Final Regulations Provide Guidance on Tax Exempt Bond Allocations

Projects funded with proceeds from tax-exempt bonds also often involve private financing that is not tax-exempt. This article describes why allocation rules regarding the use of bond proceeds are important for these types of projects and how new final regulations provide needed guidance while allowing additional flexibility.

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by Felicia Tucker and Chad Franks, Development and Exempt Organizations Tax, and Paul Kunkel, Washington National Tax

Felicia Tucker and Chad Franks are principals in the Development and Exempt Organizations practice. Paul Kunkel is a director in the Financial Institutions and Products group of Washington National Tax.

Overview

On October 26, 2015, the Treasury Department and IRS released for publication in the *Federal Register* final regulations[1] (the "Final Regulations") concerning the allocation and accounting rules for purposes of the "private activity bond" restrictions under section 141. The Final Regulations apply to all tax-exempt bond issuances by state and local governments, including "qualified" section 501(c)(3) bonds. Prior to the release of the Final Regulations, issuers had been relying on proposed regulations issued during 2006 (the "2006 Proposed Regulations") with regard to the allocation and accounting rules for tax-exempt bond proceeds, including special rules for so-called "mixed use" projects and rules regarding the use of partnerships. The Final Regulations withdrew certain provisions of the 2006 Proposed Regulations; clarified other portions of those regulations; and provide guidance on "remedial actions" to prevent tax-exempt bonds from becoming private activity bonds after issuance.

Background

In general, interest on state and local governmental bonds is excludable from gross income under section 103 upon satisfaction of certain requirements. Interest on a private activity bond, other than a qualified private activity bond within the meaning of section 141, is not excludable under section 103. Section 141 provides certain tests that are used to determine whether a state or local bond is a private activity bond.

[1] T.D. 9741.

These tests look to the amount of use of bond-financed assets by nongovernmental persons (the private business use test), whether the bonds are secured by property or payments with respect to property used in private business (the private security or payment test in section 141(b)), and whether the bond proceeds have been used to make loans to nongovernmental persons (the private loan financing test in section 141(c)). Section 145 defines similar tests that apply in modified form to "qualified section 501(c)(3)" bonds.

Final regulations providing comprehensive guidance on most aspects of the private activity bond restrictions had been published in 1997 (the "1997 Regulations").[2] However, the 1997 Regulations did not address most of the general application and accounting rules for section 141 purposes. Allocation and accounting rules regarding the use of bond proceeds are critical for purposes of the private activity bond tests because in many instances issuers expend both tax exempt bond proceeds and their own capital or other funds (e.g., taxable bond proceeds) on a project. To calculate the percentage of private business use in these cases, issuers must determine how to allocate the tax exempt bond proceeds and other funds to the bond-financed assets and the uses of those assets. The Final Regulations provide guidance on making these allocations.

Summary of Final Regulations

Allocation of Bond and Equity Proceeds

The Final Regulations state that the allocations of bond proceeds and other sources of funds to expenditures made for purposes of the arbitrage rebate rules under section 1.148-6(d) also apply for purposes of the private business use tests under section 141. Except with regard to the allocation of proceeds to an "eligible mixed-use" project (discussed below), if two or more sources of funding (including two or more tax-exempt bond issues) are allocated to capital expenditures for a "project," those sources are allocated throughout that project to the governmental use and private business use of the project in proportion to the relative amounts of those

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] T.D. 8712.

sources of funding spent on the project (pro rata allocation). A "project" is defined broadly in the Final Regulations to include "all facilities or capital projects financed in whole or part with the proceeds of the [tax-exempt bond] issue," but does not include subsequent improvements to those facilities or projects financed by a separate issue.

Under a special rule for "output facilities,"[3] if an output facility has multiple undivided ownership interests (respectively owned by governmental persons or by both governmental and nongovernmental persons), each owner's interest in the facility is treated as a separate facility for purposes of the allocation rules, provided that all owners of the undivided ownership interests share the ownership and output in proportion to their contributions to the capital costs of the output facility.

Special Allocation Rules for Eligible Mixed-Use Projects

The Final Regulations define a special allocation methodology for "eligible mixed use projects," which are defined as projects financed with proceeds of "governmental bonds" (as defined in section 1.150-1(b))[4] and with "qualified equity" pursuant to "the same plan of financing." The definition of qualified equity places restrictions on the source of funds that may be applied to a mixed-use project, while the requirement that qualified equity be spent under the same plan of financing as the governmental bonds (the "applicable bonds") puts restrictions on the timing of expenditures that may be treated as funded with qualified equity.

"Qualified equity" means proceeds of bonds that are not tax-advantaged bonds[5] and funds that are not derived from proceeds of a borrowing that are spent on the same eligible mixed-use property as the applicable bonds. Qualified equity does not include equity interests in real or tangible personal property, and does not include funds used to redeem or repay governmental bonds.

Qualified equity finances a project under the "same plan of financing" that includes the applicable bonds if the qualified equity pays for capital expenditures of the project on a date that is no earlier than a date on

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[3] *See* section 141(b)(4); *see also* section 1.141-7 (discussing special rules applicable to output facilities).

[4] "Governmental bond means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds."

[5] Tax Advantaged or "[t]ax-exempt bond means any bond the interest on which is excludable from gross income under section 103(a)." *See* section 1.150-1(b).

which these expenditures would be eligible for reimbursement by proceeds of the applicable bonds and generally no later than the date on which the measurement period for private business use of the project begins. While this definition helps create some clarity around when capital proceeds should be allocated to a project, it can also limit the allocation of equity to projects with longer construction lives.

An eligible mixed-use project must be wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner. In the case of a partnership,[6] the private business use by the nongovernmental partner in the partnership is determined by the nongovernmental partner's greatest percentage share of specified partnership items during the measurement period.

Under the special allocation rule in the Final Regulations for eligible mixed-use projects, the sources of funding allocated to capital expenditures are allocated to undivided portions of the project and the governmental and private business uses of each undivided portion is measured in the following manner (the "undivided portion" method).[7] Qualified equity is allocated first to the private business use of the eligible mixed-use project and then to governmental use, and proceeds of the applicable bonds are allocated first to the governmental use and then to private business use, using the percentages of the eligible mixed use project financed with the respective sources and the percentages of the respective uses.[8] This method allows allocations of qualified equity and bond proceeds to "float"

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[6] These regulations also apply equally to section 501(c)(3) private activity bonds under Section 145. Therefore, the use of "governmental bond" is intended to apply equally to a section 501(c)(3) private activity bond.

[7] The 2006 Proposed Regulations allowed the issuer to elect the pro rata or the undivided portion method. The Final Regulations require the use of the undivided portion method.

[8] Example: Mixed-use project. City A issues $70x of bonds (the "Bonds") and finances the construction of a 10-story office building costing $100x (the "Project") with proceeds of the Bonds and $30x of qualified equity (the "Qualified Equity"). To the extent that the private business use of the Project does not exceed 30 percent in any particular year, the Qualified Equity is allocated to the private business use. If private business use of the Project were, for example, 44 percent in a year, the Qualified Equity would be allocated to 30 percent ($30x) private business use and proceeds of the Bonds would be allocated to the excess (that is, 14 percent or $14x), resulting in private business use of the Bonds in that year of 20 percent ($14x/$70x). Conversely, if private business use of the Project were 20 percent, Qualified Equity would be allocated to that 20 percent. The remaining Qualified Equity (that is, 10 percent or $10x) would be allocated to the governmental use in excess of the 70 percent to which the proceeds of the Bonds would be allocated.

around the bond-financed project permitting the equity to be applied to any private business use and the bond proceeds to governmental use. The Final Regulations do not permit any unused qualified equity to be "carried over" from year to year to cover any increases in private business use in any year; however, because the calculation of private business use must be conducted annually, the full amount of qualified equity is available each year to be allocated to any private business use.

Remedial Actions

As noted earlier, bonds are private activity bonds if the bonds meet either the private business use and private security or payment test (the private business use tests) or the private loan financing test. Under the section 141 regulations, a bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business use tests or the private loan financing test, or if the issuer takes a "deliberate action," subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met.

A deliberate action is any action taken by the issuer that is within its control, regardless of whether there is any intent to violate the requirements of section 141. The 1997 Regulations allow the issuer to take certain "remedial actions" that prevent a deliberate action with respect to bond-financed property from causing that issue of bonds to meet the private business use tests or private loan financing test. Remedial actions under the 1997 Regulations include redemption or defeasance of "nonqualified" bonds within 90 days of the deliberate action; disposing of the bond-financed property and using the disposition proceeds in a manner that complies with certain requirements; or changing to an alternative use of the facility, if certain requirements are met. Because a remedial action "cures" the improper use of bond proceeds, the use of the allocation rules is required in order to determine the nonqualified bonds that are remediated. The Final Regulations expand the circumstances under which a remedial redemption of nonqualified bonds is permitted and adopt more issuer-favorable provisions regarding the amount and allocation of nonqualified bonds for purposes of the remedial action rules.

In addition to allowing an issuer to defease or redeem nonqualified bonds within 90 days after a deliberate act, the Final Regulations now allow an issuer to redeem or defease bonds at any time in advance of a deliberate action that would cause those bonds to become nonqualified bonds (an "anticipatory redemption"), if certain conditions are met.

The 1997 Regulations required the allocation of nonqualified bonds to be done on a pro rata basis across an issue, except that, for purposes of performing a remedial defeasance or redemption, the issuer could treat bonds with longer maturities as the nonqualified bonds. The Final Regulations similarly contain a general rule that allocations of nonqualified bonds must be done on a pro rata basis, but provide more flexibility in the case of a remedial defeasance or redemption by allowing the issuer to treat any bonds of the issue as nonqualified bonds so long as a certain condition on the weighted average life of the remaining bonds is met.

The Final Regulations also reduce the amount of nonqualified bonds required to be redeemed. According to both the 1997 and Final Regulations, the portion of outstanding bonds deemed to be nonqualified is determined by first calculating the highest percentage of private business use in any one-year period commencing, in the case of the 1997 Regulations, with the deliberate action, and in the case of the Final Regulations, with the one-year period during which the deliberate action occurs (the "nonqualified percentage"). Although the 1997 Regulations required the issuer to redeem or defease the entire nonqualified percentage of the outstanding bonds, thus remediating all the nonqualified use of bond proceeds, the Final Regulations require the issuer to redeem only so much of the outstanding bonds as is necessary so that the remaining bonds, if treated as issued on the date of the deliberate action, would not meet the private business use tests or private loan tests (as measured by the nonqualified percentage). Thus, under the Final Regulations not all of the private business use or private loan will be remediated. These rules in the Final Regulations not only allow issuers to remediate prior to a deliberate action, but also can reduce the need to redeem or defease all bonds or a significant portion of the bonds when a private business use arises or may arise.

Effective Dates

The Final Regulations generally apply to bonds sold on or after January 25, 2016. The rules regarding remedial actions, however, apply to deliberate actions that occur on or after January 25, 2016. The Final Regulations allow permissive application of the partnership provisions, the allocation and accounting rules, and certain corresponding rules for qualified 501(c)(3) bonds in whole, but not in part, to bonds subject to the 1997 Regulations and in certain cases to refunding issues.

Conclusion

Overall, the Final Regulations permit additional flexibility in allocating proceeds and expenditures to bond financed facilities and provide needed guidance around what constitutes "qualified equity" and when remedial actions can impact the private business use calculation. The Final Regulations will also encourage issuers to better define their projects in their bond documents, which will assist with the identification of facilities and assets that require ongoing tracking.

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