# NATIONAL ASSOCIATION OF BOND LAWYERS

**NABL U PRESENTS - THE ESSENTIALS 2023**
**April 19-21 ♦ Baltimore, MD**

## Avoiding Private Activity

**Faculty:**


| | |
|---|---|
| Ben Kitto | Ice Miller, LLP – Columbus, OH |
| Marc Oberdorff | Pope Flynn Group – Charleston, SC |
| Victoria Ozimek | Bracewell LLP – Austin, TX |
| Lori Smith-Lalla | Weiss Serota Helfman Cole + Bierman – Fort Launderdale, FL |


### I. INTRODUCTION

#### A. Regulations Addressing Private Activity Bond Tests

**1.** Rules regarding the private activity bond tests described in Internal Revenue Code ("I.R.C.") § 141 are generally set forth in Treasury Regulations §§1.141-0 through 1.141-16 (the "Regulations," "Regs." or "Treas. Regs."). Bonds issued prior to May 16, 1997, are subject to earlier versions of the regulations, and special rules may apply to refunding bonds issued to refund bonds that trace back to original bonds issued prior to such date. However, as a general rule, most issuers will want to apply the current Regulations.

**2.** Treas. Reg. §1.141-6 relating to allocation and accounting, including rules relating to "mixed-use" projects and partnerships, was released in 2015 and is effective for bonds sold on or after January 25, 2016.

#### B. Two General Tests to Establish Private Activity

**1.** **General rule.** A bond is a "private activity bond" if the issuer of the bond (a) reasonably expects on the issue date that the bond issue will meet either (i) both private business tests (the "Private Business Tests") or (ii) the private loan test (the "Private Loan Test") or (b) takes a deliberate action that causes the Private Business Tests or the Private Loan Test to be met.

**a.** **Private Business Tests**: Generally, the Private Business Tests are met if (a) more 10% of the proceeds of an issue are to be used for private business use (the "Private Business Use Test") AND (b) the payment of debt service of more than 10% of the proceeds of the issue is directly or indirectly secured by privately-used property or payments therefrom or derived from private payments. (the "Private Payments or Private Security Test").

Even if the 10% threshold on private business use is not exceeded, an issue with a "nonqualifed amount" in excess of $15 million will be a private activity bond unless the issuer allocates volume cap (available under I.R.C. § 146) to any such excess amount. The "nonqualified amount" is the lesser of the amount bond proceeds (i) allocated to private business use or (ii) with respect to which there are payments, property or borrowed money taken into account under the Private Payments or Private Security Test.

**b.** **Private Loan Test**: The Private Loan Test is met if the amount of bond proceeds loans to nongovernmental entities exceeds the lesser of 5% or $5 million.

**2.** **Unrelated or disproportionate use.** If the private business use is "unrelated" or "disproportionate" to the governmental use, then 5% (rather than 10%) applies for purposes of the Private Business Tests described above. Private business use is *unrelated* if the use is for a different purpose than the governmental use. Private business use is *disproportionate* to the extent that the amount of proceeds spent for the use exceeds the amount of proceeds spent for the governmental use to which the private business use is related.

**3.** **Special rule for qualified 501(c)(3) bonds**. In general, the Regulations also apply to qualified 501(c)(3) bonds issued under I.R.C. § 145, with conforming changes to test compliance with the Private Business Tests based on a 5% (instead of a 10%) limitation. For this purpose, any use by the non-profit that is outside of its exempt purpose and costs of issuance paid from proceeds are treated as private business use.

## C. Reasonable Expectations (Reg. §1.141-2(d))

**1.** **In General.** At issuance, whether the determination of whether a bond is a "private activity bond" is based on the issuer's reasonable expectations with respect to use over the life of the issue.

**a.** the issuer takes a "deliberate action" subsequent to the issue date that causes the bonds to meet the Private Business Tests or the Private Loan Test. Generally, a "deliberate action" is a voluntary act taken by the issuer subsequent to the issue date of the bonds (see the change in use rules discussed in Section VII below).

**2.** **Exceptions to the Reasonable Expectations Test**

**a.** **Special rule for bonds issued with mandatory redemptions.** An issuer may disregard an action that is "reasonably expected" to violate the Private Business Tests or the Private Loan Test if, as of the issue date, all of the following apply:

(1) the issuer reasonably expects to use the financed property for a qualified use for a substantial period of time (note: a "substantial period of time" is not defined in the Regulations);

(2) the issuer is required to redeem ALL "nonqualified bonds" within 6 months of the deliberate action (note: this requires the issuer to contribute its own funds if the property is sold for less than the outstanding amount of nonqualified bonds);

(3) the issuer has not entered into any arrangement with a private user as of the issue date with respect to the specific action; and

(4) the mandatory redemption provision of the bonds meets the conditions for the taking remedial action under the change in use provisions (*i.e.,* the preliminary conditions for taking a remedial action under Treas. Reg. § 1.141-12(a)).

**Example.** A City issues bonds to rehabilitate an existing hospital that it currently owns. On the issue date of the bonds, the City expects that it will use the hospital for a governmental use for a substantial period of time, but that it eventually will sell or lease the rehabilitated hospital to a private user. The bond documents provide that all of the outstanding bonds may be redeemed within 6 months of the sale or lease to a private party. Assuming the issuer can satisfy the conditions for taking remedial action under Treas. Reg. § 1.141-12(a), the City satisfies the reasonable expectations test. (*See* Treas. Reg. § 1.141-2(g), example 3).

**b. Special Rule for General Obligation Bonds that Finance 25 or more Separate Purposes.** The Regulations also contain a special rule which allows an issuer of a bond issue for certain general governmental programs that finance at least 25 purposes (but that do not predominantly finance fewer than 4 purposes) to rely solely on reasonable expectations as of the issue date for private activity bond status, without regard to future deliberate actions, assuming a number of qualifications are satisfied.

## D. Deliberate Actions (Regs. §1.141-2(d))

**1. In General.** A "deliberate action" is any action taken by the issuer that is within its control, regardless of whether such action is intended to violate the private use rules (see the change in use rules discussed in Section VII below). The deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

2. **Dispositions of Personal Property in the Ordinary Course of an Established Program**. Certain dispositions of personal property in the ordinary course of an established governmental program are not treated as a deliberate action if all of the following apply:

(1) the weighted average maturity of the bonds financing the personal property is not greater than 120% of the reasonably expected actual use of that property for governmental purposes;

(2) the issuer reasonably expects on the issue date that the fair market value of the property on the disposition date will not exceed 25% of its cost; and

(3) the property is no longer suitable for its governmental purposes.

Under this exception, the issuer is required to deposit the disposition proceeds in a commingled fund with other governmental revenues that it reasonably expects to spend on governmental programs within 6 months from the date of deposit.

**Example.** A City may finance police cars and later dispose of them at a public auction when they are no longer suitable for police use. Under this exception, the City may generally dispose of the cars without jeopardizing the tax-exempt status of the bonds issued so long as the sale proceeds are recycled into governmental programs. (*See* Treas. Reg. § 1.141-2(g), example 4)

3. **Remedial Actions.** An issuer that takes a deliberate action that causes the Private Business Tests or the Private Loan Test to be met may be able to take remedial actions under Regulations §1.141-12.

## II. PRIVATE BUSINESS USE TEST (Treas. Reg. §1.141-3)

**A. In General.** In general, the Private Business Use Test is met if one or more nongovernmental persons, in the aggregate, directly or indirectly uses in their trade or business more than 10% (or, if applicable, 5%) of the proceeds of a bond issue.

**B. Who is a Nongovernmental Person?** A nongovernmental person is an entity other than a state or local government or an instrumentality thereof. For example, a "nongovernmental person" includes any of the following:

1. the federal government;

2. a section 501(c)(3) organization;

**3.** any for-profit entity or non-profit entity that is not a section 501(c)(3) organization (*e.g.,* a corporation or partnership).

## C. What Creates Private Business Use?

**1. General.** Under the Regulations, a nongovernmental person will generally be a user of bond proceeds/bond-financed property as a result of:

**a.** ownership (for federal tax law purposes);

**b.** a lease/sublease;

**c.** certain management contracts (see below);

**d.** certain output contracts (e.g., "take or pay contracts");

**e.** certain research agreements (see below);

**f.** a joint venture; or

**g.** other types of arrangements that convey a "special legal entitlement" similar to the types of use set forth above or, in some cases, a "special economic benefit" with respect to the bond-financed property, as further discussed below.

**2. Management Contracts.** The Regulations define management contract as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. Examples of bond-financed facilities that are often subject to management contracts include parking lots and garages, cafeterias, hotels, convention centers, and health care facilities. The Regulations adopt a "facts and circumstances approach" in determining whether such use gives rise to private business use.

**a. Not Management Contracts.** The Regulations provide that the following types of arrangements are not management contracts that give rise to private business use:

(1) Incidental Services – Contracts for services that are solely incidental to the primary function of the bond-financed property, such as janitorial services, hospital billing or equipment repair.

(2) Hospital Admitting Privileges – The mere granting of admitting privileges by a governmental hospital to a doctor, if such privileges are available to all qualified physicians in the area.

(3) Operation of Public Utility Property – A contract to provide for the operation of "public utility property" (as defined in I.R.C. § 168(i)(10)) if the only compensation is the "reimbursement" of actual and reasonable administrative expenses of the provider.

(4) Direct Cost Arrangements – A contract in which the only compensation is the reimbursement to the service provider for actual and direct expenses paid by the provider to unrelated parties.

**b. Qualified Management Contracts and Rev. Proc. 2017-13.** A "qualified management contract" meets certain requirements that, if satisfied, provide a safe harbor from such management contract resulting in private business use.

For a number of years Revenue Procedure ("Rev. Proc.") 97-13 set forth the safe harbor management contract guidelines issuers adhered to when entering into contracts for management of certain bond financed property. The Internal Revenue Service made a number of changes to these guidelines in 2016 and 2017. Ultimately, under Rev. Proc. 2017-13 the Internal Revenue Service established new safe harbor management contract guidelines. Rev. Proc. 2017-13 is generally effective for management contracts entered into, materially modified or extended (other than pursuant to a renewal option) on or after January 17, 2017. Issuers may elect to apply Rev. Proc. 97-13 to contracts entered into before August 18, 2017.

To qualify as a qualified management agreement under the provisions of Rev. Proc. 2017-13, a management contract must either be an eligible expense reimbursement arrangement (as defined in the Rev. Proc.) or meet the following requirements:

(1) General financial requirements. Payments to the service provider under the contract must be reasonable compensation for services that were rendered during the term of the agreement. The elements of reasonable compensation consist of eligibility for, the amount of and the timing of the payments of the compensation. Note: compensation cannot include a share of net profits from the operation of the property and the contract cannot impose on the service provider the burden of bearing any share of net losses from the operation of the property. Notwithstanding the foregoing, incentive awards are permissible if the incentive award is determined by the service provider's

performance in meeting certain requirements (e.g., quality of services, performance, or productivity).

(2) Term of the contract and revisions. The term of the contract, including all renewal options, must be no greater than the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property. A contract that is "materially modified" following its effective date must be retested to determine compliance with these guidelines and treated as a new contract.

(3) Control over use of the property. The qualified user must exercise a significant degree of control over the use of the managed property. This requirement is satisfied if the qualified user must approve (i) the annual budget of the property, (ii) the capital expenditures, (iii) the disposition of any part of the property, (iv) the rates to be charged for the use of the property and (v) the use of the property.

(4) Risk of loss of the Property. The qualified user must bear the risk of loss upon damage or destruction of the managed property. This does not prevent the qualified user from procuring insurance for the property.

(5) No inconsistent tax position. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the property. For example, the service provider must agree not to take depreciation or amortization deductions, investment tax credits or deduction for any payment as rent with respect to the property.

(6) No circumstances substantially limiting exercise of rights. The service provider may not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract.

**3. Research Contracts.** Certain types of sponsored corporate research may result in private business use. The Regulations adopt a facts and circumstances approach to determine whether such use gives rise to private business use. An arrangement that results in the sponsor being treated as the lessee or owner of the bond-financed property for federal income tax purposes will result in private business use unless one of the exceptions of Treas. Reg. § 1.141-3(d) applies.

Rev. Proc. 2007-47 is the principal guidance establishing "safe harbor" guidelines regarding research agreements, and it contains two safe harbors. The first is for "corporate sponsored" research agreements and has the following requirements: (1) any licensee of the sponsor must be permitted to use the results of the research on the same terms that the owner of a bond-financed facility would allow an unrelated party; and (2) the sponsor must pay a competitive price for the right to use the research funded by that sponsor, and the price must be determined at the time such research is available for use.

The second safe harbor is for industry or federally sponsored research agreements. This safe harbor requires (1) the research to be performed by the owner of bond-financed property in a manner determined by such owner, (2) title is in the bond issuer, and (3) sponsors are entitled to no more than a non-exclusive, royalty-free license to use the product of the research. Rights of the federal government under the Bayh-Dole Act are permitted so long as (1) and (2) are met and the license granted to any third party is no more than a non-exclusive, royalty free license.

4. **Special Legal Entitlements.** Although the term is not defined in the Regulations, a special legal entitlement appears to be the ability to control the bond-financed property in some manner or a special right to receive a portion of the net profits generated by the bond-financed property. In other words, the use does not fit in the enumerated list, but such use is not on the same basis as the rest of the general public.

**Example.** A Corporation (*i.e.,* a nongovernmental person) and a City enter into a plan to finance the construction of a parking lot adjacent to the Corporation's factory. Pursuant to the agreement, the Corporation conveys the site for the parking lot to the City "subject to" a covenant running with the land that the property will only be used for a parking lot. In addition, the City agrees that the Corporation will have a right to approve rates charged by the City for use of the parking lot. The parking lot will otherwise be available for use by members of the general public. The bond issue will meet the private business use test because a nongovernmental person has "special legal entitlements" for beneficial use of the financed facility that are comparable to an ownership interest. (*See* Treas. Reg. § 1.141-3(f), example 5)

**Example.** A bond-financed arena and convention center contract with a nongovernmental user for the naming rights of the facility. The private party can select the name of the facility, have such name used in all identification of the facility, and control certain aspects of how and when such name is used. In Private Letter Ruling 200323006, the Internal Revenue Service determined that the contract provided special legal entitlements to control the use of the facility.

5. **Special Economic Benefit.** For bond-financed property that is not available for general public use, the Regulations provide that private business use of such property arises if a nongovernmental person derives a "special economic benefit" from the property, based on all the facts and circumstances, even if the private user has no special legal entitlements with respect to the financed property.

The following factors are taken into account in determining whether special economic benefit gives rise to private business use:

**a.** whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person or entity;

**b.** whether a small number of nongovernmental persons or entities receives a special economic benefit; and

**c.** whether the cost of the bond-financed property is being depreciated by any nongovernmental person or entity.

**Example – Solid Waste Facility.** A City issues obligations to finance a solid waste disposal facility on land that it owns adjacent to a factory owned by a Corporation. The City will own and operate the facility, and the Corporation will have "no special legal entitlements" to use the facility. The City, however, expects that the Corporation will be the only user of the facility and the facility will not reasonably be available for use on the same basis by natural persons not engaged in a trade of business. Under all of the facts and circumstances (*e.g.,* the facility is functionally related and physically proximate to property used in the Corporation's trade or business), the Corporation derives a special economic benefit from the facility and the Corporation's use is treated as a private business use. *See* Treas. Reg. § 1.141-3(f), example 7.

## D. What are the Exceptions to Private Business Use?

1. **Exception for General Public Use.** I.R.C. § 141(b)(6) provides that, generally, a nongovernmental user's use of bond-financed property as a member of the general public is NOT treated as private business use, even if such use happens to be in the course of its trade or business.

The Regulations provide that, for the exception to apply, the property must be intended to be available, and is in fact is reasonably available, for use on the same basis by natural persons not engaged in a trade or business. If a long-term arrangement (including all renewal options, greater than 200 days) is in place, such arrangement is not treated as general public use. Note: a right of first refusal to renew use of financed property is not treated as a renewal option if (i) the compensation to be paid for use of the property is redetermined at the time of renewal at fair market value and (ii) the use

of the property under same or similar circumstances is mainly used by natural persons not engaged in a trade or business.

**Example.** City issues bonds to finance a City-owned parking garage at the City airport. The City reasonably expects that more than 10% of the actual use of the garage will be used by employees of the commercial airlines. The airline employees' use of the garage will be on the same basis as passengers and other members of the general public using the airport. The airlines have no priority rights to the parking garage, and the rent that the airlines pay to the City for the lease of airport terminal space is not adjusted to take into account revenues generated by the parking garage (*i.e.,* the airlines don't get a benefit of lower rent payments if parking revenue goes up). Although the airlines may receive an "economic benefit" from the use of the parking garage, the economic benefit is not enough to cause the airlines to be private business users because the parking garage is available to members of the general public. (*See* Treas. Reg. § 1.141-3(f), example 9). (Compare Internal Revenue Service Chief Counsel Memorandum 200143031 – private business use where lease with private carrier gave carrier interest in net profits generated by the parking garage.)

2. **Short-Term Non-Ownership Arrangements**. The Regulations provide the following short-term use exceptions:

(1) 100-Day Rule. This exception covers certain arrangements involving terms of use, including all renewal options, of not more than 100 days in the aggregate. To be eligible for this exception, the arrangement would need to be considered as general public use, except that is not reasonably available on the same basis to natural persons not engaged in a trade or business because generally applicable or uniformly applied rates are not available to such parties. Further, this exception is only available if the property was not finance for the principal purpose of providing that property to such user and it does not result in ownership by the nongovernmental person.

**Example.** Authority uses bond proceeds to construct a prison and enters into a contract with a federal agency to house federal prisoners for a fee. The Authority expects that it will enter into similar transfer agreements with other entities, but such use is not available to natural persons not engaged in a trade or business. The term of contract is for not longer than 100 days; however, while the federal agency does not have a right to renew, renewals are expected. Though the principal purpose of financing the prison was not to provide such space for use by the federal agency, it is reasonably expected that more than 10 percent of the prisoners will be federal prisoners. The issue does not meet the Private Business Use Test, however, because it falls under the 100-Day Rule exception. (*See* Treas. Reg. § 1.141-3(f), example 14).

(2) 50-Day Rule. This exception covers certain arrangements for terms of use, including renewal options, of not more than 50 days in the aggregate, if negotiated at arm's-length and the compensation represents fair market value. This exception is applicable if the principal purpose of financing the property is other than providing that property to such user.

(Note: The exception for "general public use" described above is also subject to a maximum use term of 200 days. It may be easiest to think of the 200-day, 100-day and 50-day exceptions collectively as the "short-term use" exceptions - each having special requirements for application.)

**3.** **Incidental Use**. Consistent with the position taken in Internal Revenue Service Notice 87-69, the Regulations exclude from private business use certain incidental nonpossessory uses (such as kiosks, vending machines, etc.) of up to 2.5% of the proceeds of the bonds.

**4.** **Agents.** Private business use excludes use of bond proceeds by a private business solely in the capacity as an agent for a governmental unit (*e.g.,* a nongovernmental person or entity that issues "on behalf of" a governmental unit). *See* Rev. Rul. 63-20.

**5.** **Use Incidental to Financing Arrangements.** Private business use excludes use solely incidental to financing arrangements (*e.g.,* the nominal ownership by a private business of bond-financed property in a sale-leaseback to a governmental unit as a lessee).

**6.** **Temporary Use by Developers.** Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

**7.** **Qualified Improvements.** Proceeds that provide a governmentally owned improvement to a governmentally owned building (including its structural components and land functionally related and subordinate to the building) are not used for a private business use if -

(i) The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;

(ii) The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;

(iii) No portion of the improved building or any payments in respect of the improved building are taken into account under section 141(b)(2)(A) (the private security test); and

(iv) No more than 15 percent of the improved building is used for a private business use.

## III. MEASUREMENT OF PRIVATE BUSINESS USE (Regs. §1.141-3(g))

**A. Generally.** With one exception, the 10% (or, if applicable, 5%) private business use test limit generally is measured based on the "average percentage of private business use" over a "measurement period." For property owned by a private business user, the "highest-one-year-use percentage test" applies to measure private business use, and no averaging over the measurement period is permitted.

**1. Measurement Period.** The "measurement period" begins on the later of (a) the issue date of the bonds, or (b) the date the financed property is placed in service. The measurement period ends on the earlier of (a) the last day of the reasonably expected economic life of the property (determined on the issue date), or (b) the final maturity date of the bonds (disregarding optional redemptions).

**2. Average Percentage of Private Business Use.** Generally, the measurement of private business use involves a two-step process: (a) finding the percentage of private business use in each 1-year period (determined as a percentage of actual use); and (b) finding the average of these 1-year percentages.

**Example –** Assume a City issues bonds to finance a 20-story office building. The office building has an expected economic life of 20 years. The City expects to lease a number of the floors out to private business users for the term of the bonds and the term of the bonds exceeds the expected economic life of the building. Under the Regulations, the City could lease two floors for the term of the bonds to a private party (*e.g.,* 2/20) or the City could lease ALL of the floors to the private user for a period not to exceed 2 years.

**B. Special Rules for Special Situations.**

**1. Use at Different Times.** Generally, the average amount of private business use is based on the actual use by the private user, disregarding periods during which the facilities is not in use.

**2. Simultaneous Use.** If different types of governmental use and private business use occur at the same time, the entire facility is generally determined to have private business use. However, if use by both is on the

same basis, the average amount of private business use may be determined on a reasonable basis that is reflective of proportionate use.

3. **Discrete Portion.** Use of a discrete portion of a facility is determined by treating the discrete portion as a separate facility.

4. **Fair Market Value.** If private business use is reasonably expected to have a significantly greater fair market value than the governmental use, the amount of private business use must be calculated taking into account the value of use.

5. **Common Areas.** The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit.

**C. Mixed-use Property and Qualified Equity (Regs. §1.141-6(b))**

1. For property that is both financed with tax-exempt bonds and with "qualified equity" (i.e., a mixed use project), private business use will first be allocated in each year to the qualified equity before it is allocated to bond proceeds. Note that qualified equity is allocated to private business use on an annual basis and not over the measurement period in the aggregate.

2. "Qualified equity" must be proceeds of bonds that are not tax-advantaged or amounts that are not derived from proceeds of a borrower that are spent on the same mixed use project with the time period beginning when reimbursement would be allowed and ending when the project is placed in service.

3. Special rules relate to partnerships between governmental and nongovernmental persons that essentially treat that partnership as a private user to the extent of the nongovernmental persons' or entities' interests in the partnership.

**D. Output Facilities**. See Regulations §1.141-7 and -8 for special rules for output facilities.

## IV. PRIVATE PAYMENTS OR SECURITY TEST (Regs. §1.141-4)

**A. In General.** In general, the Private Payments or Security Test is met if payment of more than 10% (or, if applicable, 5%) of debt service on the bond issue is directly or indirectly (a) secured by any interest in property used or to be used for a private business use or payments in respect of such property or (b) to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use.

**B. Measurement of Private Payments and Security.**

**1. Present Value Measurement.** The Private Payment Test is met if the present value of all private payments over the term of the bond issue exceeds 10% (or, if applicable, 5%) of the present value of the debt service on the bond issue. The Private Security Test is met if the fair market value of the pledged property determined as of the first date such property secures the bonds exceeds 10% (or, if applicable, 5%) of the present value of the debt service on the bond issue.

**2. Computation of Present Value.**

**a. Fixed Rate Issues.** For purposes of a fixed yield issue, the bond yield on the issue is used as the discount rate.

**b. Variable Rate Issues.** To determine the reasonably expected yield on a variable yield issue at any time, the issuer may assume that the future interest rate on the issue will be the then-current interest rate.

**3. Adjustments to Debt Service**. Bond debt service is adjusted upward to include certain amounts treated as part of the bond yield for arbitrage purposes (*e.g.,* qualified guarantee payments and qualified hedge fees), and is adjusted downward for certain debt service paid from bond proceeds (*e.g.,* capitalized interest or funded reserve funds).

**C. Private Payments**

**1. Payments Taken into Account.** The Regulations provide that private payments include direct and indirect payments made by private business users to the extent allocable to that private business use. In addition, payments are only taken into account for the period of time that the financed property is actually used for a private business use.

**2. Private Payments Cannot Exceed Private Use.** The Regulations limit private payments to the percentage of private business use. For example, if a private business uses 7% of a financed facility, the amount of private payments taken into account will not exceed the present value of 7% of the debt service on the bonds, even if the use arrangement in question requires the user to make payments to the issuer with a present value equal to 8% of the present value of debt service on the bonds.

**3. Operating Expenses Excluded.** The Regulations exclude from private payments those amounts properly allocable to ordinary and necessary business expenses (under I.R.C. § 162) that are directly attributable to the operation and maintenance of the property. General overhead or administrative expenses do not qualify for this exclusion.

4. **Generally Applicable Taxes Excluded.** The Private Payments or Security Test excludes "generally applicable taxes." A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the jurisdiction and a generally applicable manner of determination and collection.

   a. **Agreements that Negate a Generally Applicable Tax.** The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to be personally liable on a tax that does not generally impose personal liability, to provide additional credit support such as a third-party guarantee, or to pay unanticipated shortfalls; an agreement regarding the minimum market value of property subject to property tax; and an agreement not to challenge or seek deferral of the tax.

   b. **Payments In Lieu of Taxes (PILOTs)**

      (1) **General.** PILOTs are treated as a generally applicable tax if the payment (i) is commensurate with and not greater than amounts imposed by a statute for a tax of general application, and (ii) the payment is for a public purpose and is not a special charge.

      (2) **Special Charges.** A payment for a special privilege granted or service rendered is not a generally applicable tax. A tax or a payment in lieu of tax that is limited to the property of persons benefited by an improvement is not a generally applicable tax.

      (3) **Private Letter Rulings.** PLR 200640001 and PLR 200640002 provide that payments in lieu of taxes made by a private party in connection with the use of baseball stadiums in New York City do not constitute private payments or private security with respect to bonds issued by an agency of the State of New York to finance construction of those baseball stadiums. Because the PILOTs in question are designated for the public purposes of promoting tourism and economic development and are calculated with respect to generally applicable *ad valorem* taxes, they do not constitute a special charge as defined in Treas. Reg. § 1.141-4(e)(5).

      (4) **Proposed Regulations.** On October 19, 2006, the Internal Revenue Service issued proposed amendments to Treas. Reg. § 1.141-4(e)(5). The proposed Regulations omit the sentence previously contained in Treas. Reg. § 1.141-4(e)(5) that states "For example, a payment in lieu of taxes made in

consideration for the use of property financed with tax-exempt bonds is treated as a special charge." The proposed regulations also state that a PILOT is "commensurate" with generally applicable taxes "only if the amount of such payment represents a fixed percentage of, or reflects a fixed adjustment to, the amount of generally applicable taxes that otherwise would apply to the property in each year if the property were subject to tax."

**5. Private Payment Allocations**

**a. In General.** The Regulations provide that, in general, private payment allocations among different sources are based on all the facts and circumstances and focus on the nexus between the payment and both the financed property and source of funding.

**b. Discrete Portions.** Payments for the use of a "discrete portion" (*e.g.,* 1 floor of a 10-story building) are generally allocable to the source of funding of that discrete portion.

**c. Allocations Among Two or More Sources.** Unless a special rule applies (*e.g.,* planned arrangements or equity allocations described below), if a private payment is made for the use of property financed with two or more sources of funding, that payment must be allocated between those sources in a manner that reasonably corresponds to the relative amounts of those sources of funding that were expended on the property.

**d. Certain Planned Arrangements.** Private payments made for the use of property under an "arrangement" entered into in connection with a bond issue that finances that property generally is allocated to that bond issue. An "arrangement" generally exists if the private payments correspond to debt service on the issue and if the issuer enters into the arrangement during the three-year period beginning 18 months before the issue date.

**e. Equity Allocations.** Allocations of private payments to equity are permissible if the issuer adopts an official intent resolution similar to those used for reimbursement bonds within 60 days after the expenditure and makes the allocation within 18 months after the later of the expenditure or the placed in service date.

**f. Output Contracts**. Payments under an output contract that result in private business use of a mixed-use project are allocated to the same source of funding allocated to the private business use from such contract.

**D.** **Private Security.** Private security includes an interest in property used or to be used for private business use or any payments from such property that secure a bond issue (*e.g.,* securities or unimproved land), whether or not the bond issue finances that security. Similar to the rules for private payments, private security is taken into account only to the extent it is provided directly or indirectly by a user of the proceeds of the bonds. Note: If payments count as both private payments and private security, they are not double counted.

## V. PRIVATE LOAN TEST (Regs. §1.141-5)

**A.** **In General.** I.R.C. § 141(a)(2) provides that bonds are private activity bonds if more than the lesser of 5% or $5 million of the bond proceeds are to be used (directly or indirectly) to make or finance loans (excluding certain permitted tax assessment loans) to nongovernmental persons or entities.

**1.** **Amount is not Discounted.** Unlike the Private Payments or Private Security Test, the amount of proceeds loaned is not discounted to reflect the present value of the loan payments.

**2.** **Certain Prepayments may be treated as Loans.** Unless certain narrow exceptions can be satisfied, the use of bond proceeds to finance a prepayment for goods or services may be viewed as a loan. The exceptions are similar to those contained in the arbitrage regulations regarding investment property.

**3.** **Grant is not a Loan**. Under the Regulations, a grant of proceeds is not a loan. As defined in Regs. §1.150-1(f), a grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor or a related party. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

**B.** **Exception for Loans to Finance Taxes or Assessments**

**1.** Under federal tax law, real property assessments that are deferred and paid over time are generally treated as loans. Thus, bonds that are issued to finance improvements to be paid by assessments could be seen as meeting the Private Loan Test.

**2.** I.R.C. § 141(c)(2), however, contains an exception for loans that enable the borrower to finance any tax or assessment of general application where the tax or assessment finances a specific essential governmental function and satisfies other conditions set forth in Regs. § 1.141-5(d)(3)-(5). Issues arise as to what is "of general application" and what is an "essential governmental function."

## VI. ALLOCATION AND ACCOUNTING RULES (Regs. § 1.141-6)

**A. General Rule.** The allocations of proceeds and other sources of funds to expenditures under the arbitrage rules (Regs. §1.148-6(d)) apply for purposes of applying the private activity bond tests. Allocations generally may be made using any reasonable, consistently applied accounting method.

**B. Proportionate Allocation Between Sources**. Except in the case of eligible mixed-use projects, discussed in III.D above, if two or more sources are allocated to a project, the sources are allocated proportionately to the uses of the project.

## VII. REMEDIAL ACTIONS (Regs. § 1.141-12)

**A. General Rule.** An action that causes the Private Business Tests or Private Loan Test to be met is not treated as a deliberate action if the issuer takes a specified remedial action and all of the following requirements are met:

**1. Reasonable Expectations.** The issuer reasonably expected on the date of issue that the issue would not meet either the Private Business Tests or the Private Loan Test for the entire term of the bonds. If the issuer reasonably expects to take deliberate action during the term of the bonds and the special redemption requirements described in I.C.2 – "Exceptions to the Reasonable Expectations Test" above are met, the term of the bonds for this purpose may be determined taking into account such redemption provisions.

**2. Maturity not Unreasonably Long.** The term of the issue must not be longer than reasonably necessary for the governmental purposes of the issue.

**3. Fair Market Value Consideration.** Except with respect to the alternative use of facility remedial action described in C.3. below, the terms of any agreements that result in satisfaction of either the Private Business Tests or the Private Loan Test are bona fide and arm's-length and the new user pays fair market value for its use.

**4. Disposition Proceeds.** The issuer must treat any disposition proceeds as gross proceeds for the purposes of I.R.C. § 148 (relating to arbitrage).

**5. Proceeds Expended.** Except with respect to the redemption or defeasance remedial action, the proceeds of the issue affected by the deliberate action must have been expended before the deliberate action.

**B. Definition of Nonqualified Bonds.** The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the Private Business Tests or Private Loan Test, as applicable. The amount of private business use equals the highest percentage of private business use in any one-year period commencing with the deliberate action. Allocations to nonqualified bonds

must be made on a pro rata basis, except that for the purposes of the remedial action, the issuer may treat any bonds as the nonqualified bonds so long as (i) the remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (the "Determination Date"), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer as described above, is not greater than (ii) the remaining weighted average maturity of the issue, determined as of the Determination Date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the Determination Date.

For example, if a deliberate action causes 12% of the proceeds of a bond issue to be subject to private business use (and the issue meets the Private Payment or Security Test), in general, slightly more than 2% of the outstanding bonds would be "nonqualified bonds."

## C. Options for Remedial Action

### 1. Redemption or Defeasance of Nonqualified Bonds

**a.** If there is a transfer exclusively for cash, the requirements are satisfied if the disposition proceeds are used to redeem a *pro rata* portion of the nonqualified bonds within 90 days of the deliberate action or establish a defeasance escrow within such period. If the deliberate action does not involve a transfer exclusively for cash, funds other than proceeds of a tax-exempt bond must be used to redeem all the nonqualified bonds within 90 days of the deliberate action or a defeasance escrow must be established within such period.

**b.** If a defeasance escrow is established, the issuer must notify the Internal Revenue Service of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

**c.** Notwithstanding the foregoing, the establishment of a defeasance escrow will not be considered a remedial action if the period between the issue date and the first call date is more than 10.5 years.

**d.** The final Regulations promulgated in 2015 allow issuers to take anticipatory remedial action, described in paragraph 4 below.

**2. Alternative Use of Disposition Proceeds.** Use of disposition proceeds for an alternative use is a remedial action if all of the following apply:

**a.** The deliberate action involves a transfer exclusively for cash;

**b.** The issuer reasonably expects to spend the disposition proceeds within 2 years of the deliberate action;

**c.** The disposition proceeds are used in a manner that does not cause the issue to meet either the Private Business Tests or the Private Loan Test; and

**d.** Any disposition proceeds not so used are used for another remedial action.

**3. Alternative Use of Facility.** Alternative use of a facility is treated as a remedial action if all of the following are met:

**a.** The facility is used in an alternative manner (*i.e.,* use by a nongovernmental person or entity for a qualifying purpose or use by a Section 501(c)(3) organization);

**b.** The nonqualified bonds are treated as reissued as of the date of deliberate action for purposes of I.R.C. §§ 55-59, 141-147, 149 and 150, and the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds;

**c.** The deliberate action does not involve a transfer to a purchaser that finances the acquisition with proceeds of tax-exempt bonds; and

**d.** Any disposition proceeds other than those arising from an agreement to provide services are used to pay debt service on the bonds on the next debt service payment date or are deposited in a yield restricted escrow within 90 days of receipt to pay debt service on bonds on the next available debt service payment date.

**4. Anticipatory Remedial Actions**. For many years, an issuer could not take a remedial action until after a deliberate action had occurred. In 2015, Treas. Reg. §1.141-12(d) was amended to provide for an issuer's redemption or defeasance of nonqualified bonds taken in anticipation of a deliberate action. The requirements for redemption or defeasance of the nonqualified bonds within 90 days of the deliberate action are met if the issuer declares its official intent to redeem or defease all of the bonds that would become nonqualified bonds in the event of a subsequent deliberate action that would cause the Private Business Tests or the Private Loan Test to be met and redeems or defeases such bonds prior to that deliberate action.

The declaration of official intent must be made in a manner similar to that prescribed for declarations of official intent under the reimbursement rules of Treas. Reg. §1.150-2. The issuer must declare its official intent on or before the date on which it redeems or defeases such bonds, and the declaration of intent must identify the financed property or loan with respect to which the anticipatory remedial action is being taken and describe the

deliberate action that potentially may result in the Private Business Tests being met.

**5. Other Remedial Actions**

**a. In General.** The Commissioner may provide additional remedial actions.

**b. Rev. Proc. 97-15.** This procedure establishes an Internal Revenue Service closing agreement program applicable to failures to meet the requirements for excludability of interest from gross income in I.R.C. §§ 141 through 150 that can be remediated under Treas. Reg. §§ 1.141-12, 1.142-2, 1.144-2, 1.145-2 or 1.147-2. The revenue procedure has no effect on the application of I.R.C. § 150(b) and (c).

**c. Payment in Lieu of Taxability.** In the case of a closing agreement providing that the interest on the bonds will not be includible in the gross income of bondholders, Rev. Proc. 97-15 requires, among other things, that the issuer agree to redeem the nonqualified bonds on the next redemption date and pay a closing agreement amount equal to an estimate of the federal tax liability that is not required to be paid by holders with respect to interest accruing on the nonqualified bonds, as computed in accordance with Rev. Proc. 97-15.

**d. AMT Payments.** In the case of a closing agreement providing that the interest on bonds will not be treated as an item of tax preference for purposes of the alternative minimum tax, Rev. Proc. 97-15 requires, among other things, that the issuer pay a closing agreement amount equal to an estimate of the federal tax liability that is not required to be paid by holders because of this treatment, as computed in accordance with the Rev. Proc. 97-15.

**e. Voluntary Closing Agreement Program.** Violations that cannot be remediated under the existing remedial action procedures described above or other tax-exempt bond closing agreement programs such as the program set forth in Rev. Proc. 97-15 may be resolved by entering into a closing agreement under the Voluntary Closing Agreement Program ("VCAP") described in Notice 2008-31. VCAP is not available if the bond issue is under examination.

**f. Rev. Proc. 2018-26**. This procedure provides certain remedial actions that issuers of State and local tax-exempt bonds and other tax-advantaged bonds may take to preserve the tax-advantaged status of the bonds when nonqualified uses resulting from a long-term lease or concession to a nongovernmental person occurs. This procedure also permits issuers of direct pay bonds to cure excessive

nonqualified use by reducing the amount of the refundable tax credit claimed by the amount allocable to the nonqualified bonds. The procedure also permits issuers of direct pay bonds and tax credit bonds to cure excessive nonqualified use by employing a redemption or defeasance remedial action or an alternative use of disposition proceeds remedial action that are similar in some respects to those applicable to governmental and 501(c)(3) bonds.

## VIII. ANTI-ABUSE RULES (Regs. § 1.141-14)

The Regulations state that the Commission has the authority to take action to reflect the substance of the transaction if the issuer enters into one or a series of transactions with a principal purpose of transferring to nongovernmental persons or entities other than the general public significant benefits of the tax-exempt financing in a manner that is inconsistent with the purposes of Section 141 of the Code. This may include treating separate issues as a single issue for purposes of the private activity bond tests, reallocating proceeds to expenditures, property, or bonds, reallocating payments, or adjusting the measurement of private business use. Treas. Reg. § 1.141-14(b) provides examples of how the anti-abuse provisions are applied.