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Foley: New IRS Regulations For Mixed Use Projects Financed With Tax-Exempt Bonds Have Practical Importance.

On October 27, 2015 the U.S. Treasury Department and Internal Revenue Service published final regulations concerning the treatment of "mixed-use" projects financed with tax-exempt bonds. These new regulations have significant and immediate importance for tax planning and tax compliance of tax-exempt bond issuers and borrowers.

A copy of the new final regulations can be obtained here. See 80 FR 65637.

The new regulations, which are published as "general allocation and accounting regulations" most importantly provide rules for the measurement of private use of a project that is financed in part with proceeds of tax-exempt bonds and in part with other funds of an issuer or borrower. The new regulations also facilitate the use of tax-exempt bonds in certain "public-private partnerships." In addition, the new regulations clarify the rules for taking "remedial actions" to correct noncompliance.

The new regulations apply to both bonds issued for the benefit of State and local government projects ("governmental bonds") and bonds issued for the benefit of borrowers that are section 501(c)(3) exempt organizations ("qualified 501(c)(3) bonds").

For convenience, references in this alert to "issuers" of tax-exempt bonds refer to both State or local government issuers of governmental bonds and borrowers that are section 501(c)(3) organizations. Reference to "private persons" in this alert refer to nongovernmental persons, in the case of governmental bonds, and to nongovernmental persons and persons that are not governmental persons or section 501(c)(3) organizations, in the case of qualified 501(c)(3) bonds.

Background

The Internal Revenue Code generally restricts the amount of "private business use" of projects to small amounts (generally, 10% for governmental bonds and 5% for qualified 501(c)(3) bonds, although other limitations apply in some circumstances). Although tax-exempt bond issues technically fail to comply only if the bond issue also fails to comply with a second "private security or payment" test, in most cases issuers rely on the private business use test to comply. Over the years, application of these "private business tests" has become increasingly burdensome and complex. In particular, in 1997 the Treasury Department published final regulations that require private use compliance to take into account "deliberate actions" after the date of issuance, which rule requires tax compliance monitoring throughout the term of a bond issue.

One of the most helpful strategies that issuers use to manage compliance with these complex rules is to finance the costs of a project that will be used for private uses with funds other than proceeds of tax-exempt bonds. Under that approach, the proceeds of the tax-exempt bonds are not treated as used for private uses, because the portion of the project paid with the "equity carve out" is instead treated as privately used. The new regulations set forth detailed new rules for how and when this commonly-used "equity carve out" approach works.

The Treasury Department published proposed regulations on this topic on September 26, 2006. Since the publication of the proposed regulations in 2006, issuers and practitioners have looked to the proposed regulations for general themes about how mixed-used projects should be treated, but have not been bound to follow all the specific details of the proposed regulations.

The 2006 proposed regulations also suggested that the Treasury Department would consider permitting projects financed with tax-exempt bonds to be used by a partnership including private persons. The Service has historically taken the position that use of projects financed with tax-exempt bonds by a partnership including private persons results in private business use.

Summary of the Final Regulations

Rules for equity contributions that are generally more flexible, but not in all cases more favorable. The new regulations provide that private business use of a project is allocated first to the portion of the project financed with "qualified equity."

The rules for "qualified equity" contain important limitations. Qualified equity generally means proceeds of taxable bonds (other than taxable bonds that are tax-advantaged, such as tax credit bonds) and funds that are not derived from proceeds of a borrowing. For example, qualified equity includes an issuer's cash derived from revenues and cash donations. Qualified equity does not include equity interests in real property or personal property. This approach is consistent with prevailing practice and the proposed regulations.

The rules for "qualified equity" also contain new limitations that may be problematic in some cases. Qualified equity must be contributed to a project as part of the "same plan of financing" as the tax-exempt bonds and must pay for capital expenditures of the project on a date that is not earlier than the date on which the expenditures would be applicable to reimbursement by proceeds of the applicable tax-exempt bonds. Among other things, this appears to mean that the tax-exempt bonds generally can qualify for the "qualified equity" benefits only to the extent bonds are issued no later than 18 months after the date of the expenditure (or 18 months after the placed in service date of the project, if later, but no more than three years after the date of the expenditure), although a definitive interpretation of certain aspects of this timing limitation may require clarification from the Service. This timing rule is new, and may raise a number of problems, including particular problems for projects that have a long construction period. Similarly, the new regulations may present difficulties in some cases where a single project is financed with a series of bond issues.

The new regulations also state that qualified equity contributions must be made before the placed in service date of the financed project, except for reasonable retainage.

"Floating use" is expressly permitted. The new regulations expressly and helpfully permit "floating" use of the portion of a project treated as financed with qualified equity. For example, suppose the costs of a 10-story building are funded 70% with tax-exempt bonds and 30% with an issuer's cash. The new regulations generally provide that private use of three floors will not be treated as private use of the tax-exempt bonds, even if the particular three floors change from year to year. The new regulations remove certain limitations on "floating" use that were set forth in the proposed regulations.

A "project" that may be treated as funded in part with qualified equity is defined very broadly. One of the most favorable rules in the new regulations is a very flexible definition of a "project." These rules are particularly important in light of the rules that permit private use to "float" within a mixed-use project. The new regulations permit an issuer to treat as a single "project" one or more facilities or capital projects, including land, buildings, equipment, or other property financed in whole or in part with the proceeds of a bond issue. The proposed regulations generally permitted only certain functionally related facilities, such as adjacent buildings, to be treated as part of the same project. The more flexible rule in the new regulations may present significant tax planning opportunities and tax compliance relief, although it may in some cases be complex to apply.

Annual measurement is required, except for output facilities. The final regulations expressly provide that the "qualified equity" rule must be applied on an annual basis, except for "output facilities." In an example in the new regulations, a building is funded 70% with tax-exempt bonds and 30% with the issuer's cash. In one year, 44% of the building is used for a private business use. The example states that the amount of private business use for that year is 20% (that is, 14% divided by 70%), regardless of whether there is any private business use in any other year.

The rules for "output facilities" are significantly more flexible. Output facilities generally consist of electric and gas generation, transmission, distribution and related facilities and water collection, storage and distribution facilities. In the case of output facilities, the benefits of "qualified equity" may generally be applied on an average basis over the term of a bond issue. This more flexible approach is consistent with the special treatment in the regulations for output facilities, including more flexible rules for how private business use is measured.

No special elections or recordkeeping requirements. The new regulations helpfully do not require any special elections or record retention requirements to make use of the "qualified equity" rules. The proposed regulations contained a number of such requirements that could have been traps for the unwary. Thorough and rigorous identification of qualified equity contributions to projects and retention of records relating to such contributions and identifications, however, will continue to be important in practice. In addition, the time limits for making allocations of bond proceeds in the existing final regulations may have relevance for taking actions under the new regulations. The existing regulations generally require that an issuer must allocate proceeds to expenditures no later than 18 months after a project is placed in service.

Favorable treatment of partnerships. The new regulations facilitate "public-private partnerships" by permitting tax-exempt bonds to be used to finance an issuer's contribution to a partnership which includes private persons. Under this new rule, the amount of private business use by a private person resulting from the use of property by a partnership is the nongovernmental partner's greatest percentage of any partnership item of income, gain, loss, deduction, or credit attributable to the period the partnership uses the property during the period private use needs to be taken into account. The rule generally requires that a State or local government (or, in the case of qualified 501(c)(3) bonds, a 501(c)(3) organization) be one of the partners.

This favorable rule for partnerships expressly applies to qualified 501(c)(3) bonds issued to benefit 501(c)(3) organizations. For that purpose, ownership by a partnership does not violate the requirement that all bond-financed property needs to be owned by a 501(c)(3) organization or a State or local government.

This rule can be expected to make tax-exempt financing eligible to some extent for public-private partnerships not previously eligible for tax-exempt bond financing to any extent.

Clarification of "remedial action" rules. Since 1997, the regulations have permitted certain remedial actions to correct noncompliance with the private use rules. One remedial action is the redemption or defeasance of "nonqualified bonds." The new regulations make important revisions and corrections to these remedial action rules.

The most important “remedial action” rule in the new regulations concerns “anticipatory” remedial actions. The prior regulations expressly permitted remedial actions only in response to a deliberate action that resulted in noncompliance. Prevailing practice has been to permit redemption or defeasance in anticipation of such a deliberate action, but practice standards have varied. The new regulations permit redemption or defeasance of bonds in an anticipatory remedial action, but only if the issuer first declares an official intent on or before the date on which it defeases or redeems such bonds which identifies the financed property or loan with respect to which the anticipatory remedial action is being taken and describes the deliberate action that potentially may result in the private business tests being met. This rule states that it applies in a manner “similar” to the rules for declarations of intent for tax-exempt bond reimbursements. The required degree of specificity for declarations of intent for these anticipatory remedial actions will require consideration on a case-b--case basis.

Subsequent to 1997, the Treasury Department has published proposed regulations to make certain technical corrections to make the remedial action rules more readily administrable. The final regulations adopt in final form these favorable technical provisions. First, the final regulations confirm that an issuer may pick and choose the maturities of the nonqualified bonds that are required to be redeemed or defeased, provided that the weighted average maturity of the nonqualified bonds is not less than the weighted average maturity of the other bonds of the bond issue. Second, the new regulations confirm that the amount of nonqualified bonds does not need to correct all private use, but only an amount so that the remaining bond issue is compliant.

Clarification of “multipurpose allocation” rules. The new regulations include additional examples explaining how the rules for “multipurpose allocations” apply. The “multipurpose allocation” rules permit an issuer to break a bond issue into different portions, and to apply the private activity bond rules separately to each portion. The most helpful new example clarifies that an issuer may make a multipurpose allocation to treat governmental bonds and qualified private activity bonds for airport facilities as separate issues, even when sold on the same date pursuant to the same plan of finance.

The multipurpose allocation rules can be applied at any time and can be an important and useful tax planning and tax compliance tool, but may be complex to apply in many contexts.

Effective dates. Issuers are generally required to apply the new regulations to bonds that are sold on or after January 25, 2016, although certain special effective date rules apply.

Issuers are generally required to apply the rules for remedial actions to any “deliberate actions” that occur on or after January 25, 2016, even if the bonds were sold before that date. In this regard, it is important to note that, although the remedial action rules in the new regulations are generally favorable, the new regulations contain certain new requirements. In particular, the new rule for “anticipatory” remedial actions will generally apply to any deliberate action occurring on or after January 25, 2016. The new regulations also contain a special transition rule for remedial actions that is intended to accommodate existing bond indentures that require optional redemptions of a portion of a term bond to be applied first to reduce the earliest mandatory sinking fund payments on that bond; that special transition rule only applies to bonds issued before January 25, 2016.

Issuers may apply the new regulations to bonds sold before that date, but the effective date rules impose certain limitations on such retroactive application. An important limitation is that the effective date provisions provide that retroactive application is generally permitted only if all of the provisions of the new regulations are applied in whole. The clarification in the new regulations for “multipurpose allocations,” however, may be applied separately.

Except as described above, the application of the new regulations to bonds sold before the effective date is expressly permissive. There is no implication that bonds sold before the effective date need to comply with the new regulations, although as a practical matter issuers and practitioners may look to principles in the new regulations in taking positions with respect to pre-effective date bonds.

Implications for tax-exempt bond compliance procedures. Many issuers may wish to consider whether to revise their tax-exempt bond compliance procedures to reflect certain provisions of the new regulations. For example, an issuer may be able to make best use of the favorable provisions in the new regulations by adopting a formal process to review how those provisions can be applied to particular bond issues.

Expected future developments. In 2014, the Treasury Department published Notice 2014-67, which provided for more flexible safe harbors for management contracts for use of property financed with tax-exempt bonds that have a term not exceeding five years. Accordingly, the new regulations are the second significant recent action by the Treasury Department to facilitate more flexible public/private arrangements involving projects financed with tax-exempt bonds. In that light, there is reason to anticipate that the Treasury Department may follow the new regulations with guidance that provides additional safe harbors for longer-term management contracts involving projects financed with tax-exempt bonds.

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.