

Avoiding Private Activity

Real World Examples

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APRIL 19–21, 2023

What is a Private Activity Bond

A bond is a private activity bond if...

- **Private Use and Private Security/Payments.** 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 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

OR

- **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.

HYPOTHESIS No. 1 - Big Plans!!

You are working on a \$20 million new money, general obligation bond issuance with a 20-year maturity for a small suburban city that predicts that it will grow substantially in the next 20 years. On the diligence call, you ask the city to describe the projects that it will finance with the bonds, and the city manager responds with...



We are purchasing a 10-story office building downtown for our new city hall. Like us, the private company that currently owns the building is growing and plans to build a new office complex that will be completed in about 2 years. It will mean about 200 more jobs in the city – isn't that great? They'll be leasing most of the building back until it's time for them to move to their new place, but we don't need the building right away, except for the top two floors that will house our facilities staff. Once the private company is out in 2 years, we plan to take over 6 more floors, and let nonprofits use the remaining 2 floors for community programs until we need them. Anyway, the company is looking to sell the building now and it's in the perfect location for us, right downtown and next to a big park.



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APRIL 19–21, 2023

It also has a big, 10-floor parking garage next door that is part of the deal, so we will have parking for our employees, which is a big problem for us right now because our staff is scattered over 6 different lots that are sort of far away.

The great news is that the parking garage is so big that the current owners have contracts with employees of local businesses to use the top 4 floors, so we have a built-in revenue stream already in place. We can also open up the garage to the public use in the evenings, which will be good because....





We are hoping to contract with an event promoter who will bring in some entertainers and events from time to time and the company that we are buying the building from is interested in sponsoring the amphitheater in some way or another – you know, having their name on the stage or something. I think that about covers it, so, as you can see, there are really only two projects, so it's pretty straightforward with this one.

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Straightforward, huh?

What are your next questions?

What potential private activity issues have you identified?



We are purchasing a 10-story office building downtown for our new city hall. Like us, the private company that currently owns the building is growing and plans to build a new office complex that will be completed in about 2 years. It will mean about 200 more jobs in the city – isn't that great? They'll be leasing most of the building back until it's time for them to move to their new place, but we don't need the building right away, except for the top two floors that will house our facilities staff. Once the private company is out in 2 years, we plan to take over 6 more floors, and let nonprofits use the remaining 2 floors for community programs until we need them. Anyway, the company is looking to sell the building now and it's in the perfect location for us, right downtown and next to a big park.



Private Business Users

Private business users of governmental use bonds include all of the following, unless an exception is met:

- Corporations, partnerships or any other entity engaged in business
- Exempt organizations
- Federal government and federal government agencies
- Natural persons engaged in a trade or business

Special rule for partnerships between governments and nongovernmental persons

Arrangements Creating Private Use

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

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

Measurement of Private Use

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

Remember: It's not just private use that matters – also have to meet the private payments test.

Allocation Rules

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.

Private Payments

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

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The great news is that the parking garage is so big that the current owners have contracts with employees of local businesses to use the top 4 floors, so we have a built-in revenue stream already in place. We can also open up the garage to the public use in the evenings, which will be good because....



Short-Term Exceptions to Private Use

There are “short term use” exceptions for:

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

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Naming Rights

- 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
- 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

HYP0 No. 2 - Sink or Swim

You are catching up on all the latest bond-related developments by reading your “NABL Weekly Wrap” when your phone rings. It’s the finance director at one of your municipal clients who frantically blurts out:



Thank goodness you are in the office! I just got word from our facilities department that they entered into a management contract for the swim center that was financed with our Series 2010 bonds. They thought the company could run the place more efficiently than we can. The contract is set up so that the company compensation is 50% of the profits, so I guess they are really expecting to turn it around! Great, I guess, but I seem to remember that this is bad for our tax-exempt bonds...are they going to be taxable? I told them to contact me about stuff like this before anything gets signed, but they apparently didn't...



Are the bonds
going to be
taxable?



Qualified Management Contracts

Service or management 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

Relax and Remember



Measured on an issue-by-issue, not facility-by-facility basis.



The measurement is of average annual use over the life of the issue, so excessive use in one year may be balanced out by low use in another year.



It's not just private use that matters – also have to meet the private payments test.

HYPO No. 3 - Tabula Rasa

You return from a coffee run to
the following voicemail...



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Hi, its City Finance Director. Now that we've adopted those written post-issuance compliance procedures you've been asking us to implement, we noticed that one issue of bonds has some excess private business use because we allowed that private company to extend their lease on the building we purchased when construction was delayed on their new office complex. Interest rates are down, so we were thinking of doing a refunding anyway. That'll give us blank slate for measuring private use, right?



After you've had a few more gulps of coffee, how do you respond?



Measuring Private Business Use

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
 - See the “Refunding/Reissuance” panel

HYP0 No. 4 - Cha-ching!

While you are perusing
Section 141 of the Code,
your client calls with the
following news of a
windfall...



Great news! That tract of land that we bought a few years ago from the 2020 Bonds for the fairgrounds expansion is apparently a gold mine. We used \$1.2M of our \$10M bond proceeds to purchase land and a private \$10M! The fairgrounds expansion had stalled anyway, so we want to go for it. Frankly, we need the extra money in the general fund to pay for \$1.5M of park improvements and the rest to cover the settlement of that big lawsuit against us.

So, how does this affect our bonds?
What are our options?



Well, how does it?
What are the
options?



Deliberate Actions

- Bonds are private activity bonds based on expectations on the date of issuance or subsequent “deliberate action”
- **Exceptions to this rule:**
 - “General Obligation” bonds financing at least 25 separate projects, with total governmental projects in next six months to exceed bond proceeds by 25%
 - Sales of equipment/vehicles below 25% of cost
- A change in use is not treated as a “deliberate action” if the issuer takes one of several “remedial actions”
- Newish rule clarified “anticipatory remedial action”

Remedial Actions

Types of remedial action:

- Redeem or defease “nonqualified bonds”
- Alternative use of disposition proceeds
- Alternative use of the facility
- Other remedial actions
 - Rev. Proc. 97-15
 - Rev. Proc 2018-26

Can only take remedial action if:

- Reasonable expectations test was met
- Maturity of the bonds is not unreasonably long
- Fair market value consideration paid
- Disposition proceeds are “gross proceeds”

Remedial Actions

Redeem or Defease “Nonqualified Bonds”

- “nonqualified bonds” are portion of outstanding bonds that, if remaining bonds were issued on date of deliberate action, the remaining bonds would not meet private business use test
- $1.2\text{M}/10\text{M} = 12\%$
- A little over 2% of bonds would be required to be redeemed to reduce private use under 10% and take into account common costs
- Other amounts may be used for any authorized purposes

Alternate use of Disposition Proceeds

- Prior IRS web posting suggested that entire \$10M in receipts (not just the \$1.2M purchase price) would be required to be used for “good” alternative uses
- Unclear whether that still is IRS position, but hard to ignore prior position without more clarification
- Capital projects are generally good uses, but would the legal judgement qualify?

Questions

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