

# **Bond Case Briefs**

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## **IRS LTR: Lease Arrangement in Bond-Financed Project Doesn't Give Rise to Security Interest.**

The IRS ruled that a lease arrangement under which bonds are issued by an authority that acquires, constructs, and maintains facilities on behalf of a state which then leases the buildings does not give rise to a security interest in the facilities within the meaning of reg. section 1.141-4(d)(4).

Citations: LTR 201346002

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Dear \* \* \*

This letter is in response to your request for a ruling that the lease arrangement described herein will not cause the Bonds to meet the private security or payment test under section 141(b)(2) of the Internal Revenue Code.

### **FACTS AND REPRESENTATIONS**

You make the following factual representations. Authority was created by the Act as a body corporate, separate from the State. Authority acquires, constructs, and maintains facilities on behalf of the State and is the primary issuer of debt to finance the acquisition and construction of buildings for various State purposes. Typically, Authority holds legal title to the buildings and the State leases the building pursuant to long term operating leases. Authority uses the lease payments from the State to pay debt service on the lease revenue bonds issued for acquisition or construction of buildings.

Authority issued the Bonds to finance construction and/or renovation of various buildings, including the Facility. Authority holds legal title to the Facility and the State leases the Facility pursuant to a multi-year operating lease (the "Lease"). The debt service on the Bonds is payable from, and secured by, the State's payments on the Lease (the "Lease Payments") along with the rentals with respect to various other facilities financed with proceeds of Authority's bonds issued under the same indenture (the "Parity Bonds"). The State is obligated to pay all costs of operating and maintaining the Facility. The only payments from nongovernmental persons with respect to the Facility are payments that do not exceed direct operating costs of the Facility attributable to use by such persons.

The Bondholders do not have a mortgage on or other security agreement creating a security interest in the Facility under State law. The remedies available to the Bondholders upon nonpayment of debt service are obtaining a money judgment against the State for unpaid Lease Payments or other

rentals and filing suit to compel Authority or the State to perform in accordance with the terms of the leases, Act, or related indenture by means of an action in the nature of mandamus.

Pursuant to the Lease, the State may cease Lease Payments only if the Facility becomes untenable for reasons other than those caused by the State. In the indenture for the Bonds, Authority has covenanted not to sell, lease, mortgage, or otherwise dispose of the Facility, other than the Lease, so long as the Parity Bonds are outstanding, with the following exceptions. Authority can do so (1) in a manner it determines is in the best interest of the bondholders if the Lease is terminated, (2) if the rental for the part of the Facility retained is not less than the rental just prior to such action, (3) at the end of the Lease term, or (4) if Authority has sufficient funds to pay the remaining Lease Payments when due.

The State intends to enter into management contracts with nongovernmental persons for performance of certain substantial services at the Facility (the "Management Contracts"). Authority represents that the terms of the Management Contracts will cause the Bonds to satisfy the private business use test of section 141(b)(1).

## LAW

Section 103(a) provides generally that gross income does not include interest on any state or local bond. Section 103(b)(1) provides that this exclusion does not apply to any private activity bond unless it is a qualified bond under section 141. Under section 141(a), a bond is a private activity bond if either the private business use test under section 141(b)(1) and the private security or payment test under section 141(b)(2) are satisfied, or the private loan financing test under section 141(c) is satisfied.

Section 141(b)(2) provides, in part, that the private security or payment test is satisfied if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 1.141-4(a)(1) of the Income Tax Regulations provides that the private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use.

Section 1.141-4(a)(3) provides that the security for, and payment of debt service on, an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in private business use, the issue meets the private security or payment test.

Section 1.141-4(c)(2)(i)(A) provides that both direct and indirect payments made by any

nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments are taken into account as private payments only to the extent that they are made for the period of time that proceeds are used for a private business use. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market value compensation for that other use.

Section 1.141-4(c)(2)(i)(C) provides that payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses (as defined under section 162) directly attributable to the operation and maintenance of the financed property used by that person. For this purpose, general overhead and administrative expenses are not directly attributable to those operations and maintenance.

Section 1.141-4(d)(4) provides that property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase “any interest in” is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments.

Section 1.141-4(d)(5) provides that the payments taken into account as private security are payments in respect of property used or to be used for a private business use. Except as otherwise provided in this paragraph (d)(5) and paragraph (d)(6) of this section, the rules in paragraphs (c)(2)(i)(A) and (B) and (c)(2)(ii) of this section apply to determine the amount of payments treated as payments in respect of property used or to be used for a private business use. Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

## ANALYSIS

Authority represents that the terms of the Management Contract will cause the Bonds to satisfy the private business use test. Because the private use test is met, the Bonds will be private activity bonds if the private security or payment test is also met. Specifically, you ask whether the Lease and covenants related to the Facility will give rise to private security when Authority enters into the Management Contracts. Whether or not a particular arrangement rises to a security interest for purposes of section 1.141-4(d)(4) depends on the facts and circumstances associated with the arrangement.

The Lease Payments and the State’s rental payments on other facilities financed by the Parity Bonds are security for the Bonds. These payments are not private payments as they are made by a governmental person. Accordingly, neither are they private security.

Authority represents that the Bondholders do not have a mortgage or other security agreement creating a security interest in the Facility under State law. However, because section 1.141-1(d)(4) provides that the phrase “any interest in property” is to be interpreted broadly, Authority is concerned that in its documents relating to the Facility and the Bonds, it has given the Bondholders rights in the Facility that might be within the meaning of that provision.

The Bondholders' remedies for nonpayment of debt service include obtaining a money judgment against the State or filing suit to compel performance under the Lease, Act, or indenture. Authority has covenanted that generally it will not sell, lease, mortgage, or otherwise dispose of the Facility other than the Lease, as long as the Parity Bonds are outstanding. These restrictions do not apply after the Lease is terminated or if the rentals or Authority's other monies are sufficient to cover the amounts of the Lease Payments. However, only Authority can initiate these actions, such as leasing or selling the Facility for the benefit of the Bondholders after the Lease is terminated. The Bondholders cannot compel Authority to so act.

We conclude that the terms of the Lease and the covenants contained in the indenture merely provide some assurance to Bondholders that Authority will continue to make the Facility available to the State and that the State will continue to use the Facility and make Lease Payments until the Lease is ended or other monies are available to pay debt service on the Bonds. Until such time, neither the Bondholders nor any other parties (other than the State or Authority) will be granted rights in the Facility. Accordingly, the terms do not give rise to a security interest in the Facility within the meaning of section 1.141-4(d)(4).

## CONCLUSION

Based solely on the facts described herein and representations made by Authority, we conclude that the Lease and related covenants will not cause the private security or payment test of section 141(b)(2) to be met.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter. Specifically, we express no opinion as to whether the interest paid on the Bonds is excludable from gross income.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to Authority's authorized representative.

The ruling contained in this letter is based upon information and representations submitted by Authority and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for a ruling, it is subject to verification upon examination.

Sincerely,

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