IRS issues final allocation and accounting regulations for tax-exempt bonds

On October 26, 2015, the Internal Revenue Service (the “IRS”) issued final regulations (the “Final Regulations”) providing guidance on the allocation and accounting rules and remedial action rules for purposes of applying the private activity bond tests to tax-exempt bonds. The Final Regulations finalize proposed regulations issued in 2006 and 2003 (together, the “Proposed Regulations”). As described below, the focus of the Final Regulations is to permit governmental entities and 501(c)(3) organizations to use tax-exempt bonds to finance the governmental or 501(c)(3) portions of a project when the project is used for both a governmental or 501(c)(3) use and a private business use (these are referred to as “mixed-use projects”). The Final Regulations generally apply to bonds sold on or after January 25, 2016, although certain rules may be applied retroactively.

Private activity bond tests

The Internal Revenue Code of 1986 (the “Code”) provides that governmental bonds will be taxable private activity bonds if more than a de minimis amount of the bond proceeds are (1) used for a private business use and secured by or paid from property used for a private business use, or (2) used to make loans to nongovernmental persons. A similar rule applies to the issuance of bonds on behalf of 501(c)(3) organizations. The Final Regulations provide guidance on how to allocate bond proceeds and other amounts to private business use in order to comply with these limitations.

Mixed-use projects

The Final Regulations provide new rules to address situations in which a project is financed with both tax-exempt bond proceeds and other funds (“equity”) and to determine the extent to which any private business use of the project is allocable to the tax-exempt bond proceeds. Specifically, in the case of a mixed-use project, the Final Regulations permit an issuer to treat the privately used portion of the project as if it comprised a separate portion of that project (the “undivided portion method”). The Final Regulations then permit any equity used to finance the project to be allocated first to that separate, privately used portion. Under this method, “floating” allocations of private business use and equity are permitted so that the equity can initially be allocated to private business use occurring in one portion of the mixed-use project and, after that private business use ends, the equity can be allocated to private business use in another portion of the mixed-use project.

The final rules apply to mixed-use projects and thus it is necessary to identify the “project.” A “project” is defined as 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. This definition permits issuers to identify as a single project either all of the properties to be financed by proceeds of a single bond issue, or specific properties or portions of properties, regardless of the location or placed-in-service date of the properties. The ability to include all properties financed by a bond issue as comprising part of the project is a significant improvement from the Proposed Regulations and, when coupled with the ability to make floating allocations of equity, provides significantly greater flexibility than under current law. This expanded definition of project further allows issuers to separately identify the projects financed by issues of governmental bonds and qualified private activity bonds issued simultaneously, such as exempt facility bonds issued for airport facilities. The Final Regulations also clarify that improvements to a project financed with a subsequent bond issue are treated as a separate project from the original project for purposes of the Code.

The special allocation rules that permit equity to be first allocated to private business use only apply to “eligible” mixed use projects. The Final Regulations define an “eligible mixed-use project” as a project that is financed with proceeds of governmental or 501(c)(3) bonds and with qualified equity pursuant to the same plan of financing. Qualified equity includes proceeds of taxable bonds (excluding build America bonds and other tax-advantaged bonds) and funds of the issuer that are spent on the same eligible mixed-use project as the proceeds of the applicable bonds. Qualified equity does not include equity interests in property or funds used to redeem or repay governmental bonds. Qualified equity and governmental or 501(c)(3) bonds finance a project under the same plan of financing if the equity pays for capital expenditures of the project on a date no earlier than the date that is (i) 60 days before the tax-exempt bonds are issued, or (ii) would otherwise be eligible for reimbursement with tax-exempt bond proceeds, and no later than the date the project is placed in service.

Partnerships

The Final Regulations make significant changes to the rules regarding the treatment of partnerships in recognition of the development of various financing and management structures for governmental and 501(c)(3) facilities that involve the participation of private business, and to remove barriers to tax-exempt financing of the government’s or 501(c)(3)’s portion of the benefit of property used in joint ventures. Accordingly, unlike the Proposed Regulations, the Final Regulations provide that a partnership is treated as an aggregate of its partners rather than as a separate entity and, as a result, permit the governmental partner to use tax-exempt bonds to finance its portion of the partnership assets. In addition, the Final Regulations provide that these rules also apply in the context of 501(c)(3) organizations. The Final Regulations provide a rule for measuring the private business use of financed property resulting from the use of property by a partnership that includes a private partner. The amount of private use is based on the private partner’s largest share of any partnership item of income, gain, loss, deduction or credit attributable to the time the partnership uses the property during the measurement period.

Remedial actions

Under the regulations, a failure to comply with the private activity bond rules throughout the period that a bond issue is outstanding results in the need to “remediate” that noncompliance, typically by redeeming or defeasing the affected portion of the bond issue. The existing final regulations do not include a mechanism for issuers to remediate bonds in advance of the actual noncompliance occurring. The Final Regulations provide new rules that permit issuers to redeem or defease bonds in advance of a deliberate action that would cause the private activity bond tests to be met. Thus, for example, this rule would allow a governmental owner of a hospital to redeem its tax-exempt bonds that financed the facility at a time when it was considering the sale of the facility,
but has not yet taken any action to do so. To utilize the provision in the Final Regulations, an issuer must declare its official intent to redeem or defease all of the bonds that would become nonqualified in the event of a subsequent deliberate action, and redeem or defease the bonds prior to that deliberate action being taken. The declaration of intent must identify the financed property and describe the deliberate action that potentially may result in the private activity bond tests being met. The Final Regulations, however, seem to permit anticipatory remedial actions to be taken only when the private activity bond limits are expected to be exceeded, which has limited utility to issuers who want to redeem bonds to address smaller amounts of private business use as a “best practice” regardless of whether the deliberate action in fact results in exceeding the limits.

In order to remediate an impermissible private business use, it is necessary to identify the portion of the bond issue that relates to the amount of that private business use (referred to as the “nonqualified bonds”). The Final Regulations adopt the rules in the Proposed Regulations that reduce the amount of nonqualified bonds that are subject to the taking of a remedial action to reflect the de minimis limits permitted under the private activity bond test. Thus, the “nonqualified bonds” are the 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 activity bond tests. For this purpose, the amount of private business use is the greatest percentage of private business use in any one-year period beginning with the one-year period in which the deliberate action occurs. Allocations of nonqualified bonds must be made on a pro rata basis or an issuer may treat any bonds of the issue as the nonqualified bonds so long as the remaining weighted average maturity of the issue is not extended.

Output facilities

The Final Regulations generally preserve the private business use rules that are applicable to electric generation and transmission and other “output” facilities. In particular, the Final Regulations confirm the ability of output facilities to be owned in part by governmental entities and in part by nongovernmental persons. In addition, the ability to allocate private business use first to taxable bonds and other equity before the private business use would be attributable to tax-exempt bonds has been retained in the Final Regulations. Finally, private business use continues to be measured over the term of a bond issue rather than on a year-by-year basis.

Effective dates

As indicated above, the provisions of the Final Regulations generally apply to bonds sold on or after January 25, 2016. The rules related to remedial actions apply to deliberate actions that occur on or after January 25, 2016. At their option, issuers are permitted to apply the Final Regulations in whole to bonds sold (or deliberate actions taken) prior to January 25, 2016. In addition, the changes to the remedial action rules can be applied to deliberate actions that occur before January 25, 2016.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

— Carla A. Young, 202-585-8340, cyoung@nixonpeabody.com
— Mitch Rapaport, 202-585-8305, mrzapaport@nixonpeabody.com
— Travis Gibbs, 415-984-8336, tibbs@nixonpeabody.com
— Bruce M. Serchuk, 202-585-8267, bserchuk@nixonpeabody.com
— Amy Phuong Pham, 213-629-6091, apham@nixonpeabody.com