

Lesson 7

Remedial Actions / Change in Use Rules

Overview

Introduction

When bonds are issued to finance a specific project, the parties involved in the transaction expect that all will go as planned. For example, when a county issues bonds to construct and equip a hospital, it may expect that it will be able to operate the hospital indefinitely. The county also may expect that the hospital will generate enough profit to cover the debt service on the bonds. Sometimes, however, projects don't work out as planned. Assume that after a few years, the county realizes that it cannot operate the hospital at a profit because of rising operating costs and inadequate management skills. It decides that its only option is to sell the hospital. The highest bidder turns out to be a for-profit hospital system. This transaction would cause the bonds to meet the private business tests, resulting in the bonds being classified as private activity bonds. Would the interest on these bonds still be tax-exempt? In this case, they may be if certain requirements are met.

This lesson discusses post-issuance events and how they can affect the tax exempt status of the bonds.

Continued on next page

Overview, Continued

Objectives

After completing this lesson, you will be able to:

- Define and identify a deliberate action
 - Explain the effect of a deliberate action on the tax-exempt status of bonds
 - Determine if proper remedial action has taken place
 - Determine if the §150(b) change in use disallowance applies to a transaction
 - Explain how the disallowances affect the owner and user of the tax-exempt bond-financed property.
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Contents

This lesson contains the following topics:

Topic	See Page
Overview	1
Change in Use Remedies Section 1	5
Change in Use Disallowances Section 2	27
Summary	36
Exercises	39

Continued on next page

Overview, Continued

Typical Changes Which May Affect the Bond's Status

Typical transactions which may affect the status of tax-exempt bonds usually involve the sale, transfer, or lease of property financed with bond proceeds to another entity. Often this other entity is a for-profit entity.

These types of transactions jeopardize the tax-exempt status of bonds because they can allow the bonds to meet the private business use and private security or payment tests of §141(a) long past the issuance date. Even though the issuers did not expect to issue taxable bonds, these types of post-issuance events can cause the bonds to become taxable private activity bonds.

Effect of Change in Use

When a change in use occurs, the bonds are usually considered to be taxable as **of the date of issuance**. This is because the issuers took a deliberate action after the issuance date which caused the bonds to be taxable.

History

Until the early 1990's a bond's exemption from tax was based on the reasonable expectations of the issuer/borrower that the bond proceeds would not be used in a manner that would cause the bonds to become private activity bonds. A subsequent change to the use of the proceeds did not affect the tax exemption of the bonds per Revenue Ruling 77-416, 1977-2 C.B.34. Over time the IRS moved away from this position and formalized this point with Revenue Procedure 93-17, 1993-1 C.B. 507, which revoked Revenue Ruling 77-416. This imposed requirements that had to be met to preserve the tax exemption of the bonds when there was a change in use of a bond finance facility. Also, the private activity bond regulations issued in 1997 provided that the private activity bond tests are to be applied on the basis of actual facts over the term of the bond issue.

See Exhibit 7-1 for specific applications and exceptions.

Continued on next page

Overview, Continued

Current Rules This lesson will cover the current change in use rules for governmental bonds and qualified 501(c)(3) bonds which are generally effective for all bonds issued on or after May 16, 1997. These rules are contained in Regulations §§ 1.141-12, 1.145-2, and 1.150-4.

Many of the rules may also be applied in whole, but not in part, to bonds that were issued before, but were still outstanding on May 16, 1997. (See Regulations §§ 1.141-15 and 1.141-16 for specific information.)

Section 1

Change in Use Remedies

Overview

Introduction

“Change in use” means a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used, as of the date of issue.

The test for private activity bonds is based on the issuer’s reasonable expectations on the issuance date **and** subsequent deliberate actions of the issuer. Even though an issuer reasonably expects on the issuance date to use the bond proceeds for a governmental purpose throughout the life of the bonds, obviously events will occur which are unexpected. These unexpected - though deliberate - actions affect the taxability of the interest on the bonds **from the issuance date**, even though the events may occur much later.

The regulations provide for certain actions, which, if properly taken by issuers, will preserve tax-exemption of the bonds starting from the issuance date. This section explains these remedial actions and the other conditions which are also required.

Contents

This lesson contains the following topics:

Topic	See Page
Overview	5
Concept of Use	6
Reasonable Expectations & Deliberate Actions	8
Remedial Actions	12
Nonqualified Bonds	22
Exhibit 7-1 Applicability	26

Concept of Use

Use vs. User

The use of bond proceeds and of bond-financed property is the basis for determining whether bonds are issued for general government operations or for an activity of a nongovernmental person.

When speaking of “use”, we tend to think of the actual use of the property rather than the user. For example, when you were reading the example about the county’s hospital in the Overview to this lesson, you may not have thought that the sale of the hospital constituted a change in use, because the hospital would still be used as a hospital. However, you need to broaden your way of thinking about these rules. Instead of thinking only in terms of actual use of bond-financed property, think about the user of the property. Now when you review the example, does your position change? It should - because now we have a bond-financed hospital being used by a nongovernmental person.

Purpose

The private use rules and the change of use rules work to limit the amount of tax-exempt subsidy being transferred to a nongovernmental person.

Who is a User?

A person can be a user of bond proceeds or a user of bond-financed property through both direct and indirect use.

A person can be treated as a user of bond proceeds or bond-financed property as a result of:

- ownership of property, or
 - actual or beneficial use of property pursuant to a
 - lease,
 - management contract, or
 - an arrangement such as a take-or-pay or output contract
-

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Concept of Use, Continued

Management Contracts

Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-28 I.R.B. 38, provides the conditions under which a management contract does not result in private business use under §141(b) and does not result in §145(a)(2)(B) being met.

Research Agreements

Rev. Proc. 97-14, 1997-1 C.B. 634, as modified by Rev. Proc. 2007-47, 2007-29 I.R.B. 108, provides the conditions under which a research agreement does not result in private business use under §141(b) and does not result in §145(a)(2)(B) being met.

Reasonable Expectations and Deliberate Action

Section 141 Revisited

According to Regulations §1.141-2(d)(1), an issue is an issue of private activity bonds if the issuer:

- **reasonably expects**, AS OF THE ISSUE DATE, that the issue will meet either the private business tests or the private loan financing test, OR
 - takes a **deliberate action**, SUBSEQUENT TO THE ISSUE DATE, that causes the conditions of either the private business tests or the private loan financing test to be met.
-

Deliberate Action

Regulations §1.141-2(d)(3) defines a deliberate action as any action taken by the issuer that is within its control. The intent to violate the requirements of §141 is not necessary for an action to be deliberate.

Example 1

Hospital Q borrows the bond proceeds from County X to renovate its main facility. Hospital Q reasonably expects that sometime soon it will build an entirely new facility, and sell the current one to a for-profit entity. But on the issuance date, it does not know when this will happen.

Technically, these bonds are private activity bonds, because the issuer reasonably expects, ON THE ISSUANCE DATE that the bonds will eventually meet the private business tests. (We will see later, though, how the issuer can avoid this.)

Continued on next page

Reasonable Expectations and Deliberate Action, Continued

Example 2

County A issues bonds in the principal amount of \$40M. The proceeds are loaned to an organization exempt under §501(c)(3) and are used to build the organization's main facility. On the issue date, A reasonably expects that the issue will not meet the private business tests or the private loan financing test as applied under §145. Subsequently, the organization engages in a series of transactions with for-profit subsidiaries which result in revocation of the organization's tax-exempt status.

The organization has taken a deliberate action, which can affect the tax-exempt status of the bonds. The organization as the conduit borrower is treated as the issuer. **(See Regulations §§ 1.141-1(a) and 1.148-1(b) for definitions.)**

Safe-Harbor Exceptions

Regulations §1.141-2(d)(3)(ii) provides for the following safe harbor exceptions from the definition of deliberate action:

- involuntary or compulsory conversions under § 1033, and
 - actions taken in response to a regulatory directive made by the Federal Government
-

Example 3

City C issues bonds to finance the purchase of land. On the issue date, C reasonably expects that it will be the sole user of the land for the entire term of the bonds. Subsequently, the Federal Government acquires the land in a condemnation action. C sets aside the condemnation proceeds to pay debt service on the bonds but does not redeem the bonds on their first call date.

The bonds do not lose their tax exempt status because C has not taken a deliberate action after the issue date.

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Reasonable Expectations and Deliberate Action, Continued

Exception for Mandatory Redemption Provision

Regulation § 1.141-2(d)(2)(ii) provides that actions reasonably expected, as of the issue date, to occur after the issue date and cause the private business tests or the private loan financing test to be met, may be disregarded if

- the non-qualifying bonds are required to be redeemed within six months of the date of the action;
 - as of the issue date the financed property will be used for a governmental purpose for a substantial period prior to the deliberate action;
 - the issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that deliberate action; and
 - the mandatory redemption of bonds meets all of the conditions for remedial action under §1.141-12(a).
-

Example 4

City C issues bonds to renovate an existing hospital that it currently owns. On the issuance date, C reasonably expects that the hospital will be used for a governmental purpose for a substantial period. Also on the issuance date, C plans to construct a new hospital but is uncertain about when this will occur. C reasonably expects that when the new hospital is placed in service, it will sell or lease the renovated hospital to a private hospital corporation. The bond documents require that the bonds must be redeemed within six months of the sale or lease of the renovated hospital (regardless of the amount actually received from the sale.) The bonds meet the reasonable expectations requirement of the private activity bond tests if the mandatory redemption of bonds meets all of the conditions of a remedial action under Regulations § 1.141-12(a).

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Reasonable Expectations and Deliberate Action, Continued

Special Rules Governmental Bonds Only	The regulations provide special rules as follows: (Note that these special rules apply only to governmental bonds and do not apply to § 501(c)(3) bonds or other qualified private activity bonds.)
Regulations §	Provides special rules relating to...
1.141-2(d)(4)	dispositions of personal property in the ordinary course of an established governmental program
1.141-2(d)(5)	general obligation bond programs that finance a large number of separate purposes.

Remedial Actions

Introduction

Regulations § 1.141-12 provides for certain remedial actions that, if properly undertaken, will prevent a deliberate action from causing an issue to meet the private business use test or the private loan financing test.

Note that these actions do not protect against a violation of the private security or payment test, but since violations of the private business use test and the private loan financing test will be cured, then the bonds will be tax-exempt.

There are four possible remedial actions, and five conditions, which must be met before those actions, will apply.

Required Conditions

The five conditions as provided by Regulations § 1.141-12(a) that are required to be met are:

1. The reasonable expectations test must be met;
 2. The maturity cannot be unreasonably long;
 3. The terms of the arrangement that satisfies the private business tests or private loan financing test must be bona fide, arm's length, and the new user must pay fair market value. (See Regulations § 1.141-12(f));
 4. Disposition proceeds are treated as gross proceeds for arbitrage purposes; AND
 5. Proceeds affected by the deliberate action are expended on a governmental purpose. (See Regulations § 1.141-12(d)).
-

Condition # 1 Reasonable Expectations

In order to avail themselves of the remedial action provisions of Regulation §1.141-12, the issuer must have reasonably expected on the issue date that the issue would meet neither the private business tests nor the private loan financing test for the entire term of the bonds.

However, if the issuer reasonably expected on the issue date to take a deliberate action prior to the final maturity of the issue that would cause the private business tests or the private loan financing test to be met, the term of the bonds for applying the reasonable expectations test may be determined by taking into account a redemption provision if the provisions of the Mandatory Redemption Exception of §1.141-2(d)(2)(ii)(A) through (C) applies to the bonds.

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Remedial Actions

**Condition # 2
Maturity**

The second condition that must be met in order to use the remedial action provisions is that the bonds may not be outstanding longer than reasonably necessary for the governmental purpose of the issue.

This requirement is met if the weighted average maturity of the bonds of the issue is not greater than 120% of the average reasonably expected economic life of the property financed with the proceeds of the issue as of the issue date.

**Condition # 3
Fair Market
Value**

The third condition that must be met in order to use the remedial provisions involves the concept of fair market value.

Except for a situation in which the remedial action provision of Regulation §1.141-12(f) concerning the alternative use of the facility is used, the terms of any agreement that cause the private loan or the private business test to be exceeded must be bona fide and arm's length. The new user must pay fair market value for the use of the bond financed property.

**Condition # 4
Disposition
Proceeds**

The fourth condition that must be met in order to utilize the remedial provisions provides that the disposition proceeds must be treated as gross proceeds for arbitrage purposes.

This means that the disposition proceeds are subject to yield restrictions when necessary and the investment earnings are subject to the rebate provisions. The day that the disposition proceeds are received is treated as the issue date of the bonds for the purpose of applying the temporary period rules and qualifying for a spending exception to rebate. For the purpose of determining the spending exceptions that were met before the disposition, the disposition proceeds are ignored.

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Remedial Actions, Continued

Condition # 5 The final condition that must be met in order to utilize the remedial provisions provides (except for a situation in which the redemption or defeasance rule of Regulation §1.141-12(d) is applied) is that the proceeds of the issue that are affected by the deliberate action must have been expended on a governmental purpose before the date of the deliberate action.

Remedial Actions If the conditions precedent to taking a remedial action are met, there are four possible remedial actions as provided by Regulations §§ 1.141-12(d), (e), (f), & (h):

1. Redemptions or defeasances of nonqualified bonds.
2. Alternate uses of disposition proceeds.
3. Alternate uses of affected facility.
4. Additional remedial actions provided by publication.

These actions are discussed below. Note that they do not apply in all cases.

Redemption or Defeasance of Nonqualified Bonds Regulations § 1.141-12(d) provides that this action is met if all of the nonqualified bonds of the issue:

- are redeemed within 90 days of the deliberate action, or
 - if not redeemed, then a defeasance escrow is established within 90 days of the deliberate action. (**The first call date cannot be more than 10.5 years from the date of issuance §1.141-12(d)(4).**)
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Remedial Actions, Continued

Example 5

On June 1, 2007, City C issues bonds with an issue price of \$10M to finance the construction of a hospital building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C leases the building to Corporation P for 7 years. C uses other funds to immediately retire all of the bonds within 90 days of entering into the lease agreement. The five required conditions are also assumed to be met.

The transaction does not cause the bonds to be private activity bonds (retroactively) because C has taken a remedial action, which prevents P from being treated as a private business user of bond proceeds.

Special Rule for Cash Received

Regulations § 1.141-12(d)(2) provides that if the disposition proceeds are exclusively cash, only a pro rata portion of the bonds needs to be redeemed. This is helpful in situations where the cash received is less than the amount due on the outstanding bonds.

Example 6

An issuer has \$15M in bonds outstanding at the time of the sale of tax-exempt financed property to a private business. The disposition proceeds are \$10M in cash.

Under the special rule, the issuer need only redeem \$10M of the outstanding bonds within 90 days. Alternatively, if the first call date is beyond 90 days, the \$10M is used to establish a defeasance escrow to redeem \$10M of the bonds.

The remaining \$5M in bonds is not affected by the change in use.

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Remedial Actions, Continued

Notice of Defeasance

Regulations § 1.141-12(d)(3) requires that the issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

Regulations § 1.150-5 provides that this notice must be filed with the Internal Revenue Service, 1111 Constitution Avenue NW, Attention: T:GE:TEB:O, Washington, DC 20224.

Alternate Use of Disposition Proceeds

Regulations §1.141-12(e) provides that the requirements of this remedial action are met if:

- the deliberate action is a disposition exclusively for cash,
 - the issuer reasonably expects to expend the disposition proceeds within two years of the date of the deliberate action,
 - the disposition proceeds:
 - are treated as proceeds for purposes of §141,
 - are used in a manner that does not cause the issue to meet either the
 - private business tests or the private loan test, AND
 - the issuer does not take any action subsequent to the deliberate action to cause either of the above tests to be met, AND
 - any excess disposition proceeds are used for redemption or defeasance, in a manner described in Regulation §1.141-12(d)
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Remedial Actions, Continued

Example 7

On June 1, 2007, County B issues bonds with a principal amount of \$10M to finance the construction of a hospital building. On the issue date, B reasonably expects that it will be the only user of the building for the entire term of the bonds. Five years after the issue date, B sells the building to Corporation P for \$5M, which is the fair market value of the building. B expects to use the \$5M disposition proceeds for the construction of roads within two years of receipt. B treats these proceeds as gross proceeds for purposes of §141.

The bonds are not private activity bonds because B has taken appropriate remedial action. Note that the bonds are NOT redeemed.

Special Rule for Use by 501(c)(3) Organizations

In addition to the rule set forth above, if the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds are treated as reissued for purposes of §§ 141, 145, 147, 149, and 150. In addition, the nonqualified bonds must satisfy all of the applicable requirements for qualified 501(c)(3) bonds.

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Remedial Actions, Continued

Alternate Use of Facility

Regulations § 1.141-12(f) provides that the requirements for this remedial action are met if:

- The facility with respect to which the deliberate action occurs is used for a qualified governmental or private activity bond purpose,
- The nonqualified bonds:
 - are treated as reissued for purposes of §§ 55 through 59, 141, 142, 144 through 147, 149, and 150, AND
 - the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds,
- The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds, AND
- Disposition proceeds (other than those arising from an agreement to provide services) resulting from the deliberate action are:
 - used to pay debt service on the bonds on the next payment date, OR
 - are deposited (within 90 days of **receipt**) into an escrow that is yield restricted AND used to pay debt service on the bonds on the next available payment date.

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Remedial Actions, Continued

Example 8

County F issues bonds with an issue price of \$10M to finance the construction of a health care center. Five years later, the county realized that the needs of the rural residents would be better served if the facility were operated by another organization. The county leased the facility to a 501(c)(3) organization for 30 years. The lease payments to be paid equal the debt service payments due on the bonds. Lease payments, as received, will be deposited into a yield-restricted escrow account and used to pay debt service on the bonds. At the expiration of the term, all assets revert to the authority, including any tenant improvements. The bonds are treated as reissued under the appropriate Code sections.

The actions taken meet all of the requirements for alternative use of a facility. The bonds are treated as qualified 501(c)(3) bonds beginning with the date of the lease. The bonds are NOT redeemed AND must meet the requirements for qualified 501(c)(3) bonds while outstanding.

Additional Remedial Actions Provided by Publication

Regulations § 1.141-12(h) provides that the Commissioner may provide for additional remedial actions through publication. Pursuant to this authority, the Internal Revenue Service released Rev. Proc. 97-15, 1997-1 C.B. 635 on February 3, 1997. Rev. Proc. 97-15 provides a program under which a request for a closing agreement can be made and can be found in your Deskbook.

Provisions of Rev. Proc. 97-15 Closing Agreement

The Revenue Procedure permits an issuer to enter into a closing agreement to prevent interest on the bonds:

- from becoming taxable due to a deliberate action which causes the bonds to fail to meet certain requirements of sections 141-150, and
 - from being treated as a tax preference item in cases where the bonds were issued as governmental bonds but as a consequence of a remedial action taken by an issuer are qualified private activity bonds
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Remedial Actions, Continued

Required Issuer Actions	<p>To prevent interest on governmental or 501(c)(3) bonds from being included in gross income, the following must be met:</p> <ul style="list-style-type: none">• The requirements of Regulations §§ 1.141-12, and 1.145-2 as applicable, relating to conditions for remedial action must be satisfied, AND <p>The issuer must:</p> <ul style="list-style-type: none">• submit a proper request for a closing agreement which describes the subsequent action and explains computation of the proposed closing agreement amount within 180 days of the subsequent action,• agree to redeem the bonds at the next call date,• notify the bondholders that the bonds will be redeemed on the next redemption date, and if not redeemed, the bonds will be nonqualified private activity bonds,• not make any closing agreement payment from tax-exempt bond proceeds,• sign a disclosure consent authorizing the Service to make certain documents relating to the agreement public if the bonds are not redeemed in accordance with the terms of the agreement, AND• pay the full amount due upon execution of the closing agreement.
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Effective Date	<p>This revenue procedure is effective for bonds issued on or after May 16, 1997. Issuers may apply the revenue procedure to any bonds issued before May 16, 1997.</p> <p>Prior to the issuance of this revenue procedure, Rev. Proc. 93-17, 1993-1 C.B. 507, controlled changes in use.</p>
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Special Note Regarding Eligibility	<p>A bond issue that is under an examination by the Service is NOT eligible for the program. An issue is under examination if the issuer of the bonds has been notified in writing by the Service that the issue has been selected for examination.</p>
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Remedial Actions, Continued

Example 9

County T issues bonds with a principal amount of \$50M on June 1, 1995. The bond proceeds are loaned to a 501(c)(3) organization which uses the funds to construct a hospital wing. The first call date of the bonds is on June 1, 2007. During the course of an examination it was discovered that the exempt status of the 501(c)(3) organization was officially revoked in June 1997 due to inurement. Revocation of exempt status due to inurement constitutes a deliberate action.

The closing agreement program is not available to the County because the organization's deliberate action was uncovered during an IRS examination.

Example 10

County X issues \$75M bonds used to develop and operate a hospital facility. Three years later, the county finds that operation of the facility is beyond its abilities. It decides to lease the facility to a private for-profit firm. All of the conditions precedent to a remedial action are satisfied.

The County may request a closing agreement under the provisions of Rev. Proc. 97-15 to prevent the interest from being taxable for a specific period of time.

Nonqualified Bonds

Introduction The remedial action provisions provide a way to preserve the tax-exempt status of bonds based on post issuance actions taken by the issuer. Certain of these provisions reference “nonqualified” bonds. Therefore, in order to ascertain whether the remedial action provisions were properly applied, an understanding of nonqualified bonds is essential.

Definition Section 1.141-12(j) states the percentage of outstanding bonds that are nonqualified bonds equals the highest percentage of private business use in any 1-year period commencing with the deliberate action.

Once a change in use occurs that causes a bond issuance to meet the private activity bond tests, all bonds attributable to private use are treated as nonqualified bonds. This would include the percentage permitted by the private activity bond tests.

Example 11 Governmental bonds are issued for \$150 million. \$7.5 million or 5% are used for private business purposes. If \$50 million of the proceeds were used to finance a building that was originally used for governmental purposes and that building is subsequently sold to a private person, the nonqualified bonds would be the \$50 million attributed to the building that was sold plus the \$7.5 million attributed to the original private use or \$57.5 million

Allocation Allocation to nonqualified bonds must be made on a pro rata basis; except for purposes of redemption or defeasance of nonqualified bonds, per the remedial action provision of 1.141-12(j), an issuer may treat bonds with longer maturities as the nonqualified bonds.

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Nonqualified Bonds, Continued

**Proposed
Regulation**

Proposed regulations 132483-03, 2003-34 I.R.B. 410 [68 FR 43059] published July 21, 2003 revise the definition of nonqualified bonds in §1.141-12, and modify the rules in Regulation §1.141-12 pertaining to the allocation of nonqualified bonds.

**Definition of
Nonqualified
Bond**

These proposed regulations provide that the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test or private loan financing test, as applicable. For this purpose, the proposed regulations provide that the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the deliberate action.

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Nonqualified Bonds, Continued

Example 12

In 2000, City G issued bonds with proceeds of \$10 million to finance a courthouse. G uses \$1 million of the proceeds for private business use and more than 10 percent of the debt service on the issue is secured by private security or payments. In 2004, in a bona fide and arm's length arrangement, G enters into a management contract with a nongovernmental person that results in private business use of 40 percent of the courthouse per year during the remaining term of the bonds. G immediately redeems the nonqualified bonds, or 44.44 percent of the outstanding bonds. This is the portion of the outstanding bonds that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not satisfy the private business use test.

The amount of private business use is the greatest percentage of private business use in a one-year period commencing with the deliberate action. Thus, 10% original private use plus 40% new private use generated as a result of the management contract results in 50% private business use in the year of the deliberate action.

The amount of nonqualified bonds is computed by dividing the percentage of the facility used for a government use by the minimum amount of government use required and subtracting the resulting percentage from 100 percent.

$$\begin{array}{r} 50 \% \text{ used for government use} \\ \div \\ 90\% \text{ minimum government use required} \\ \hline (55.56\%) \end{array}$$

$100\% - 55.56\% = 44.44\%$ non qualified bonds calculated utilizing the proposed regulations.

Contrasting this calculation with the regulations as written, reveals that the nonqualified bonds would be 50% under the current regulations versus 44.44% under the proposed regulations.

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Nonqualified Bonds, Continued

Allocation of Nonqualified Bonds

The second change envisioned by the proposed regulations would amend the provisions of Regulation §1.141-12 (relating to redemption or defeasance). Under the proposed regulations, allocations of nonqualified bonds must be made on a *pro rata* basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as (i) the remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (the determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer, is not greater than (ii) the remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

Applicability of Proposed Regulations

The proposed regulations will apply to deliberate actions or failures to properly use proceeds, as applicable, that occur on or after the date of publication of final regulations in the Federal Register.

Exhibit 7-1 Applicability

The table below summarizes how the change of use provisions, apply to governmental and qualified 501(c)(3) bonds.

SUBJECT	REGULATIONS §	GOVT	QUALIFIED 501(c)(3)*
Deliberate action	1.141-2(d)(3)	YES	YES
Failure to properly use proceeds	1.142-2(a)	NO	NO
Special rules	1.141-2 (d)(4) and (d)(5)	YES	NO
Conditions for Remedial Action	1.141-12(a)	YES	YES
Redemption	1.141-12(d)	YES	YES
Redemption	1.142-2(c)	NO	NO
Dispositions of personal property	1.142-2(c)(4)	NO	NO
Dispositions for cash	1.141-12(d)(2)	YES	YES
Alt use-proceeds	1.141-12(e)	YES	YES
Special rule for 501(c)(3) orgs	1.141-12(e)(2)	NO	YES
Alt use-facility	1.141-12(f)	YES	YES
Nonqualified bonds	1.141-12(j)(1)	YES	YES
Nonqualified bonds	1.142-2(e)	NO	NO
Rev Proc 97-15	1.141-12(h)	YES	YES
NOTES:			*See modifications in § 1.145-2(b) and (c)(2). N/A to § 145(b),(c),(d).

Section 2

Change-in-Use Disallowances

Overview

Introduction The change-in-use disallowances of § 150(b) apply to qualified 501(c)(3) private activity bonds when an event occurs subsequent to the issuance date which causes the bonds to become nonqualified private activity bonds.

Example 12 On January 1, 1994, City X issues bonds in the principal amount of \$50M. On that date, the bonds satisfied all of the requirements for tax-exempt qualified 501(c)(3) bonds under §§ 141 through 150. Hospital Y borrows the proceeds and uses them to finance construction and renovation of its facility, to fund a debt service reserve fund, and to pay costs of issuance. Five years later, the hospital proposes to enter into a partnership with a for-profit affiliate. Seven percent of the facility will be leased and operated by the partnership. The lease payments will be used to pay greater than 5 percent of the debt service on a portion of the bonds.

Absent appropriate remedial action, these bonds would become nonqualified private activity bonds on the agreement date. The interest on the bonds would be taxable back to the issuance date and § 150(b)(3) would apply.

Contents This lesson contains the following topics:

Topic	See Page
Overview	27
Qualified 501(c)(3) Bonds	30
Facilities Required to be Owned by Governmental Units or 501(c)(3) Organizations	32
Auditing Techniques	33

Continued on next page

Overview, Continued

Purpose Section 150(b) affects the users of qualified 501(c)(3) bond financed facilities who fail to use the facilities for a qualifying purpose. The change in use disallowances are generally separate and distinct from any retroactive or prospective loss of exemption of bond interest that may result if applicable Code requirements are not met.

The disallowances were enacted in response to the concern that the proper use of bond-financed facilities was generally under the control of the users of such facilities and that such users should be penalized for any misuse.

Effective Date Section 150(b) was added to the Code in 1986 and generally applies to changes in use of bond-financed property occurring after August 15, 1986 with respect to financing provided after that date.

Applicability The provisions of §§ 150(b) and (c) apply to:

- qualified 501(c)(3) bonds (§ 145)
- bonds financing facilities required to be owned by governmental units or 501(c)(3) organizations (§ 145(a))
- certain qualified private activity bonds which will be covered in Phase II

The provisions do NOT apply to property financed with governmental bonds.

Exception and Special Rules Section 150(c) provides an exception and several special rules which relate to § 150(b). The exception is discussed below. The special rules concern:

- the treatment of amounts payable for the use of a facility that are not interest (such as leases), AND
 - allocations where only a portion of a facility is used for private use (**See Regulations § 1.150-4(c)**)
-

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Overview, Continued

Effect of Remedial Action

Regulations § 1.150-4 provides generally that the rules of §§ 150(b)(3), 150(b)(5), and 150(c) **apply even if the issuer takes a remedial action described in Regulations § 1.145-2.**

Exceptions

The change in use rules have limited application if the remedial action taken is:

- redemption within 90 days of the deliberate action under § 1.145-2,
- an alternative qualifying use of a bond-financed facility under Regulations § 1.145-2 and 1.141-12(f), OR
- an alternative use of disposition proceeds under Regulations § 1.145-2 or 1.141-12(e)

(See Regulations § 1.150-4(b) for specific rules.)

Note

Section 150(c)(1) provides that any use with respect to facilities financed with proceeds of an issue which are not required to be used for the exempt purpose of such an issue shall not be taken into account.

Example 13

Hospital Y enters into an agreement whereby approximately 15 percent of Hospital Y's facility will be leased to and managed by a partnership. The entire facility was financed with tax-exempt bonds.

Section 145(a)(2)(B) provides that one of the requirements for qualified 501(c)(3) bonds is that no more than 5 percent of the property is used for private business use. This means that up to 5 percent of the tax-exempt financed property can be used for private business use without jeopardizing the tax-exempt status of the bonds. The change in use rules under § 150(b) will apply only when the private business use exceeds 5 percent. In this example, 15 percent of the facility (and the bond proceeds) are treated as being used by the partnership. That percentage is not reduced by the 5 percent that may be used for non-exempt purposes under § 145(a). If the private use amounted to less than 5 percent, then the 150(b) penalties would not apply.

Qualified 501(c)(3) Bonds

General Rule There are two provisions of § 150(b) that directly apply to qualified 501(c)(3) bonds - §150(b)(3) and § 150(b)(5).

Section 150(b)(3) applies when over 5 percent of the facility is used in a trade or business of any person other than a 501(c)(3) organization or a government unit, but continues to be owned by a 501(c)(3) organization.

Disallowance The results of § 150(b)(3) are twofold:

- The owner of the property (the 501(c)(3) organization) is treated as engaged in an unrelated trade or business with respect to the portion of the property used by that other person, AND
- no deduction is allowed for interest on financing which accrues during the period that the property is so used.

The amount of income derived is equal at least to the fair rental value of the portion of the property so used.

Example 14 County G issues bonds in the principal amount of \$75M. The bond is issued as a qualified 501(c)(3) bond. L (a 501(c)(3) organization) borrows the proceeds and uses them to finance construction and renovation of its hospital. Six years later, L enters into an agreement with Partnership M to lease the oncology department of the hospital for a period of 10 years. The amount of the lease payments is equal to the fair rental value of that portion of the facility. Approximately 6 percent of the proceeds of the bonds are allocable to the renovations made to the property to be used by the partnership. The bonds cannot be redeemed within 90 days because the first call date is beyond that date. However, the bonds are defeased and a proper escrow account is established within 90 days.

Continued on next page

Qualified 501(c)(3) Bonds, Continued

Example 15
(continued)

In this situation, remedial action has been taken which prevents the lease with Partnership M from being a deliberate action that causes the private business use test under § 145(a) to be met. However, defeasance does not prevent § 150(b)(3) from applying. (See Regulations § 1.150-4(b)(2).) Therefore, the change in use rules apply and L is required to file Form 990-T for the period beginning on the date the agreement is signed and continuing until the private use ceases or the bonds are redeemed. In computing the amount of unrelated business taxable income shown on the return, L is not allowed a deduction for interest accruing on the loan from County G for the portion of the property used by the partnership.

Facilities Required to be Owned by Governmental Units or 501(c)(3) Organizations

General rule Section 150(b)(5) provides for a denial of interest deduction when property financed by tax-exempt bonds is required to be owned by a governmental unit or a 501(c)(3) organization, and there is a change in ownership to an organization which is other than a governmental unit or a 501(c)(3) organization.

Disallowance The owner is denied a deduction for interest on the financing which accrues during the period:

Beginning on the date...	Ending on the date...
the property is not owned as required	the property is owned as required.

Example 16 County H issued bonds and loaned the proceeds to a 501(c)(3) organization to construct a nursing home. Five years after the nursing home had begun operations, the organization discovered financial difficulties precluded it from meeting the financial obligations of the bonds. The nursing home was sold to a private, unrelated operator of nursing home facilities. Terms of the sale called for the new operator to assume the 501(c)(3) organization's note to the County. Within 90 days of the sale, a defeasance escrow was established to redeem the bonds. The first call date was one year after the sale.

Although the redemption qualifies as a remedial action, which prevents the bonds from becoming nonqualified private activity bonds, the defeasance escrow is not an exception under Regulations § 1.150-4(b)(2). Therefore, the general rule of § 1.150-4(b)(1) applies. As a result, the new owner is denied a deduction for interest incurred on the assumption of the note until the loan is repaid, the bonds are redeemed, or the nursing home is sold. The amount of the denied deduction is limited to the amount of interest on the bonds.

Auditing Techniques

§ 150(b)(3) Use by other than an § 501(c)(3) organization or governmental unit -WHICH EXCEEDS 5 PERCENT- will result in Unrelated Business Income Tax (“UBIT”) to the section 501(c)(3) organization for the fair rental value of the use of bond-financed facility.

Interest deductions are denied equal to the amount of bond interest.

Audit Tips During an examination, the agent should:

- review conduit borrower’s records/facilities to determine non-§ 501(c)(3) use,
 - analyze sources of revenue that would disclose use by others,
 - analyze contracts and agreements that would disclose use by others,
 - review in-house publications to uncover private activities, AND
 - tour the facilities to identify any private use
-

Example 17 Assume that you are examining a bond issue, the proceeds of which are used by an § 501(c)(3) membership organization (“sub.”) The sub is controlled by a parent organization (“parent”), which is a § 501(c)(4) membership organization.

You reviewed the publications of each organization. These publications list the facilities available to the members of the sub and the parent. Your review disclosed that some of the facilities available to the parent’s members are those that are owned by the sub and were financed with tax-exempt bonds.

This bond is potentially a nonqualified § 145 bond. If so, then the 501(c)(3) organization could be liable for UBIT on the fair rental value of the portion of the facility used by the parent.

The next page illustrates the financial aspects of this situation.

Continued on next page

Auditing Techniques, Continued

Example 18
(continued)

Remember that use by the parent's members must exceed 5 percent in order to cause a private use problem. Also remember that the private payment test must be met. Assume the following:

Fair rental value of entire facility	\$200,000/annually
Portion used by parent's members	7 percent
Fair rental value of portion of facility used by parent's members	\$ 14,000
Bond gross proceeds	\$1,700,000
Bond interest rate	6.5 percent
Annual interest payment	\$ 110,500
Bond term	20 years
Lease payments made by sub:	
Principal portion	\$ 85,000
Interest portion	110,500
UBIT:	
Gross income	\$ 14,000
Operating/maintenance expense	< 3,500>
Specific deduction	<u>< 1,000></u>
Taxable income	\$ 9,500
Interest portion of lease payment for portion used by parent's members	\$7,735 (110,500x.07)

This \$7,735 is not permitted to be deducted from gross income.

§ 150(b)(5)

Tax exempt bond facilities owned or used by a § 501(c)(3) or governmental entity must remain owned by any such entity or no interest deduction is allowed for the portion which is not owned.

Auditing Techniques, Continued

Audit Tips

During an examination, the agent should review records of issuer/conduit borrower noting the following:

- depreciation schedule for disposals,
 - in-house publications for discussion of sales, etc,
 - CPA reports for decrease in assets, notes for disposals or future dispositions, AND
 - minute books for discussions of dispositions
-

Summary

Review

Lesson 7 discussed the change in use rules included in Regulations §§ 1.141-12, 1.145-2, and 1.147-2 and the change in use disallowances provided by §§ 150(b) and (c) and the accompanying regulations.

Note that the disallowance rules of § 150(b) and (c) and the accompanying regulations apply to qualified 501(c)(3) bonds, while the other change in use regulations generally apply to governmental bonds and qualified 501(c)(3) bonds.

The § 1.141 regulations clearly state that a private activity test considers both the issuer's:

- reasonable expectations about the use of bond proceeds on the issuance date, AND
- subsequent deliberate actions

These subsequent deliberate actions become very significant to us as examiners. Bond counsel renders an opinion on the tax status of the bonds on the issuance date based on reasonable expectations. Even though these expectations are quite reasonable on the issuance date, circumstances frequently change, resulting in a situation which can suddenly affect the bonds. Bond counsel is usually no longer involved in the bond issue, but the issue can be subject to an IRS examination. Upon arrival, the agent reviews the bond transcript noting the expected plans for the proceeds and also analyzes the subsequent use of the proceeds to determine if those plans actually were carried out. Sometimes it is determined that the use of the proceeds has changed in some way resulting in consideration of the change in use rules.

When a change in use occurs, it can result in the bond issue becoming a nonqualified issue retroactive to the issuance date. Therefore, it becomes necessary for the examiner to verify that proper remedial action was taken in order to preserve the tax-exempt status of the bonds.

The regulations provide four different remedial actions, which if properly performed by the issuer, will prevent the private use or private loan financing test from being met. In addition to meeting all of the requirements of the specific remedial action, the issuer must also meet five required conditions. If accomplished correctly, then the subsequent action will not be a deliberate action causing the private use or loan financing test to be met.

Summary, Continued

**Review of
Lesson 7**
(continued)

The change in use disallowances apply only to certain types of qualified private activity bonds. These rules apply whenever a subsequent deliberate action has caused the bonds to become nonqualified, but their effects are limited by the remedial action that is taken.

**Preview of
Lesson 8**

Lesson 8 covers § 149 provisions of the law. These requirements apply to all tax-exempt bonds. They include such things as registration and information reporting obligations, constraints against federal guarantees and conditions for advance refunding, pooled bonds and hedge bonds.

Because these rules affect all tax-exempt obligations, they are very significant.

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Exercises

Exercise 1

City B issues bonds to finance the purchase of land. On the issue date, City B reasonably expects that the land will be used for governmental purposes throughout the life of the bonds. Three years later, City B decides that this land will not be suitable for its intended purposes and sells the land to an unrelated private developer at fair market value. The disposition proceeds are invested pending the first call date which is 2 years after the sale date. At this time, the City had no plans to begin another project. The debt service on the bonds continues to be paid out of the city's general fund.

Does the sale of the property constitute a deliberate action?

If the sale is a deliberate action, has the city taken proper remedial action to preserve the tax-exempt status of the bonds?

If not, what effect will the deliberate action have on the bonds?

Continued on next page

Exercises, Continued

Exercise 2

On June 1, 2007, City C issues 30-year bonds with an issue price of \$10M to finance the construction of a hospital building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C sells the building to Corporation Y for \$5M. The fair market value of the building at the time of the sale is \$6M. C uses all of the sale proceeds to immediately retire a pro rata portion of the bonds.

Has C met all of the requirements for proper remedial action?

Why or why not?

Continued on next page

Exercises, Continued

Exercise 3

On June 1, 1987, County M issues \$70M of 20-year bonds, the proceeds of which are used to build a county administration building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, County M reasonably expects that it will be the only user of the building for the entire term of the bonds. After 10 years, the county decides that the building is too small and agrees to sell it at fair market value to an unrelated non-governmental person. Part of the disposition proceeds are placed into a defeasance escrow account which will pay debt service on the bonds until redemption in 1999. The remainder of the proceeds is used to begin construction of a new administration building.

Has the county taken proper remedial action to prevent the bonds from becoming taxable? Explain your answer.

Is the county subject to the change in use rules of § 150(b)? Why or why not?

Is the new owner subject to the change in use rules of § 150(b)?
Why or why not?

Continued on next page

Exercises, Continued

Exercise 4

On May 1, 2000, County K issues \$40M bonds, the proceeds of which are loaned to Hospital L. The hospital uses the bond proceeds to construct an adjacent building. On the issuance date, the bonds are qualified 501(c)(3) bonds. Upon examination by the Internal Revenue Service in August 2007, it is determined that over 5 percent of the building is used by commercial enterprises. This use causes the bonds to meet the private business tests. The leases for this unrelated use are dated January 1, 2007.

Are these bonds qualified 501(c)(3) bonds?

If not, what options are available for the county to preserve the tax-exempt status of the bonds?

Do the change in use rules of § 150(b) apply to the hospital and the lessees?

If the rules apply, explain the effect the rules will have on the hospital and the lessees.
