Lesson 11

Introduction to Qualified Private Activity Bonds

Overview

General Rule

Interest on State and local government bonds is taxable if the bonds are private activity bonds (bonds issued to finance private activities not specifically authorized by Congress) unless a specific exception is included in the Code.

See §§ 103(b) and 149(c).

Objectives

At the end of this lesson, you will be able to:

- Define a qualified private activity bond
- Identify additional requirements applicable to qualified 501(c)(3) bonds that are not applicable to governmental bonds

Scope of Lesson

The material in this lesson is tailored to the requirements for qualified 501(c)(3) bonds. For a more complete discussion of the rules applicable to other types of qualified private activity bonds see text for Phase II Lesson 4

Contents

This lesson contains the following topics:

Background

Definition of Private Activity Bond

Very generally, private activity bonds are obligations that benefit nongovernmental persons, such as private businesses, charitable organizations or individuals. Section 141 outlines the tests that, if met, make a bond a private activity bond.

A bond 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 (private business use test AND private security or payment test),

  OR

- the private loan financing test

Private Business Use - Rule

If **more than** 10 percent of the proceeds of the issue are to be used in a trade or business of a nongovernmental person, the issue meets the private business use test. Any activity carried on by a person other than a natural person is treated as a trade or business. If the private business use test is met and the private security or payment test (discussed below) is also met, the issue is an issue of private activity bonds. .

See § 141(a), (b)(1), and (b)(6); Regulations § 1.141-3(a)(1).

Private Security or Payment Test

Except as otherwise provided in § 141(b), an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly:

(i) secured by an interest in:

- property used or to be used for a private business use, or
- payments in respect of such property, OR

(ii) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

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Background, Continued

Private Loan Financing Test

Bonds of an issue are private activity bonds if more than the lesser of five percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons.

See § 141(c).

Reasonable Expectations or Deliberate Actions

A bond 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 (business use and security or payment) or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the private business tests or the private loan financing test to be met.

See Regulations 1.141-2(c).

501(c)(3) Bonds

Generally bonds issued to finance facilities for 501(c)(3) organizations are private activity bonds because:

- the facilities are to be used in the trade or business of a nongovernmental 501(c)(3) organizations, and
- the bonds are secured by the financed facility or revenues derived from the financed facility

Audit Technique

An issuer filing Form 8038 Information Return for Tax-Exempt Private Activity Bond Issues is admitting that the bonds are private activity bonds. Accordingly, it is not necessary for the examining agent to do an independent determination under § 141 on whether or not the bonds are private activity bonds. The focus of the examination of a Form 8038 return is on whether the bonds are qualified private activity bonds.

Qualified Private Activity Bonds

Qualified Private Activity Bonds; § 103(a)

Recall that §103(a) provides that except as provided in § 103(b) gross income does not include interest on any State or local bond. Section 103(b) (1) provides that § 103(a) does not apply to, among other bonds, any private activity bond which is not a qualified bond.

Private activity bonds used to finance certain activities are considered by Congress to be qualified private activity bonds, thus permitting exclusion of the interest to holders of the bonds.

Definition

Section 141(e) defines the term "qualified bond."

The term "qualified bond" means any private activity bond if, in addition to satisfying the requirements for volume cap in § 146 and other requirements in § 147, such bond is:

- an exempt facility bond
- a qualified mortgage bond
- a qualified veterans' mortgage bond
- a qualified small issue bond
- a qualified student loan bond
- a qualified redevelopment bond, or
- a qualified 501(c)(3) bond

Other lessons provide an in-depth exploration of these bonds.

Miscellaneous Code Sections

Several other sections of the Code provide that bonds are to be treated as if they were exempt facility bonds or small issue bonds and therefore will be qualified private activity bonds. See §§ 1394 and 1400A (Enterprise Zone Facility Bonds), § 1400L(d) (New York Liberty Bonds), § 1400N(a) (Gulf Opportunity Zone Bonds), and § 1400U-3 (Recovery Zone Facility Bonds), and § 7871(c) (Tribal manufacturing bonds).

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Qualified Private Activity Bonds, Continued

95% Test

An exempt facility bond, a small issue bond, and a redevelopment bond are not qualified bonds unless at least 95% of the net proceeds of the bonds are used to provide the type of facility described in the Code sections authorizing such bonds.

See §§ 142(a), 144(a), and 144(c).

Section 150(a)(3) defines "net proceeds" as the proceeds of an issue reduced by amount in a reasonably required reserve or replacement fund.

Volume Cap

Introduction

Generally, each state and US possession is limited to a maximum amount of qualified private activity bonds that can be issued on an annual basis. This amount is based on the state's population and is computed annually. The amount allocated to each state is called the "state ceiling." The amount of the state ceiling is then allocated among the qualified private activity bond issuers within a state. This allocation is called the issuing authority's volume cap.

Bonds issued in excess of an issuer's volume cap do not satisfy the requirements of § 146, and therefore, are NOT tax-exempt bonds.

Remember that generally only qualified private activity bonds are required to meet § 146. With one exception, governmental bonds are not required to receive an allocation of the volume cap.

Qualified 501(c)(3) bonds are not required to receive an allocation of volume cap. See § 146(g)(2).

Volume cap is covered in detail in Phase II Lesson 4.

Maturity Limitation

Introduction	To prevent bonds from remaining outstanding longer than necessary, § 147(b) limits the average length of maturity of certain qualified private activity bonds.
Statutory Provisions	Section 147(b) provides the rules regarding the maturity limitation. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(14) of the 1954 Code.
General Rule	Section 147(b)(1) provides that a private activity bond is not a qualified private activity bond if it is issued as part of an issue and the average maturity of the bonds issued as part of such issue EXCEEDS 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of such issue.
Special Rule for Pooled Financings of 501(c)(3) organizations	Section 147(b)(4) provides that certain qualified 501(c)(3) pooled financings satisfy the maturity limitation if the conditions relating to use of proceeds, average maturity of loans, demand surveys, and timing of loans as set forth in § 147(b)(4)(B) are satisfied.

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Maturity Limitation, Continued

Special Rule for Healthcare Financings

Section 147(b)(5) provides that the maturity limitation does not apply to bonds that finance mortgage loans insured under "FHA 242" or a similar FHA program (as in effect on the date of enactment of the Tax Reform Act of 1986) where the mortgage loan term approved by FHA plus the maximum maturity of the debentures which could be issued by FHA in satisfaction of its obligations exceeds the term permitted under § 147(b)(1).

Exception for Working Capital Financings

Regulations § 1.147(b)-1 provides that § 147(b) does not apply to bond proceeds used to finance working capital expenditures. Regulations § 1.150-1(b) defines the term working capital expenditures as any cost that is not a capital expenditure and further states that generally current operating expenses are working capital expenditures.

(Remember that qualified 501(c)(3) bonds are the only qualified private activity bonds can be used to finance working capital expenditures.)

Determination of Average Maturity

Section 147(b)(2)(A) provides that the average maturity of any issue shall be determined by taking into account the respective issue prices of the bonds issued as part of the entire issue.

Determination of Average Reasonably Expected Economic Life

Section 147(b)(2)(B) provides that the average reasonably expected economic life of the facilities being financed with any issue shall be determined by taking into account the respective cost of such facilities.

Determination Date

Section 147(b)(3)(A) provides that the reasonably expected economic life of any facility shall be determined as of the LATER OF:

- the date on which the bonds are issued, OR
- the date on which the facility is placed in service (or expected to be placed in service).

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Maturity Limitation, Continued

Determination of Economic Life

The House Conference Report No. 97-760, at 519 (1982) provides that the economic life of assets is determined on a case-by-case basis. However, to provide guidance and certainty, the conferees intend that the administrative guidelines established for the useful lives used for depreciation prior to the ACRS system (i.e., the midpoint lives under the ADR system where applicable and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) may be used to establish the economic lives of assets. See also Rev. Proc. 87-56, 1987-2 CB 674. However, the taxpayer can issue bonds with maturities longer than these administrative guidelines would allow where the taxpayer can show, on the basis of the facts and circumstances that the economic life to the principal user or users of the assets for whom the bonds are issued is longer than the lives established by the administrative guidelines.

Treatment of Land

Section 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land.

When land is taken into account, it is treated as having an economic life of 30 years.

Prohibited Facilities

Statutory Provisions

Section 147(e) provides the rules regarding prohibited facilities. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(18) of the 1954 Code.

There are no regulations applicable to this rule.

Rule

Section 147(e) provides that a private activity bond shall not be a qualified bond if any portion of the proceeds of the issue is used to provide any of the following.

- Airplanes
- Skyboxes or other private luxury boxes
- Health club facilities
- Facilities primarily used for gambling
- Stores the principal business of which is the sale of alcoholic beverages for consumption off premises

Note that pursuant to § 147(h)(2), **§ 147(e) does not apply to qualified 501(c)(3) bonds that finance health club facilities**. Rev. Rul. 2003-116, 2003-2 C.B. 1083, held that a helicopter is not an "airplane" within the meaning of § 147(e).

Public Approval Requirement

Introduction

Section 147(f) provides the rules regarding the public approval requirement. Prior to the Tax Reform Act of 1986, these rules were in § 103(k) of the 1954 Code.

Regulations § 5f.103-2 also contains rules that pertain to the public approval requirement. (See below regarding proposed regulations.)

Section 147(f) provides that a private activity bond shall not be a qualified bond unless such bond is part of an issue which has been approved by:

- the governmental unit which issued such bond, or on behalf of which such bond was issued, AND
- generally each governmental unit having jurisdiction over the area in which the facility financed by the proceeds of such bond is located.

Public approval by a governmental unit can be either by:

- an "applicable elected representative" of such governmental unit after a **public hearing** following **reasonable public notice** about the bond issuance, OR
- voter referendum of such governmental unit

This requirement is commonly known as the "TEFRA requirement" because it was originally added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Applicability

Section 147(f) applies to ALL qualified private activity bonds, without exception.

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Public Approval Requirement, Continued

Issuer Approval

Generally that approval must always be provided by the government issuer or governmental unit on whose behalf the bonds will be issued. However, if a governmental unit issues bonds on behalf of more than one governmental unit (e.g. an authority issuing bonds on behalf of multiple counties), any of such units may satisfy the issuer approval requirement.

See § 147(f)(2)(A)(i) and Regulations § 5f.103-2(c)(2)

Host Approval

Each governmental unit the geographic jurisdiction of which contains the facility to be financed by the issue must approve the issue. However, if the entire site of a facility to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of such units may provide host approval for the issue with respect to the facility.

The issuer approval may be treated as satisfying the host approval requirement if the governmental unit giving the issuer approval meets both the issuer and host approval requirements.

See § 147(f)(2)(A)(ii) and Regulations § 5f.103-2(c)(3)

Definition of Governmental Unit

Regulations § 5f.103-2(g)(1) provides that the term "governmental unit" has the same meaning as in § 1.103-1, which provides that a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

Definition of Applicable Elected Representative

Section 147(f)(2)(E) and Regulations § 5F.103-2(e) provide that the term "applicable elected representative" means with respect to any governmental unit:

- its elected legislative body,
- its chief elected executive officer,
- if a State, its chief elected legal officer of the State's executive branch (e.g. Attorney General), OR
- any other official elected by the voters of such unit and designated for purposes of this requirement by such unit's chief elected executive officer or by State or local law to approve issues for the unit

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Public Approval Requirement, Continued

What is "Reasonable Public Notice?"

Regulations § 5f.103-2(g)(3) provides that reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the unit where a facility is to be located, of the proposed issue.

The notice must state the time and place for the hearing and generally be published no fewer than 14 days before the hearing.

The notice is presumed reasonably designed to inform residents if:

- except in the location of the facility, given in the same manner and locations required by the governmental unit under state law for notice of public meetings,
- published in one or more newspapers of general circulation, or announced by radio or television broadcast in the area AND
- published no fewer than 14 days before the hearing.

Notice Must Contain Certain Information

Regulations § 5f.103-2(f)(2) provides that the notice of hearing and the approval must contain the following.

- A general, functional description of the type and use of the facility to be financed (*e.g.* ,10,000 square foot machine shop and hardware manufacturing plant, 400-room airport hotel building, dock facility for supertankers, convention center auditorium and sports arena with 25,000 seating capacity, air and water pollution control facilities for oil refinery)
- The maximum aggregate face amount of obligations to be issued with respect to the facility
- The initial owner, operator, or manager of the facility
- The prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.

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Public Approval Requirement, Continued

Inadequate Notice

Regulations § 5f.103-2(f)(2) provides that an approval will not be rendered invalid due to an **insubstantial deviation** from the information required in a notice. However, an approval or notice of hearing will not be considered adequate if any of the required information is unknown on the date of the approval or the date of the public notice.

Public Hearing

Regulations § 5f.103-2(g)(2) provides generally that a public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the proposed issue of bonds and the location and nature of a proposed facility to be financed.

Refunding Bonds

No approval is necessary for current refunding bonds as long as:

- the original bond met the public approval requirements, and
- the average maturity date of the refunding issue is NOT later than that of the refunded bonds.

The public approval requirements of § 147(f) must be met by advance refundings.

Proposed Regulations

Proposed regulations (REG 128841-07, September 9, 2008) would create a new set of regulations under § 147(f) to update and supplement portions of the existing regulations. Except as otherwise provided in proposed regulation § 1.147(f)-1, the proposed regulations will apply to bonds that are sold on or after the date of publication of final regulations in the Federal Register and that are subject to § 147(f).

Restriction on Issuance Costs

Statutory & Regulatory Provisions	Section 147(g) provides the rules regarding costs of issuance. These rules were added to the Code by the Tax Reform Act of 1986. Regulations § 1.150-1(b) provides a definition of issuance costs.
Rule	Section 147(g)(1) provides that a private activity bond shall not be a qualified bond if the issuance costs financed by the issue exceed 2 percent of the **proceeds** (NOT face amount) of the issue.
Applicability	Section 147(g) applies to all types of qualified private activity bonds.
Relationship with "95 percent" Test	Generally, at least 95 percent of the net proceeds of qualified private activity bonds must be used for the qualified purposes of the issue. Amounts used to finance any costs of issuance are NOT treated as spent for the qualified purpose of the issue. Thus, the amount of proceeds allocated to issuance costs must also be allocated to the 5 percent permissible "bad use" portion of the net proceeds.

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Restriction on Issuance Costs, Continued

What are Issuance Costs?

Regulations § 1.150-1(b) includes the following costs as issuance costs.

- Underwriter's discount
- Counsel fees
- Financial advisory fees
- Rating agency fees
- Trustee fees
- Paying agent fees
- Bond registrar, certification, and authentication fees
- Accounting fees
- Printing costs for bonds and offering documents
- Public approval process costs
- Engineering and feasibility study costs
- Guarantee fees, other than for qualified guarantees
- And costs similar to the above.

Additional Issuance Costs

Section 147(g) does not prohibit an issuer from incurring issuance costs in excess of the 2 percent limitation. An issuer can always use other funds to pay for these excess issuance costs.

Summary

Review of Lesson 11

A private activity bond is any bond which meets:

- the private business use test and the private security or payment test, **OR**
- the private loan financing test

The interest on a private activity bond cannot be tax-exempt, unless the bond is a qualified bond.

Both the reasonable expectations of the issuer on the issuance date and subsequent deliberate actions of the issuer are considered when determining if the private activity bond tests are met.

Qualified 501(c)(3) bonds are not required to receive an allocation of volume cap but are subject to certain of the other requirements generally applicable to private activity bonds. Qualified 501(c)(3) bonds are subject to the maturity limitation, which limits the average maturity of bonds to no more than 120 percent of the average reasonably expected economic life of the facilities being financed. The general prohibition on financing certain facilities applies to qualified 501(c)(3) bonds, except that such bonds may finance health club facilities whereas other types of bonds cannot. Like all other private activity bonds (except certain current refundings) qualified 501(c)(3) bonds are subject to the public approval requirement. Costs of issuance financed with proceeds of qualified 501(c)(3) cannot exceed 2 percent of the proceeds.

Preview of Lesson 12

Lesson 12 discusses qualified 501(c)(3) bonds as described in § 145. The term "qualified hospital bond" will be defined and the test for determining whether non-hospital bonds meet the $150 million volume cap will be explored. Additionally, lesson 12 will explore whether bonds used for residential rental property are qualified 501(c)(3) bonds. The private activity bond rules of other Code sections which apply to qualified 501(c)(3) bonds will also be discussed.

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