# TAXING ISSUES
**The Jones Hall Municipal Finance Tax Newsletter**

**By: David Walton**

**Vol. 1** **January, 1998**

**What Can We Expect From Washington?**

As I look into my crystal ball to devine what the Federal regulators and Congress have in store for us, I see the possibility of positive things to come. On the regulatory front, the IRS is expected to release the other reserved portions of the private activity regulations with guidance on accounting, mixed-use facilities and refundings. Also, after almost two years, it is expected that the IRS or Treasury will replace Revenue Procedure 96-41 (the controversial set of rules regarding yield burning) with a more reasonable approach to this issue. Yield burning is the use of yield-restricted bond proceeds to purchase open-market securities, such as those used in refunding escrows, at a price higher than their fair market value, resulting in an artificially lower yield.

As a Director on the governing board of the National Association of Bond Lawyers (NABL), I oversee the General Tax Committee of NABL. This Committee, along with other organizations representing bond issuers, has been drafting a proposed replacement for Rev. Proc. 96-41. NABL and others have met with Treasury and IRS representatives, and early impressions are that Rev. Proc. 96-41 may be withdrawn and replaced with something more workable. To date, we are not aware of a single issuer who has paid the Federal government any money under the "safe harbor" set forth in Rev. Proc. 96-41.

On the Legislative front, this may be the year in which some real pressure is put on Congress to increase the private activity bond statewide volume caps. The volume cap formula has remained unchanged since enactment in 1986 and some estimates show that the value of the volume cap is 50% of what it was in 1986 due to inflation. In California, it is not uncommon for the volume cap to be exhausted by mid-year. With the revival of the California economy and renewed population growth, the availability of extra volume cap for projects such as low-income multifamily housing would be especially welcome.

**New Private Activity Output Regulations**

The IRS last week released private activity regulations regarding output contracts. Municipalities with bond-financed electric or gas utility enterprises had been anxiously awaiting these regulations in light of the imminent deregulation of the utility industry. Generally, these regulations are helpful and should have little effect on issuers other than those with bond-financed utility enterprises.

**The Taxpayer Relief Act of 1997**

On August 5, 1997, the Taxpayer Relief Act of 1997 (the "1997 Act") became law. This legislation contained some beneficial provisions for tax-exempt bonds. Two of the most significant bond provisions are:

*Good News For School Districts - Increase of Small Issuer Rebate Exception for Public School Facilities.*

Since 1986 governmental issuers with general taxing powers (and subordinate entities) have been exempt from rebate if they do not issue, in the aggregate, more than $5,000,000 of governmental bonds in a calendar year. The 1997 Act allows an additional $5,000,000 of

governmental bonds to be issued during a calendar year and to be exempt from rebate so long as the additional $5,000,000 finances the construction of public school facilities. While this is not the $25 million across the board increase in the small issuer exception that many issuer groups sought, this is a good start. For example, a school district issues a $5 million TRAN in June, 1998, to finance its cash flow deficit and issues an additional $5 million general obligation bond in September, 1998, to finance the construction of new school facilities. Both the $5 million TRAN and the $5 million GO bond are exempt from rebate (assuming no other issuances by the district during the year). However, if the district were to issue a $6 million TRAN and a $4 million GO bond, both obligations would be subject to rebate because only $5 million of non-school construction bonds issued by the district during the calendar year are permitted and the $6 million TRAN is a non-school construction bond. I wrote a short article on the small-issuer rebate exemption which was published in the Fall 1997 *Municipal Finance Journal*. This article is available on our web site - http://www.jhhw.com.

*Good News for Nonprofit Issuers - Repeal of the $150 Million Limit*.

The 1997 Act repealed the $150 million limit on non-hospital qualified 501(c)(3) bonds. This means that nonprofit organizations may issue an unlimited amount of qualified 501(c)(3) bonds (non-hospital). Among the primary beneficiaries of this change are nonprofit educational institutions (private universities) and nonprofits providing senior residential housing.

**The New Private Activity Bond Regulations**

In January, 1997, the IRS released final regulations (effective for all bonds issued after May 16, 1997) describing when a bond will be treated as a private activity bond. A private activity bond is generally taxable unless it qualifies under an exception. A bond is a private activity bond if it meets both the private use test and the private security or payment test (the "private business tests"), or it meets the private loan financing test. The vast majority of bonds issued for traditional governmental purposes such as schools, roads, municipal water and sewer systems, city halls and courthouses are not issued as private activity bonds and are commonly referred to as "governmental bonds".

Are these regulations good for the typical issuer? Generally, yes, because they are an improvement over their predecessors. These regulations provide more flexibility and are more in touch with the way modern municipalities do things than the prior regulations. However, the regulations cannot change the law and so we are stuck with the same limitations enacted in 1986. The regulations are 138 pages long and I will not attempt to summarize the entire package here. A detailed memorandum on these regulations is available from us and can also be accessed on our web site. We have had a year's experience with these regulations and, based on this experience, I will discuss some provisions that have been shown to be particularly relevant to California issuers.

*Expanded and Clarified Public Use Exception*

The most common means of avoiding private activity bond status is the public use exception. Under this exception bond-financed facilities will not be treated as being used for a private business use (and thus passing the private use test) if the only use of the facilities is by members of the general public on the same basis. In other words, a private business can use the bond-financed facilities without causing the bonds to be private activity bonds, but only if such use is on the same basis as any other member of the general public. However, any priority or preferential use of the facilities is not treated as public use. Depending on the facts, contracts for use of the bond-financed facility for 180 days, 90 days or 30 days may be entered into without disqualifying the facility under the public use exception.

***Planning tip***: The new public use exception may permit tax-exempt financing of more public parking facilities than was previously possible. In general, parking facilities should qualify for the public use exception if they (i) are available to the general public (reserved spaces are possible but limited), (ii) are expected to be used by the general public, (iii) offer no preferential parking rates, (iv) are owned and controlled by the municipal issuer (e.g., the issuer can shut the parking facilities down whenever it wants to and use it for some other purpose), and (v) do not convey a "special economic benefit" to a nongovernmental person (e.g., the parking facilities do not relieve a specific person of an obligation to provide parking).

*Initial Developer Use is Not Private Use*

Proposed private activity regulations would have treated traditional governmental improvements (such as roads, curbs and gutters, and streetlights) as used by a developer if the developer had a legal obligation to provide these facilities (thus passing the private use test). This would have made most land-based financing in California taxable because most developer agreements require the developer to provide these types of facilities in the event assessment or special tax bonds are not issued to pay for the facilities. I worked with a California land-based financing group to educate California issuers regarding this issue.

Thanks to a very effective letter writing campaign by many California issuers (and yes, the tax lawyers wrote nasty letters to the IRS too, but the IRS listens to issuers more than they listen to tax lawyers), the IRS dropped this provision when they wrote the final regulations. Improvements that carry out "essential governmental functions" (e.g., sidewalks, streets and streetlights, utilities, and water and sewer systems) used during a development period by a developer do not cause the private use test to be passed as long as the developer expects to use the bond proceeds with reasonable speed to develop the project and the improvements are transferred to a governmental unit upon completion of the development. This provision in the final regulations is consistent with how standard land-based financings are done in California and elsewhere.

*New Management Contract Rules*

Contracts (commonly referred to as "management contracts") permitting use of a bond-financed facility by a nongovernmental person may result in the private use test being passed. Revenue Procedure 97-13, released with the new regulations, provides more liberal "safe harbors" regarding the types of compensation and duration of management contracts. If one of these safe harbors is met, management of a government facility by a non-governmental person will not result in private use. The following summarizes the new safe harbors:

- 95% fixed compensation; 15/20 year term; 1 time incentive award.
- 80% fixed compensation; 10/20 year term; 1 time incentive award.
- 50% fixed compensation/50% anything else other than net profits or 100% capitation/fixed compensation; 5 year term; terminable at 3 years.
- 100% per unit or 100% per unit/fixed compensation; 3 year term; terminable at 2 years.
- 100% gross revenues/gross expenses percentage compensation; 2 year term, terminable at 1 year (limited to services to third parties and start-up facilities).

Note that before Revenue Procedure 97-13, the longest management contract possible under the previous safe harbors was 5 years.

*Change in Use - Remedial Actions*

The regulations provide significantly more flexible rules when a bond-financed facility is no longer used for a qualifying governmental purpose. For example, assume that eight years after bonds are issued to finance a new county-owned and operated hospital, financial conditions force the county to sell the hospital to a for-profit health care corporation. The change-in-use rules provide "remedial actions" which, if taken, prevent the bonds from becoming taxable. In order to be eligible to take remedial actions, the following conditions must be satisfied:

- Reasonable Expectations. The issuer must reasonably expect on the issue date that the private business tests and private loan financing test will not be met during the entire term of the bonds.

- Term Not Unreasonably Long. The weighted average maturity of the bonds may not be greater than 120 percent of the average reasonably expected economic life of the financed property.

- Fair Market Value Consideration. The terms of any arrangement resulting in satisfaction of the private activity bond tests must be bona fide and arm's-length and the new user must pay fair market value for the use of the financed property (taking into account use restrictions that serve a governmental purpose).

- Gross Proceeds for Arbitrage. Amounts received from the disposition of the property are "disposition proceeds" and must be treated as "gross proceeds" (i.e., bond proceeds) for arbitrage purposes.

- Prior Expenditure. The proceeds affected by the change in use must have been expended on a governmental purpose before the action (except for a remedial action consisting of redemption of nonqualified bonds).

If all of the preceding conditions are met, then one of the following three alternative remedial actions must be taken:

- Redemption or Defeasance of the Bonds. Generally, the bonds must be called on the first call date and a defeasance escrow must be created if the bonds cannot be called within 90 days.

- Alternate Use of Disposition Proceeds. Proceeds from the sale of the facility must be used within 2 years in a manner that does not violate the private business tests and the private loan financing test (for example - spending the money from the sale of the hospital on bona fide governmental purposes such as roads or schools) [**note, this is only available for a disposition for cash**]; or

- Alternate Use of the Facility. The bond-financed facility must be used for another qualifying purpose (for example - sell the hospital to another governmental unit that will use it for governmental purposes).

**A Final Thought** - "Contrary to what some people claim, the tax laws have a lot of respect for logic. They use it so sparingly." Jeffery L. Yablon.