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Treasury, IRS Issue Rules that Will Help Facilitate P3s.

WASHINGTON — The Treasury Department and Internal Revenue Service have released final allocation and accounting rules that bond lawyers say will help in administering public-private partnerships for transportation and joint ventures involving hospitals.

“These final regulations are a great step forward for encouraging public and private funding for projects and therefore for encouraging public-private partnerships,” said Vicky Tsilas, a partner at Ballard Spahr in Washington.

The rules, which lawyers said are much better than those proposed in 2006, were released Monday and are scheduled to be published in the Federal Register on Tuesday. Some provisions of the proposed rules were withdrawn rather than finalized.

The rules will generally apply to bonds sold on or after a date that is 90 days after publication in the Federal Register, and the provisions regarding remedial actions will apply to deliberate actions that occur on or after that date. The rules provide issuers with guidance for applying the private-activity bond restrictions. Under federal tax law, for governmental bonds, no more than 10% of the proceeds can be used by private parties and no more than 10% of the debt service can be paid for or secured by private parties. The thresholds are lowered to 5% for 501(c)(3) bonds. If these limits are exceeded, bonds become private-activity bonds and are not tax-exempt unless they fall within specific categories.

Two key parts of the rules are the flexible proportional allocation provisions for mixed-use projects and the look-through treatment of public-private partnerships, said John Cross, Treasury associate tax legislative counsel.

Issuers may want to develop “mixed-use” projects that have some governmental use and some private use, finance the public portion with tax-exempt bonds and finance the private portion with equity. Under the rules, qualified equity is allocated first to the private-business use of the mixed use project and then to governmental use, while bond proceeds are allocated first to governmental use and then to private business use.

Carol Lew, a shareholder at Stradling Yocca Carlson & Rauth in Newport Beach, Calif, said that the concept of allocating equity first to private business use is helpful and “issuer sensitive.”

“These allocation provisions look good,” said Matthias Edrich, an attorney at Kutak Rock in Denver, though there’s a lot for bond lawyers to still consider.

The allocation rules for mixed-use projects are simpler in the new guidance than they were in the proposed rules, lawyers said. Under the proposed rules, there were two different allocation methods that could be used for mixed-use projects, and issuers had to elect to use one of the methods. But under the final rules, issuers do not have to make elections and bond proceeds and equity are always allocated using the “undivided portion” method, which is based on the percentage of use by an entity rather than the percentage of physical space used.

The rules expand the definition of a project that can be treated as partially financed with tax-exempt bond proceeds and partially funded by other means, a feature that bond lawyers praised.

“Under the new regulations, an issuer can choose to treat any property financed with the same bond issue as the same ‘project’ regardless of any functional relationship. That flexibility could provide for substantial post-issuance compliance relief,” said Michael Bailey, a partner at Foley & Lardner in Chicago.

However, Bailey expressed concerns that the time limits placed on when equity contributions can be made might be overly restrictive for projects with long construction periods.

The rules also address allocating bond proceeds and other funds in cases where property is used by public-private partnerships.

In the proposed rules, partnerships were automatically treated as private entities unless all of its members were public. But the final rules take a different approach and treat partnerships as aggregates of their partners. Under the rules, the amount of private business use is the private partner’s share of the amount of the use of the property by the partnership. The share is defined as the private partner’s greatest percentage share of any of the partnership items attributable to the time during the measurement period that the partnership uses the property.

Tsilas said that “permitting aggregate treatment for all partnerships has become particularly important in recent years because of the need to implement policies of the Affordable Care Act that are intended to promote cooperation between the public and private sectors.”

The look-through treatment of partnerships is in line with the recommendations made by the National Association of Bond Lawyers and the tax-exempt financing committee of the American Bar Association’s taxation section.

The rules also provide guidance about when and how issuers can take “anticipatory remedial actions” and redeem tax-exempt bonds before they take actions that would cause there to be excessive private-business use. The proposed rules had set a lot of conditions that issuers had to meet to take anticipatory remedial action. The final rules are simpler and allow issuers to redeem or defease bonds if they declare their intent in advance. The declaration of intent has to identify the financed property or loan that the anticipatory remedial action would concern and describe the action that potentially may result in the private business tests being met.

Tom Vander Molen, a partner at Dorsey and Whitney in Minneapolis, praised the availability of anticipatory remedial actions under the rules but said, “the need to describe possible future private business use for anticipatory remedial actions is unnecessarily detailed.”

Treasury and the IRS are also working on a separate project relating to remedial action rules, Cross said. One of the items that project will address is how leases fit with the remedial action rules.

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