

Avoiding Private Activity

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The Essentials

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



*Quite probably leading to more questions

What are the Private Activity Tests?

General 2-Prong Test

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

AND

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

What are the Private Activity Tests?

\$15 Million Limitation on “nonqualified” amount unless the issuer allocates volume cap to the excess.

Private Loan Financing. More than the lesser of 5% or \$5M of the bond proceeds are used to make or finance loans to a person other than a state or local government unit.

Who are Private Business Users?

Private business users include all of the following:

- Corporations, partnerships or any other entity engaged in business
- Exempt organizations (but I.R.C. § 145 permits Private Activity Bonds for 501(c)(3) orgs for facilities used in their exempt purposes)
- Federal government and federal government agencies
- Natural persons engaged in a trade or business

Special rule for partnerships between governments and nongovernmental persons

What types of arrangements create private use?

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

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

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

There are “short term use” exceptions for:

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

Does having an outside manager create a private business use problem?

Contract is
“qualified” if it
meets certain
requirements:

Eligible expense reimbursement

Financial requirements

- Reasonable compensation
- No net profits
- No bearing of net losses

Term no greater than the lesser of 30 years or 80% of weighted average reasonably expected economic life

Qualified user exercises significant control

Qualified user bears risk of loss

No inconsistent tax position

No circumstances substantially limiting exercise of rights

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What if a nonqualified management contract covers the entire facility?

Are the related bonds taxable?

Remember:

- Measured on an issue-by-issue, not facility-by-facility basis.
- The measurement is of average annual use over the life of the issue, so excessive use in one year may be balanced out by low use in another year.
- The Regulations contain a number of special rules for measuring private use for instances in which:
 - use of the facility occurs at different times
 - use of the facility in which governmental use and private use occur simultaneously
 - the private business use occurs in discrete portions
 - private use which has a greater value than governmental use
- It's not just private use that matters – also have to meet the private payments test.

How do I allocate private use if there are multiple financing sources?

General rule: if two or more sources are allocated to a project, the sources are allocated proportionately to the uses of the project.

For property that is both financed with tax-exempt bonds and with “qualified equity” (i.e., mixed use property), private business use is first 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.)

- “Qualified equity” must be non-tax-exempt bond proceeds spent on the same “project” with the time period beginning when reimbursement would be allowed and ending when the project is placed in service.

The issuer wants to name an arts facility after a company - any issues?

Not all naming rights are problematic

When coupled with conditions regarding display of name, IRS concluded that a naming rights contract would give rise to private business use (PLR 200323006)

IRS has applied a measurement approach that compares the fair market value of the naming rights contract to the fair market value of the bond-financed facility.

- FMV of use may equal payments made for naming rights
- IRS has suggested FMV of facility may be measured by:
 - Revenues generated by the facility during its reasonably expected economic life
 - Cost of constructing the facility

If tax revenues pay debt service, can payments from private parties be ignored?

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

How do tax assessments fit into the private business analysis?

- Special assessments imposed are not generally applicable taxes of the limited scope of application
- Section 1.141-5(d)(3)-(5) provides for a “tax assessment loan” exception to the private loan test:

Mandatory

- Enforced contribution imposed under a state law of general application
- Applied equally to natural persons and entities in trade or business

Essential Governmental Function

“Equal Basis”

- Terms of payment must be the same for all persons
- Guarantees of collections by a “borrower” violates “equal basis” requirement if there is a reasonable expectation that payments will be made under guarantee

If the bonds are refunded, is there a “do over” for private activity?

General rule

- Look at the average use over the life of the facility (or life of the bonds, if shorter)

Special rules for refunding bonds

- **Combined Treatment**
 - Measurement period spans the life of both the prior and refunding bonds
 - Blended yield for purposes of private payment/security test
- **Separate Treatment**
 - Can start over only if prior issue complies with private business use limitation

Some excess private business use was identified. What can be done?

Reallocation (within 18-month limit)

Contract renegotiation

Remedial action

- Prerequisites include, but are not limited to:
 - No reasonable expectation at closing that would meet private activity tests
 - Receipt of FMV consideration and treatment of disposition proceeds as gross proceeds
- Options for remedial action generally include:
 - Redemption or defeasance of nonqualified bonds
 - Alternative use of disposition proceeds
 - Alternative use of facility

Voluntary Closing Agreement Program (Notice 2008-31 and I.R.M. 7.2.3)

Questions

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