



MEMORANDUM¹

PRIVATE BUSINESS USE RULES APPLICABLE TO REFUNDINGS OF TAX-EXEMPT BONDS

March 1, 2012

This memorandum contains an overview of United States Treasury Regulations published in December of 2005, which apply to bond issuers that issue tax-exempt governmental bonds or qualified 501(c)(3) bonds to refinance (refund) outstanding debt (the “Refunding Regulations”). Governmental entities and tax-exempt charities that currently have outstanding tax-exempt debt need to carefully consider whether the record keeping they currently have in place to account for the use of the financed property and sources of security and repayment of the outstanding debt is sufficient to allow them to make meaningful factual representations that are required in connection with the issuance of tax-exempt refunding bonds. This summary is not intended to cover every factual situation. Governmental issuers and tax-exempt organizations with questions are encouraged to discuss their specific circumstances with bond counsel.

For the full text of the Refunding Regulations please click on the following link:
http://www.irs.gov/pub/irs-reg/td_9234.pdf.

Background

The 1997 “Private Use” Regulations

In 1997 the U.S. Treasury Department published a comprehensive set of regulations governing the permitted uses of proceeds of tax-exempt governmental bonds (the “1997 Regulations”). Governmental bonds are subject to a set of statutory rules designed to restrict the issuance of tax-exempt debt that is both used and directly or indirectly secured or repaid by persons or entities other than a state or local government. These rules are commonly referred to as the “private business tests.”² These same

¹ This memorandum is for general information purposes only. For legal advice concerning how these rules may apply to your specific facts, please contact a Gilmore & Bell attorney or your issuer’s regular legal counsel.

² The private business tests consist of two parts: the *private business use test* and the *private security or payment test*. Both tests must be met before interest on the bond is taxable. An issue of bonds meets the *private business use test* if more than 10 percent (5% in some cases) of the issue is used in a private business use. “Use” generally means some sort of special legal entitlement to use property financed with the proceeds of a tax-exempt financing. A special legal entitlement can arise from a variety of circumstances, such as ownership, leases, management contracts, output or requirements contracts or service agreements. A “private business” is any trade or business carried on by a natural person or any activity carried on by an entity other than a state or local governmental unit. An issue of bonds meets the *private security or payment test* if the payment of principal or interest on more than 10% (5% in some cases) of the issue is directly or indirectly (i) secured (A) by any interest in property used in a private business use (such as a mortgage), or (B) by payments “in respect of” such property, or (ii) derived from

rules apply (with certain modifications) to tax-exempt debt issued to finance property owned and operated by certain tax-exempt organizations (“501(c)(3) organizations”).³ Bonds issued to benefit 501(c)(3) organizations are usually referred to as “501(c)(3) bonds.” The 1997 Regulations also contained rules for measuring the amount of “private use” and “private security or payments” over the period the bond issue is outstanding.

Refunding Bonds Under the 1997 Regulations

The 1997 Regulations generally did not address how the private business tests applied to debt that was issued to refinance or “refund” previously issued governmental bonds or 501(c)(3) bonds. Specifically, there was no guidance in the 1997 Regulations as to whether the use of property financed by a governmental bond or a 501(c)(3) bond *prior* to the date the refunding bonds were issued had to be taken into account for purposes of determining whether interest on the refunding bonds was tax-exempt. Similarly the 1997 Regulations did not address the application of the private security or payment test to refunding bonds.

For example, assume a County issued tax-exempt governmental bonds to finance a hospital in 2004 and that the hospital was placed in service in January 2007. If the County decided to refinance these bonds in 2012, the question not answered in the 1997 Regulations was whether the County’s use of the hospital during the 2007-2012 timeframe was relevant in determining whether the new refunding bond issue met the private business tests.

Prior to the adoption of the Refunding Regulations, the tax exempt bond community hoped that the private business tests could be applied to refunding bonds only for the period *after* the refunding bonds were issued, absent some evidence that the issuer or the 501(c)(3) organization (in the case of qualified 501(c)(3) bonds) was seeking to use the refunding to circumvent the purposes of the private business tests. Compliance with the private business tests for the period prior to the date the refunding bonds were issued generally was thought to be relevant only for the purpose of determining whether interest on the refunded bond was tax-exempt.

The Result Under the Refunding Regulations

The Refunding Regulations permit application of the private business tests to the refunded bonds and the refunding bonds on a separate basis only under limited circumstances. For the most common situation, where the bonds to be refunded were issued as tax-exempt governmental bonds or 501(c)(3) bonds, the private business tests generally apply for the time-period (referred to as the “Measurement Period”) (a) beginning on the date the bond-financed project was *originally placed in service* (or the issue date of the first tax-exempt financing, if later) and (b) ending on the date the *refunding bonds mature* (or the end of the expected economic useful life of the financed property -- if earlier). An issuer may apply the private business tests to the refunding issue taking into account *only* the time period beginning after the refunding bonds are issued, *but only if* (1) the refunded issue was not issued as a governmental bond or a 501(c)(3) bond (e.g. the refunded bonds were issued as taxable debt), or (2) the issuer can demonstrate that the private business tests would not be satisfied if the combined Measurement Period (described above) was used.

payments (whether or not paid to the issuer) in respect of property (or borrowed money) used for a private business use.

³ The tests generally are applied in the same way as the private business tests for governmental bonds except that private use does not include use by a 501(c)(3) organization and the limitation on private business use and private security or payments is 5% instead of 10% in all cases.

Thus, under the Refunding Regulations in the example discussed above regarding the County hospital, the County would need to make representations regarding the use of its hospital for the period beginning as of the date it was first placed in service (2007).

What Debt Issues are Covered by the Refunding Regulations?

Generally, the Refunding Regulations apply to a governmental bond or a 501(c)(3) bond

- a. that is sold on or after February 17, 2006 and
- b. (i) that refunds a bond originally issued on or after May 16, 1997 or
(ii) that refunds a bond originally issued prior to May 16, 1997, if the refunding bonds have a weighted average maturity (WAM) that is longer than the remaining WAM of the bond being refunded.

The general rules contained above reflect that the Treasury Department recognized that prior to the publication of the 1997 Regulations, governmental bond issuers and 501(c) organizations may not have been able to determine exactly how the private business tests applied or what records governmental bond issuers or 501(c)(3) organizations needed to retain. For that reason the Refunding Regulations apply to a refunding of a bond originally issued prior to the effective date of the 1997 Regulations (May 16, 1997) only if the effect of the refunding is to extend the WAM of the bond being refunded.

The Refunding Regulations provide an additional exception for bonds originally issued prior to May 16, 1997 where the WAM of the refunding bonds exceeds the remaining WAM of the refunded issue. For these bonds, the issuer or the 501(c)(3) organization can elect to apply the combined private activity bond testing period for the period beginning as of the earlier of December 19, 2005 or the issue date of the first bond issued on or after May 16, 1997 and ending on the maturity date of the refunding bonds. Thus, for example, if bonds were originally issued in 1987, refunded in 1998 and it was proposed to refund the 1998 bonds in 2007, an election could be made to apply the private business tests beginning as of the issue date of the 1998 bonds.

Special Considerations for Certain Issues that Meet the Private Business Use Test and which are Paid and Secured Primarily From Taxes

Tax-exempt financing for economic development projects such as tax increment financing often involve the issuance of tax-exempt debt where the private business use test is met. The interest on the bonds is exempt from tax only because the private security or payment test is not met. This typically occurs when taxes of general application are used pay substantially all of the debt and the amount of private security or payments, on a present value basis, does not exceed 10% of the net proceeds of the issue. In making these present value calculations, the yield on the refunded bonds is used. The Refunding Regulations contain complex rules and several exceptions for applying the private security and payment test to take into account the fact that following the date of the refunding, the original debt service is modified to include both the debt service on the original issue and debt service on the refunding bonds.

What does this mean for Governmental Issuers and 501(c)(3) Organizations?

When governmental issuers and 501(c)(3) organizations use tax-exempt financing to refund a prior issue of tax-exempt bonds, they will be required to make specific representations regarding whether there has been any private business use or private security or payment with respect to the refunded bonds and, if so, the character and amount of that use, security or payment. In general, these representations

will be limited to time periods beginning no earlier than May 16, 1997. These representations will be incorporated into the Federal Tax Certificate or Tax Compliance Agreement that the issuer or 501(c)(3) organization signs when the refunding bonds are issued. On a more positive note, because the Refunding Regulations clarify that the applicable testing period for the private business tests generally includes both the period the refunded bond and the refunding bond are outstanding, issuers of governmental bonds and 501(c)(3) organizations may be able to justify higher levels of private business use and private security or payment for a refunded bond than otherwise might have been possible if the private business tests were applied only with respect to the refunding issue.⁴

What Should Governmental Bond Issuers and 501(c)(3) Organizations Do in Response to the Refunding Regulations?

The Refunding Regulations reflect the fact that the IRS and the Treasury Department continue to be concerned about compliance with tax requirements contained in the Code and the 1997 Regulations related to the ongoing use of property financed by tax exempt bonds. Issuers that fail to create and retain records concerning how tax-exempt bond proceeds are spent and the how financed facilities are used, particularly in situations where private entities are using bond financed facilities under a special exception to the private business use tests (such as a qualified management agreement), are likely to find it much more difficult to refinance the bonds on a tax-exempt basis in the future. In addition, if the IRS selects the bond issue for a random tax audit, the failure to maintain records may ultimately result in a determination by the IRS that interest on the bonds is taxable, since there is no automatic “presumption” that the issuer or the 501(c)(3) organization has complied with the tax law requirements.

Governmental bond issuers and 501(c)(3) organizations should contact bond counsel for answers to questions concerning documentation and record retention in connection with a particular tax-exempt financing.

⁴ For example, assume a City issued bonds in 1997 to acquire an office building and used the building exclusively to house governmental offices for 10 years. In 2007 the City issued refunding bonds with a final maturity of 2017. Under the Refunding Regulations the office could be leased to a private business for up to two years without meeting the private business tests (2 years / 20 years (1997-2017)). On the other hand, if the private business tests were applied only with respect to the refunding issue, the lease to the private business could last for only one year (1 year / 10 years (2007-2017)).