

Public Finance Tax Update

IRS 2009-2010 Priority Guidance Plan Released

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1. IRS 2009-2010 Priority Guidance Plan. This article briefly discusses the IRS initiatives affecting tax-exempt bond financing published in the IRS 2009-2010 Guidance Plan.

2. Proposed Solid Waste Regulations Released. This article briefly analyzes recently released proposed regulations regarding solid waste disposal facilities financeable with tax-exempt private activity bonds.

On November 24, 2009, the IRS released its 2009-2010 Priority Guidance Plan. The plan contains 315 projects to be completed over a twelve-month period, from July 2009 through June 2010. The IRS intends to update and republish the plan during the plan year to reflect additional guidance that IRS intends to publish during the plan year. Below is a summary of certain projects affecting tax-exempt bonds addressed in the plan.

As outlined in the plan, the IRS intends to complete the following projects:

- Modification of Revenue Procedure 2003-84 regarding monthly closing elections for partnership investments in tax-exempt bonds.
- Guidance under Section 54A of the Internal Revenue Code of 1986 (the "Code") on tax credit bonds.
- Guidance under Section 54F of the Code on Qualified School Construction Bonds.
- Guidance under section 54AA of the Code on Build America Bonds.
- Final regulations under Section 141 of the Code, including allocation and accounting principles. Proposed regulations regarding allocation and accounting principles were published on September 26, 2006.
- Final regulations on public approval requirements for private activity bonds under Section 147(f) of the Code.
- Proposed regulations on arbitrage investment restrictions under Section 148 of the Code.
- Final regulations under Section 1397E of the Code on Qualified Zone Academy Bonds.
- Guidance on tax-exempt bonds issued in Midwestern and Hurricane Ike disaster areas.
- Final regulations on solid waste disposal facilities under Section 142 of the Code. Proposed regulations were published on September 16, 2009.

- Guidance on a revised arbitrage exception for certain state guarantee funds under Section 148 of the Code.
- Guidance under Sections 265 and 291 of the Code involving the treatment of bank investment subsidiaries.
- Guidance under Treas. Reg. Section 1.1001-3 to clarify whether a deterioration in the financial condition of the issuer is taken into account to determine whether a modified debt instrument is debt or equity.
- Update the regulations under Section 1273 of the Code for determining when a debt instrument is publicly traded.
- Revisions to Circular 230 regarding practice before the IRS. Final regulations regarding matters relating to tax shelters, including standards for covered opinions and other written advice, were published on December 20, 2004. Proposed regulations regarding the standards with respect to tax returns under Section 10.34 were published on September 26, 2007, and proposed regulations regarding contingent fees were published on July 28, 2009.

Proposed Solid Waste Regulations Released

Under the Internal Revenue Code (the “Code”), tax-exempt private activity bonds can be issued for certain types of facilities, including solid waste disposal facilities. Existing Treasury regulations (the “Current Regulations”), adopted in the 1970s, contain a general definition of solid waste disposal facilities. In May, 2004, the Treasury published Proposed Regulations (the “2004 Proposed Regulations”) that would have amended the definition of solid waste disposal facilities for the purposes of the tax-exempt bond financing rules. The Treasury recently released Proposed Regulations (the “Proposed Regulations”) that withdrew the 2004 Proposed Regulations and provided a new and substantially different definition of solid waste disposal facilities for tax-exempt bond purposes. The Treasury is currently accepting public comments on the Proposed Regulations and has scheduled a hearing on the Proposed Regulations for January 5, 2010.

CURRENT AND 2004 PROPOSED REGULATIONS

The Current Regulations generally define solid waste disposal facilities as facilities used for the collection, storage, treatment, utilization, processing or final disposal of solid waste. The definition of solid waste in the Current Regulations specifically provides that a material is not solid waste unless it has no market or other value at the place where it is located, and that where any person is willing to purchase a material at any price, the material is not solid waste (the “no-value test”). The Current Regulations provide that a facility that disposes of solid waste by reconstituting, converting or otherwise recycling it into material that is not waste also qualifies as a solid waste disposal facility if solid waste constitutes at least 65 percent, by weight or volume, of the total materials introduced into the recycling process. The Current Regulations generally provide that, for mixed-use facilities that serve a solid waste disposal function and other functions, only the portion of the cost of the property allocable to the function of solid waste disposal qualifies as an eligible cost of a solid waste disposal facility.

Under the Current Regulations, a facility that otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than solid waste disposal merely because material or heat that has utility or value is recovered or results from the disposal process. However, when materials or heat are recovered, the waste disposal function includes the processing of those materials or heat that occurs in order to put them into the form in which the materials or heat are in fact sold or used, but does not include further processing that converts the materials or heat into other products.

The Current Regulations also provide that the portion of the cost of property allocable to solid waste disposal is determined by allocating the cost of the property between the property's solid waste disposal function and any other functions by any method that reasonably reflects a separation of costs for each function of the property, based on the facts and circumstances.

The 2004 Proposed Regulations dropped the no-value test and generally defined solid waste as garbage, refuse and other discarded solid material that is introduced into (i) a final disposal process, (ii) a conversion process, (iii) a recovery process or (iv) a transformation process. The 2004 Proposed Regulations also added several specific exclusions from the definition of solid waste.

THE PROPOSED REGULATIONS

The Proposed Regulations, if adopted as final regulations, would replace the Current Regulations defining solid waste disposal facilities. The Proposed Regulations make significant changes to the definition of solid waste disposal facilities. Below is a summary of the Proposed Regulations.

Solid Waste Disposal Facility

The Proposed Regulations define a solid waste disposal facility as any facility to the extent that it (1) processes solid waste in a qualified solid waste disposal process, (2) performs a preliminary function or (3) is functionally related and subordinate (within the meaning of existing Section 1.103-8(a)(3) of the Treasury Regulations) to a facility that either processes solid waste in a qualified solid waste disposal process or performs a preliminary function.

Definition of Solid Waste

The Proposed Regulations eliminate the no-value test, as did the 2004 Proposed Regulations. The Treasury stated in the preamble to the Proposed Regulations that whether material has value is unadministrable. The Proposed Regulations define solid waste as garbage, refuse and other solid material derived from any agricultural, commercial, consumer or industrial operation or activity (a) that is either used material or residual material and (b) that is reasonably expected by the person who purchases or otherwise acquires such material to be introduced within a reasonable time after such purchase or acquisition in a qualified solid waste disposal process. While the type of disposal or recycling process does not affect the treatment of material as solid waste, the person acquiring such material must intend to place such materials into a qualified solid waste disposal process within a reasonable time after acquisition. Material that the acquiring party intends to store or resell to the general public is not solid waste under the Proposed Regulations.

Used material is defined as any material that has been used previously as an agricultural, commercial, consumer or industrial product or as a component of any such product. Residual material is defined as any residual byproduct or excess unused raw material that remains from the production of any agricultural, commercial, consumer or industrial product. Material qualifies as residual material only to the extent that it constitutes less than 5 percent of the total material introduced into the production process and it has a fair market value that is reasonably expected to be lower than that of any product made in that production process.

Specific Exclusions from the Definition of Solid Waste

The Proposed Regulations exclude from the definition of solid waste the following items: (1) virgin material; (2) solids within liquids and liquid waste; (3) certain precious metals; (4) certain hazardous material; and (5) radioactive material. The term virgin material means material that has not been processed into an agricultural, commercial, consumer or industrial product or a component of any such product. For this purpose, material continues to be virgin material after it has been grown, harvested, mined or otherwise extracted from its naturally occurring location and cleaned, divided into component elements, modified or enhanced as long as further processing is required before it becomes an agricultural, commercial, consumer or industrial product or a component of any such product. As such, the Proposed Regulations clarify that a material does not cease to be virgin material until it has been processed to a point where no further processing is expected. Solid waste excludes any solid or dissolved material in domestic sewage or other significant pollutant in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants, and liquid or gaseous waste. The precious metals excluded from the definition of solid waste are gold, silver, ruthenium, rhodium, palladium, osmium, iridium, platinum, gallium and rhenium. In addition, solid waste excludes any hazardous material that is disposed of at a facility that is subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act as in effect on the date of the enactment of the Tax Reform Act of 1986 (which is October 22, 1986).

Qualified Solid Waste Disposal Process

The Proposed Regulations provide for three eligible types of solid waste disposal processes, i.e., a final disposal process, an energy conversion process and a recycling process. To provide flexibility for future innovation, absent an express restriction in the Proposed Regulations, a solid waste disposal function may employ any biological, engineering, industrial or technological method.

A final disposal process means the placement of solid waste in a landfill, the incineration of solid waste without capturing any useful energy or the containment of solid waste with the reasonable expectation that the containment will continue indefinitely and that the solid waste has no current or future beneficial use.

An energy conversion process means a thermal, chemical or other process that is applied to solid waste to create and capture synthesis gas, heat, hot water, steam or other useful energy. The Proposed Regulations also permit 35 percent or less of the material introduced to an energy conversion process to be material other than solid waste to accommodate disposal processes that require the introduction of materials other than solid waste. Generally, an energy conversion process begins at the point of the

first application of a process to create and capture useful energy and ends at the point at which the useful energy is first created or captured in the form of a first useful product, provided that, in all events, the energy conversion process ends before any transfer or distribution of synthesis gas, heat, hot water, steam or other useful energy.

An eligible recycling process means a process that reconstitutes, transforms or otherwise processes solid waste into a useful product. The recycling process begins at the point of the first application of a process to reconstitute or transform the solid waste into a useful product, such as decontamination, melting, re-pulping, shredding or other processing of the solid waste to accomplish this purpose. The recycling process ends at the point of completion of production of the first useful product from the solid waste. A recycling process does not include refurbishment, repair or similar activities. For such purpose, refurbishment means the breakdown and reassembly of a product if such activity is done on a product-by-product basis and if the finished product contains more than 30 percent of its original materials or components.

First Useful Product Principle

The Proposed Regulations provide guidance on the standard for determining the first useful product for purposes of the end point of an eligible energy conversion process and recycling process. For this purpose, the Proposed Regulations provide that the term “first useful product” means the first product that is useful for consumption in agricultural, consumer, commercial or industrial operation or activity and that could be sold for such use, whether or not actually sold. A useful product includes both a product useful to an individual consumer as an ultimate end-use consumer product and a product useful to an industrial user as a material or input for processing in some stage of a manufacturing or production process to produce a different end-use consumer product. Further, for this purpose, in the case of a continuous or integrated production process, the determination of when a useful product may result from such an integrated process may take into account operational constraints that affect the point in production when a useful product reasonably can be extracted or isolated and sold independently.

Preliminary Function

A preliminary function means a function to collect, separate, sort, store, treat, process, disassemble or handle solid waste that is preliminary to and directly related to a qualified solid waste disposal process. A function qualifies as a preliminary function only if more than 50 percent of the total materials that result from the function are solid waste in each year that the issue is outstanding.

Mixed-Use Facilities

Under the Proposed Regulations, if a facility is used for both a qualified solid waste disposal function (including a qualified solid waste disposal process or a preliminary function) and a nonqualified function, then the costs of the facility allocable to the qualified solid waste disposal function are determined using any reasonable method, based on all the facts and circumstances.

Mixed-Input Facilities

Under the Proposed Regulations, for each qualified solid waste disposal process, the percentage of the costs of the property used for such process that are allocable to a qualified solid waste disposal process equals the average annual percentage of solid waste processed in that process while the issue is outstanding. The average percentage of solid waste processed in such process for any year is the average percentage, by weight or volume, of the total materials processed in that process that constitute solid waste for that year. For each qualified solid waste disposal process, if the annual percentage of solid waste used in that process for each year that the issue is outstanding equals at least 65 percent of the materials used in that process, then all of the costs of the property used for such process are treated as allocable to a qualified solid waste disposal process. The percentage of solid waste used in such process for any year is the percentage, by weight or volume, of the total materials used in that process that constitute solid waste for that year.

Examples

Below are the examples set forth in the Proposed Regulations that illustrate the concepts set forth in the Proposed Regulations.

Proposed Effective Date

In general, the Proposed Regulations will apply to bonds to which Section 142 of the Code applies that are sold on or after the date that is 60 days after the date of publication of final regulations under Section 142(a)(6) of the Code in the Federal Register.

EXAMPLES

Example 1. Nonqualified unused material—cloth. Company A takes wool and weaves it into cloth and then sells the cloth to a manufacturer to manufacture clothing. The cloth is material that has not been used previously as an agricultural, commercial, consumer or industrial product or as a component of any such product. Accordingly, the cloth is not solid waste.

Example 2. Residual material from refining of crude oil. Company B takes crude oil and refines it into various products, including finished motor gasoline, distillate fuel oil and jet fuel. The balance of the crude oil remaining after this production process is in the form of a nonhazardous material which subsequently is used to make asphalt. This nonhazardous material constitutes less than 5 percent of the total crude oil that was introduced into the production process and it has a fair market value that is reasonably expected to be lower than that of any product produced in that oil refining process. The portion of the crude oil that remains after the refining process as the nonhazardous material is residual material within the meaning of the Proposed Regulations that qualifies as solid waste. The portion of the facility directly related to the production of asphalt from such residual material may be treated as a qualified solid waste disposal facility up to the point of the production of a first useful product (here, asphalt) within the meaning of the Proposed Regulations from the residual material.

Example 3. Residual material—waste coal. Company C mines coal. Less than 5 percent of ore mined is low quality byproduct of coal mining known as waste coal, which cannot be converted to energy

under a normal energy-production process because the BTU content is too low. Waste coal has a lower fair market value than any product produced in the coal mining operation. Waste coal is solid waste because it is residual material within the meaning of the Proposed Regulations and Company C reasonably expects to introduce the waste coal into a solid waste disposal process. A facility that converts this waste coal into energy may be treated as a solid waste disposal facility.

Example 4. Virgin material—logs. Company D cuts down trees and sells the lumber to another company, which further processes the lumber into paper. In order to facilitate shipping, Company D cuts the trees into uniform logs. The trees are not solid waste because they are virgin materials within the meaning of the Proposed Regulations. The division of such trees into uniform logs does not change the status of the trees as virgin material.

Example 5. Qualified solid waste disposal process—landfill. Company E plans to construct a landfill. The landfill will not be subject to the final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on the date of enactment of the Tax Reform Act of 1986). Company E expects that the landfill will be filled entirely with material that will qualify as solid waste within the meaning of the Proposed Regulations. Company E does not expect that a significant portion of the material placed in the landfill will be virgin materials or precious metals. Placing solid waste into a landfill is a qualified solid waste disposal process. The landfill is a qualified solid waste disposal facility.

Example 6. Qualified solid waste disposal process—recycling tires. Company F owns a facility that converts old, previously used tires into roadbed material. The used tires are used material within the meaning of the Proposed Regulations that qualifies as solid waste. Between the introduction of the old tires into the roadbed manufacturing process and the completion of the roadbed material, the facility does not create any interim useful products. The process for the manufacturing of the roadbed material from the old tires is a qualified solid waste disposal process as a recycling process and the facility that converts the tires into roadbed material is a qualified solid waste disposal facility. This conclusion would be the same if the recycling process took place at more than one plant.

Example 7. Nonqualified refurbishment. Company G purchases used cars and restores them. This restoration process includes disassembly, cleaning and repairing of the cars. Parts that cannot be repaired are replaced. The restored cars contain at least 30 percent of the original pieces. While the cars are solid waste, the refurbishing process is not a qualified solid waste disposal process. Accordingly, Company G's facility is not a qualified solid waste disposal facility.

Example 8. Qualified solid waste disposal facility—first useful product rule—paper recycling. Company H employs an integrated process to re-pulp discarded magazines, clean the pulp, and produce retail paper towel products. Operational constraints on Company H's process do not allow for reasonable extraction, isolation and sale of the cleaned paper pulp independently without degradation of the pulp. Company H further processes the paper pulp into large industrial-sized rolls of paper which are about 12 feet in diameter. At this point in the process, Company H could either sell such industrial-sized rolls of paper to another company for further processing to produce retail paper products or it could produce those retail products itself. In general, paper pulp is a useful product that is bought and sold on the market as a material for input into manufacturing or production processes. The discarded magazines are solid

waste because they are used material within the meaning of the Proposed Regulations. Company H's facility is engaged in a recycling process within the meaning of the Proposed Regulations to the extent that it re-pulps and cleans the discarded magazines generally and further to the extent that it produces industrial-sized rolls of paper under the particular circumstances here. Specifically, taking into account the operational constraints on Company H's facility that limit its ability reasonably to extract, isolate and sell the paper pulp independently, the first useful products within the meaning of the Proposed Regulations from Company H's recycling process are the industrial-sized rolls of paper. The portion of Company H's facility that produces industrial-sized rolls of paper is a qualified solid waste disposal facility, and the portion of Company H's facility that further processes the industrial-sized rolls of paper into retail paper towels is not a qualified solid waste facility. Further, if the operational characteristics of Company H's facility allowed for reasonable extraction, isolation and sale of the paper pulp independently, the first useful product would be the paper pulp and the portion of Company H's facility that cleans and re-pulps the magazines before processing in the paper machine to produce industrial-sized rolls of paper would be a qualified solid waste disposal facility.

Example 9. First useful product rule—energy conversion process. Company I receives solid waste from a municipal garbage collector. Company I burns that solid waste in an incinerator to remove exhaust gas and to produce heat. Company I further processes the heat in a heat exchanger to produce steam. Company I further processes the steam to generate electricity. The first useful product in this process is the useful energy in the form of steam. The facilities used to burn the solid waste and then capture the steam as useful energy are qualified solid waste disposal facilities because they process solid waste in an energy conversion process. The generating facilities used for further processing of the steam to create electricity do not engage in the energy conversion process and are not qualified solid waste disposal facilities.

Example 10. Preliminary function. Company J owns a paper mill. At the mill, logs from nearby timber operations are processed through a machine that removes bark. The stripped logs are used to manufacture paper. The stripped bark represents less than 5 percent of the logs processed into paper and has a lower fair market value than any product produced from the paper mill. The stripped bark falls onto a conveyor belt that transports the bark to a storage bin that is used to store the bark briefly until Company J feeds the bark into a boiler. The conveyor belt and storage bin are used only for these purposes. The boiler is used only to create steam by burning the bark, and the steam is used to generate electricity. The stripped bark is solid waste because it is residual material within the meaning of the Proposed Regulations and because Company J expects to introduce the bark into a conversion process within a reasonable period of time. The creation of steam from the stripped bark is an energy conversion process that starts with the incineration of the stripped bark. The energy conversion process is a qualified solid waste disposal process. The conveyor belt performs a collection activity that is preliminary and that is directly related to the solid waste disposal function. The storage bin performs a storage function that is preliminary and that is directly related to the solid waste disposal function. Thus, the conveyor belt and storage bin are solid waste disposal facilities. The bark removal process is not a preliminary function because it is not directly related to the energy conversion process and it does not become so related merely because it results in material that is solid waste.

Example 11. Mixed-input facility. Company K owns an incinerator financed by an issue and uses the incinerator exclusively to burn coal and solid material to create steam that is used to generate electricity. Each year while the issue is outstanding, 40 percent by volume and 45 percent by weight of the solid material that Company K processes in the conversion process is coal. The remainder of the solid material is either used material or residual material within the meaning of the Proposed Regulations. Sixty percent of the costs of the property used to perform the energy conversion process are allocable to a solid waste disposal function.

Example 12. Mixed-function facility. Company L owns and operates a facility financed by an issue and uses the facility exclusively to sort damaged bottles from undamaged bottles that may be reused. The damaged bottles are directly introduced into a process that melts them for use in the fabrication of an end product. The damaged bottles are solid waste within the meaning of the Proposed Regulations, and the melting process is a qualified solid waste disposal process as a recycling process within the meaning of the Proposed Regulations. Refilling the bottles is not a qualified solid waste disposal process. Each year while the issue is outstanding, more than 50 percent, by weight or volume, of all of the bottles that pass out of the sorting process are damaged bottles that are processed in a recycling process. The sorting facility performs a preliminary function, but it also performs another function. The costs of the sorting facility allocable to the preliminary function are determined using any reasonable method, based on all the facts and circumstances.

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