

Client Alert

Current Issues Relevant to Our Clients

October 30, 2015

Final Allocation and Accounting Regulations Released

Federal income tax law generally restricts the private use of property financed with tax-exempt governmental use bonds or qualified 501(c)(3) bonds. Private use generally refers to use by nongovernmental and non-501(c)(3) users, or to use by a 501(c)(3) organization operating an unrelated trade or business. The federal income tax law does allow for a de minimis amount of private use of tax-exempt bond financed property. However, if there is private use of bond-financed property in excess of the de minimis allowance, tax-exempt governmental use bonds or qualified 501(c)(3) bonds may lose their tax-exempt status and become taxable private activity bonds.

On October 26, 2015, the Department of the Treasury released Final Regulations (the “Final Regulations”) on allocation and accounting, and certain remedial actions, for purposes of the private activity bond restrictions that apply to tax-exempt bonds. Generally, the Final Regulations address and provide guidance on (i) the allocation of bond proceeds and other sources of funds in mixed use projects for private use purposes, (ii) the treatment of partnerships for purposes of the private use and ownership restrictions and (iii) anticipatory remedial actions.

Allocation Rules for Mixed-Use Projects

On many occasions, a capital project will be financed with proceeds of tax-exempt bonds and other sources of funding. The Final Regulations provide allocation rules for “eligible mixed-use projects.” An eligible mixed-use project is defined as a project that is financed both with proceeds of tax-exempt bonds or tax-advantaged bonds and with “qualified equity” pursuant to the same plan of financing. The project must be wholly owned by one or more governmental persons (or, in the case of qualified 501(c)(3) bonds, one or more 501(c)(3) organizations) or a partnership in which at least one governmental person (or 501(c)(3) organization, in the case of qualified 501(c)(3) bonds) is a partner. The Final Regulations define project as one or more facilities or capital projects, including land, buildings, equipment, or other property, financed in whole or in part with proceeds of the issue. Qualified equity is defined as proceeds of taxable bonds that are not tax-advantaged bonds and funds that are not derived from proceeds of a borrowing that are spent within certain time periods on the same eligible mixed-use project as the proceeds of the applicable bonds, but does not include equity interests in real property or tangible personal property and does not include funds used to redeem or repay bonds.

The Final Regulations allow issuers to use an undivided portion allocation method for eligible mixed-use projects. Under the undivided portion allocation method, during each one-year period in the measurement period, the

private use of the project is determined first by allocating any private use in such one-year period to the qualified equity in the project. When the percentage of private use of the project in a one-year period is less than the percentage of qualified equity, all of the private use is allocated to the qualified equity, so there would be no private use of the proceeds of the applicable bonds in that year. When the percentage of private use of the project in a one-year period is in excess of the percentage of qualified equity, the excess private use is allocated in such period to bond proceeds. Under such methodology, qualified equity is not restricted to the financing of particular, discrete areas of projects, but rather qualified equity is allowed to be allocated in a floating manner to all private use (regardless of where located in a facility) in each one-year period. These allocation rules do not affect the current regulations regarding private use of certain output facilities.

Treatment of Partnerships

Federal income tax law treats partnerships in two different manners for various tax purposes. A partnership may be treated as a separate entity from its partners, with each partner owning an interest in the partnership (the “*Entity Approach*”) or a partnership may be treated as an aggregate of its partners, with each partner treated as directly owning a portion of the partnership assets (the “*Aggregate Approach*”). Generally, under the Entity Approach, a partnership would be treated as a nongovernmental person for purposes of the private

activity bond tests. The Final Regulations adopt the Aggregate Approach for purposes of the private activity bond rules for entities that are partnerships for federal income tax purposes. Additionally, the Final Regulations provide a rule for measuring private use of tax-exempt bond financed property resulting from use of such property by a partnership that includes a nongovernmental person. The amount of such private use is the nongovernmental partner's greatest percentage share of any of the specified partnership items (income, gain, loss, deduction or credit) attributable to the time that the partnership uses the tax-exempt bond financed property.

Anticipatory Remedial Actions

Generally, under current regulations, an issuer may cure certain deliberate actions that cause the private activity bond tests to be met by redeeming or defeasing the nonqualified bonds within 90 days of the deliberate action. The Final Regulations permit an issuer to redeem or defease bonds at any time in advance of a deliberate action, so long as the issuer declares its intent to redeem or defease the bonds that could potentially become the nonqualified bonds and the intent identifies the tax-exempt bond financed property with respect to which the remedial action is being taken and describes the deliberate action that potentially may result in the private use.

Effective Dates

The Final Regulations generally apply to bonds sold on or after January 25, 2016; the remedial action rules, however, apply to deliberate actions that occur on or after January 25, 2016. Most provisions of the Final Regulations can be permissibly applied to certain bonds sold before January 25, 2016.

For More Information

To discuss any of the topics discussed in this Client Alert, please contact a member of our Public Finance Group or visit us online at chapman.com.

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