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A PROFESSIONAL LAW CORPORATION

**OVERVIEW OF FINAL PRIVATE ACTIVITY BOND REGULATIONS
INCLUDING REVENUE PROCEDURES
97-13 (MANAGEMENT CONTRACT RULES)
97-14 (RESEARCH AGREEMENT RULES)
97-15 (CLOSING AGREEMENTS FOR OUTSTANDING BONDS)**

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HIGHLIGHTS OF FINAL PRIVATE ACTIVITY BOND REGULATIONS

New, final private activity bond regulations (the "Regulations") apply to bonds issued on or after May 16, 1997, except certain refunding bonds, for the purposes of applying private activity bond tests. The Regulations remove most of the difficult bright-line restrictions of the proposed regulations, but reserve certain areas (*e.g.*, output facility rules, allocation rules and refunding rules).

Standards. The private activity bond tests are applied on the basis of *two standards*: reasonable expectations as of the issue date and deliberate actions after the issue date. Thus, if it is reasonably expected on the issue date that the tests will be met, or if deliberate action is taken after the issue date to cause the tests to be met, then bonds are private activity bonds.

Generous exceptions apply. If an action is reasonably expected as of the issue date to occur after the issue date and to cause the private activity tests to be met, that action is disregarded if the issuer provides for mandatory redemption in the bond documents and does not enter into an arrangement with a nongovernmental person with respect to that action. Also, three remedial actions (redemption or defeasance, alternate qualified use of the financed facility and alternative qualified use of disposition proceeds) are permitted for post-issuance deliberate action if certain conditions are satisfied (such as, reasonable expectations on the issue date not to meet the private activity bond tests). (See below regarding Revenue Procedure 97-15.)

Private Business Use Test. The private business use test of the Regulations generally *establishes a framework* under which facilities are identified as publicly available facilities (in that they are available for, and reasonably expected to be used by, natural persons not in a trade or business) and facilities that are not publicly available. For publicly available facilities, private business use arises only in the case of "special legal entitlements" for use, meaning generally, ownership, lease, management contracts (see below regarding Revenue Procedure 97-13), output contracts and research agreements (see below regarding Revenue Procedure 97-14), but also including arrangements comparable to the described special legal entitlements (such as arrangements that convey priority rights to use). For facilities not publicly available, private business use may arise not only from special legal entitlements, but also from "special economic benefit" (determined on the basis of facts and circumstances, such as whether the financed property is functionally related or physically proximate to trade or business property).

Specific exceptions to private business use include use as a member of the general public (excluding, however, priority or preferential use and arrangements in excess of 180 days), short term use (as described), use as an agent (*e.g.*, as an "on-behalf-of" issuer), use incidental to a financing arrangement (*e.g.*, as a title holder in a sale-leaseback financing), use of a governmental improvement by a developer if the developer expects to transfer it to a governmental person (but there is no requirement to transfer property benefited by the improvement), and incidental use (applying a total limit of 2.5 percent).

The use test is *measured over the term* of the bonds by averaging annual percentages of private business use. A present value concept does not apply. In the case of facilities used at different times for private business use and governmental use, annual percentages of private business use are determined by comparing the private business use to the sum of that use and the governmental or public use, but disregarding non-use. For example if in a year a facility is leased to a private business user for 6 months, used by a governmental unit for 2 months and

vacant for 4 months, then the percentage of private business use of the facility is 75 percent (6 months divided by 8 months, not by 12 months). Measurement of use allocated to a discrete facility or discrete portion of a facility is permitted by treating that facility or portion as a separate facility. As an overall limitation, the average amount of private business use must be determined on the basis of fair market value if the private business use is expected to have a significantly greater fair market value than government use

Private Security or Payment Test. This test is applied over the term of the issue, based upon the present value of payments or security arising from a private business use as compared to the present value of debt service (adjusted to exclude payments from proceeds and to include hedge receipts and qualified guarantee payments). Present value is determined on the basis of the yield on the bonds on the issue date in the case of fixed yield issues and on the assumption that the issuance interest rate will be the initial rate over the term of the bonds in the case of variable yield issues.

Payments taken into account exclude the present value of payments in excess of the present value of the debt service on those proceeds used for a private business use and also exclude payments allocable to operating expenses. *Private payments must be allocated* among the sources of financing of a facility and may not, for example, be arbitrarily assigned to equity contributions. An exception exists, however, to permit private payments to be allocated to equity where a reimbursement resolution was timely adopted and the private payment is made within 18 months of the date of expenditure or the project being placed in service. The multiple-source allocation rules also state that a payment for use of property under an arrangement entered into in connection with an issue (as defined) are allocated to that issue.

In the case of the security portion of the test, security includes the financed property and security provided by a user of proceeds though not financed, but does not include unexpended proceeds (in most, but not all, cases) or property not provided by a private business user and not financed (*e.g.*, certain leased facilities in the case of asset-transfer certificate of participation financings). Security also includes payments in respect of bond-financed property used for a private business use even though the payments are made by the general public (*e.g.*, parking revenues for a bond-financed parking facility leased to a nongovernmental person).

Generally applicable taxes are excluded, but such taxes do not include service charges, special taxes or benefit assessments, or general taxes paid under certain impermissible agreements (such as an agreement to be personally liable or to provide credit support for the tax).

Private Loan Financing Test. For this test any transaction characterized as a loan for general federal income taxes is treated as a loan for purposes of the test and prepayments that are investment property for arbitrage purposes are also loans for the test. Specifically excluded, however, are grants such as a grant of proceeds of an issue secured by generally applicable taxes attributable to improvements made by the grant (*e.g.*, tax increment financing) unless impermissible agreements cause the tax payments not to be generally applicable taxes.

Also excluded are *tax assessment (deemed) loans* if the tax or assessment is (i) mandatory (*i.e.*, an enforced contribution imposed to raise revenue for a specific purpose such as capital costs), (ii) imposed for an essential governmental function (including improvements to governmental systems and to facilities where the service provided by the facility is customarily performed by governments, *e.g.*, undergrounding of utilities), and (iii) satisfies an equal basis requirement in that both business and nonbusiness assessed properties are equally eligible to, or required to, make deferred payments or to pay immediately or to prepay upon sale on the same conditions (*i.e.*, not that the method of spread of benefit is equal).

Certain private activity bonds. The Regulations provide that most of the above-described rules apply to qualified 501(c)(3) bonds and, in addition, contain remedial action provisions for exempt facility bonds (excluding multifamily housing and facilities for the local distribution of electricity or gas), qualified small issue bonds and qualified redevelopment bonds, as well as for many general restrictions applicable to qualified private activity bonds (including the public hearing and approval restriction).

New Revenue Procedures. Accompanying the Regulations are three Revenue Procedures: 97-13 (relating to management contract rules), 97-14 (relating to research agreements) and 97-15 (establishing a post-issuance closing agreement program).

The *management contract rules* (which extend to service contracts, but not to incidental services, such as janitor services, that are solely incidental to the primary governmental function of a financed facility) are substantially the same as the existing rules, but also permit 15 year-term contracts where 95 percent of the compensation is based on a periodic fixed fee and 10 year contracts where 80 percent of the compensation is based on a fixed fee and 20 year fixed-fee contracts for "public utility property." This term (which is defined by cross-reference to the depreciation rules) means property used for the furnishing or sale of water, sewage disposal services, electricity, or (through a local distribution system) gas or steam, or telephone services.

The *research agreement rules* provide a safe harbor for determining when facilities are used for a private business use if they are used for basic research under a corporate-sponsored research program or a cooperative research agreement.

The *post-issuance closing agreement program* establishes a program under which an issuer may apply to enter into an agreement with the IRS under which interest on bonds will not be taxable for the period from the issue date to the date of redemption even though a post-issuance deliberate action has caused the private business use test, the private loan financing test or certain requirements relating to qualified private activity bonds to be satisfied. The program requires that the issuer submit a proper request for a closing agreement, enter into a specified closing agreement, pay a specified amount and agree to provide notice of redemption to bondholders. The program does not apply if the preconditions to remedial action have not been satisfied (e.g., the reasonable expectations test) or if the bond issue is under audit.

In sum, the Regulations and accompanying Revenue Procedures provide an understandable, comprehensive, workable set of rules for applying the private activity bond tests and are, for the most part, favorable to issuers.

January 20, 1997

OVERVIEW OF FINAL PRIVATE ACTIVITY BOND REGULATIONS

I INTRODUCTION

A. Issuance. Final private activity bond regulations (the "Regulations") were issued by the Department of the Treasury on January 10, 1997 (TD 8712 published in the Federal Register on January 16, 1997). The Regulations relate primarily to application of rules for determining whether bonds are private activity bonds,¹ but also contain provisions relating to certain qualified private activity bonds (primarily regarding remedial action).²

B. Reserved Topics. The Regulations follow the organization of the proposed private activity bond regulations, but specifically reserve general allocation and accounting rules,³ output contracts provisions,⁴ volume cap application for large issues,⁵ and rules for refunding issues.⁶

II EFFECTIVE DATES

A. In General. The Regulations apply to bonds issued on or after May 16, 1997,⁷ that (in the case of the provisions relating to application of the private activity bond tests) are subject to section 1301 of the Tax Reform Act of 1986.⁸

B. Special Rule for Refunding Bonds. The Regulations do not apply to bonds that refund bonds that were not subject to the Regulations unless (i) the weighted average maturity is extended, (ii) the refunded bonds were short-term bonds obligations expected to be refunded with long-term obligations (such as bond anticipation notes) and the weighted average maturity is more than 120 percent of the weighted average reasonably expected economic life of the financed facilities, or (iii) a principal purpose for the refunding bonds is to make one or more new conduit loans.⁹

All § references below are to the Regulations unless otherwise referenced. As used herein the term "Code" means the Internal Revenue Code of 1986.

¹ §§ 1.141-1 through 1.141-15 and 1.150-1 (definition of bond documents).

² §§ 1.141-16 (effective date of qualified private activity bond provisions), 1.142-1 through 1.141-2 (exempt facility private activity bonds), 1.144-1 through 1.144-2 (qualified small issue and redevelopment private activity bonds), 1.145-1 through 1.145-2 (qualified 501(c)(3) private activity bonds), 1.147-1 through 1.147-2 (other requirements applicable to private activity bonds), 1.148-6 (certain allocation and accounting rules), and 1.150-4 (change in use for private activity bonds).

³ § 1.141-6 (except for a statement, in subsection (a), that any reasonable consistently applied accounting method may be used and that allocations for private activity bond rules and arbitrage rules must be consistent with each other; and except that § 1.148-6 of the arbitrage regulations is amended by the Regulations to provide that (i) if an issuer fails to maintain records sufficient to establish accounting methods and allocation of proceeds, the general allocation rules are applied using the specific tracing method and (ii) issuers must account for allocation of proceeds to expenditures no later than 18 months after the date an expenditure is paid or the date the project financed by the issue is placed in service and in no event later than 60 days after the fifth anniversary of the issue date or the retirement of the issue, if earlier. Under arbitrage regulations § 1.148-0(b), § 1.148-6 applies for purposes of arbitrage restrictions on bonds, as contrasted with private activity bond restrictions.)

⁴ §§ 1.141-7 (relating to special rules for output contracts), 1.141-8 (relating to the \$15 million limitation for output facilities) and 1.141-11 relating to acquisition of nongovernmental output property).

⁵ § 1.141-10.

⁶ § 1.141-13.

⁷ §§ 1.141-15(b), 1.141-16, 1.145-1, 1.148-6(a)(3) and 1.148-6(d)(1)(iii).

⁸ § 1.141-15(b).

⁹ § 1.141-15(c).

C. Permissive Application in Whole. An issuer may apply the Regulations in whole, but not in part, to bonds outstanding on the effective date of the Regulations and subject to Code section 141 or to refunding bonds issued on or after the effective date.¹⁰

D. Permissive Application in Part. An issuer may apply the following sections of the Regulations to bonds issued before the effective date: § 1.141-3(b)(4) (relating to management contracts), § 1.141-3(b)(6) (relating to research agreements) and § 1.141-12 (relating to remedial actions).¹¹

III. OVERVIEW OF PROVISIONS RELATING TO APPLICATION OF PRIVATE ACTIVITY BOND TESTS

A. Purpose and Definitions

1. Application to Further Purposes. The Regulations may not be applied in a manner inconsistent with the purposes for the private activity bond tests.¹² The purpose of these tests is to limit the volume of tax-exempt bonds that finance activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person.¹³

2. Certain Definitions. The following terms have the following special or new meanings:

a. "Bond documents." The term "bond documents" means the bond indenture or resolution, transcript of proceeds and any related documents.¹⁴

b. "Proceeds." The term "proceeds" means (i) sale proceeds other than sale proceeds used to retire bonds that are *not* deposited in a reserve fund, (ii) investment proceeds accruing during the project period (net of rebate amounts attributable to that period), and (iii) disposition proceeds to the extent referenced for remedial actions (see below).¹⁵

c. "Project period." The term "project period" means the period from the issue date to the date the project is placed in service, except that for multipurpose issues, the issuer may elect to treat the end of the project period for the entire issue as either (i) the expiration of the temporary period for the issue or (ii) the last day of the fifth bond year.¹⁶

d. "Renewal option." The term "renewal option" means a provision under which a party has a legally enforceable right to renew a contract; but a provision under which a contract is automatically renewed for 1-year periods absent cancellation is not a renewal option.¹⁷

¹⁰ § 1.141-15(d).

¹¹ § 1.141-15(e).

¹² § 1.141-2(a).

¹³ *Id.*

¹⁴ Amendment to § 1.150-1(b).

¹⁵ § 1.141-1(b).

¹⁶ *Id.*

¹⁷ *Id.*

e. "Person." The term "person" includes any related party, and all related parties are treated as one person.¹⁸

3. Elections. Elections permitted by the Regulations must be made in writing on or before the issue date, must be retained with the bond documents and may not be revoked.¹⁹

B. Application of Private Activity Bond Tests

1. In General. Bonds are private activity bonds if they meet either the private business use ("PBU") test and the private security or payment test ("PSPT") referenced below or the private loan financing test ("PLFT") referenced below.²⁰

2. Two Standards. An issue is an issue of private activity bonds if either (i) the issuer reasonably expects as of the issue that the issue will meet the private activity bond tests or (ii) the issuer takes a deliberate action, after the issue date, that causes the conditions of the tests to be met.²¹

a. Reasonable Expectations Standard. In determining whether the issuer reasonably expects that an issue will meet the private activity bond tests, the issuer must take into account reasonable expectations about events and actions over the entire stated term of the issue;²² but an action reasonably expected to occur and to cause the tests to be met may be disregarded if (i) the issuer reasonably expects that the financed property will be used for a governmental purpose for a substantial period before the action,²³ (ii) the issuer is required to redeem all "nonqualified" bonds within 6 months of the action,²⁴ (iii) the issuer does not enter into any arrangement with a nongovernmental person ("NGP") as of the issue date with respect to that specified action,²⁵ and (iv) the mandatory redemption meets the conditions for remedial action discussed below.²⁶

b. Deliberate Action Standard. In determining whether the issuer has taken deliberate action to cause the issue to meet the private activity bond tests, "deliberate action" means any action taken by an issuer that is within its control²⁷ (an intent to violate requirements is not necessary²⁸), but an action is not deliberate if it would be treated as an involuntary or compulsory conversion²⁹ or if it is taken in response to a federal regulatory directive.³⁰ A deliberate action occurs on the date the issuer enters into a binding contract, not subject to any material contingencies, with a NGP for use of financed property.³¹

18 § 1.141-1(d).

19 § 1.141-1(c).

20 § 1.141-2(a).

21 § 1.141-2(d)(1).

22 § 1.141-2(d)(2)(i).

23 § 1.141-2(d)(2)(ii)(A).

24 § 1.141-2(d)(2)(ii)(B). See Part III.G.6. below regarding determination of "nonqualified" bonds.

25 § 1.141-2(d)(2)(ii)(C).

26 § 1.141-2(d)(2)(ii)(D). See Part III.G.2. below.

27 § 1.141-2(d)(3)(i).

28 *Id.*

29 § 1.141-2(d)(3)(ii)(A), citing section 1033 of the Internal Revenue Code (relating to involuntary conversions).

30 § 1.141-2(d)(3)(ii)(B).

31 § 1.141-2(e).

c. Regulatory Exceptions. Assuming satisfaction of detailed restrictions described in the Regulations, (i) a disposition of personal property in the ordinary course of an established governmental program is not a deliberate action even if reasonably expected,³² and (ii) only reasonable expectations (and not post-issuance deliberate actions) apply for certain large general obligation bond programs of 25 projects or more.³³

d. Examples. See Attachment A for examples of application of these standards.

C. Private Business Use Test

1. In General. The PBU test is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a NGP.³⁴ Any activity carried on by a person other than a natural person, is treated as a trade or business.³⁵ Both the indirect and the direct uses of proceeds must be examined.³⁶ Thus, a facility is used for a private business use if it is leased to a NGP and subleased to a governmental person or leased to a governmental person and subleased to a NGP *provided* (in both cases) that the NGP's use is in a trade or business.³⁷ The use of proceeds by all NGPs is aggregated.³⁸

2. Types of PBU Arrangements.

a. Framework of Regulations. PBU ordinarily arises only if a NGP has a special legal entitlement for use under an arrangement with the issuer (including arrangements for beneficial use that are comparable to special legal entitlements³⁹), except that in the case of facilities that are not available for use by the general public, PBU may arise solely on the basis of special economic benefit even if there is no special legal entitlement for use.⁴⁰

b. Five Specific Special Legal Entitlements For Use. The Regulations describe five specific special legal entitlements for use that result in PBU: (i) ownership, (ii) lease, (iii) management contracts, (iv) output contracts and (v) research arrangements.⁴¹

i. Ownership. Ownership of financed property by a NGP is a special legal entitlement that is PBU,⁴² except ownership as an agent (such as ownership by and "on behalf of" issuer)⁴³ or ownership incidental to a financing arrangement (such as ownership by a title holder in a sale-leaseback transaction).⁴⁴ "Ownership" means ownership for federal income tax purposes.⁴⁵

32 § 1.141-2(d)(4).

33 § 1.141-2(d)(5).

34 § 1.141-3(a)(1).

35 *Id.*

36 § 1.141-3(a)(2).

37 *Id.*

38 § 1.141-3(a)(3).

39 § 1.141-3(b)(7)(i).

40 § 1.141-3(b)(7)(ii).

41 § 1.141-3(b)(1).

42 § 1.141-3(b)(2).

43 §§ 1.141-3(b)(2) and 1.141-3(d)(1).

44 §§ 1.141-3(b)(2) and 1.141-3(d)(2).

45 § 1.141-3(b)(2).

ii. Lease. The lease of financed property by a NGP is a special legal entitlement that is PBU.⁴⁶ A "lease" is any arrangement properly characterized as a lease for federal income tax purposes.⁴⁷ In some cases a management contract may be properly characterized as a lease or as ownership (and thus not be eligible for the exception for "qualified" management contracts, as referenced below).⁴⁸ Relevant factors are the degree of control over property exercised by a NGP and whether the NGP bears the risk of loss of the property.⁴⁹

iii. Management contracts.

(A) General Rule. A management contract by a NGP for financed property may be PBU of that property if the contract provides for compensation based, in whole or in part, on a share of net profits from operation.⁵⁰ If the contract does not provide for compensation on such basis, then whether it causes PBU may be determined under the safe harbors of Revenue Procedure 97-13 (also released on the date of release of the Regulations).⁵¹

(B) Revenue Procedure 97-13. In general, Revenue Procedure 93-17 provides that PBU does not arise from management contract arrangements comparable to those approved in Revenue Procedure 93-19 and, in addition, permits management contracts (i) where 95 percent of the compensation is on a fixed fee basis, having a term equal to the lesser of 15 years or 80 percent of the economic life,⁵² or 20 years in the case of "public utility property",⁵³ and (ii) where 80 percent of the compensation is on a fixed fee basis, having a term equal to the lesser of 10 years or 80 percent of the economic life,⁵⁴ or 20 years in the case of public utility property.⁵⁵ "Public utility property" means property used predominately in the furnishing or sale of water, sewage disposal, electricity, or (through a local distribution system) gas or steam, or telephone or communication services furnished by the Communications Satellite Corporation.⁵⁶ See Attachment B for a summary of Revenue Procedure 97-13.

(C) Definition. A management contract is a management, service or incentive payment contract under which a service provider provides services for all, or a portion of, or a function of, a facility.⁵⁷

(D) Exclusions. The following are not management contracts that give rise to PBU: (I) contracts for services incidental to the primary governmental functions of a facility (e.g., janitor contacts, office

46 § 1.141-3(b)(3).

47 *Id.*

48 §§ 1.141-3(b)(3) and 1.141-3(b)(4)(iv)

49 *Id.*

50 § 1.141-3(b)(4)(i).

51 Rev. Proc. 93-17 applies to contracts entered into, modified or extended after May 15, 1997 and specifically makes Rev. 93-19, 1993-1 C.B. 526 obsolete.

52 Rev. Proc. § 5.03(1).

53 Rev. Proc. § 5.03(3).

54 Rev. Proc. § 5.03(2).

55 Rev. Proc. § 5.03(3).

56 As further specified in Code section 168(i)(10).

57 § 1.141-3(b)(4)(ii).

equipment repair contracts, hospital billing contracts);⁵⁸ (II) the granting of admitting privileges by a hospital to a doctor if those privileges are available to all qualified physicians in the area and consistent with the size and nature of the facilities;⁵⁹ (III) a contract for operation of a facility consisting primarily of public utility property if the compensation is limited to reimbursement of actual expenses and reasonable overhead;⁶⁰ and (IV) a contract to provide services if the only compensation is the reimbursement of actual and direct expenses paid by the service provider to unrelated parties.⁶¹

iv. Output contracts. The degree to which take or pay or other output-type contracts result in PBU is a topic reserved in the Regulations.⁶² Presumably the general guidance of existing rulings applies until the reserved sections are released.

v. Research agreements

(A) General Rule. An agreement by a NGP to sponsor research performed by a governmental person may result in PBU, based upon the facts and circumstances,⁶³ and will result in PBU if the sponsor is treated as the lessee or owner of the financed property.⁶⁴ Whether it causes PBU may be determined under the safe harbors of Revenue Procedure 97-14 (also released on the date of release of the Regulations).⁶⁵

(B) Revenue Procedure 97-14. In general, Revenue Procedure 97-14 provides that PBU does not arise from corporate-sponsored research agreements if any license of resulting technology is permitted only on the same terms that the recipient would permit use by non-sponsoring parties (*i.e.*, with a competitive price)⁶⁶ or from cooperative research agreements if multiple sponsors agree to fund government research performed in the same manner as government research, with title to patents and other products with the qualified user and with only non-exclusive royalty-free license to sponsors to use research products.⁶⁷ See Attachment C for a summary of Revenue Procedure 97-14.

c. Comparable Entitlements For Use. In addition to the five specific special legal entitlements for use that constitute PBU of publicly-available facilities, any other arrangement that is comparable to the five described special legal entitlements for use results in PBU (*e.g.*, an arrangement that conveys priority rights to use or capacity of a facility).⁶⁸

58 § 1.414-3(b)(4)(iii)(A).

59 § 1.141-3(b)(4)(iii)(B).

60 § 1.141-3(b)(4)(iii)(C). See (B) above for definition of "public utility property."

61 § 1.141-3(b)(4)(iii)(D).

62 § 1.141-3(b)(5).

63 § 1.141-3(b)(6)(i).

64 § 1.141-3(b)(6)(ii).

65 Rev. Proc. 97-14 applies to agreements entered into after May 15, 1997.

66 Rev. Proc. 97-14 § 5.02.

67 Rev. Proc. 97-14 § 5.03.

68 § 1.141-3(b)(7)(i).

d. Use as a Result of Special Economic Benefit. In the case of financed property that is *not* available for use by the general public, PBU may arise not only from special legal entitlements for use as referenced above, but also from special economic benefits to one or more NGPs, even though those persons have no special legal entitlements.⁶⁹ The determination is made on the basis of the facts and circumstances,⁷⁰ including the following: whether the property is functionally related or physically proximate to property used in a trade or business,⁷¹ whether only a small number of NGPs receive special economic benefit⁷² and whether the cost of the financed property is treated as depreciable by any NGP.⁷³

3. Exceptions.

a. Exception for General Public Use. If use of financed property is use as a member of the general public, then such use is not PBU⁷⁴ (*i.e.*, if the use of financed property is use by persons only as members of the general public, then such property has no PBU, whether or not such persons are natural persons). This exception applies only if the property in question is intended to be available, and is in fact reasonably available, for use on the same basis (as the use in question) by natural persons not engaged in a trade or business.⁷⁵ Below are two instances of use that is *not* general public use (*i.e.*, the use is not on the same basis as use by natural persons not engaged in a trade or business):

i. Priority or preferential use excluded from exception. Use that conveys priority rights or preferential benefits is not general public use, but arrangements providing for use available to the general public at no charge or on the basis of generally applicable rates uniformly applied do not convey preference or priority.⁷⁶ (Rates are uniform even if different rates apply to different classes of users, such as volume purchasers, if the differences are customary and reasonable,⁷⁷ or if the rates are imposed in a rate arrangement that is specially negotiated because the user is prohibited by federal law from paying generally applicable rates and the rates are as comparable as reasonably possible to the generally applicable rates.⁷⁸)

ii. Long-term arrangements excluded from exception. Use under an arrangement having a term of more than 180 days is not general public use.⁷⁹ In determining whether the term is greater than 180 days, renewal options are included.⁸⁰ A renewal option does not include a provision under which a contract is automatically renewed for 1-year periods absent cancellation by either party,⁸¹ and, in addition, for the purpose of this exception only, a right of first refusal to renew use under an arrangement is not a renewal option if the

69 § 1.141-3(b)(7)(ii)

70 *Id.*

71 § 1.141-3(b)(7)(ii)(A).

72 § 1.141-3(b)(7)(ii)(B).

73 § 1.141-3(b)(7)(ii)(C).

74 § 1.141-3(c)(1).

75 § 1.141-3(c)(1).

76 § 1.141-3(c)(2).

77 § 1.141-3(c)(2)(i).

78 § 1.141-3(c)(2)(ii).

79 § 1.141-3(c)(3).

80 *Id.*

81 § 1.141-1(b).

compensation under the arrangement is redetermined at generally applicable fair market value rates in effect at the time of the renewal and if the use of the property under similar arrangements is predominantly by natural persons not engaged in a trade or business.⁸²

b. Exception for Short-Term Use. There are two exceptions to PBU for short-term use.

i. Use for 90 days or less. Use under an arrangement of not longer than 90 days (including renewal options) is not PBU,⁸³ if (A) the arrangement does not result in ownership of financed property by a NGP,⁸⁴ (B) the arrangement would be treated as general public use except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable rates are not reasonably available to natural persons not engaged in a trade or business,⁸⁵ and (C) the property is not financed for a principal purpose of providing that property for use by that NGP.⁸⁶

ii. Use for 30 days or less. Use under an arrangement of not longer than 30 days (including renewal options) is not PBU,⁸⁷ if (A) the arrangement does not result in ownership of financed property by a NGP,⁸⁸ (B) the arrangement is a negotiated arm's length arrangement and compensation is at fair market value,⁸⁹ and (C) the property is not financed for a principal purpose of providing that property for use by that NGP.⁹⁰

c. Exception for Use as an Agent. Use by a NGP solely as an agent (e.g., solely as an on-behalf-of issuer) is not PBU.⁹¹

d. Exception for Use Incidental to Financing Arrangements. Use by a NGP that is solely incidental to a financing arrangement is not PBU,⁹² but only if the NGP has no substantial rights to use bond proceeds or the financed property other than as an agent of the bondholders (e.g., bond trustees, servicers, guarantors and owners of title in sale-leaseback financings if the NGPs have assigned all rights to use the leased facility to a trustee for the bondholders).⁹³

e. Exception for Use as a Developer. Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not PBU⁹⁴ if (i) the issuer and the developer reasonably expect to proceed with reasonable speed to develop the improvement and the property benefited by that improvement;⁹⁵ (ii) the issuer and the developer reasonably expect to proceed with

82 *Id.*

83 § 1.141-3(d)(3)(i)(A).

84 § 1.141-3(d)(3)(i).

85 § 1.141-3(d)(3)(i)(B).

86 § 1.141-3(d)(3)(i)(C).

87 § 1.141-3(d)(3)(ii)(A).

88 § 1.141-3(d)(3)(ii).

89 § 1.141-3(d)(3)(ii)(B).

90 § 1.141-3(d)(3)(ii).

91 § 1.141-3(d)(1).

92 § 1.141-3(d)(2).

93 *Id.*

94 § 1.141-3(d)(4).

95 *Id.*

reasonable speed to transfer the improvement to a governmental person⁹⁶ and (iii) the *improvement* is in fact transferred to a governmental person after the benefited property is developed.⁹⁷

f. Exception for Incidental Uses. Incidental uses (excluding output purchases⁹⁸) are not PBU to the extent that those uses do not exceed 2.5 percent of the proceeds used to finance the facility.⁹⁹ Use is incidental if (i) except for vending machines, pay telephones, kiosks and similar uses, the use does not transfer to a NGP possession and control of space separated from other areas of a facility by walls or physical barriers (such as a night gate affixed to a building);¹⁰⁰ (ii) the nonpossessory use is not functionally related to other use of the facility by the same person;¹⁰¹ and (iii) all nonpossessory uses do not exceed 2.5 percent of the facility.¹⁰² Examples of incidental use are pay telephones, vending machines, advertising displays, and use for television cameras.¹⁰³

g. Exception for Qualified Improvements. Governmentally-owned improvements to a governmentally-owned building are deemed not to be used for PBU¹⁰⁴ if (i) the building was placed in service more than a year before construction or acquisition of the improvement,¹⁰⁵ (ii) the improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for PBU,¹⁰⁶ (iii) no portion of the improved building or payments therefor are taken into account under the private security test¹⁰⁷ and (iv) no more than 15 percent of the improved building is used for PBU.¹⁰⁸

h. Special Rule for Tax Assessment Bonds. Deemed loans (*i.e.*, assessments or special taxes) are disregarding in determining whether the PBU test is met.¹⁰⁹

4. Examples. See Attachment A for examples of the application of the PBU test.

5. Measurement of PBU.

a. General Rule. In the case of PBU by reason of ownership by a NGP, the amount of PBU arising from such ownership is the greatest percentage of ownership in any one-year period.¹¹⁰ In case of other PBU of property, the amount of PBU is determined according to the average percentage of PBU during the "measurement period".¹¹¹

96 *Id.*

97 *Id.*

98 § 1.141-3(d)(5)(ii).

99 § 1.141-3(d)(5)(i).

100 § 1.141-3(d)(5)(i)(A).

101 § 1.141-3(d)(5)(i)(B).

102 § 1.141-3(d)(5)(i)(C).

103 § 1.141-3(d)(5)(ii).

104 § 1.141-3(d)(6).

105 § 1.141-3(d)(6)(i).

106 § 1.141-3(d)(6)(ii).

107 § 1.141-3(d)(6)(iii).

108 § 1.141-3(d)(6)(iv).

109 § 1.141-3(e).

110 § 1.141-3(g)(2)(iv).

111 § 1.141-3(g)(1).

b. Measurement Period

i. Beginning of period. The measurement period begins on the later of (A) the issue date, and (B) the date the property is placed in service.¹¹² (See below regarding commencement of PBU.)

ii. End of period. The measurement period ends on the earlier of (i) the last date of the reasonably expected economic life of the financed property (based upon reasonable expectations on the issue date), and (ii) the latest maturity date of any bond of the issue (determined without regard to any optional redemption dates)¹¹³ or, in the case of short term obligations expected to be refunded with long-term obligations (e.g., bond anticipation notes), the latest maturity date of any bond of the last refunding issue (determined without regard to any optional redemption dates).¹¹⁴ If, however, an issuer reasonably expects, on the issue date, that during the term of the bonds the private business tests or the private loan financing test will be met and if the issuer is required to redeem the bonds to meet the reasonable expectations test (see above regarding reasonable expectations standard), then the measurement period ends on the reasonably expected redemption date.¹¹⁵

iii. Alternate period in case of abuse. The Commissioner may determine PBU based upon the greatest percentage of PBU in any one-year period if (A) the issue has a term longer than reasonably necessary for the governmental purpose of the issue and (B) the establishment of such term is for the principal purpose of increasing the permitted amount of PBU.¹¹⁶

c. Average Percentage.

i. For the issue. The average percentage of PBU for the issue is the average of the percentages of PBU during one-year periods within the measurement period, with appropriate adjustments made for beginning and ending periods of less than one year.¹¹⁷

ii. For annual periods. The percentage of PBU during any one-year period is the average PBU during that year determined by comparing the amount of PBU during the year to the total amount of PBU and use that is not PBU during the year.¹¹⁸

iii. For use at different times. For a facility in which actual government use and PBU occur at different times (e.g., different days), the average amount of PBU is based on the amount of time that a facility is used for PBU as a percentage of the total time for all actual use.¹¹⁹

¹¹² *Id.*

¹¹³ § 1.141-3(g)(2)(i).

¹¹⁴ § 1.141-3(g)(2)(ii).

¹¹⁵ § 1.141-3(g)(2)(iii).

¹¹⁶ § 1.141-3(g)(3)(v).

¹¹⁷ § 1.141-3(g)(3).

¹¹⁸ § 1.141-3(g)(4)(i).

¹¹⁹ § 1.141-3(g)(4)(ii).

iv. Non-use disregarded. Periods during which a facility is not in use are disregarded.¹²⁰ (For example, assume a sports training facility is rented to the '49s football team for 6 months of a year, is used by the local school district for football games during 2 months of the year and is vacant for 4 months of the year. Four months are disregarded in applying the test. Therefore, 6/8 (75 percent) is the percentage of PBU of the facility. If the 4 months were not disregarded, but were assumed to be a government use, then 6/12 (50 percent) would be the percentage of PBU.)

v. For simultaneous use. For a facility in which government use and PBU occur simultaneously (e.g., a governmentally-owned facility that is leased for PBU), the entire facility is treated as used for PBU,¹²¹ but if there is also PBU on the same basis as government use, then the average amount of PBU may be determined on a reasonable basis reflecting proportionate benefit by various users (e.g., reasonably expected fair market value of use, or number of spaces in a parking facility having unassigned spaces).¹²²

vi. For discrete portions of a facility. Measurement of use allocated to a discrete portion of a facility is determined by treating the discrete portion as a separate facility.¹²³

d. Limitation. The average amount of PBU must be determined on the basis of reasonably expected fair market value of use if PBU is expected to have a significantly greater fair market value than government use, and other measures (such as average time of use) may not be used.¹²⁴ If making the determination of fair market value as of the issue date is not reasonably possible (e.g., the financed property has not been identified as of the issue date), then fair market value may be determined on the date property is acquired or placed in service.¹²⁵ Fair market value must take into account the amount of reasonably expected payments for PBU for a period in a manner that properly reflects the proportionate benefit derived from PBU.¹²⁶

e. Common Areas and Neutral Costs. PBU of common areas is based on a reasonable method that reflects proportionate benefit (generally a method that is based on the average amount of PBU of the remainder of the facility).¹²⁷ Neutral costs (e.g., reserve fund, guarantee fees, qualified hedge fees) are allocated ratably.¹²⁸

f. Commencement of PBU. PBU begins on the date there is a right to actual use by the NGP,¹²⁹ or, if earlier, the date an arrangement for PBU is entered into, if (i) the issuer enters into an arrangement for PBU a substantial period before the right to actual PBU commences (i.e., 10 percent of the measurement period or more) and (ii) the arrangement transfers ownership or is an arrangement for other long-term use (e.g., a lease).¹³⁰

120 *Id.*

121 § 1.141-3(g)(4)(iii).

122 *Id.*

123 § 1.141-3(g)(4)(iv).

124 § 1.141-3(g)(4)(v).

125 *Id.*

126 *Id.*

127 § 1.141-3(g)(5).

128 § 1.141-3(g)(6).

129 § 1.141-3(g)(7).

130 *Id.*

g. Examples. See Attachment A for examples of the measurement of PBU.

D. Private Security or Payment Test

1. General Rule. The PSPT is met if payment of principal or interest on more than 10 percent of the proceeds of an issue is directly or indirectly secured by any interest in property used or to be used for a PBU or payments in respect of such property or (ii) to be derived from payments in respect of property or borrowed money used or to be used for a private business use.¹³¹

a. Two Portions of Test. The PSPT is thus comprised of (i) the private payment portion of the test (which takes into account payment of debt service directly or indirectly to be derived from payments in respect of property or borrowed money used for a PBU), and (ii) the private security portion of the test (which takes into account payment of debt service directly or indirectly secured by any interest in property used for a PBU or payments in respect of property used for a PBU).¹³²

b. Aggregation. Payments taken into account as private payments and payments and property taken into account as private security are aggregated for purposes of the PSPT, but the same payments are not taken into account as both private payments and private security.¹³³

c. Basis of Determination. Debt service and payment are determined both from the bond documents and on the basis of underlying arrangements.¹³⁴ Such arrangements may result from separate agreements or from the facts and circumstances surrounding the issuance of bonds.¹³⁵

2. Measurement.

a. Present Value Standard. In determining whether the PSPT is met, the present value of payments or property taken into account is compared to the present value of debt service over the term of the issue.¹³⁶ Debt service, for this purpose, excludes amounts paid from sale and investment proceeds (e.g., capitalized interest)¹³⁷ and is adjusted to take into account payments and receipts that adjust yield for arbitrage purposes (e.g., qualified guarantee payments and qualified hedge payments and receipts).¹³⁸

b. Present Value Defined. Present values are determined on the basis of discounting all amounts to the issue date, using the yield of the issue.¹³⁹

i. Fixed yield issues. In the case of fixed yield issues, yield is determined on the issue date and not adjusted for subsequent events.¹⁴⁰

¹³¹ Code § 141(b)(2) and Regulations section § 1.141-4(a)(1).

¹³² § 1.141-4(a)(1).

¹³³ § 1.414-4(a)(2).

¹³⁴ § 1.141-4(a)(3).

¹³⁵ *Id.*

¹³⁶ § 1.141-4(b)(2)(i).

¹³⁷ § 1.141-4(b)(2)(ii)(A).

¹³⁸ § 1.141-4(b)(2)(ii)(B).

¹³⁹ § 1.141-4(b)(2)(iii)(A).

¹⁴⁰ § 1.141-4(b)(2)(iii)(B).

ii. Variable yield issues. In the case of variable yield issues, yield is determined over the term of the issue, but to determine the reasonably expected yield on any date, the issuer may assume that the future interest rate will be the same as the then current rate.¹⁴¹ In the case of a deliberate action (see standards for application of private activity bond tests above), yield on a variable rate issue must be recomputed to determine the present value of payments and the recomputed yield determined on the date of the deliberate action must be used for the purpose of determining the present value of payments under the arrangement causing the deliberate action for the purpose of the PSPT.¹⁴²

c. Application to Property. To determine present value of debt service secured by property, the property is valued at fair market value on the first date on which the property secures the bonds.¹⁴³

3. Private Payments.

a. Payments Taken into Account. Both direct and indirect payments made by any NGP treated as using proceeds are taken into account as private payments, but such payments are taken into account only (i) to the extent allocable to the proceeds used by the NGP and (ii) to the extent made for the period of time that proceeds are used for a PBU.¹⁴⁴

b. Includes Payments for Property. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed with the proceeds, even if not made by a private business user,¹⁴⁵ but payments are not made in respect of financed property if (i) the payments are directly allocable to other property being used directly by the person making the payment and (ii) those payments represent the fair market value of compensation for that other use.¹⁴⁶

c. Payments Not to Exceed Use. Payments for a PBU are not taken into account to the extent that the present value of the payments exceeds the present value of debt service on proceeds used for a PBU.¹⁴⁷ Thus, if 7 percent of the financed property is used by a person over the measurement period, then payments with respect to that property are taken into account only to the extent that the present value of those payments does not exceed the present value of 7 percent of the (adjusted) debt service on the issue.¹⁴⁸

d. Operating Expense Exclusion. Payments by a person exclude the portion of the payment allocable to ordinary and necessary expenses directly attributable to the operation and maintenance of the financed property used by that person.¹⁴⁹ "Ordinary and necessary expenses" are determined on the basis of Code section 162 (relating to deductions for trade or business expenses).¹⁵⁰ General overhead and administrative

141 § 1.141-4(b)(2)(iii)(C).

142 *Id.*

143 § 1.141-4(b)(2)(iv).

144 § 1.141-4(c)(2)(i).

145 *Id.*

146 *Id.*

147 § 1.141-4(c)(2)(i)(B).

148 *Id.*

149 § 1.141-4(c)(2)(i)(C).

150 *Id.*

expenses are not considered directly attributable to operation and maintenance.¹⁵¹ (For example, if an issuer receives \$5,000 rent during a year for use of space in a financed facility and pays \$500 for ordinary and necessary expenses properly allocable to operation of that space and \$400 for general overhead properly allocable to that space, then only \$4,500 of the rent would be counted for purposes of the PSPT, regardless of the actual use of the \$500.¹⁵²)

e. Certain Refinancings. If debt service on an issue is to be paid from the proceeds of a refunding issue, that debt service is deemed paid from private payments in the same proportion that the present value of the private payments taken into account for the refunding issue bears to the present value of debt service to be paid in the refunding issue (*e.g.*, if a note is paid from a refunding issue, the note meets the PSPT to the same extent that the refunding issue meets the PSPT).¹⁵³ This rule, however, does not apply to payments that arise from deliberate actions more than three years after retirement of the prior issue that are not reasonably expected on the issue date of the refunding issue.¹⁵⁴ A "refunding issue" includes both issues defined as refunding issues for arbitrage purposes and issues where proceeds are used to pay interest on another issue that are not refunding issues for arbitrage purposes.¹⁵⁵

f. Allocation of Private Payments

i. Among sources. Private payments for the use of property must be allocated among the various sources of funding (including different tax-exempt issues, taxable issues, equity and other amounts not derived from a borrowing) of the property¹⁵⁶ in a manner that reasonably corresponds to the relative amounts of those sources.¹⁵⁷

ii. Discrete property. Payments for use of a discrete facility or discrete portion of a facility must be allocated to the source or different sources of funding of that discrete property.¹⁵⁸

iii. Determination of sources. If an issuer has not retained records of amounts expended on property (*e.g.*, for a building built 30 years before allocation), an issuer may use reasonable estimates of expenditures.¹⁵⁹ Neutral costs (*e.g.*, costs of issuance) are allocated ratably among expenditures.¹⁶⁰

iv. Special rule for allocation among multiple issues. Where two or more issues finance property, a payment for the use of the property may be allocated according to the relative amounts of debt service (paid and accrued) on the issues during the annual period for which the payment is made if that allocation reflects the economic substance of the arrangements.¹⁶¹ Ordinarily that allocation will reflect the economic substance of the arrangements if (A) the maturity of the

151 *Id.*

152 *Id.*

153 § 1.141-4(c)(2)(ii).

154 *Id.*

155 *Id.* and §§ 1.150-1(d)(2)(i) and 1.148-6(d)(3)(ii)(A)(3).

156 § 1.141-4(c)(3)(i).

157 § 1.141-4(c)(3)(iii).

158 § 1.141-4(c)(3)(ii).

159 *Id.*

160 *Id.*

161 *Id.*

bonds reasonably corresponds to the reasonably expected economic life of the property and (B) debt service payments on the bonds are approximately level from year to year.¹⁶²

v. Special rule for allocation to equity. Payments may *not* be allocated to equity before they are allocated to debt issues unless (A) not later than 60 days after the date of expenditure, the issuer adopted official intent for reimbursement and (B) the private payment is made not later than 18 months after the date the expenditure is made or the project placed in service.¹⁶³

vi. Special rule for allocation in accordance with arrangements made in connection with issuance. A payment for use of property under an arrangement entered into in connection with issuance of an issue is generally allocated to that issue.¹⁶⁴ An arrangement is ordinarily treated as "in connection with" the issuance of an issue if (i) the issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date, and (ii) the amount of payments reflects all or a portion of debt service on the issue.¹⁶⁵

vii. Example. Assume a City office facility is financed with a tax-exempt issue of \$4 million, a taxable issue of \$3 million, a City contribution of \$2 million and a private lessee contribution of \$1 million (being a total of \$10 million). Assume further that 20 percent of the City office facility is later leased to ABC Company which pays \$1 million per year. Of those annual payments, 4/10 (40%) would be allocable to the tax-exempt bond issue unless one of the three special rules above enables a different allocation and (present valuing the same over the term of the issue) would be likely to satisfy the PSPT even though 60% of the City facility was financed with sources other than tax-exempt bond proceeds. This result can be avoided if it can be demonstrated that the Company payment is allocable to a discrete portion of the property and the tax-exempt financing is allocable to portions of the property other than that discrete portion.

4. Private Security.

a. Source of Security. Security taken into account for the PSPT includes the financed property as well as security (e.g., unimproved land or investment securities used for a private business use) provided directly or indirectly by a user of the proceeds of the issue even though not financed with the proceeds of the issue.¹⁶⁶

b. Exclusion for Unexpended Proceeds. Unexpended proceeds of an issue are not taken into account as security (though pledged to debt service) if they qualify for an initial temporary period for arbitrage purposes or are deposited in a reasonably required reserve or replacement fund.¹⁶⁷

c. Any Interest in Property May be Security. PBU property and payments in respect of that property are private security if any interest in that property or payments

162 *Id.*

163 § 1.141-4(c)(3)(v).

164 § 1.141-4(c)(3)(iv)

165 *Id.*

166 § 1.141-4(d)(2).

167 § 1.141-4(d)(3).

secures payment of debt service, including any right, claim, title or legal share in the property or payments.¹⁶⁸

d. Payments in Respect of Property. Payments in respect of property taken into account as private security are payments in respect of property used or to be used for PBU and the rules relating to private payments (see above) generally apply to payments treated as private security.¹⁶⁹ (Thus, for example, payments made by the general public for use of a facility also used for a private business use through a lease, unqualified management contract or similar use are taken into account as private security to the extent made for the period that the property is used by a private business user.¹⁷⁰)

e. Allocation. Property, or payments from disposition of that property, taken into account as private security must be allocated to each issue secured by the property or payments on a reasonable basis taking into account bondholders' rights to the payments or property upon default.¹⁷¹

f. Exception for Generally Applicable Taxes. Generally applicable taxes are not taken into account for purposes of the PSPT (*i.e.*, they are not deemed to be payments from a NGP and are not payments in respect of property used for a PBU¹⁷²).

i. Generally applicable tax defined. A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue for governmental purposes.¹⁷³ It must have a uniform tax rate applied to all persons of the same classification in the jurisdiction as well as a generally applicable manner of determination and collection.¹⁷⁴

ii. Charges, assessments and special taxes excluded. A payment for a special privilege granted or service rendered is not a generally applicable tax nor is a special assessment paid by a benefited property owner nor a tax or payment in lieu of a tax that is limited to property or persons benefited by an improvement.¹⁷⁵

iii. Determination and collection. A tax does not have a generally applicable manner of determination and collection to the extent that taxpayers make an impermissible agreement relating to payment (whether or not it is reasonably expected to result in payments).¹⁷⁶ If there is an impermissible agreement, then the entire tax paid by that taxpayer is treated as a special charge unless the agreement is limited to a specific portion of the tax.¹⁷⁷

iv. Examples of impermissible agreements. The following are impermissible agreements: to be personally liable on a tax, to provide additional credit support for the tax, to pay unanticipated shortfalls, to assure a specified

168 § 1.141-4(d)(4). Under this section, the phrase "interest in" is to be interpreted broadly.

169 § 1.141-4(d)(5).

170 *Id.*

171 § 1.141-4(d)(6).

172 § 1.141-4(e)(1).

173 § 1.141-4(e)(2).

174 *Id.*

175 § 1.141-4(e)(3).

176 § 1.141-4(e)(4)(i).

177 *Id.*

minimum market value of property, and not to challenge or seek deferral of the tax.¹⁷⁸

v. Examples of permissible agreements. The following are permissible agreements: an agreement to use a grant for specified purposes (whether or not the agreement is secured),¹⁷⁹ a representation regarding expected property value following an improvement, an agreement to insure the property and, if damaged, to restore the property, a right to rescind a grant if property taxes are not paid, and an agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purposes (e.g., to abate taxes to encourage a property owner to rehabilitate property in a distress area).¹⁸⁰

vi. Payments in lieu of taxes. A payment in lieu of a tax is a generally applicable tax if (A) it is commensurate with and not greater than amounts imposed by a statute for a tax of general application, and (B) it is designated for a public purpose and is not a charge, assessment or special tax (e.g., a payment in lieu of taxes made in consideration for the use of property financed with tax-exempt bonds).¹⁸¹

5. Application of Test to Waste Remediation Bonds. In the case of bonds issued to finance hazardous waste clean-up activities on privately-owned land, payments (including payments that secure, directly or indirectly, debt service on the bonds) from NGPs who are not users of the site or potentially responsible for disposing of hazardous waste on that site are not taken into account as private security if (i) the payments are made pursuant to a generally applicable statute that regulates activities on an industry-wise basis of persons handling hazardous waste or petroleum, and (ii) the payments are not in substance payment for the use of proceeds.¹⁸² Moreover, payments by NGPs who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on the site are not taken into account as private payments for purposes of the PSPT if the payments do not secure, directly or indirectly, payment of debt service on the bonds under the terms of the bonds and are not material to the security for the bonds (as defined).¹⁸³

6. Examples. See Attachment A for examples regarding application of the PSPT.

E. Unrelated or Disproportionate Use Test

1. In General. An issue meets the private business tests described above if the amount of PBU and private security or payments attributable to "unrelated" or "disproportionate" PBU exceed 5 percent of the proceeds of the issue.¹⁸⁴

¹⁷⁸ § 1.141-4(e)(4)(ii).

¹⁷⁹ § 1.141-4(e)(4)(i) and (iii).

¹⁸⁰ § 1.141-4(e)(4)(iii).

¹⁸¹ § 1.141-4(e)(5).

¹⁸² § 1.141-4(f)(1) and (2)

¹⁸³ § 1.141-4(f)(3). Under this section, payments are not material to security if they are not required for debt service, if the amount and time are not structured to reflect payment of debt service, if the receipt is uncertain, if the payments when received are either used for redemption or to pay costs of a hazardous waste remediation project and if, when a judgment has been entered by the issue date against a NGP, there are, as of the issue date, costs of hazardous waste remediation (other than those financed with the bonds) that may be financed with the payments.

¹⁸⁴ § 1.141-9(a)(1).

2. Application of Rule. This rule is applied by (i) determining whether a PBU is related to a governmental use, (ii) examining related PBU to determine whether it is disproportionate to government use,¹⁸⁵ and (iii) aggregating all unrelated use and disproportionate use to determine compliance.¹⁸⁶ Permissible unrelated and disproportionate PBUs are not reduced by PBU that is neither unrelated use nor disproportionate use.¹⁸⁷

3. Determination of Unrelated Use

a. In General. Whether use is related is determined by emphasizing the operational relationship.¹⁸⁸ Generally, a facility used for a related PBU must be located within, or adjacent to, the governmentally-used facility.¹⁸⁹ If the government use is not insignificant then, (i) use for the same purpose is not treated as unrelated use, and (ii) use of a facility in the same manner for related PBU and unrelated PBU does not result in unrelated use.¹⁹⁰

b. Examples. A privately-owned pharmacy in a governmentally-owned hospital does not result in unrelated use solely because the pharmacy also serves individuals not using the hospital; and use of parking spaces in a garage by a NGP is not unrelated if more than an insignificant portion of the spaces is use for a government use or a PBU that is related, even though the use by the NGP is not directly related to the other use.¹⁹¹

4. Determination of Disproportionate Use

a. Disproportionate Use Defined. PBU is disproportionate to a related governmental use only to the extent that the proceeds used for that PBU exceeds the amount of proceeds used for the related government use (e.g., PBU of \$100 related to a government use of \$70 results in \$30 disproportionate use).¹⁹²

b. Aggregation and Allocation. Multiple PBUs that are related to a single governmental use are aggregated,¹⁹³ but if a single PBU relates to multiple governmental uses (or to a government use and a private use), the amount of a disproportionate use is determined by one of the following methods: (i) reasonably allocating the PBU proceeds among the related uses; (ii) aggregating government uses that are directly related to each other, or (iii) allocating PBU to the governmental use to which it is primarily related.¹⁹⁴

5. Reasonable Expectations Test. The determination of the amount of unrelated and disproportionate use is based on the maximum amount of reasonably expected government use during the measurement period¹⁹⁵ and no unrelated or disproportionate use arises solely because a facility initially has excess capacity to be used by a NGP if the facility will be completely used by the issuer during the term of the issue for more than an insignificant period.¹⁹⁶

185 § 1.141-9(a)(2)(i).

186 § 1.141-9(a)(2)(ii).

187 *Id.*

188 § 1.141-9(b)(1).

189 *Id.*

190 § 1.141-9(b)(2).

191 *Id.*

192 § 1.141-9(c)(1).

193 § 1.141-9(c)(2).

194 § 1.141-9(c)(3).

195 § 1.141-9(d).

196 *Id.*

6. Examples. See Attachment A for examples of application of the unrelated or disproportionate use test.

F. Private Loan Financing Test

1. Test In General. The private loan financing test ("PLFT") is met if more than the lesser of 5 percent or \$5 million of the proceeds of an issue is used, directly or indirectly, to make loans to persons other than governmental persons.¹⁹⁷ In determining whether the PLFT is met, the amount loaned is not present valued.¹⁹⁸

2. Loan Defined.

a. In General. A transaction characterized as a loan for federal income tax purposes is a loan for purposes of the PLFT.¹⁹⁹ In addition, however, a loan may arise from a transaction in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, a contractual arrangement with respect to a facility (including a lease, management contract or output contract) may be a loan if it transfers tax ownership of the facility or shifts significant burdens and benefits of ownership to a NGP.²⁰⁰

b. Substance Rather Than Form Applies. The ultimate determination depends upon the substance of a transaction rather than form.²⁰¹ Thus, for example, the loan of proceeds to a developer for rehabilitation of property under a turnkey arrangement is not a loan.²⁰² A loan that is a nonpurpose investment (as contrasted with a purpose investment) also does not cause the PLFT to be met.²⁰³

c. Prepayments. A prepayment for property or services is a loan for purposes of the PLFT if a principal purpose for prepaying is to provide a benefit to the seller²⁰⁴ and either (i) the prepayment is for a substantial business purpose other than providing tax-exempt financing benefits to the seller and the issuer has no commercially reasonable alternative to the prepayment, or (ii) prepayments on substantially the same terms are made by a substantial percentage of similarly situated persons who are not beneficiaries of tax-exempt financing.²⁰⁵

d. Grants. A grant is not a loan, but characterization of a transaction as either a grant or a loan depends upon the facts and circumstances.²⁰⁶ A grant of proceeds of an issue for improvements, where the issue is secured by generally applicable taxes attributable to the improvements, is generally not treated as a loan unless the grantee

¹⁹⁷ § 1.141-5(a).

¹⁹⁸ § 1.141-5(b).

¹⁹⁹ § 1.141-5(c)(1).

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² § 1.141-5(e). Example 1.

²⁰³ § 1.141-5(c)(2)(i).

²⁰⁴ § 1.141-5(c)(2)(ii).

²⁰⁵ *Id.*

²⁰⁶ § 1.141-5(c)(3)(i).

enters into impermissible agreements resulting in the taxes not being treated as generally applicable (see above).²⁰⁷

e. Hazardous Waste Remediation Payments. A loan is generally not involved for purposes of the PLFT simply by reason of payments from users of sites being remediated or payments from persons responsible for disposing hazardous waste on such sites, but only if those payments are not taken into account under the private payment test (see above) and (also) do not secure debt service on the bonds.²⁰⁸

3. Tax Assessment Loans. A "tax assessment loan" is not a loan for purposes of the PLFT if it satisfies (i) the mandatory tax or assessment requirement, (ii) the essential governmental function requirement and (iii) the equal basis requirement.²⁰⁹ A "tax assessment loan" is a loan that is deemed to arise when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies the requirements below.²¹⁰

a. Mandatory Tax or Assessment Requirement. This requirement is met if the tax or assessment is (i) an enforced contribution (whether or not subject to protest procedures), (ii) imposed for the purpose of raising revenue for a specific purpose (e.g., for capital improvements), (iii) pursuant to a state law of general application, and (iv) that can be imposed upon (both) natural persons not acting in a trade or business and a person acting in a trade or business.²¹¹ Tax and assessments do not include fees for services.²¹²

b. Essential Governmental Function Requirement. This requirement is met if the tax or assessment is imposed for one or more specific, essential governmental functions.²¹³ Improvements to utilities and systems that are owned by a governmental person and available for use by the general public serve essential governmental functions (e.g., sidewalks, streets, street lights, electric, telephone and cable television systems, sewage treatment and disposal systems and municipal water facilities).²¹⁴ For other facilities, a primary factor is whether the service provided by the facility is customarily performed by governments with general taxing powers and financed with governmental bonds (e.g., parks).²¹⁵ Commercial or industrial facilities and improvements to property owned by a NGP do not serve an essential governmental function.²¹⁶ For example, environmental clean-up of non-governmentally-owned property is not an essential governmental function.²¹⁷

c. Equal Basis Requirement. This requirement is met if (i) owners of both business and nonbusiness property benefiting from the improvements are eligible or required to make deferred payments of the tax or assessment and (ii) the terms for

²⁰⁷ § 1.141-5(c)(3)(ii)(A). The title of this provision indicates that it applies specifically to tax increment financing. Subparagraph (B) indicates that if an impermissible agreement is limited to only a specific portion of a tax, then the entire agreement may not be treated as a loan.

²⁰⁸ § 1.141-5(c)(4).

²⁰⁹ § 1.141-5(d)(1).

²¹⁰ § 1.141-5(d)(2).

²¹¹ § 1.141-5(d)(3).

²¹² *Id.*

²¹³ § 1.141-5(d)(4)(i).

²¹⁴ § 1.141-5(d)(4)(ii).

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ § 1.141-5(e). Example 1.

payment of the tax or the assessment (*as contrasted with the formula for levy*) are the same for all taxed or assessed persons (*e.g.*, if some owners may prepay, then all must be permitted to prepay; or if some owners must prepay on sale of the property, then all must be required to prepay on sale).²¹⁸ A guarantee of debt service, taxes or assessments by a person treated as a borrower of bond proceeds (*i.e.*, by an assessed person) does not violate this requirement if it is not expected that payments will be made under the guarantee.²¹⁹

4. Examples. See Attachment A for examples of application of the PLFT.

G. Remedial Actions

1. In General. Bonds are private activity bonds if it is reasonably expected that the private business tests or the private loan financing test will be satisfied or if deliberate action is taken to cause the tests to be satisfied.²²⁰ Action is not treated as deliberate action if five specified remedial action conditions are satisfied and if one of three alternative deliberate actions is taken.²²¹

2. Five Remedial Action Conditions. The five required remedial action conditions are as follows:

a. Reasonable Expectations. The issuer must reasonably expect on the issue date that the tests will not be met during the entire term of the bonds.²²² ("Term of the bonds" means the stated term, except that it means the term to a mandatory redemption date if, as of the issue date, (i) the issuer reasonably expects that the financed property will be used for a governmental purpose for a substantial period, (ii) the issuer is required to redeem all nonqualifying bonds (regardless of the amount of any disposition proceeds actually received) within six months of the date of the action, and (iii) the issuer does not enter into any arrangement with a NGP, as of the issue date, with respect to that specific action.²²³)

b. Term Not Unreasonably Long. The term of the issue may not be unreasonably long (*i.e.*, 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).²²⁴

c. 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).²²⁵

d. Gross Proceeds for Arbitrage. Disposition proceeds must be treated as gross proceeds for arbitrage purposes.²²⁶ For temporary periods and rebate exemptions, the date of receipt of disposition proceeds may be treated as the issue date of the bonds.²²⁷

²¹⁸ § 1.141-5(d)(5)(i).

²¹⁹ § 1.141-5(d)(5)(ii).

²²⁰ See discussion under Part III.B.2. above.

²²¹ § 1.141-12(a).

²²² § 1.141-12(a)(1).

²²³ *Id.* and § 1.141-2(d)(2)(ii)(A) - (C).

²²⁴ § 1.141-12(a)(2).

²²⁵ § 1.141-12(a)(3).

²²⁶ § 1.141-12(a)(4).

²²⁷ *Id.*

Also, for purposes of the expenditure exemptions to the rebate requirement, if those exemptions were satisfied before the date of receipt of disposition proceeds, then the receipt of disposition proceeds may be disregarded.²²⁸

e. Prior Expenditure. The proceeds affected by the deliberate action must have been expended on a governmental purpose before the action (except for a remedial action consisting of redemption of nonqualified bonds).²²⁹

3. Three Alternative Types of Remedial Actions. There are three permitted remedial actions: (i) redemption of nonqualified bonds; (ii) alternate use of disposition proceeds so as to assure that the private activity bond tests are not satisfied; and (iii) alternate use of the facility for a qualifying purpose. The requirements for these alternatives are set forth below.

a. Redemption or Defeasance

i. General rule. The redemption remedial action is satisfied if all of the nonqualified bonds (see below) are redeemed or, if not redeemed within 90 days, a defeasance escrow is established within 90 days (subject to the limitations below).²³⁰

ii. Source of redemption. Redemption may be made from proceeds of tax-exempt bonds, but only if the bonds are qualified bonds, based upon the purchaser's use of the facility.²³¹ If there is disposition of financed property exclusively for cash, the redemption remedy is met if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds on the first call date after the deliberate action or, if not redeemed within 90 days of the deliberate action, the disposition proceeds are used to establish a defeasance escrow for the nonqualified bonds within 90 days of the deliberate action.²³²

iii. Escrow notice, limitation and structure. If an escrow is created, then written notice must be provided to the Commissioner of the establishment of the escrow within 90 days of the date that it is established.²³³ An escrow may not be created (and so defeasance is not a permitted remedial action) if the period between the issue date and the first call date for the bonds is more than 10.5 years.²³⁴ In all cases, the defeasance escrow must provide for redemption of the bonds on their earliest call date, must be sized taking into account investment earnings and may not be invested in investments having a yield higher than bond yield or in any investment under which the obligor is a user of the bond proceeds.²³⁵

b. Alternative Use of Disposition Proceeds.

²²⁸ *Id.*

²²⁹ § 1.141-12(a)(5).

²³⁰ § 1.141-12(d)(1).

²³¹ *Id.*

²³² § 1.141-12(d)(2). Note, however, that the ability to redeem only a pro rata portion does not apply if the reasonable expenditure test does not apply to the entire term of the bonds but only to the mandatory redemption date. See Part III.B.2.a. above and § 1.141-2(d)(2)(ii)(B).

²³³ § 1.141-12(d)(3).

²³⁴ § 1.141-12(d)(4).

²³⁵ § 1.141-12(d)(5).

i. General rule. This remedial action is satisfied if (A) the deliberate action is a disposition for cash,²³⁶ (B) the issuer reasonably expects to spent the disposition proceeds within two years of the date of deliberate action,²³⁷ (C) the disposition proceeds are treated as proceeds for purposes of the private activity bond tests, are not used so as to cause satisfaction of those tests and the issuer does not take action after the date of deliberate action to cause the tests to be met,²³⁸ and (D) proceeds not used for such alternative purpose are used for redemption or creation of a defeasance escrow as referenced above.²³⁹

ii. 501(c)(3) use. If disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must be treated as reissued for purposes of the private activity bond tests, the qualified 501(c)(3) bond rules, the requirements pertaining to qualified 501(c)(3) bonds and to tax-exempt bonds, and the change of use provisions of the Code.²⁴⁰

c. Alternative Use of Financed Facility.

i. General rule. This remedial action is satisfied if (A) the financed facility is used in an alternative manner that satisfies the rules relating to tax-exemption,²⁴¹ (B) the nonqualified bonds are treated as reissued on the date of deliberate action for purposes of Code section requirements pertaining to alternative minimum tax, private activity bond tests, qualifying private activity bond purposes, volume cap, requirements pertaining to qualified private activity bonds (except that the limitation of Code section 147(d), relating to acquisition of existing property does not apply²⁴²), limitations pertaining to tax-exempt bonds generally and change of use, (C) such requirements are satisfied through the remaining term of the bonds²⁴³, and (D) the disposition is not to a purchaser that finances the acquisition with proceeds of tax-exempt bonds.²⁴⁴

ii. Use of disposition proceeds. Disposition proceeds resulting from the deliberate action (including installment sale proceeds) must be used for debt service on the next payment date or, within 90 days, must be deposited in an escrow restricted to bond yield to pay debt service on the next available payment date.²⁴⁵

4. Effect of Remedial Action.

a. General Rule. A remedial action will cure a use of proceeds that causes the PBU test or the PLFT test to be satisfied, but does not affect application of the PSPT.²⁴⁶

²³⁶ § 1.141-12(e)(1)(i).

²³⁷ § 1.141-12(e)(1)(ii).

²³⁸ § 1.141-12(e)(1)(iii).

²³⁹ § 1.141-12(e)(1)(iv).

²⁴⁰ § 1.141-12(e)(2).

²⁴¹ § 1.141-12(f)(1).

²⁴² § 1.141-12(g)(2).

²⁴³ § 1.141-12(f)(2).

²⁴⁴ § 1.141-12(f)(3).

²⁴⁵ § 1.141-12(f)(4).

²⁴⁶ § 1.141-12(b)(1). See Part III.D.2.b.ii. above, however, regarding recomputation of yield on deliberate action for variable yield issues for purposes of determining present value so as to apply the PSPT under § 1.141-4(b)(2)(iii)(C).

b. Refunding Bonds. If remedial action is taken with respect to an advance refunding bond, it proportionately reduces the amount of the refunded bond that is taken into account under the PBU test or the PLFT.²⁴⁷

c. Subsequent Deliberate Actions. For determining whether a deliberate action taken after a remedial action causes satisfaction of the private business tests, the PBU and private loans resulting from the deliberate action are not taken into account²⁴⁸ and the amount of disposition proceeds equals the proceeds of the issue that had been allocable to the transferred property prior to the disposition.²⁴⁹

5. Disposition Proceeds.

a. Defined. Disposition proceeds are amounts or property (such as an agreement to provide services) derived from the sale, exchange, or other disposition of property (other than investments) provided with proceeds.²⁵⁰

b. Tracing. Generally, after disposition, the proceeds of an issue are treated as financing the disposition proceeds (and their ultimate use) rather than the property that has been deposited of.²⁵¹ If, however, a disposition is through an installment sale, the proceeds of the issue continue to be allocated to the transferred property.²⁵² If an issuer does not satisfy the conditions for remedial action or the issuer does not take an appropriate remedial action, the proceeds are allocable to either the transferred property or the disposition proceeds, whichever allocation produces the greater amount of PBU and private security or payments.²⁵³

c. Allocation Among Sources. If property has been financed with different sources, the disposition proceeds are first allocated to the outstanding bonds in proportion to the principal amounts of the outstanding bonds.²⁵⁴ In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funds not borrowed (such as issuer revenues) if the disposition proceeds are not greater than the total amount of the outstanding bonds allocable to that property.²⁵⁵ "Outstanding" bonds do not include bonds that have been advance refunded.²⁵⁶

6. Nonqualified Bonds. The percentage of outstanding bonds that are nonqualified equals the highest percentage of any PBU in any one-year period commencing with the deliberate action.²⁵⁷ Allocations to nonqualified bonds must be made on a pro rata basis except that, in the case of remedial action relating to redemption or defeasance, an issuer may treat bonds with longer maturities as the nonqualified bonds.²⁵⁸

7. Examples. See Attachment A regarding application of the remedial action rules.

247 § 1.141-12(b)(2).

248 § 1.141-12(i)(1).

249 § 1.141-12(i)(2).

250 § 1.141-12(c)(1).

251 § 1.141-12(c)(2).

252 *Id.*

253 *Id.*

254 § 1.141-12(c)(3).

255 *Id.*

256 *Id.*

257 § 1.141-12(j)(1).

258 § 1.141-12(j)(2).

8. Revenue Procedure 97-15. Revenue Procedure 97-15 (issued January 17, 1997) establishes a program under which issuers may apply for a closing agreement to prevent taxability of interest on bonds where deliberate action has been taken causing bonds to satisfy the private activity bond tests. Attachment D attached hereto summarizes the provisions of Revenue Procedure 97-15.

H. Anti-Abuse Rules. If an issuer enters into a transaction with a principal purpose of transferring to NGPs significant benefits of tax-exempt financing in a manner inconsistent with the purposes of Code section 141, the Commissioner may treat separate issues as a single issue, reallocate proceeds, reallocate payments, measure PBU on a basis reflecting economic benefit, measure private payments or private security in a manner differently than set forth in the Regulations or take any other action to reflect the substance of the transaction.²⁵⁹

IV. OVERVIEW OF PROVISIONS RELATING TO QUALIFIED PRIVATE ACTIVITY BONDS

A. Exempt Facility Bonds, Small Issue Bonds and Qualified Redevelopment Bonds

1. In General. The qualified private activity bond rules for exempt facilities, small issues and qualified redevelopment require that 95 percent of the proceeds be used for certain specified purposes (the "95% Rule").²⁶⁰ The Regulations permit remedial action if the 95% Rule is not satisfied.²⁶¹ The remedial action rules, however, do not apply with respect to net proceeds that have been spent in the case of exempt facility private activity bonds for residential rental facilities and facilities for the local distribution of electric energy or gas²⁶² or in the case of the capital expenditure and \$40 million limitations applicable to qualified small issue private activity bonds.²⁶³

2. Permitted Remedial Action.

a. Redemption or Defeasance. If less than 95 percent of the proceeds are used for qualifying purposes, then the 95% Rule will be deemed satisfied if (i) the issuer reasonably expected on the issue date that the 95% Rule would be satisfied for the entire term of the bonds (disregarding redemption provisions and assuming that the amount of the issue was based on reasonable cost estimates)²⁶⁴, and (ii) all of the nonqualified bonds of the issue are redeemed on the earliest call date after the date on which the failure to properly use the proceeds occurs or, if not redeemed within 90 days, a defeasance escrow is established within 90 days²⁶⁵

b. Escrow Notice and Limitation. If an escrow is created, then written notice must be provided to the Commissioner of the establishment of the escrow within 90 days of the date that it is established.²⁶⁶ An escrow may not be created if the period between the issue date and the first call date for the bonds is more than 10.5 years.²⁶⁷

²⁵⁹ § 1.141-14(a).

²⁶⁰ §§ 1.142-1(a) and 1.144-1(a).

²⁶¹ §§ 1.142-1(b) and 1.144-1(b).

²⁶² *Id.*

²⁶³ § 1.144-1(b).

²⁶⁴ § 1.142-2(b).

²⁶⁵ § 1.142-2(c)(1).

²⁶⁶ § 1.142-2(c)(2).

²⁶⁷ § 1.142-2(c)(3).

c. Alternative for Personal Property. In lieu of redemption, in the case of disposition of personal property exclusively for cash, the issuer may expend the disposition proceeds within 6 months of disposition for replacement property used for the same qualifying purpose.²⁶⁸

3. Date of Failure.

a. Proceeds Not Spent. Where the proceeds of an issue are not spent then, for purposes of the remedial action described above, the date of failure to spend for a qualifying purpose occurs on the earlier of (i) the date the issuer determines that the facility will not be completed or (ii) the date the facility is placed in service.²⁶⁹

b. Proceeds Spent. Where the proceeds of an issue are spent for a qualifying purpose, then, for purposes of the remedial action described above, the date of failure of use of proceeds for a qualifying purpose occurs on the date the action is taken that causes the bonds not to be used for the qualifying purposes.²⁷⁰

4. Determination of Amount of Nonqualified Bonds. The nonqualified bonds are the portion of the outstanding bonds that equal the amount that, if the remaining bonds were issued on the date on which the failure occurred, at least 95 percent of the net proceeds of the remaining bonds would have been used for the qualifying purpose, but if no proceeds have been spent, then all outstanding bonds are nonqualified bonds.²⁷¹ Ordinarily pro rata allocation is applied, but the issuer may treat the longer maturities as the nonqualified bonds.²⁷²

B. Qualified 501(c)(3) Bonds

1. In General. The Regulations relating to application of the private activity bond tests apply to qualified 501(c)(3) private activity bonds.²⁷³ For example, if a conduit borrower takes deliberate action following issuance (e.g., an action causing revocation of an organization's 501(c)(3) status), that action will cause the issue to fail to be a qualified 501(c)(3) bonds.²⁷⁴

2. Application of Certain References. In applying the Regulations to qualified 501(c)(3) bonds, (a) references to "governmental persons" include 501(c)(3) organizations with respected to activities that are not unrelated business activities;²⁷⁵ (b) references to "10 percent" and "proceeds" for the PBU test and the PSPT mean "5 percent" and "net proceeds";²⁷⁶ and (c) references to the PBU test in the standards (reasonable expectation and deliberate action) and in the remedial action provisions include the ownership requirement of Code section 145(a)(1).²⁷⁷

3. Exceptions.

a. Certain Applications of Standards. The following do not apply to Code section 145 (relating to qualified 501(c)(3) bonds): the provisions of the Regulations

²⁶⁸ § 1.142-2(c)(4).

²⁶⁹ § 1.142-2(d)(1).

²⁷⁰ § 1.142-2(d)(2).

²⁷¹ § 1.142-2(e).

²⁷² *Id.*

²⁷³ § 1.145-2(a).

²⁷⁴ *Id.*

²⁷⁵ § 1.145-2(b)(1).

²⁷⁶ § 1.145-2(b)(2).

²⁷⁷ § 1.145-2(b)(3).

providing that dispositions of personal property in the ordinary course of an established governmental program do not violate reasonable expectation and deliberate action standards,²⁷⁸ and that reasonable expectations (and not deliberate actions) apply to certain general obligation bond programs for financing a large number of separate purposes.²⁷⁹

b. Costs of Issuance Not Allocated. Costs of issuance are treated as PBU and are not allocated ratably among other purposes for which proceeds are used.²⁸⁰

C. Other Requirements Applicable to Certain Private Activity Bonds

Certain provisions of Code section 147 (relating to other requirements applicable to private activity bonds) permit or prohibit certain uses of proceeds.²⁸¹ The remedial actions described above for failure to comply with the 95% Rule apply to those provisions of Code section 147.²⁸² These provisions are as follows:

(c)(3) permitting the use of proceeds to acquire land for environmental purposes,

(d)(2) and (3) permitting the use of proceeds for certain rehabilitations,

(e) prohibiting the use of proceeds for skyboxes, airplanes, gambling establishments and similar facilities, and

(f) the public hearing and approval requirement.²⁸³

D. Change in Use of Facilities Financed with Tax-Exempt Private Activity Bonds

1. In General. Code sections 150(b)(4), (5) and (6) and (c) contain provisions regarding the tax effect of changes in use for qualified 501(c)(3), exempt facility and small issue private activity bonds and private activity bonds where facilities are required to be owned by governmental units or 501(c)(3) organizations and providing generally that the interest deduction NGPs is lost and, in the case of 501(c)(3) organizations, certain income is treated as unrelated business income. The Regulations state that these provisions continue to apply even if the issuer takes a remedial action permitted by the Regulations for such private activity bonds.²⁸⁴

2. Exceptions. There are three exceptions to the above general rule:

a. Redemption. The above general rule does not apply prior to the redemption date if nonqualified bonds are redeemed within 90 days of a deliberate action (in the case of qualified 501(c)(3) bonds) or of the date upon which a failure to properly use proceeds occurs (in the case of the other private activity bonds listed above).²⁸⁵

²⁷⁸ §§ 1.141-2(d)(4) and 1.145-2(c)(1).

²⁷⁹ §§ 1.141-2(d)(5) and 1.145-2(c)(1).

²⁸⁰ § 1.145-2(c)(2).

²⁸¹ § 1.147-1.

²⁸² § 1.147-2.

²⁸³ *Id.*

²⁸⁴ § 1.150-4(a) and (b).

²⁸⁵ § 1.150-4(b)(2)(i).

b. Alternate Use of Facility. The general rule does not apply if a bond-financed facility is used for a permitted (by the remedial action provisions) alternative qualifying use.²⁸⁶

c. Alternate Use of Proceeds. If disposition proceeds are used for a qualifying purpose, the change of use provisions do not apply to the deliberate action that gave rise to those proceeds after the date on which the disposition proceeds are expended for the qualifying purpose, and if all of those proceeds are spent within 90 days of the date of the deliberate action, then the change of use provisions do not apply at all to the deliberate action.²⁸⁷

3. Allocation. If a change in use of a portion of financed property causes the Code change of use rules referenced above to apply, then the bonds allocable to that portion for purposes of those rules are the same as the nonqualified bonds except that the bonds allocable to all common areas are also allocated to the unqualified portion,²⁸⁸ but if remedial action is taken, the bonds allocable to a portion of property are the same as the nonqualified bonds.²⁸⁹

January 20, 1997

²⁸⁶ § 1.150-4(b)(2)(ii).

²⁸⁷ § 1.150-4(b)(2)(iii).

²⁸⁸ § 1.150-4(c)(1).

²⁸⁹ § 1.150-4(c)(2).

JONES HALL,
A PROFESSIONAL LAW CORPORATION

ATTACHMENT A
EXAMPLES (SHORTENED) CONTAINED IN
PRIVATE ACTIVITY BOND REGULATIONS

JONES HALL,
A PROFESSIONAL LAW CORPORATION

ATTACHMENT A

**EXAMPLES (SHORTENED) CONTAINED IN
PRIVATE ACTIVITY BOND REGULATIONS**

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ATTACHMENT A

**EXAMPLES (SHORTENED) CONTAINED IN
PRIVATE ACTIVITY BOND REGULATIONS**

A. General Rules of Application

Involuntary action. Bonds are not private activity bonds where a city expects on the issue date to use land acquired with proceeds for the entire term of the bonds, where the federal government later condemns the land and where the City sets aside the condemnation proceeds to pay debt service but does not redeem the bonds on their first call date.¹

Reasonable expectations test -- involuntary action. Bonds are private activity bonds where the city issues bonds to acquire land but reasonably expects that the federal government will condemn the land during the term of the bonds, where on the issue date the present value of the amount expected to be received from the federal government is more than 10 percent of the present value of debt service on the bonds, and where the bonds do not require redemption within 6 months of acquisition by the federal government.²

Reasonable expectations test -- mandatory redemption. Bonds are not private activity bonds where the city issues bonds to rehabilitate an existing city-owned hospital, where the city reasonably expects that the hospital will be used for a governmental purpose for a substantial period, where on the issue date the city plans a new hospital and expects that when it is placed in service the city will sell or lease the rehabilitated hospital and where the bond documents require the bonds to be redeemed within 6 months of sale or lease regardless of the amount actually received from the sale or lease.³

Disposition of personal property in ordinary course of governmental program. Bonds are not private activity bonds where the city issues bonds with a weighted average maturity of 6 years to acquire police cars, where the city expects that the cars will be used only by the city police department except that (in the ordinary course of operations) they will be sold to a taxicab corporation after 5 years of actual use since they will then be no longer suitable for police use, where the city also expects that the value of the police cars will be no more than 25 percent of cost when they are no longer suitable for use, and where the city sells 20 percent of the cars after only 3 years of use and deposits the proceeds in a commingled fund with general tax and other revenues and expects to spend the proceeds on governmental programs within 6 months of deposit.⁴

B. Private Business Use Test

Nongovernmental ownership. Bonds satisfy the PBU test where proceeds are used to buy land and construct a factory that is sold to a corporation on an installment sale basis.⁵

All § references herein are to final private activity bond regulations.

¹ § 1.141-2(g). Example 1.

² *Id.* Example 2.

³ *Id.* Example 3.

⁴ *Id.* Example 4.

⁵ § 1.141-3(f). Example 1.

Lease to a nongovernmental person. Bonds satisfy the PBU test where proceeds are used to buy land and construct a factory, where the factory is leased to a corporation for 3 years, and where annual lease payments are based on the tax-exempt interest rate on the bonds.⁶

Lease to a nongovernmental person. Bonds satisfy the PBU test where proceeds are used to buy land and construct a factory, where the factory is leased to a corporation for 3 years, and where annual lease payments equal fair rental value and exceed the amount needed to pay debt service.⁷

Management contract in substance a lease. Bonds satisfy the PBU test where the term of bonds issued to finance a hospital is 30 years, where the city enters into a 15-year fixed fee contract (with no compensation based on net profits) with an HMO relating to treatment of the HMO's members at the hospital, and where the contract provides that 30 percent of the capacity of the hospital will be available exclusively to the HMO's members and that the HMO will bear the risk of loss of that portion of the hospital capacity.⁸

Ownership of title in substance a leasehold interest. Bonds issued by nonprofit corporation on behalf of a city to finance hospital construction satisfy the PBU test where the nonprofit corporation owns legal title to the hospital and operates the hospital, but not as an agent of the city, and where the nonprofit corporation has certain rights to the hospital that establish that it is properly treated as the owner for federal income tax purposes even though the nonprofit corporation does not have rights directly to control operation of the hospital while the city has legal title to it. (The interest of the nonprofit corporation is comparable to a leasehold interest.)⁹

Rights to control use of property treated as PBU -- parking lot. Bonds issued to finance construction of a parking lot satisfy the PBU test where a corporation conveys a site adjacent to its factory to a city for a nominal amount with a covenant running with the land that the property be used only for a parking lot and where (even though the parking lot is available for general public use on the basis of rates generally applicable and uniformly applied), the city agrees that the corporation will have the right to approve rates charged by the city for use of the parking lot.¹⁰

Other actual or beneficial use -- non-publicly-available facility -- hydroelectric enhancements. Bonds satisfy the PBU test where bonds are issued to finance fish preservation facilities by a political subdivision that owns and operates a hydroelectric generation plant and sells 15 percent of the output of the plant to an investor-owned utility which is a private business user of the plant, and where such facilities are functionally related to the operation of the plant and are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business. (The utility derives a special economic benefit from the fish preservation facilities, which are not used by the public generally, and that benefit is treated as PBU).¹¹

Other actual or beneficial use -- publicly-available facility -- hydroelectric enhancements. Bonds do not satisfy the PBU test where bonds are issued to finance public recreation facilities by a political subdivision that owns and operates a hydroelectric generation plant and sells 15

⁶ *Id.* Example 2, paragraph (i).

⁷ *Id.* Example 2, paragraph (ii).

⁸ *Id.* Example 3.

⁹ *Id.* Example 4.

¹⁰ *Id.* Example 5.

¹¹ *Id.* Example 6.

percent of the output of the plant to an investor-owned utility which is a private business user of the plant, and where the recreation facilities are available to natural persons on a short-term basis with generally applicable, uniformly applied rates. (The facilities are used by the public generally, and the utility has no special legal entitlements for beneficial use of the recreation facilities.)¹²

Other actual or beneficial use -- non-publicly-available facilities -- pollution control.

Bonds satisfy the PBU test where bonds are issued by a city to finance a pollution control facility on land adjacent to a factory owned by a corporation, where the city owns and operates the facility, where the corporation has no special legal entitlement to use of the facility, but where the city expects that the only user of the facility will be the corporation. (The facility will not be available for use by the public generally and the corporation derives a special economic benefit from the facility since the facility is functionally related and physically proximate to property used in the corporation's trade or business and such special economic benefit is PBU.)¹³

General public use -- airport runway. Bonds do not satisfy the PBU test, where bonds are issued to finance an airport runway available for take-off and landing by any operator of an aircraft desiring to use the airport (including general aviation operators who are natural persons not engaged in a trade or business), where it is expected that most actual use will be by private charter and commercial airlines in connection with their use of the airport terminals leased by those carriers, where the terminal space leases provide no priority rights to the air carriers for use of the runway, and where lease payments are determined without taking into account revenues generated by runway landing fees, *i.e.*, the lease payments are not determined on a residual basis. (Because the runway is available for general public use, the special economic benefit to the air carriers is not PBU.)¹⁴

No public use -- airport runway. Bonds satisfy the PBU test under the same facts as above except that the runway is available only for use by private air carriers. (Because the runway is not available for general public use, the special economic benefit to the air carriers from the runway is PBU.)¹⁵

General public use -- special legal entitlements -- airport runway. Bonds satisfy the PBU test under the same facts as the penultimate paragraph above except that the lease payments under the leases with the private air carriers are determined on a residual basis taking into account the net revenues generated by runway landing fees. (Although the runway is available for general public use, the air carriers have PBU because the leases are arrangements that convey special legal entitlements to the financed facility, *i.e.*, lower rent on the terminal space that arises by reason of fees paid for runway use.)¹⁶

General public use -- airport parking garage. Bonds do not satisfy the PBU test where bonds are issued to finance a city-owned parking garage at a city-owned airport, where the city expects that more than 10 percent of the use of the garage will be by employees of private air carriers in connection with their use of airport terminals leased to those carriers, where the air carriers' use of the garage is on the same basis as passengers and other members of the general public using the airport, where the leases for terminal space provide no priority rights to the

¹² *Id.* Example 6.

¹³ *Id.* Example 7.

¹⁴ *Id.* Example 8, paragraph (i).

¹⁵ *Id.* Example 8, paragraph (ii).

¹⁶ *Id.* Example 8, paragraph (iii).

parking garage, and where the lease payments are determined without taking into account the revenues of the parking garage.¹⁷

Long-term arrangements not general public use -- insurance fund. Bonds satisfy the PBU test where the proceeds are deposited in the issuer's insurance fund and invested in tax-exempt bonds and where the insurance fund provides insurance with a one-year term to a large number of businesses and natural persons not engaged in a trade or business. (The use by persons other than natural persons is PBU because the participants have special legal entitlements to bond proceeds in the form of contractual rights, even though those rights are not necessarily properly characterized as ownership, leasehold or similar interests; moreover, the use of bond proceeds is not general public use because the term of the insurance is greater than 180 days.)¹⁸

General public use -- port road. Bonds do not satisfy the PBU test where bonds are issued by a highway authority to finance a 25-mile road connecting an industrial port owned by a corporation with roads owned by the authority, where the nearest development to the new road is 12 miles away, where there is no reasonable expectation that other development will occur, where the authority and the corporation enter into no arrangement that conveys special legal entitlements to the corporation for use of the road and where use of the road will be available without restriction to all users including natural persons who are not engaged in a trade or business.¹⁹

General public use of governmentally-owned hotel. Bonds do not satisfy the PBU test where bonds are issued to finance the construction of a hotel for tourists and business travelers, and where no user of the hotel will enter into a lease or license for a period of longer than 180 days, though users may actually use the rooms for consecutive periods longer than 180 days. (Use by business travelers is not PBU because the hotel is intended to be available and is in fact reasonable available for use by the same basis by natural persons not engaged in a trade or business.)²⁰

General public use with rights of first refusal. Bonds do not satisfy the PBU test where bonds are issued to construct a parking garage, where 90 percent of the spaces are available on a first-come, first-served basis, where the issuer expects that the spaces will be predominantly leased to natural persons not engaged in a trade or business who have priority rights to renew at the then current fair market value rates, and where more than 10 percent of the spaces will be leased to NGPs acting in a trade or business. (The leases are not treated as arrangements with a term of use greater than 180 days because (i) the rights to renew are not renewal options since the compensation for the spaces is redetermined at generally applicable fair market value rates in effect at the time of renewal, and (ii) the use of the spaces under similar arrangements is predominantly by natural persons not engaged in a trade or business.)²¹

General public use with specially negotiated rate agreement with agency of United States. Use of district's sewage treatment facilities by a federal agency is not PBU, but rather is on the same basis as the general public, where the district enters into a specially negotiated rate agreement and uses its best efforts to impose a charge as closely as possible to the same amount paid by other customers who pay for services based on standard district charges and taxes, and where the federal agency is prohibited by federal law from paying services based on standard district charges and tax levies.²²

¹⁷ *Id.* Example 9.

¹⁸ *Id.* Example 10.

¹⁹ *Id.* Example 11.

²⁰ *Id.* Example 12.

²¹ *Id.* Example 13.

²² *Id.* Example 14.

Arrangements not available for use by natural persons not engaged in a trade or business -- short-term use -- federal use of prisons. Bonds do not satisfy the PBU test where bonds are issued to construct a prison that contracts with a federal agency to house federal prisoners on a space-available basis, where the agency is charged approximately the same for each prisoner as other persons that enter into similar transfer arrangements, where the term of use is no longer than 90 days and the agency has no right to renew (though it expects to renew indefinitely), where the prison is not financed for a principal purpose of providing a prison for use by the federal agency, and where it is expected that more than 10 percent of the prisoners will be federal prisoners.²³

Negotiated arm's-length arrangements -- auditorium reserved in advance. Obligations satisfy the PBU test where obligations are issued to finance the construction of a municipal auditorium open to anyone who wishes to use it for a short period on a rate-scale basis, where the issuer expects use by schools, churches, sororities and commercial organizations, where a corporation enters into an arm's length arrangement with the issuer to use the auditorium for one week each year for 10 years (70 days) being charged a specific price reflecting fair market value, but where the issuer has not established generally applicable rates for future years. (The corporation does not use the auditorium as a member of the general public because its use is not on the same basis as the general public and, since the term is more than 30 days, the arrangement does not satisfy the exception for short-term use.)²⁴

Negotiated arm's-length arrangements -- short-term use -- auditorium reserved in advance. Obligations do not satisfy the PBU test under the facts described above but where the arrangement is for 4 years (a total of 28 days). (The contract satisfies the exception for negotiated arm's-length arrangements.)²⁵

Measurement of PBU -- Simultaneous use -- research facility. Bonds do not satisfy the PBU test where bonds are issued by a state-owned university to finance improvements to a university research facility used simultaneously for governmental research and sponsored research that is PBU, where it is not practical to estimate relative revenues from the research because it is not possible to predict which research projects will be successful, and where the university contributes 90 percent of the cost of the facility and the NGPs contributes 10 percent of the cost. (The NGPs are treated as using only 10 percent of the proceeds of the issue since the portions of costs contributed by the various users provides a reasonable basis to determine proportional benefit.)²⁶

Measurement of PBU -- use at different times -- stadium. Bonds do not satisfy the PBU test where bonds are issued to build a stadium, where the issuer enters into a long-term contract with a professional sports team under which the team will use the stadium 20 times during each use occurring on nights and weekends, where the issuer expects (based upon a feasibility study and historical use of a replaced stadium) that the stadium will be used more than 180 other times each year without PBU, and where there is not a significant difference in the value of the team's use when compared to other use, taking into account the payments the team is reasonably expected to make for its use. (No more than 10 percent of the facility is used for PBU.)²⁷

²³ *Id.* Example 15.

²⁴ *Id.* Example 16, paragraph (i).

²⁵ *Id.* Example 16, paragraph (ii).

²⁶ § 1.141-3(g)(8), Example 1.

²⁷ *Id.* Example 2, paragraph (i).

Measurement of PBU -- use at different times -- stadium. Bonds satisfy the PBU test under the facts set forth above but where the issuer expects that the stadium will be used not more than 60 other times each year. (Under these facts, 25 percent of the proceeds are used for PBU.)²⁸

Airport terminal areas treated as common areas. Bonds satisfy the PBU test where the city issues bonds to finance the construction of an airport terminal, where 80 percent of the leasable space will be leased to private air carriers, where the remaining 20 percent of leasable space will be used by the city for administrative purposes and where common areas (waiting area, lobbies and hallways of the terminal) are treated as 80 percent used by the air carriers.²⁹

C. Private Payment or Security Test

Aggregation of payments. Bonds satisfy the PSPT where the state issues bonds of \$10 million and uses \$9.7 million to construct a 10-story office building of which 1 floor is leased to a corporation, where the remaining proceeds are used to make a loan to another corporation, where the present value of lease payments is 8 percent of the present value of debt service and where the present value of loan repayments is 3 percent of the present value of debt service. (For purposes of the PSPT, the private payments are more than 10 percent of the present value of debt service on the bonds.)³⁰

Indirect private payments. Bonds satisfy the PSPT, where several series of bonds are issued to finance urban rehabilitation, where bond proceeds are used for the rehabilitation and construction of buildings that will be leased or sold to NGPs for use in their trade or businesses, where there is no limitation on the number of issues of bonds or the aggregate amount of bonds that may be outstanding, where no group of bondholders has any legal claim prior to any other bondholders with respect to specific revenues of the issuer, where there is no arrangement whereby revenues from a particular project will be paid into a trust or constructive trust or sinking fund or otherwise segregated or restricted for the benefit of any group of bondholders, but where there is an unconditional obligation by the issuer to pay debt service on the bonds. (Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements and are taken into account as indirect private payments for purposes of the PSPT.)³¹

Computation of payment in variable yield issues. Bonds do not satisfy the PSPT where the city issues \$10 million general obligation bonds for a 5-story office building where the bonds bear interest of a variable rate recomputed monthly on the basis of an index and have an issue date yield of 6 percent based upon that index, where the issuer leases one floor of the building to a corporation for the term of the bonds, where by applying the 6 percent yield the issuer reasonably expects on the issue date that the present value of lease payments will be 8 percent of the present value of total debt service on the bonds and where interest rates decline after the issue date so that the yield on the bonds over their entire term is 4 percent (with the result that if the actual yield is used, the present value of lease payments made by the corporation is 12 percent of the present value of actual total debt service), and where the issuer does not take any subsequent deliberate action to meet the PSPT.³²

Computation of payment in variable yield issues. Bonds satisfy the PSPT where the facts are the same as above, except that 5 years after the issue date, the issuer leases a second

²⁸ *Id.* Example 2, paragraph (ii).

²⁹ *Id.* Example 3.

³⁰ § 1.141-4(g) Example 1.

³¹ *Id.* Example 2.

³² *Id.* Example 3, paragraph (i).

floor to another corporation and, on the date of that lease, reasonably expects that the yield of the bonds over their term will be 5.5 percent based on the actual interest rates to the date of the second lease and upon the then current rate on the variable yield bonds. (Using this yield, the present value of lease payments made by the second corporation is 3 percent and the aggregate private payments is more than 10 percent.)³³

Payments not in respect of financed property. The bonds do not satisfy the PSPT, where a city issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground, where the utility company is under no obligation to move the lines and where the debt service on the bonds will be paid using assessments levied by the city on the customers of the utility. (The assessments are payments in respect of the cost of relocating the line and are not in respect of property used for a PBU, but any direct or indirect payments made to the city by the utility company for the undergrounding are taken into account as private payments).³⁴

Payments from users of proceeds that are not private business users taken into account. Bonds satisfy the PSPT where bonds are issued to finance renovation of a hospital operated under a non-qualified management contract, and where the bonds are general obligation bonds but hospital revenues will be used for debt service. (The hospital revenues are payments in respect of property used for a PBU.)³⁵

Limitation of amount of payments to amount of private business use not determined annually. Bonds satisfy the PSPT where 15-year bonds are issued by a city to construct an office building, where the city enters into a 5-year lease with a corporation under which the corporation is treated as a user of 11 percent of the proceeds, where the corporation makes lease payments equal to 20 percent of annual debt service for each year of the lease, and where the present value of the corporation's lease payments is 12 percent of the present value of debt service over the term of the bonds. (If the lease payments were limited to 11 percent of debt service in each year of the lease, then the present value of those payments would be only 8 percent of debt service over the term of the bonds.)³⁶

Allocation of payments to funds not derived from a borrowing. Bonds do not satisfy the PSPT where the city buys property for \$1,250,000 using \$1 million of proceeds of tax increment bonds and \$250,000 of redevelopment fund revenues, where within 60 days of purchase, the city declares its intent to sell the property and to use the sale proceeds to reimburse the redevelopment fund, where the bonds are secured only by tax increment, and where within 18 months, the city sell the property to a developer for \$250,000 and uses that amount to reimburse its redevelopment fund.³⁷

Allocation of payments to different sources of funding -- improvements. If in 1997 the city issues \$8 million to finance the acquisition of a building, if in 2002 the city spends \$2 million of its general revenues to improve the building, and if in 2002 the city enters into a 10-year lease with a corporation providing for annual payments of \$1 million at fair market value and without a significant nexus to the issue or the general revenue expenditure, then of each lease payment, 80 percent is allocated to the issue and is taken into account under the private payment test.³⁸

33 *Id.* Example 3, paragraph (ii).

34 *Id.* Example 4.

35 *Id.* Example 5.

36 *Id.* Example 6.

37 *Id.* Example 7.

38 § 1.141-4(g), Example 8.

Security not provided by users of proceeds not taken into account. The PSPT is not satisfied, where a county issues certificates of participation in a lease of a building owned by the county and covenants to appropriate annual lease payments, where a portion of each lease payment is specified as interest, where more than 10 percent of the building is used for private business use, where none of the proceeds of the certificates are used for the building, but rather are used to make a grant to a corporation for the construction of a factory, where if the city defaults on the lease, the trustee has the limited right of repossession under which it may not foreclose, but may lease the property to a new tenant at fair market value. (Although the obligations are secured by an interest in the building which is property used for a PBU, because the property is not provided by a private business user and is not the financed property, the obligations do not satisfy the PSPT.)³⁹

Allocation of payments among issues. The private payment test, but not the private security test, is met for 1997 bonds where the university (a political subdivision) issued bonds in 1989, 1991 and 1993 and used the proceeds to construct facilities for its own use, where the bonds were equally and ratably secured and payable solely from income derived by the university from rates imposed by it for the use of facilities, where in 1997 the university issues another series of bonds to finance additional facilities, where 20 percent of the new facilities are leased for the term of the 1997 bonds to NGPs for use in their trades or businesses, where the present value of lease payments equals 15 percent of the present value of debt service on the 1997 bonds, where the university commingles all revenues in a revenue fund, and where the present value of the portion of the lease payments from the nongovernmental lessees of the new facilities allocable to the 1997 bonds is less than 10 percent of the present value of debt service on the 1997 bonds because the bond documents provide that the bonds are equally and ratably secured. (The private payment test is satisfied because the private lease payments for the new facility are properly allocated to those bonds since none of the proceeds of the other issues were used for the new facilities.)⁴⁰

Generally applicable tax for financed facility. Bonds satisfy the PSPT where an authority issues bonds to finance a stadium, where under a long-term lease a professional sports team will use more than 10 percent of the stadium, where the team will not make payments for that use, where the security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium, and where the portion of the ticket tax attributable to tickets purchased by persons attending the team's events will (on a present value basis) exceed 10 percent of the present value of debt service on the bonds. (The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to the team's events, the taxes are payments in respect of property used for a PBU.)⁴¹

Generally applicable tax for multiple facilities. Bonds do not satisfy the PSPT under facts the same as those above except that the ticket tax is imposed by the authority on tickets for events at a number of large entertainment facilities within the authority's jurisdiction, some of which are not financed with tax-exempt bonds. (The ticket tax is a generally applicable tax.)⁴²

D. Unrelated and Disproportionate Use Test

School and remote cafeteria. Bonds satisfy the test and meet the private business tests where of proceeds of \$20 million, \$18.1 million are used for construction of a school and \$1.9 million are used for a privately-operated cafeteria in an issuer-owned administrative office

³⁹ *Id.* Example 9.

⁴⁰ *Id.* Example 10.

⁴¹ *Id.* Example 11, paragraph (i).

⁴² *Id.* Example 11, paragraph (ii).

building located at a remote site. (The cafeteria is unrelated to the governmental school construction and exceeds 5% of \$20 million).⁴³

Public safety building and courthouse. Bonds do not satisfy the test where of proceeds of \$50 million, \$32 million are used for a public safety building, \$15 million are used for improvements to a courthouse and \$3 million are used for renovations to a private-owned cafeteria in the courthouse. (Expenditures for the cafeteria are neither unrelated nor disproportionate.)⁴⁴

Unrelated garage. Bonds do not satisfy the test where the facts are the same as above except that \$30.5 million is used for the public safety building and \$1.5 million is used to construct a privately operated parking garage adjacent to a private office building. (The PBU of the parking garage is unrelated to any government use of proceeds, but proceeds for unrelated uses and disproportion uses do not exceed 5 percent.)⁴⁵

Disproportionate use of garage. Bonds do not satisfy the test where of the proceeds of \$20 million, \$17 million are used for a hospital with no PBU, \$1 million are used for an office building with no PBU and \$2 million are used for a garage used for PBU. (The garage is related to the office building, but not the hospital, and the PBU of the garage results in \$1 million of disproportionate use because the proceeds used for the garage exceed the related government use, but the total disproportionate use, however, does not exceed 5 percent of the proceeds.)⁴⁶

Multiple projects. Bonds do not satisfy the test where of the proceeds of \$80 million, \$72 million is used for a County-owned incinerator, \$1 million is used for a County-owned facility for temporary storage of hazardous waste prior to final disposal, \$1 million is used to construct a privately-owned recycling facility located at a remote site, and \$6 million is used to build a garage adjacent to the County-owned incinerator, which garage will be leased to a private company to store and repair trucks it owns and uses, as to 75 percent of the trucks, to haul County refuse to the incinerator, and as to the remaining 25 percent of the trucks to haul County refuse to the temporary storage facility. (The recycling facility is an unrelated use. The garage is a related use. Of that related use (\$6 million), 75 percent is allocable to governmental use of the incinerator. The remaining 25 percent (\$1.5 million) relates to government use of the temporary storage facility but exceeds by \$0.5 million the proceeds used for the storage facility and the excess is disproportionate use. The aggregate amount of unrelated use and disproportionate use is \$1.5 million and this does not exceed the permitted 5 percent (\$4 million). Alternatively, the entire garage may be treated as related use and, under this method of allocation, is not disproportionate use.)⁴⁷

E. Private Loan Financing Test

Turnkey contract not treated as a loan. Notes do not satisfy the PLFT where the proceeds are loaned to a developer under a turnkey arrangement for rehabilitation of property conveyed by the issuer for reconveyance by the developer to the issuer upon completion of the rehabilitation because the arrangement is not a loan.⁴⁸

Essential government function requirement not met. Special tax bonds satisfy the PLFT where the proceeds are used to pay for environmental clean-up on property owned by

⁴³ § 1.141-9(e). Example 1.

⁴⁴ *Id.* Example 2.

⁴⁵ *Id.* Example 3.

⁴⁶ *Id.* Example 4.

⁴⁷ *Id.* Example 5.

⁴⁸ § 1.141-5(e). Example 1.

nongovernmental persons within a special taxing district. (The special tax is a loan, but since environmental clean-up of non governmentally-owned property is not an essential governmental function, the exception for tax assessment loans does not apply.)⁴⁹

F. Remedial Actions

Disposition proceeds less than outstanding bonds used to retire bonds. Satisfactory remedial action is taken and bonds are not taxable where the city issues \$10 million 30-year bonds to finance a hospital, where 6 years after issuance the city sells the hospital to a corporation for \$5 million, and where the city uses disposition proceeds to retire pro rata portion of bonds.⁵⁰

Lease to nongovernmental person. Satisfactory remedial action is taken and bonds are not private activity bonds where the facts are the same as above except that 6 years after issuance the city leases the hospital to a corporation for 7 years and uses other funds to redeem \$10 million outstanding bonds.⁵¹

Sale for less than fair market value. Satisfactory remedial action is not taken and bonds are private activity bonds where a city issues \$10 million 30-year bonds for hospital, where 6 years after issuance the city sells the hospital to a corporation for \$5 million when fair market value is \$6 million, and where the city uses disposition proceeds to retire a pro rata portion of bonds.⁵²

Fair market value determined taking into account governmental restrictions. Satisfactory remedial action is taken and bonds are not private activity bonds where a city issues \$10 million 30-year bonds to finance a hospital building, where the city determines to sell the building after public bids subject to a restriction that it be used only for hospital purposes, where the best price with this restriction is \$4.5 million, and where the city uses all of that amount to retire a pro rata portion of the bonds.⁵³

Alternative use of disposition proceeds. Satisfactory remedial action is taken and bonds are not private activity bonds where a city issues \$10 million 30-year bonds for a hospital building, where 6 years after issuance the city sells the hospital building to a corporation for \$5 million, where the city reasonably expects to use those disposition proceeds for governmental roads within 2 years, and where the city treats the disposition proceeds as gross proceeds for arbitrage purposes. (After the date of deliberate action, the proceeds of the outstanding bonds are treated as used for the roads even though only \$5 million of the disposition proceeds was used for roads.)⁵⁴

Alternative use of financed property. Satisfactory remedial action is taken and the bonds are treated as qualified 501(c)(3) governmental bonds where a city issues \$10 million 30-year bonds to finance a hospital building, where 6 years after issuance the city determines to lease the building to a 501(c)(3) organization for a term of 10 years with lease payments less than fair market value, where before entering into the lease, the city holds a TEFRA hearing and where after the deliberate action, the bonds are treated as reissued and satisfy all requirements for qualified 501(c)(3) bonds (*e.g.*, the 2% costs of issuance limit is satisfied because the issuer

⁴⁹ *Id.* Example 2.

⁵⁰ § 1.141-12(k). Example 1.

⁵¹ *Id.* Example 2.

⁵² *Id.* Example 3.

⁵³ *Id.* Example 4.

⁵⁴ *Id.* Example 5.

pays no costs of issuance from disposition proceeds in connection with the deemed reissuance).⁵⁵

Deliberate action before proceeds are expended on a governmental purpose. Satisfactory remedial action is taken and bonds are not private activity bonds where a county issues \$10 million bonds to finance a jail, where the county reasonably expects that it will be the sole user, where after the issue date (but before the facility is placed in service) the county enters into a contract with the federal government under which it will make a fair market value lump sum payment of 25 percent of the cost, where in exchange for this payment the county provides priority rights to 25 percent of the facility to the federal government, and where the county uses the federal payment to defease the nonqualified bonds.⁵⁶ (Proceeds must be expended before remedial action is taken except for the redemption remedial action.⁵⁷)

Compliance after remedial action. City issues \$10 million of bonds to finance a courthouse, uses \$1 million for PBU and more than 10 percent of debt service is secured by private security and later sells one-half of courthouse to a NGP for cash and redeems 60 percent of bonds, which percentage is based on the highest PBU in any one year period. For later applying the private activity bond tests, the city may continue to use all proceeds of outstanding bonds in same manner (*i.e.*, for the courthouse and the existing private business use) without causing satisfaction of the PBU test. The issue continues to satisfy the PSPT. This result would also apply if, instead of redeeming the bonds, a defeasance escrow was established.⁵⁸

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⁵⁵ *Id.* Example 6.

⁵⁶ *Id.* Example 7.

⁵⁷ *Id.* and § 1.141-12(a)(5).

⁵⁸ *Id.* Example 8.

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ATTACHMENT B
REVENUE PROCEDURE 97-13
MANAGEMENT CONTRACT RULES

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ATTACHMENT B

**REVENUE PROCEDURE 97-13
MANAGEMENT CONTRACT RULES**

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ATTACHMENT B

**REVENUE PROCEDURE 97-13
MANAGEMENT CONTRACT RULES***

I. INTRODUCTION. On January 10, 1997, the Department of the Treasury issued Revenue Procedure 97-13 setting forth conditions under which a management contract does not result in private business use of a bond-financed facility (or unrelated use, in the case of qualified 501(c)(3) bonds¹). These conditions establish safe harbors.² Present Revenue Procedure 93-19 is "made obsolete" by new Revenue Procedure 97-13.³

II. EFFECTIVE DATE. Revenue Procedure 97-13 applies to any management contract entered into, materially modified or extended (other than pursuant to a renewal option, as defined below) on or after May 16, 1997.⁴ In addition, the Revenue Procedure may be applied by the issuer to any management contract entered into before that date.⁵

III. SCOPE (WHAT IS AND WHAT IS NOT A MANAGEMENT CONTRACT)

A. Management Contract Defined. A "management contract" is a management, service or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility.⁶

B. Prohibited Management Contracts. Certain management contracts will give rise to private business use and therefore are not protected by the safe harbors of Revenue Procedure 97-13. These are management contracts that (i) give the service provider an ownership or leasehold interest in the financed facility (or an interest in the nature of an ownership or leasehold interest)⁷ or (ii) provide for compensation for services rendered based in whole or in part on a share of net profits from operations of the facility.⁸

* Except as otherwise specifically stated, § references are to sections of Rev. Proc. 97-13. The term "Regulations" refers to the final private activity bond regulations (TD 8712). The term "Code" refers to the Internal Revenue Code of 1986.

¹ § 2.01(9).

² Preamble to Regulations, Part C, item 4, third paragraph.

³ § 6.

⁴ § 7.

⁵ *Id.*

⁶ Regulations § 1.141-3(d)(4)(ii).

⁷ § 2.01(4). Regulations § 1.141-3(b)(4)(iv) states that a management contract gives rise to private business use if the service provider is treated as the lessee or owner of financed property for federal income tax purposes (unless a specific exception applies). Example 3 under Regulations § 1.141-3(f) states that an HMO service provider for a hospital under a contract that provided that 30 percent of the hospital's capacity would be exclusively available to the provider's members, where the provider would bear the risk of loss of that portion of hospital capacity, was properly characterized as a lease rather than a management contract.

⁸ § 2.01(6). Regulations § 1.141-3(b)(4)(i).

The following do not represent compensation based on a share of net profits: (i) compensation based on a percentage of gross revenues (or adjusted gross revenues) or a percentage of expenses, but not both;⁹ (ii) a capitation fee (see definition below);¹⁰ (iii) a per-unit fee (see definition below);¹¹ or a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues) or reductions in total expenses, but not both, in any annual period during the contract term.¹²

C. Excluded Contracts. The following are not treated as management contracts that give rise to private business use:¹³

1. Service contracts incidental to the governmental functions of a financed facility (e.g., contracts for janitor services, office equipment repair and hospital billing);
2. Granting of admitting privileges by a hospital to a doctor if the same are available to all qualified physicians in the area consistent with the size and nature of the hospital facilities;
3. Any service contract if the only compensation is reimbursement for actual and direct expenses by the service provider to unrelated parties; and
4. Contracts to provide for the operation of a facility or system that consists primarily of "public utility property" (see definition below) if the only compensation is reimbursement of actual and direct expenses and reasonable administrative overhead expenses.

Public Utility Property Defined. The term "public utility property" means property used predominantly in the furnishing or sale of (i) water, sewage disposal, electrical energy, (ii) gas or steam through a local distribution system, (iii) transportation of gas or steam by pipeline, (iv) telephone services, and (v) certain communication services¹⁴

IV. SAFE HARBOR

A. In General. A contract satisfies the conditions of Revenue Procedure 97-13 if (i) it provides for reasonable compensation for services rendered (but reimbursement for direct expenses paid by the provider to unrelated parties is not by itself treated as compensation),¹⁵ (ii) it satisfies the compensation and term limits below,¹⁶ and (iii) it satisfies the limitation on control below.¹⁷

B. Term/Compensation. As used below, "term" includes renewal options. A "renewal option" means a provision under which the provider has a legally enforceable right to renew the

⁹ § 5.02(2)(a).

¹⁰ § 5.02(2)(b).

¹¹ § 5.02(2)(c).

¹² § 5.02(3).

¹³ § 2.01(7). Regulations § 1.141-3(b)(4)(iii).

¹⁴ Code section 168(i)(10). The referenced "communication services" are those furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701).

¹⁵ § 5.02(1).

¹⁶ § 5.03.

¹⁷ § 5.04.

contract and, so, a provision for automatic renewal for one-year periods absent cancellation is not a renewal option even if expected to operate.¹⁸ Also, as used below, "qualified user" means the governmental unit (or, in the case of qualified 501(c)(3) bonds, the 501(c)(3) organization) that is entering into the contract with the provider.¹⁹ See also the definitions of the types of fees and of "penalty" (for termination) below.

1. 95% Fixed Compensation; 15/20 Year Term

Maximum Term of Contract: The lesser of (i) 15 years (20 years in the case of public utility property) or (ii) 80 percent of the reasonably expected useful life of the financed property.²⁰

Compensation: For each annual period during the term, at least 95 percent is based on a periodic fixed fee. (In this category, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award, equal to a single, stated dollar amount, under which compensation automatically increases when a gross revenue or expense target, but not both, is reached.)²¹

2. 80% Fixed Compensation; 10/20 Year Term

Maximum Term of Contract: The lesser of (i) 10 years (20 years in the case of public utility property) or (ii) 80 percent of the reasonably expected useful of the financed property.²²

Compensation: For each annual period during the term, at least 80 percent is based on a periodic fixed fee. (In this category, a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award, equal to a single, stated dollar amount, under which compensation automatically increases when a gross revenue or expense target, but not both, is reached.)²³

3. 50% Fixed or 100% Capitation/Fixed Compensation; 5 Year Term

Maximum Term of Contract: 5 years and, in addition, the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.²⁴

Compensation: For each annual period during the term, (i) at least 50 percent is based on a periodic fixed fee, (ii) 100 percent is based on a capitation fee (see definition below), or (iii) 100 percent is based on a combination of a capitation fee and a periodic fixed fee.²⁵

18 § 4.08.

19 § 3.07.

20 §§ 5.03(1) and (3).

21 § 5.03(1).

22 §§ 5.03(2) and (3).

23 § 5.03(2).

24 § 5.03(4).

25 *Id.*

4. 100% Per-Unit or Per-Unit/Fixed Compensation; 3 Year Term

Maximum Term of Contract: 3 years and, in addition, the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.²⁶

Compensation: All compensation is based on (i) a per-unit fee or (ii) a combination of a per-unit fee and a periodic fixed fee.²⁷

5. 100% Revenues/Expenses Percentage Compensation; 2 Year Term; Limited Use

Maximum Term of Contract: 2 years and, in addition, the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term.²⁸

Compensation: All compensation is based on (i) a percentage of fees charged, or (ii) a combination of a per-unit fee and a percentage of revenue or expense fee, except during start-up the compensation may be based on a percentage of (i) facility gross revenues, (ii) facility adjusted gross revenues, or (iii) facility expenses.²⁹

Limitation. This alternative is available only for (i) contracts where the provider provides services to third parties (e.g., radiology services to patients), and (ii) management contracts for facilities during a start-up period where there are insufficient operations to estimate annual gross revenues and expenses.³⁰

C. General Limitation on Control. The following conditions relating to control must be satisfied:³¹

1. Not more than 20 percent of the voting power of the qualified user may be vested in the service provider and its directors, officers, shareholders and employees;
2. Overlapping board members may not include the chief executive officers of the service provider or the qualified user or their governing bodies; and
3. The qualified user and the service provider under the contact may not be related parties³²

D. Relevant Definitions

1. "Periodic fixed fee" means a stated dollar amount for services for a specified period (e.g., a stated dollar amount per month). It may automatically increase according to a specified, objective, external standard not linked to output or efficiency of a facility (e.g., the consumer price index).³³

²⁶ § 5.03(5).

²⁷ *Id.*

²⁸ § 5.03(6).

²⁹ *Id.*

³⁰ *Id.*

³¹ § 5.04(1).

³² § 5.04(2).

³³ § 3.05.

2. "Capitation fee" means a fixed periodic amount for each person for whom the provider or qualified user assumes responsibility to provide all needed services for a specified period (*e.g.*, a fixed dollar amount payable monthly to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified means). A capitation fee may include a variable component up to 20 percent of the total fee to protect against risks such as catastrophic loss.³⁴

3. "Per-unit fee" means a fee based on a unit of service specified in the contract or determined by an independent third party (*e.g.*, the administrator of the Medicare program) or the qualified user (*e.g.*, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile). Separate billing arrangements between physicians and hospitals are generally per-unit fee arrangements.³⁵

4. "Adjusted gross revenues" means gross revenues less allowances for bad debts and contractual and similar allowance.³⁶

5. "Penalty" (for termination).

a. A penalty includes a limitation on the qualified user's right to compete, a requirement that the qualified user purchase equipment, goods, or services from the service provider and a requirement that the qualified user pay liquidated damages for cancellation of the contract.

b. A "penalty" does not include a requirement on cancellation that the qualified user reimburse the provider for ordinary and necessary expenses or a restriction on the qualified user against hiring key personnel of the service provider.

c. A separate contract between the provider and the user (*e.g.*, a loan or guarantee by the service provider) creates a contract termination penalty if it contains terms that are not customary or arm's length that could operate to prevent the user from terminating the contract (*e.g.*, provisions for termination of the separate contract if the management contract is terminated) or that substantially restrict selection of a substitute service provider.³⁷

January 20, 1997

³⁴ § 3.02.

³⁵ § 3.06.

³⁶ § 3.01.

³⁷ § 3.04.

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ATTACHMENT C
REVENUE PROCEDURE 97-14
RESEARCH AGREEMENT RULES

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ATTACHMENT C

**REVENUE PROCEDURE 97-14
RESEARCH AGREEMENT RULES**

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ATTACHMENT C

**REVENUE PROCEDURE 97-14
RESEARCH AGREEMENT RULES ***

I. INTRODUCTION. On January 10, 1997, the Department of the Treasury issued Revenue Procedure 97-14 setting forth conditions under which a research agreement does not result in private business use of a bond-financed facility (or unrelated use, in the case of qualified 501(c)(3) bonds).¹ These conditions establish safe harbors.²

II. EFFECTIVE DATE. Revenue Procedure 97-14 applies to any research agreement entered into on or after May 16, 1997.³ In addition, the Revenue Procedure may be applied by the issuer to any research agreement entered into before that date.⁴

III. SCOPE

A. In General. The Revenue Procedure applies when, under an agreement, a sponsor (see below) uses bond-financed property⁵ and thus the Revenue Procedure generally relates to agreements by a nongovernmental person to sponsor basic research (see below) to be performed by a governmental person on financed property.⁶

B. Excluded Agreements. A research agreement with respect to financed property will result in private business use of that property if the sponsor is treated as the lessee or owner of the property for federal income tax purposes.⁷

C. Certain Definitions. As used below and in the Revenue Procedure, the following terms have the following meanings:

1. "Qualified user" means the governmental unit or, in the case of qualified 501(c)(3) bonds, the 501(c)(3) organization, that is entering into the agreement with the sponsor.⁸

2. "Sponsor" means any person, other than a qualified user, that supports or sponsors research under an agreement.⁹

* Except as otherwise specifically stated, § references are to sections of Rev. Proc. 97-14. The term "Regulations" refers to the final private activity bond regulations (TD 8712). The term "Code" refers to the Internal Revenue Code of 1986.

¹ §§ 1 and 2.05.

² Preamble to Regulations, Part C, item 5, second paragraph.

³ § 6.

⁴ *Id.*

⁵ § 4.

⁶ § 2.02. Regulations § 1.141-3(b)(6)(i) provides that an agreement to sponsor research may result in private business use of property used for the research, based on all of the facts and circumstances.

⁷ § 2.03. Regulations 1.141-3(b)(6)(ii).

⁸ § 3.02.

⁹ § 3.03.

3. "Basic research" means any original investigation for the advancement of scientific knowledge not having a specific commercial objective (*e.g.*, product testing for a specific nongovernmental person is not basic research).¹⁰

IV. TWO SAFE HARBORS

A. In General. A research agreement does not result in private business use if it satisfies the provisions below for (i) corporate-sponsored research or (ii) cooperative research agreements.¹¹

B. Corporate-Sponsored Research. This safe harbor is satisfied if

1. The research agreement relates to property used for basic research that is supported by a sponsor,

2. Any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by a non-sponsoring party (*i.e.*, the sponsor must pay a competitive price for its use),

3. The price paid for the use is determined at the time the license or other resulting technology is available for use, and

4. The price paid by the sponsor is not less than the price that would be paid by any non-sponsoring party for those same rights (although the recipient need not permit other persons to use the license or other resulting technology).¹²

C. Cooperative Research Agreements. This safe harbor is satisfied if

1. The research agreement relating to property is used pursuant to a joint industry-governmental cooperative research agreement,

2. Multiple, unrelated sponsors agree to fund governmentally performed basic research,

3. The research and manner of performance (*e.g.*, selection of the personnel to perform the research) is determined by the qualified user,

4. Title to any patent or other product resulting from the basic research lies exclusively with the qualified user, and

5. Sponsors are entitled to no more than a non-exclusive, royalty-free license to use the product of any of the research.¹³

January 20, 1997

¹⁰ § 3.01.

¹¹ § 5.01.

¹² § 5.02.

¹³ § 5.03.

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ATTACHMENT D
REVENUE PROCEDURE 97-15
CLOSING AGREEMENTS FOR OUTSTANDING BONDS

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ATTACHMENT D

**REVENUE PROCEDURE 97-15
CLOSING AGREEMENTS FOR OUTSTANDING BONDS**

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ATTACHMENT D

**REVENUE PROCEDURE 97-15
CLOSING AGREEMENTS FOR OUTSTANDING BONDS***

I. INTRODUCTION. On January 16, 1997, the Department of the Treasury issued Revenue Procedure 97-15 providing a program under which issuers may request closing agreements to prevent interest on bonds from being included in gross income, or from being treated as a tax preference for purposes of the alternative minimum tax, by reason of post-issuance actions ("Subsequent Actions").¹ The program is not based upon audits,² does not preclude audits with respect to other matters,³ does not apply to bonds where the issuer has been notified that the issue has been selected for audit,⁴ and, because expeditious processing of requests is desired, negotiations on the basis of mitigating circumstances is not be permitted under the program.⁵

II. EFFECTIVE DATE. The program is effective for bonds issued on or after May 16, 1997, but an issuer may apply the program to any bonds issued before that date.⁶

III. APPLICATION

1. **Bond Period of Application.** The closing agreement will apply to the period between the issue date and the first date after the closing date on which bonds may be redeemed by their terms⁷ or, in the case of alternative minimum tax, between the date of Subsequent Action and the date specified in the closing agreement.⁸ (Thus, presumably, if there is compliance with the Revenue Procedure, interest due on the affected bonds during the covered period will not be included in gross income if the bonds are redeemed on the redemption date specified in the closing agreement (see below) and will not be treated as a preference item for purposes of the alternative minimum tax.)

2. **Covered Provisions.** The program applies to failures that are subject to the remedial action provisions of the private activity bond regulations where proceeds have been spent.⁹ These provisions relate to the following:

- (i) the private business use test (but not the private security or payment test),

* Except as otherwise specifically stated, § references are to sections of Rev. Proc. 97-15. The term "Regulations" refers to the final private activity bond regulations (TD 8712). The term "Code" refers to the Internal Revenue Code of 1986.

- 1 § 1.
- 2 § 3.04.
- 3 § 3.05.
- 4 § 4.02.
- 5 § 3.06.
- 6 § 8.
- 7 § 3.02.
- 8 § 3.03.
- 9 § 4.01.

- (ii) the unrelated or disproportionate use test,
- (iii) the test lowering the private business tests for certain output facilities,
- (iv) the test lowering the private business tests for certain large issues,
- (v) the private loan financing test,
- (vi) the requirements for exempt facility bonds (other than those for qualified residential rental facilities and those for local furnishing of electric energy or gas),
- (vii) the requirements for small issue bonds (other than the capital expenditure limitation and the \$40 million limit),
- (viii) the requirements for qualified redevelopment bonds,
- (ix) the requirements for qualified 501(c)(3) bonds (other than the \$150 million limit and the restrictions for such bonds for residential rental housing),
- (x) the land limit exclusion for land acquired for environmental purposes,
- (xi) the requirement for rehabilitation expenditures in the case of acquisition of existing facilities,
- (xii) the prohibition upon use of proceeds for skyboxes and other prohibited facilities, and
- (xiii) the public hearing and approval requirement.¹⁰

The program does not relate to the loss of interest deductions and similar provisions relating to changes of use for tax-exempt bonds.¹¹

IV. PROCEDURE

A. In General. If an issuer properly requests a closing agreement, enters into the closing agreement, pays the closing agreement amount (see below) and notifies the bondholders (see below), then the interest on the bonds will not be included in gross income, and will not be an item of tax preference for purposes of the alternative minimum tax, by reason of the Subsequent Action.¹²

B. Request for Closing Agreement

1. **Timing.** A closing agreement must be requested within 180 days of the Subsequent Action.¹³

2. **Information Required.** The issuer must include the following information in the request: (i) a copy of the filed and executed Form 8038, (ii) the final offering document (if any), (iii) a statement detailing the Subsequent Action, (iv) an explanation of the computation of the

¹⁰ § *Id.*

¹¹ § 4.02. Code sections 150(b) and (c).

¹² § 3.01.

¹³ § 5.01.

closing agreement amount (see below), and (v) the form of notice to bondholders (see below), which "may acknowledge that the issuer does not currently have funds on hand to redeem the nonqualified bonds."¹⁴

3. **Remedial Action Conditions Precedent.** The issuer must have satisfied the conditions precedent to remedial action contained in the private activity bond regulations as a condition to the execution by the Service of a closing agreement.¹⁵

a. **Governmental and 501(c)(3) bonds.** In the case of governmental bonds and qualified 501(c)(3) bonds, the conditions precedent to remedial action consist of satisfaction of the reasonable expectations test,¹⁶ compliance with the 120 percent maturity limit,¹⁷ receipt of fair market value consideration¹⁸ and treatment of disposition proceeds as gross proceeds for arbitrage purposes.¹⁹

b. **Certain private activity bonds.** In the case of exempt facility private activity bonds, small issue private activity bonds, qualified redevelopment bonds and the requirements listed above that are applicable to certain private activity bonds, the conditions precedent to remedial action consist only of the reasonable expectations test.²⁰

4. **Execution.** The request must be signed by an official of the issuer authorized to sign a Form 8038, who has personal knowledge (i) of the facts covered by the closing agreement, (ii) of the Subsequent Action and (iii) of the computation of the closing agreement amount.²¹ To sign the request, the issuer must first comply with the requirements of section 9.02(11) and (12) (relating to representatives authorized to appear before the IRS) of Revenue Procedure 97-4 (or successor procedure).²²

5. **Declaration Under Penalty of Perjury.** A specified declaration under penalty of perjury must accompany the request (and any factual information submitted after the request and any changed request) and must be signed by the issuer (and not the issuer's representative).²³

C. The Closing Agreement

1. **Form and Content.** The closing agreement is prepared by the Service and, generally, will be in substantially the form of the exhibit that is attached to Revenue Procedure 97-15.²⁴ Among other matters, the form recites that the IRS has not formally asserted claims against the issuer or sought to tax any bondholders on the interest income,²⁵ sets forth the first date on which the bonds may be redeemed under the terms of the bond documents²⁶ and states the following:

¹⁴ § 5.02.

¹⁵ § 5.04(1).

¹⁶ Regulations §§ 1.141-12(a)(1) and 1.145-2(a).

¹⁷ Regulations §§ 1.141-12(a)(2) and 1.145-2(a).

¹⁸ Regulations §§ 1.141-12(a)(3) and 1.145-2(a).

¹⁹ Regulations §§ 1.141-12(a)(4) and 1.145-2(a).

²⁰ Regulations §§ 1.142-2(b), 1.144-2 and 1.147-2.

²¹ § 5.05.

²² § 5.06.

²³ § 5.07.

²⁴ § 5.03.

²⁵ Exhibit recital C.

²⁶ Exhibit recital F.

- that the issuer shall pay the closing agreement amount (see below);²⁷
- that bondholders are not required to include interest on the bonds in their gross income or to treat interest as a preference item for alternative minimum tax for the period specified;²⁸
- that within 30 days after the agreement, the issuer will notify bondholders of redemption;²⁹
- that the issuer is required to redeem bonds on a specified date;³⁰
- that the IRS may take actions for other violations arising after the agreement;³¹
- that no income shall be recognized by a bondholder as a result of the agreement or payments made pursuant to the agreement;³²
- that no party "shall endeavor by litigation or other means to attack the validity" of the agreement;³³
- that the agreement may not be cited or relied upon in any other case;³⁴
- that the issuer, in certain cases, will consent to public disclosure of information regarding the agreement;³⁵
- that if the bonds are retired before redemption, no amount may be refunded;³⁶ and
- that the agreement is conclusive except that it may be reopened in the event of fraud or misrepresentation, is subject to Code sections that provide that effect be given to their provisions notwithstanding other laws (including any stated exception for Code section 7122 (regarding compromise of cases by the Treasury Department prior to reference to the Justice Department for prosecution or defense) and is subject to laws enacted after the agreement that applies to a tax period ending after the date of the agreement.³⁷

2. Disclosure Upon Failure to Redeem. For closing agreements relating to non-inclusion of interest in gross income, the issuer must execute a "§ 6103(c) disclosure consent" authorizing the Service to make public any returns and return information of the issuer relating to the closing agreement if the issuer fails to redeem the nonqualified bonds in accordance with the terms of the closing agreement.³⁸

- 27 Exhibit paragraph 1.
- 28 Exhibit paragraph 2.
- 29 Exhibit paragraph 3.
- 30 Exhibit paragraph 4.
- 31 Exhibit paragraph 5.
- 32 Exhibit paragraph 7.
- 33 Exhibit paragraph 8.
- 34 Exhibit paragraph 9.
- 35 Exhibit paragraph 10.
- 36 Exhibit paragraph 11.
- 37 Exhibit paragraph 12.
- 38 § 5.04(4).

3. Execution. The request must be signed by an official of the issuer authorized to sign a Form 8038 who has personal knowledge (i) of the facts covered by the closing agreement, (ii) of the Subsequent Action and (iii) of the computation of the closing agreement amount.³⁹

D. Closing Agreement Amount

1. In General. For relief from taxability, the closing agreement amount equals an estimate of the federal income tax liability that is not required to be paid with respect to interest accruing on the nonqualified bonds commencing on the date of the Subsequent Action.⁴⁰ For relief from alternative minimum tax, the closing agreement amount equals an estimate of the federal income tax liability not required to be paid by reason of the closing agreement commencing on the date of the Subsequent Action.⁴¹

2. Computation. For relief from taxability, the amount is computed by (i) determining interest accruing on the nonqualified bonds commencing on the Subsequent Action date and ending on the next redemption date, (ii) multiplying this amount for each calendar year by 0.29, (iii) present valuing those amounts (by assuming payment on April 15 of the following year), and (iv) determining the sum of the present value amounts for all calendar years.⁴² Present value is computed as of the date on which the payment is sent to the Service and determined on the basis of a discount rate equal to the taxable applicable federal rate, with semiannual compounding, determined as of the date of Subsequent Action.⁴³ For relief from alternative minimum tax, a similar procedure is followed except that the multiplier is 0.0014 (instead of 0.29).⁴⁴

3. Time of Payment. The closing agreement amount must be paid simultaneously with the execution of the closing agreement.⁴⁵

4. Source of Payment. The closing agreement amount may not be paid from the proceeds of tax-exempt bonds.⁴⁶

E. Notice to Bondholders

1. Form of Notice. For closing agreements requesting relief from taxability, the issuer must provide written notice to the bondholders that (a) the nonqualified bonds will be redeemed on the next redemption date, and (b) if the issuer fails to redeem the bonds in accordance with the closing agreement on that date, the bonds will be treated as private activity bonds that are not qualified bonds (*i.e.*, are not tax-exempt) as of that date.⁴⁷

2. Time of Notice. The bondholders must be notified in writing within 30 days after the date the closing agreement is executed by the Service.⁴⁸

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39 § 5.05.

40 § 6.01.

41 § 6.04.

42 § 6.01.

43 § 6.02.

44 § 6.04.

45 § 5.04(5).

46 §§ 5.04(2)(b) and 5.04(3).

47 §§ 5.02(5) and 5.04(2)(a).

48 § 5.04(2)(a).