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IRS expands remedial actions to accommodate long-term leases for P3 projects and to address Build America Bonds and other tax-advantaged bonds

On April 11, 2018, the Internal Revenue Service released Revenue Procedure 2018-26 (Rev. Proc.), which contains new "remedial actions" that can be utilized by issuers of tax-exempt bonds and Build America Bonds and other tax-advantaged bonds to cure impermissible use of bond-financed projects. The guidance is also intended to facilitate public private partnerships (P3s) and other transactions that involve the long-term lease of existing facilities financed with outstanding tax-exempt bonds by providing an alternative remedial action which eliminates the need for a potentially costly defeasance of outstanding bonds.

Background

Tax-exempt bonds may be issued under the Internal Revenue Code of 1986, as amended (Code), as long as no more than a de minimis amount of the proceeds of the bonds is used for nonqualifying purposes. When the use of a financed facility changes as a result of a deliberate action taken after the bonds are issued, and such change causes the nonqualifying use limits to be exceeded, the existing Treasury Regulations provide procedures that may be followed to cure the resulting violation so that the bonds remain tax-exempt to the bondholders. For tax-exempt governmental bonds and qualified 501(c)(3) bonds, the regulations provide three alternative remedial actions that may be utilized by issuers to cure violations of certain nonqualifying purposes (i.e., the private business use and private loan restrictions): (i) the redemption or defeasance of the nonqualified bonds ("redemption or defeasance remedial action"); (ii) when the "disposition proceeds" received by the issuer from the sale of the facility is exclusively cash, the application of those disposition proceeds within two years to alternative uses that qualify for tax-exempt financing ("alternative use of disposition proceeds remedial action"); or (iii) the use of the financed facilities in an alternative manner that would continue to qualify for tax-exempt financing ("alternative use of facility remedial action"). One or more similar remedial actions are available for tax-exempt private activity bonds and for qualified zone academy bonds.

The existing rules do not permit remediation of tax-exempt governmental bonds or qualified 501(c)(3) bonds where the nonqualifying use results from a long-term lease of financed property other than by applying the redemption or defeasance remedial action. In addition, the existing rules do not permit an issuer to remediate nonqualified use related to tax-advantaged bonds (other than qualified zone academy bonds) such as "direct pay bonds" for which the issuer receives a direct subsidy payment from the IRS or "tax credit bonds" for which the bondholder receives a tax credit.[1] The Rev. Proc. establishes remedial actions that issuers may use to remediate nonqualified use with respect to such bonds.

Long-term leases—addition of alternative use of disposition proceeds remedial action

Under the existing Treasury Regulations, tax-exempt governmental bonds will lose their tax exemption if they have excessive nonqualified use of the financed facilities that results from a long-term lease or concession to a nongovernmental person. In the event of such excessive nonqualified use, the violation can be remediated by redeeming the nonqualified bonds. If the bonds cannot be retired within 90 days of entering into that lease or concession, however, the regulations require that the issuer of the bonds fund a defeasance escrow and use that escrow to retire the bonds at their earliest call date, as long as that call date is within 10.5 years of the original issue date of the bonds. Depending on the rates available on investments in a defeasance escrow, this requirement can add a significant cost to a lease or P3 transaction. In other words, to achieve the required defeasance, issuers may need to purchase investments for the escrow that cost significantly more than the amount of the tax-exempt bonds being retired, adding to the cost of the transaction and reducing the benefit to the governmental owner of the facilities. In contrast, in the case of a **sale** of a facility for exclusively cash, the existing regulations permit the issuer to maintain the tax-exempt status of the bonds by employing the alternative use of disposition proceeds remedial action. Prior to the Rev. Proc., the alternative use of disposition proceeds remedial action, however, did not in most cases apply to leases or concessions that did not involve actual sales of the bond-financed facilities.

The new guidance extends the availability of the alternative use of disposition proceeds remedial action to "eligible leases." Under the Rev. Proc., the issuer can maintain the tax-exempt status of its outstanding bonds by using an amount equal to the present value of the lease payments within two years of the lease for expenditures that would qualify for financing with new tax-exempt bonds. An "eligible lease" must have a term at least equal to the lesser of 20 years or 75 percent of the remaining weighted average economic life of the leased facility. Alternatively, a lease satisfies this term requirement if it runs through the earlier of the end of the reasonably expected economic life of the property or the latest maturity of any bond of the issue. A concession agreement in a P3 transaction would typically be treated as a lease for these purposes. Present value is computed as of the date the lease commences, using the yield on the related tax-exempt bonds. The "lease payments" that must be taken into account is the consideration paid for the lease. Although further review is needed, we do not believe ongoing payments made by the lessee in its role as lessee, such as operating and maintenance expenditures, would be treated as lease consideration for this purpose. Further review is also necessary concerning the treatment of capital improvements to be made by the lessee during the term of the lease and expenditures required to be made on handback of the facility by the lessee, particularly where the related improvements have an expected useful life that extends beyond the term of the lease.

As with remedial actions under existing Treasury Regulations, there are several other mechanical requirements that must be met in order to qualify for this remedial action, including that the lease

[1] New direct pay bonds and tax credit bonds may no longer be issued as a result of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, enacted December 22, 2017.

transaction not have been expected when the bonds were issued and the terms of the lease transaction be at fair market value.

We note that the availability of this approach under the Rev. Proc. does not eliminate potential issues under the related bond indenture or resolution for the affected bonds. Those documents could contain their own requirements on the transfer of financed facilities. In the case of revenue producing facilities being transferred, the bond documents may also contain other types of constraints, such as coverage tests or rating agency requirements.

Direct pay bonds—reducing the federal tax credit

The Rev. Proc. 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. Since direct pay bonds are taxable bonds with respect to which the IRS pays a subsidy, eliminating the subsidy puts the issuer in the same position as if it had refinanced the facilities on a taxable basis. In addition to eliminating the related subsidy, the Rev. Proc. also requires that any disposition proceeds be treated as proceeds for purposes of the arbitrage rules and as proceeds for purposes of the Code section to which the bonds relate. This results in the need to spend those amounts in compliance with the expenditure requirements for the particular type of bond involved. To effect this remedial action, the issuer must exclude that portion of the interest allocable to the nonqualified bond that accrues on or after the date of the nonqualified use from the first request for subsidy payments filed after the nonqualified use occurs. The issuer must make a special notation on the top of the form, attach an explanation stating that a nonqualified use occurred and the date of the nonqualified use, and include a revised debt service schedule for the remaining term of the bonds that reflects the excluded amounts.

Direct pay bonds and tax credit bonds—addition of redemption or defeasance and alternative use of disposition proceeds remedial actions

In addition to permitting issuers to remediate direct pay bonds by reducing the federal tax credit claimed, the Rev. Proc. 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 under the Treasury Regulations. In both cases, any disposition proceeds must be treated as proceeds for purposes of the arbitrage rules and as proceeds for purposes of the Code section to which the bonds relate, resulting in the need to spend those amounts in compliance with the expenditure requirements for the particular type of bond involved. The Rev. Proc. also requires that when using the alternative use of disposition proceeds remedial action, any unspent disposition proceeds at the end of two years be used within 90 days for a redemption or defeasance remedial action.

Rebate permitted for defeasance escrows

A defeasance escrow that is established to redeem nonqualified bonds is generally subject to yield restriction. In this regard, the Rev. Proc. helpfully provides that an issuer may use arbitrage rebate payments to satisfy the yield restriction requirement for the defeasance escrow and indicates that issuers may apply this rule to defeasance escrows established to remediate nonqualified use for tax-exempt governmental bonds, tax-exempt 501(c)(3) bonds and tax-exempt private activity bonds, as well as tax-advantaged bonds.

Effective date

The Rev. Proc. applies to a nonqualified use that occurs on or after April 11, 2018 and may be applied to nonqualified use that occurs before that date.

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