Final Treasury Regulations - Eligible Mixed-Use Projects

The complete text of the final Regulations can be found **here**.[1]

Background

Federal income tax laws limit use by private businesses and the federal government of projects financed in whole or in part with proceeds of "tax-exempt bonds."[2] This limitation generally applies when these entities have any special legal right to use the financed project and is usually referred to as "private business use" or "private use." Private use typically cannot exceed 10% for governmental bonds and 5% for bonds benefiting 501(c)(3) organizations ("501(c)(3) bonds"). These percentage limits are referred to in this memorandum as the "Private Use Limits." The Private Use Limits apply both to the sale proceeds of each issue of tax-exempt bonds and to the physical assets financed by the bonds. The Private Use Limits generally remain in place as long as any tax-exempt bonds remain outstanding.

The types of arrangements that can create private use are quite broad and can include leases, management or service contracts or, in the case of a public utility, contractual rights to a facility's capacity. Because the Private Use Limit is so small, often it would be impossible to use tax-exempt bonds to finance the entire project or facility. This has led issuers to use various strategies to "carve out" portions of a capital project (a portion of a building or other physical facility) and to finance portions that were expected to have private business use with funds other than tax-exempt bonds ("equity"). Even though this practice was widely-employed over the last thirty years, there was surprisingly very little definitive guidance available to issuers who sought to take this approach – particularly in situations where the private use did not occur 100% of the time at the facility – or where private use might shift to different parts of the facility over time. The Treasury Regulations attempted to provide guidance through proposed regulations in 2006, but those rules were criticized as being too complex and restrictive in many cases.

On October 27, 2015, the Treasury published final Regulations that provide tax allocation and accounting rules for certain projects financed with both equity and tax-exempt bonds and that have both governmental and private use ("mixed-use projects").

Effective Date for Final Regulations

In general, the final Regulations can be applied to any tax-exempt bond currently outstanding. The final Regulations must be applied to all tax-exempt bonds sold on or after January 25, 2016.

Definition of a Mixed Use Project

The final Regulations apply to eligible mixed use projects, defined to include assets that are owned by a state or local government or instrumentality (or a 501(c)(3) organization in the case of a qualified 501(c)(3) bond) that have been financed both with proceeds of tax-exempt bonds and equity pursuant to a single "plan of financing." In determining whether tax-exempt bonds are part of the same plan of financing, the purposes of the financing and the financing structure are relevant factors. Generally, construction of a single building or a project comprised of several buildings and related facilities are treated as part of a single "plan of financing."

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[1] The final Regulations also make technical changes to the remedial action regulations, which are beyond the scope of this memorandum.

[2] As used in this memorandum, the term "tax-exempt bond" means any debt obligation the interest on which is excluded from gross income for federal income tax purposes, as well as certain interest subsidy bonds, such as Build America Bonds.

Private Use Measurement – "Floating Equity"

The Private Use Limit for property financed with tax-exempt bonds is measured in one-year intervals following the date the project is placed in service. The final Regulations state that, in making this calculation, any private use occurring in an eligible mixed use project will be allocated first to the portion of the project financed with "qualified equity" and thereafter to the tax-exempt bonds.

Qualified equity is defined as money derived from a source other than a tax-exempt bond but does not include existing or contributed assets. For example, tax revenues or cash donations may be qualified equity, but an issuer may not treat existing land on which it constructs a building financed in part with tax-exempt bonds as "qualified equity." Tax-exempt bonds and qualified equity will be considered to be used as part of the same plan of financing for a project if the qualified equity is spent no earlier than the time frame permitted for reimbursement of costs financed by a tax-exempt bond, and not later than the date the project is placed in service.

Example

County plans to finance a 10,000 square foot addition to its hospital. The addition will cost $10 million, and County expects to lease 1,000 square feet of the addition to a private retail pharmacy (1/10th of the space in the new addition). County plans to pay $9 million of the cost of the addition with tax-exempt bonds and expects to finance $1 million from revenues it has on hand. County begins construction of the addition on February 15, 2016 and adopts a resolution of intent to finance the cost of the addition and to reimburse itself from a future financing on April 1, 2016. So long as County allocates its equity contribution to finance capital expenditures for the addition made during the period beginning 60 days prior to April 1, 2016 and ending on the date the addition is placed in service, these expenditures are qualified equity. The value of the land owned by County on which the hospital addition is to be constructed is not qualified equity.

In each year, County may allocate all of the private use of the building addition caused by the pharmacy lease first to the $1 million qualified equity contribution. After five years (at a time when the tax-exempt bonds are still outstanding), the pharmacy lease is terminated, and that space is no longer used in a private use. The next year, County leases 1,450 square feet (14.5%) of the hospital addition to a for-profit physician practice group. The first 1,000 square feet leased may be allocated to the qualified equity, which in effect "floats" to the space now used in a private use. The remainder (4.5% of the total space in the hospital addition and 5% of the project that had been financed with tax-exempt bonds) is used in a private use in this year.

Public Private Partnerships – Aggregate Treatment for Partnerships

In recent years, there has been increased interest in the concept of allowing state and local governments to enter into long-term ventures with private companies to own and operate utilities and other infrastructure facilities such as airports, toll roads and public ports. Efforts to use tax-exempt bonds to finance the local government's share of the project were hindered by the existence of a separate taxable entity – a partnership – that would own the property. Absent a special exception, ownership by the partnership would cause a tax-exempt bond financing to exceed the Private Use Limit. The final Regulations remove this impediment by treating the partnership as an aggregate rather than a separate taxable entity when applying the Private Use Limit. The final Regulations state that a partnership asset owned by a partnership comprised of a governmental user and a private business is treated as owned by the private business partner in a percentage equal to that partner's greatest percentage share of partnership income, gain, loss, deduction or credit. This favorable change also applies to qualified 501(c)(3) bonds.

Recordkeeping and Special Elections

The final Regulations generally can be applied without making any special election at the time tax-exempt bonds are issued. However, the final Regulations assume that issuers and 501(c)(3) borrowers will have documentation to identify the project and establish that it was financed with both tax-exempt bond proceeds and qualified equity, along with written substantiation of the timing and amount of project expenditures. For that reason, to effectively take advantage of the final Regulations, completing a final written allocation of expenditures in a timely manner (contemporaneously with the completion of the project) will be even more important than in the past. For more information on the final written allocation process and written examples, please see the Continuing Compliance Materials located at http://www.gilmorebell.com/services.shtml or contact your Gilmore & Bell bond attorney.