas. Reg. § 1.141-6(a)(3). The university also spends $2X of moneys not derived from the proceeds of tax-advantaged bonds on the remainder of the bookstore. The $2X are allocated to expenditures on the bookstore that occurred no earlier than three years prior to the date the bonds were issued and not later than the date the bookstore was placed in service. The remainder of the bookstore financed with the $2X is also part of the project for purposes of Treas. Reg. § 1.141-6(a)(3), and the $2X is treated as qualified equity allocated to the project.

Example 2: Alternative methods of identification of project

(a) The facts are the same as in Example 1, except that the university specifically identifies the bookstore and the dormitory as the "project" for purposes of Treas. Reg. § 1.141-6(a) in the tax certificate it executes at the closing of the bonds. The identification of the "project" in the tax certificate is an adequate identification for purposes of Treas. Reg. § 1.141-6(a).

(b) The facts are the same as in Example 1, except that the university specifically identifies the bookstore and the dormitory as the "project" for purposes of Treas. Reg. § 1.141-6(a) in a final allocation prepared no later than 18 months after the later of the date the bookstore or the date the dormitory is placed in service. The identification of the "project" in the final allocation is an adequate identification for purposes of Treas. Reg. § 1.141-6(a).

(c) The facts are the same as in Example 2(b), except that the university specifically identifies the bookstore and the dormitory as separate "projects" for purposes of Treas. Reg. § 1.141-6(a) in the final allocation. The identification of the two "projects" in the final allocation is adequate for purposes of Treas. Reg. § 1.141-6(a), and the two projects are treated as separate projects with the result that the $2X of qualified equity allocated to the bookstore can only be applied to private business use at the bookstore and not at the dormitory.

Example 3: Identification of projects involving governmental and qualified private activity bonds

City has a plan to finance a new airport terminal facility to be used in part by common carriers under agreements that do not involve the sharing of revenues generated by runway landing fees. A portion of the terminal (for which the direct costs are 15% of the total costs of the interior space costs) will be occupied by City and not privately used. City intends to finance the terminal with a combination of governmental bonds, exempt facility bonds and amounts not derived from any borrowing. The governmental bonds and exempt facility bonds will be a single issue as defined in Treas. Reg. § 1.150-1(c)(1). City makes multipurpose allocations under Treas. Reg. § 1.150-1(c)(3) and § 1.141-13(d) under which the governmental and exempt facility bonds will be treated as separate issues for certain purposes, and the governmental bonds, and the exempt facility bonds have separately identified series designations. City further allocates the proceeds of the governmental bonds and a portion of the amounts not derived from a borrowing to the costs of the 15% of the interior space that it will use and a proportionate share of the common costs of the building and allocates the proceeds of the exempt facility bonds and the remainder of the non-borrowed funds to the remainder of the terminal costs representing 85% of the terminal interior space and an 85% share of the common costs. City memorializes a plan of financing (under Treas. Reg. § 1.141-6) that treats the terminal as two projects. The first project ("Project 1") will include the expenditures for the space that City occupies and the allocable 15% share of common costs. The other project ("Project 2") will consist of the remainder of the expenditures (*i.e.*, those allocated to the exempt facility bonds and the remaining other funds). The expected private business use of the terminal and the revenue received from terminal spaces will be allocated to Project 2 and the exempt facility bonds (and to the funds allocated to Project 2).

<u>Example 4: Project funded in part with two separate issues of bonds</u>

(a) County identifies a project expected to cost $20,000,000 (the "Project"). The Project involves a single building with a single placed-in-service date. County will issue two series of bonds. The Series A Bonds will be issued in 2017 in the amount of $10,000,000, and the Series B Bonds will be issued in 2018 in the amount of $8,000,000. County will also contribute $2,000,000 of equity to partially fund the Project, which will be spent no earlier than three years before County issues its Series A Bonds, but more than three years before County issues its Series B Bonds. All expenditures of the $2,000,000 of equity and the $18,000,000 of proceeds of both series of bonds are declared to be part of the Project. This declaration is made no later than the date that is 18 months after the date that the facility financed by the Project is placed in service. Private business use of the facility in each year up to 10% of the total use is allocated to the equity because 10% of the facility is financed with qualified equity. If private business use of the facility in any year exceeds 10%, the excess over 10% is allocated ratably to the two bond issues, with 55.56% (10,000,000 / 18,000,000) of this excess private business use allocated to the Series A Bonds and 44.44% (8,000,000 / 18,000,000) allocated to the Series B Bonds.

(b) It would make no difference if the facilities constituting the Project consisted of two or more buildings with different placed in service dates so long as all of the equity was spent no earlier than three years before the issue date of the Series A Bonds, and the earlier of the two placed-in-service dates of the buildings was no earlier than 18 months before the issue date of the Series A Bonds and the equity was spent no later than the later of the issue date of the Series A Bonds or the placed in service date of the particular facility to which the expenditure related.

(c) The scope of the Project is defined as follows: In the tax certificate for the Series A Bonds, County defines the Project, lays out the plan of financing, including the expected sources of funding consisting of the contribution of equity in an estimated amount and the proceeds of both the Series A Bonds and the future Series B Bonds. The tax certificate also provides a reasonable estimate of the amount of each source of funding and a general description of the facility or facilities to be financed by the Project. Additional certificates of County describe Project expenditures made after the date of issue of the Series A Bonds, including those made with proceeds of the Series A Bonds and the proceeds of the Series B Bonds. A statement in the tax certificate for the Series B Bonds that all expenditures of proceeds of the Series B Bonds were to be allocated to the Project would suffice to cause those expenditures to be included in the Project.

EXHIBIT B
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