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McCarter & English: At Long Last – Allocation and Accounting Rules.

Good things come to those who wait. The tax-exempt bond industry has waited 18 years for a missing reserved section of the private activity bond regulations, the allocation and accounting regulations, Treas. Reg. Section 1.141-6. The regulations released by the IRS in final form October 27, 2015, (the "Regulations") provide welcome guidance on allocation of bond proceeds and equity to expenditures and to particular uses within a financed project. The Regulations also take steps to accommodate public-private partnerships by providing for aggregate as opposed to entity treatment of a partnership that includes governmental entities or 501(c)(3) organizations and private persons. In addition, the Regulations amend Treas. Reg. Section 1.141-12 to provide a rule for anticipatory remedial action that permits bonds to be redeemed or defeased prior to an expected action that would cause the private activity limits to be exceeded.

The promulgation of the Regulations gives issuers and conduit 501(c)(3) borrowers the opportunity to rethink relationships with private entities as potential users of bond-financed property and consider the use of different, non-tax-exempt bond funding sources as part of a financing package to accommodate these relationships. The Regulations also provide planning opportunities relating to disposition of bond-financed property and remedial action. At the heart of all of these changes continues to be the IRS' focus on effective post-issuance compliance procedures. The efforts by the IRS to provide simpler and more straightforward rules should make post-issuance compliance more manageable.

Undivided Portion Allocation

The Regulations provide a special, undivided portion allocation method as the exclusive method of allocation of sources of funding to expenditures and uses for eligible mixed-use projects. Under this method, qualified equity is allocated first to private business use of the eligible mixed-use project and then to governmental use, and tax-exempt bond proceeds are allocated first to governmental use and then to private business use. This allocation method inherently permits "floating private use"—private use that may move within a building from time to time.

An eligible mixed-use project is a project wholly owned by one or more governmental persons (or 501(c)(3) organizations) or by a partnership with at least one governmental partner that is financed with governmental bonds (or qualified 501(c)(3) bonds) and with qualified equity pursuant to the same plan of financing. Qualified equity includes proceeds of taxable bonds other than tax-credit bonds, and funds not derived from a borrowing. The qualified equity is treated as financing the project under the same plan of financing if it pays for capital expenditures of the project on a date no earlier than the date on which such expenditures would be eligible for reimbursement under the reimbursement regulations and no later than the date the measurement period begins, generally the placed-in-service date.

Read in conjunction with the allocation timing rule of Treas. Reg. Section 148-6(d)(1), which requires allocation of proceeds to expenditures not later than the later of 18 months after the

expenditure is paid or the date the project is placed in service, and in no event later than 60 days after the fifth anniversary of the issue date, the issuer will at that time be able to identify qualified equity that was part of the plan of finance and allocate private business use to that equity.

Partnerships

In response to recent pressure for the development of tax-exempt bond rules that accommodate the participation of private entities in partnership with governmental entities in financing major projects, the Regulations permit the governmental share of a project used in joint ventures to be financed with governmental bonds by treating the partnership of governmental entities and private entities as an aggregate of the partners rather than as a separate taxable entity. The private business use by a private entity partner will be determined based on that partner's greatest percentage share of any of the specified partnership items, income, gain, loss, deduction or credit attributable to the partnership during the measurement period. Taken together with the undivided portion allocation method, this treatment will permit qualified equity to be allocated to the private entity partner's private business use.

Anticipatory Remedial Action

The Regulations provide a rule that would permit an issuer to redeem or defease bonds in advance of an action that would cause the private activity limits to be violated, a remedial action not addressed by current regulations. To meet this new remedial action rule, an issuer must declare its official intent to redeem or defease all the bonds that would become nonqualified bonds as a result of a subsequent deliberate action and redeem or defease such bonds prior to the action occurring. The declaration of intent must precede the redemption or defeasance, identify the financed property with respect to which the remedial action is being undertaken and describe the deliberate action that is expected to occur. The redemption or defeasance of the nonqualified bonds must not result in an extension of the weighted average maturity of the bonds, subject to a limited transition rule.

Effective Dates

The Regulations generally apply to bonds sold on or after January 25, 2016, and the new remedial action rule applies to deliberate actions that occur on or after January 25, 2016. The partnership rules and the allocation and accounting rules may be permissively applied in whole, but not in part, to any bonds to which the private activity bond regulations apply.

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