Bond Case Briefs

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IRS Expands Remedial Action for Nonqualified Use of Tax-Advantaged Bonds.

The IRS on April 11, 2018 released Revenue Procedure 2018-26 (Rev. Proc. 2018-26), which expands remedial action options in connection with certain post-issuance leases to private parties of facilities financed with tax-exempt bonds. Whereas previously the bond issue(s) that financed the leased facility would have to be redeemed or defeased to preserve the tax-exemption of the applicable bonds, the new remedial action permits the bonds to remain outstanding if the present value of the lease payments is applied to other bondable expenses. The new Revenue Procedure also introduces remedial action for certain types of tax credit bonds and direct pay bonds that did not previously have access to remedial action options.

The Internal Revenue Code provides for the issuance of tax exempt bonds under Section 103 ("tax-exempt bonds"), qualified bonds with refundable tax credits payable to issuers under Section 6431 ("direct pay bonds") and qualified bonds providing tax credits to holders ("tax credit bonds"). Each of these types of bonds has eligibility requirements including the prescribed uses of the proceeds. For example, in the case of tax-exempt bonds issued for the benefit of government entities or 501(c)(3) non-profit borrowers, there are strict limits on private use of bond-financed facilities that are inconsistent with the sale or lease of such facilities to a private party. When proceeds are not used for qualified uses, or cease to be so used, the bonds lose their tax advantage unless an allowable remedial action is taken to cure the nonqualified use. Existing regulations provide for certain remedial actions for tax-exempt bonds and tax credit bonds issued as qualified zone academy bonds.

Rev. Proc. 2018-26 expands the existing remedial action options for tax-exempt bonds to allow an alternative use of "disposition proceeds" to cure nonqualified use resulting from eligible leases (defined below) of financed property. Prior to the new Revenue Procedure, the only remedial action available in the case of such leases was a redemption or defeasance of bonds, often requiring the redemption or defeasance of the entire bond issue that financed the leased facility. Building on the existing alternative use of disposition proceeds remedial action for exclusively cash sales of tax-exempt financed facilities, the new Revenue Procedure treats an "eligible lease" as a disposition made exclusively for cash, and deems the "disposition proceeds" to be an amount equal to the present value of all of the lease payments required to be made under the eligible lease. Instead of redeeming or defeasing the applicable bond issue, tax-exemption of the applicable bonds can be preserved by expending these deemed disposition proceeds on other bondable expenses, provided the issuer expects such expenditure to occur within two years of the date of the lease. This eligible lease remedial action is expected to be helpful to governmental issuers that wish to convert bond-financed public facilities into public-private partnerships using long-term lease arrangements, as well as others who no longer need bond-financed facilities for their original purpose and want the flexibility to lease rather than sell those facilities without retiring the associated tax-exempt debt.

A lease is an "eligible lease" if (a) the consideration for the lease is exclusively cash lease payments (regardless of when paid) that are not themselves financed with tax-advantaged bond proceeds, and (b) the term of the lease (i) is at least equal to the lesser of 20 years or 75% of the weighted average reasonable expected economic life of the leased property, or (ii) runs through the earlier of (x) the end of the reasonably expected economic life of the leased property at bond issuance or (y) the latest maturity date of the bonds.

In contrast to a sale that produces actual disposition proceeds that can be expended during the two-year period, the present value amount required to be expended during the two-year period in the context of a long-term lease is likely to exceed the lease payments actually realized by the issuer or borrower during such two-year period. However, such “out-of-pocket” expenditures may be expenditures that the issuer or borrower already was planning to finance from available cash during such period, and even if that is not the case, expending that amount from sources other than tax-exempt bonds will often be less costly than refinancing on a taxable basis part or all of the tax-exempt bond issue that financed the leased facility. Accordingly, the alternative expenditure option may substantially reduce the costs associated with disposing of a no longer needed facility financed with tax-exempt bonds in situations where a lease is preferable to a sale.

Rev. Proc. 2018-26 also provides for curing a nonqualified use of direct pay bond proceeds by simply reducing the amount of the refundable tax credit to eliminate the amount allocable to the nonqualified bonds. This is a common sense and simple way to remediate nonqualified use of otherwise taxable bonds. To effect this remedial action, the issuer must exclude the portion of the interest allocable to the nonqualified bonds that accrues on or after the date of the nonqualified use on the first Form 8038-CP filed after the nonqualified use occurs.

Finally, Rev. Proc. 2018-26 extends the availability of certain existing remedial actions to direct pay bonds and tax credit bonds. In addition to the reduction in subsidy available to direct pay bonds as described in the previous paragraph, an issuer may cure a nonqualified use by redeeming or defeasing nonqualified bonds or applying disposition proceeds to an alternative qualified use.

Rev. Proc. 2018-26 applies to a nonqualified use that occurs on or after April 11, 2018 and may be applied to a nonqualified use that occurs prior to April 11, 2018.

By Len Weiser-Varon on April 13, 2018

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