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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

26 CFR Part 1

TD 9234

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Obligations of States and Political Subdivisions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the definition of private activity bond applicable to tax-exempt bonds issued by State and local governments. These regulations affect issuers of tax-exempt bonds and provide needed guidance for applying the private activity bond restrictions to refunding issues.

DATES: Effective Date: These regulations are effective February 17, 2006.

Applicability Date: For dates of applicability, see §1.141-15(j) of these regulations.

FOR FURTHER INFORMATION CONTACT: Johanna Som de Cerff, (202) 622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) under section 141 of the Internal Revenue Code (Code) by providing rules on the application of the private activity bond tests to refunding issues. This document also amends the Income Tax Regulations under sections 145, 149 and 150 by providing rules on certain related matters.

On May 14, 2003, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-113007-99)(68 FR 25845)(the proposed regulations) relating to the matters addressed in this Treasury decision. A public hearing on the proposed regulations was scheduled for September 9, 2003. However, the public hearing was cancelled because no requests to speak were received. Written comments on the proposed regulations were received. After consideration of all the written comments, the proposed regulations are adopted as revised by this Treasury decision (the final regulations). The revisions are discussed below.

Explanation of Provisions

A. Introduction

In general, under section 103, gross income does not include the interest on any State or local bond. However, this exclusion does not apply to private activity bonds (other

than certain qualified bonds). Section 141(a) defines a private activity bond as any bond issued as part of an issue that meets either (1) the private business use test in section 141(b)(1) and the private security or payment test in section 141(b)(2) (the private business tests) or (2) the private loan financing test in section 141(c) (the private business tests and the private loan financing test are referred to collectively as the "private activity bond tests").

The private business use test is met if more than 10 percent of the proceeds of an issue are to be used for any private business use. Section 141(b)(6) defines private business use as use directly or indirectly in a trade or business that is carried on by any person other than a governmental unit.

The private security or payment test is met if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) 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.

The private loan financing test is satisfied if more than the lesser of \$5 million or 5 percent of the proceeds of an issue are to be used to make or finance loans to persons other than governmental units.

On January 16, 1997, final regulations (TD 8712) relating to the definition of private activity bonds and related rules under sections 103, 141, 142, 144, 145, 147, 148, and 150 were published in the **Federal Register** (62 FR 2275) (the 1997 regulations). Under the 1997 regulations, the amount of private business use of property financed by an issue is equal to the average percentage of private business use of that property during a defined measurement period. The measurement period begins on the later of the issue date of the issue or the date that the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, under the 1997 regulations, the amount of private security or private payments is determined by comparing the present value of the private security or private payments to the present value of the debt service to be paid over the term of the

issue, using the bond yield as the discount rate. The 1997 regulations reserve §1.141-13 for rules regarding the application of the private business tests and the private loan financing test to refunding issues.

B. Application of Private Activity Bond Tests to Refunding Issues

1. In general

The proposed regulations provide that, in general, a refunding issue and a prior issue are tested separately under section 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds.

Commentators supported this separate testing principle. The final regulations retain this approach.

2. Allocation of proceeds

The proposed regulations provide that, in applying the private business tests and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same purpose investments (including any private loan under section 141(c)) and expenditures as the proceeds of the prior issue.

Comments were not received on this allocation provision.

The final regulations retain this rule.

3. Measurement of private business use

The proposed regulations generally provide that the amount of private business use of a refunding issue is determined based on the separate measurement period for the refunding issue under §1.141-3(g) (for example, without regard to any private business use that occurred before the issue date of the refunding issue). Thus, for instance, if an issuer refunds a taxable bond or an exempt facility bond, any private business use of the refinanced facilities before the issue date of the refunding issue is disregarded in applying the private business use test to the refunding issue.

In the case of a refunding issue that refunds a prior issue of governmental bonds, however, the amount of private business use is generally determined based on a combined measurement period. For purposes of the proposed regulations, a governmental bond is any bond that, when issued, purported to be either a governmental bond, as defined in §1.150-1(b), or a qualified 501(c)(3) bond, as defined in section 145(a). The combined measurement period is the period that begins on the first day of the measurement period (as defined in §1.141-3(g)) for the prior issue (or the first issue of governmental

bonds in the case of a series of refundings of governmental bonds) and ends on the last day of the measurement period for the refunding issue.

As an alternative to the combined measurement period approach, the proposed regulations permit issuers to measure private business use based on the separate measurement period of the refunding issue, but only if the prior issue of governmental bonds does not meet the private business use test during a shortened measurement period. The shortened measurement period begins on the first day of the measurement period of the prior issue (or the first issue of governmental bonds in the case of a series of refundings of governmental bonds) and ends on the issue date of the refunding issue. Whether a prior issue meets the private business use test during the shortened measurement period is determined based on the actual use of proceeds, without regard to the reasonable expectations test of §1.141-2(d).

Commentators suggested that the proposed regulations be modified with respect to governmental bonds: (1) to delete the shortened measurement period concept; (2) to provide, absent any evidence to the contrary, and subject to general anti-abuse rules, a presumption that an issuer did not exceed the ten percent private business use limit; and (3) to specify

that the amount of private business use of the refunding issue is the amount of private business use during either the separate measurement period for the refunding issue or the combined measurement period.

These commentators suggested that a separate measurement period approach would not allow an issuer to increase the amount of private business use without jeopardizing the tax exemption of the prior issue, and thus an issuer generally should be permitted to measure private business use of a refunding issue using a separate measurement period. Nevertheless, these commentators suggested that the regulations include a general anti-abuse rule. They noted, for example, that a separate measurement period approach could permit an issuer to have an additional ten percent of private business use in connection with a refunding issue after the period of limitations for the prior bonds has run. These commentators suggested that, in such a situation, it would be fair to consider the refunding issue to be an abuse if the issuer is deliberately trying to exploit the private business use limit.

The final regulations retain the basic approach of the proposed regulations to measuring private business use. The final regulations do not adopt the suggestions to delete the

shortened measurement period concept and to provide that private business use may be measured during either a separate or combined measurement period. These suggestions are not adopted because they could result in more private business use than otherwise would be permitted after the expiration of the period of limitations for the prior issue.

The final regulations do not adopt the suggestion to create a presumption that the private business use limit was not exceeded with respect to prior bonds. It is not clear such a presumption is warranted in all cases.

The final regulations also do not adopt the suggestion to add an anti-abuse rule. The IRS and Treasury Department have concluded that the bright-line rule in the proposed regulations for determining when issuers must apply a combined measurement period and when issuers may apply either a combined measurement period or a separate measurement period is an appropriate methodology for measuring the private business use of a refunding issue and provides more administrative certainty than would be provided by an anti-abuse rule.

Commentators expressed concern regarding an issuer's ability to establish the amount of private business use during a combined measurement period if the period begins a

significant amount of time before the refunding bonds are issued. They noted that, in some cases, the refunded bonds may have been issued as many as twenty years or more before the refunding bonds are issued. These commentators stated that document retention policies vary by issuer and retaining or locating the necessary information over such long periods of time may be difficult.

The final regulations apply prospectively and only to refunding bonds that are subject to the 1997 regulations. In general, under §1.141-15, the 1997 regulations apply to refunding bonds only if, among other requirements, (1) the refunded bonds were originally issued on or after May 16, 1997, (2) the weighted average maturity of the refunding bonds is longer than the weighted average maturity of the refunded bonds, or (3) the issuer chooses to apply the 1997 regulations to the refunding bonds. Thus, the final regulations will not apply to any refunding of bonds originally issued before May 16, 1997, unless the issuer extends the weighted average maturity of the prior bonds or otherwise chooses to have the 1997 regulations apply to the refunding bonds (or an earlier issue of bonds).

In addition, to address commentators' concerns, the final regulations provide transitional relief for refundings of

bonds originally issued before May 16, 1997 (the effective date of the 1997 regulations). Specifically, the final regulations provide that, if the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) was issued before May 16, 1997, then the issuer, at its option, may treat the combined measurement period as beginning on the date (the transition date) that is the earlier of (1) December 19, 2005, or (2) the first date on which the prior issue (or an earlier issue in the case of a series of refundings of governmental bonds) became subject to the 1997 regulations. This transitional relief, which was not contained in the proposed regulations, has been added to the final regulations in response to concerns expressed by commentators regarding an issuer's ability to establish the amount of private business use during a combined measurement period if the period begins a significant amount of time before the refunding bonds are issued.

Some commentators requested guidance on how the private business tests apply to the shortened and combined measurement periods for refundings of bonds originally issued before the effective date of the Tax Reform Act of 1986, 100 Stat. 2085 (the 1986 Act), if the refunding does not qualify for

transitional relief under the 1986 Act or prior law.

Specifically, commentators requested guidance on whether (1) the ten-percent private business use limitation under the 1986 Act or (2) the applicable private business use limitation under prior law (for example, the 25-percent limitation under the Internal Revenue Code of 1954) applies in the case of a non-transitioned refunding of a bond issued under law in effect prior to the 1986 Act. The final regulations clarify in an example that the 1986 Act limitations apply to the shortened and combined measurement periods. The issuer, however, may treat these periods as beginning on the transition date described above.

4. Measurement of private security and private payments

Under the proposed regulations, if the amount of private business use is determined based on the separate measurement period for the refunding issue, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141-4 by treating the refunding issue as a separate issue. On the other hand, if the amount of private business use is determined based on a combined measurement period, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141-4 by treating the refunding issue and

all earlier issues taken into account in determining the combined measurement period as a combined issue. The proposed regulations contain specific rules for determining the present value of the debt service on, and the private security and private payments allocable to, a combined issue.

Commentators requested clarification regarding how the private security or payment test applies under the combined issue methodology in the case of a refunding of only a portion of the original principal amount of a prior issue. The final regulations clarify that, in these circumstances, (1) the refunded portion of the prior issue is treated as a separate issue and (2) any private security or private payments with respect to the prior issue are allocated ratably between the combined issue and the unrefunded portion of the prior issue in a consistent manner based on relative debt service.

The proposed regulations also permit an issuer to use the yield on a prior issue of governmental bonds to determine the present value of private security or private payments under arrangements that were not entered into in contemplation of the refunding issue. For this purpose, any arrangement that was entered into more than one year before the issue date of the refunding issue will be treated as not entered into in contemplation of the refunding issue.

Comments were not received on this special rule for arrangements not entered into in contemplation of the refunding issue. The final regulations retain this provision.

5. Multipurpose issue allocations

Section 1.148-9(h) permits an issuer to use a reasonable, consistently applied allocation method to treat the portion of a multipurpose issue allocable to a separate purpose as a separate issue for certain of the arbitrage provisions of section 148. Section 1.141-13(d) of the proposed regulations allows an issuer to apply §1.148-9(h) to a multipurpose issue for certain purposes under section 141. An allocation will not be reasonable for this purpose if it achieves more favorable results under section 141 than could be achieved with actual separate issues. In addition, allocations under the proposed regulations and §1.148-9(h) must be consistent for purposes of sections 141 and 148. The proposed regulations do not permit allocations for purposes of section 141(c)(1) (relating to the private loan financing test) or section 141(d)(1) (relating to certain restrictions on acquiring nongovernmental output property).

Commentators supported the multipurpose allocation provisions in the proposed regulations. The final regulations retain those provisions. Commentators also requested

clarification that an allocation under §1.141-13(d) may be made at any time. The final regulations provide that an allocation under §1.141-13(d) may be made at any time, but once made may not be changed. The final regulations also provide that the issue to be allocated and each of the separate issues under the allocation must consist of one or more tax-exempt bonds. Thus, an allocation of a multipurpose issue into two or more separate issues is not permitted under §1.141-13(d) if, at the time of the allocation, the issue to be allocated or any of the separate issues under the allocation consists of taxable private activity bonds.

6. Application of reasonable expectations test to certain refunding bonds

Section 1.141-2(d) provides that an issue consists of private activity bonds if the issuer (1) reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test, or (2) 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 satisfied. Section 1.141-2(d)(3) provides, in general, that a deliberate action is any action taken by the issuer that is within its control.

The proposed regulations provide that an action that would otherwise cause a refunding issue to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of §1.141-2(d) if (1) the action is not a deliberate action within the meaning of §1.141-2(d)(3), and (2) the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

Commentators suggested that the limitation on the weighted average maturity of the refunding bonds to the remaining weighted average maturity of the prior bonds could penalize issuers for issuing shorter-term obligations initially, or provide an incentive to issue longer-term obligations initially. These commentators requested that the weighted average maturity of the refunding bonds be limited only to 120 percent of the weighted average reasonably expected economic life of the property financed by the prior bonds. The final regulations amend this provision to provide that the weighted average maturity of the refunding bonds may not exceed the weighted average reasonably expected economic life of the property financed by the prior bonds.

Commentators also requested that an example illustrating this provision be added to the regulations. The final regulations add such an example.

7. Refundings of certain general obligation bonds

Section 1.141-2(d)(5) provides that the determination of whether bonds of an issue are private activity bonds may be based solely on the issuer's reasonable expectations as of the issue date (and not on whether there are any subsequent deliberate actions) if, among other requirements, the issue is an issue of general obligation bonds of a general purpose governmental unit that finances at least 25 separate purposes.

Commentators suggested that a refunding issue should not consist of private activity bonds if the prior issue meets the requirements of §1.141-2(d)(5). The final regulations adopt this comment.

C. Treatment of Issuance Costs Financed by Prior Issue of Qualified 501(c)(3) Bonds

Under the 1997 regulations, the use of proceeds of an issue of qualified 501(c)(3) bonds to pay issuance costs of the issue is treated as a private business use. The proposed regulations provide that, solely for purposes of applying the private business use test to a refunding issue, the use of proceeds of the prior issue (or any earlier issue in a series

of refundings) to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

Comments were not received on this provision. The final regulations retain this rule.

D. Limitation on Advance Refundings of Private Activity Bonds

Under section 149(d)(2), interest on a bond is not excluded from gross income if any portion of the issue of which the bond is a part is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond). The proposed regulations provide that, for purposes of section 149(d)(2), the term private activity bond includes a qualified bond described in section 141(e) (other than a qualified 501(c)(3) bond), regardless of whether the refunding issue consists of private activity bonds under the proposed regulations. The proposed regulations also provide that, for purposes of section 149(d)(2), the term private activity bond does not include a taxable bond. Section 1.150-1(b) defines taxable bond as any obligation the interest on which is not excludable from gross income under section 103.

Commentators recommended that the regulations be modified to permit a tax-exempt private activity bond to be advance refunded by a governmental bond if the nongovernmental

entity's participation in the financing has been terminated and the only beneficiary of the financing is the governmental unit. Based on the plain language of section 149(d)(2) and the policies underlying that Code provision, the final regulations do not adopt this comment.

Effective Date

The final regulations apply to bonds that are (1) sold on or after February 17, 2006, and (2) subject to the 1997 regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Drafting Information

The principal authors of these regulations are Johanna Som de Cerff and Laura W. Lederman, Office of Chief Counsel (Tax-exempt and Government Entities), Internal Revenue Service

and Stephen J. Watson, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.141-0 is amended by adding entries to the table in numerical order for §§1.141-13 and 1.141-15(j) to read as follows:

§1.141-0 Table of contents

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§1.141-13 Refunding issues.

- (a) In general.
- (b) Application of private business use test and private loan financing test.
 - (1) Allocation of proceeds.
 - (2) Determination of amount of private business use.
- (c) Application of private security or payment test.
 - (1) Separate issue treatment.
 - (2) Combined issue treatment.
 - (3) Special rule for arrangements not entered into in contemplation of the refunding issue.
- (d) Multipurpose issue allocations.

- (1) In general.
- (2) Exceptions.
- (e) Application of reasonable expectations test to certain refunding bonds.
- (f) Special rule for refundings of certain general obligation bonds.
- (g) Examples.

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§1.141-15 Effective dates.

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- (j) Effective dates for certain regulations relating to refundings.

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Par. 3. In §1.141-1, paragraph (b) is amended by revising the definition of governmental bond to read as follows:

§1.141-1 Definitions and rules of general application.

* * * * *

(b) * * *

Governmental bond has the same meaning as in §1.150-1(b), except that, for purposes of §1.141-13, governmental bond is defined in §1.141-13(b)(2)(iv).

* * * * *

Par. 4. Section 1.141-13 is added to read as follows:

§1.141-13 Refunding issues

(a) In general. Except as provided in this section, a refunding issue and a prior issue are tested separately under section 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds.

(b) Application of private business use test and private loan financing test--(1) Allocation of proceeds. In applying the private business use test and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the proceeds of the prior issue.

(2) Determination of amount of private business use--(i) In general. Except as provided in paragraph (b)(2)(ii) of this section, the amount of private business use of a refunding issue is determined under §1.141-3(g), based on the measurement period for that issue (for example, without regard to any private business use that occurred prior to the issue date of the refunding issue).

(ii) Refundings of governmental bonds. In applying the private business use test to a refunding issue that refunds a prior issue of governmental bonds, the amount of private

business use of the refunding issue is the amount of private business use--

(A) During the combined measurement period; or

(B) At the option of the issuer, during the period described in paragraph (b)(2)(i) of this section, but only if, without regard to the reasonable expectations test of §1.141-2(d), the prior issue does not satisfy the private business use test, based on a measurement period that begins on the first day of the combined measurement period and ends on the issue date of the refunding issue.

(iii) Combined measurement period--(A) In general.

Except as provided in paragraph (b)(2)(iii)(B) of this section, the combined measurement period is the period that begins on the first day of the measurement period (as defined in §1.141-3(g)) for the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) and ends on the last day of the measurement period for the refunding issue.

(B) Transition rule for refundings of bonds originally issued before May 16, 1997. If the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) was issued

before May 16, 1997, then the issuer, at its option, may treat the combined measurement period as beginning on the date (the transition date) that is the earlier of December 19, 2005, or the first date on which the prior issue (or an earlier issue in the case of a series of refundings of governmental bonds) became subject to the 1997 regulations (as defined in §1.141-15(b)). If the issuer treats the combined measurement period as beginning on the transition date in accordance with this paragraph (b)(2)(iii)(B), then paragraph (c)(2) of this section shall be applied by treating the transition date as the issue date of the earliest issue, by treating the bonds as reissued on the transition date at an issue price equal to the value of the bonds (as determined under § 1.148-4(e)) on that date, and by disregarding any private security or private payments before the transition date.

(iv) Governmental bond. For purposes of this section, the term governmental bond means any bond that, when issued, purported to be a governmental bond, as defined in §1.150-1(b), or a qualified 501(c)(3) bond, as defined in section 145(a).

(v) Special rule for refundings of qualified 501(c)(3) bonds with governmental bonds. For purposes of applying this paragraph (b)(2) to a refunding issue that refunds a qualified

501(c)(3) bond, any use of the property refinanced by the refunding issue before the issue date of the refunding issue by a 501(c)(3) organization with respect to its activities that do not constitute an unrelated trade or business under section 513(a) is treated as government use.

(c) Application of private security or payment test--(1) Separate issue treatment. If the amount of private business use of a refunding issue is determined based on the measurement period for that issue in accordance with paragraph (b)(2)(i) or (b)(2)(ii)(B) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141-4 by treating the refunding issue as a separate issue.

(2) Combined issue treatment. If the amount of private business use of a refunding issue is determined based on the combined measurement period for that issue in accordance with paragraph (b)(2)(ii)(A) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141-4 by treating the refunding issue and all earlier issues taken into account in determining the combined measurement period as a combined issue. For this purpose, the present value of the private security and private payments is compared to the present value

of the debt service on the combined issue (other than debt service paid with proceeds of any refunding bond). Present values are computed as of the issue date of the earliest issue taken into account in determining the combined measurement period (the earliest issue). Except as provided in paragraph (c)(3) of this section, present values are determined by using the yield on the combined issue as the discount rate. The yield on the combined issue is determined by taking into account payments on the refunding issue and all earlier issues taken into account in determining the combined measurement period (other than payments made with proceeds of any refunding bond), and based on the issue price of the earliest issue. In the case of a refunding of only a portion of the original principal amount of a prior issue, the refunded portion of the prior issue is treated as a separate issue and any private security or private payments with respect to the prior issue are allocated ratably between the combined issue and the unrefunded portion of the prior issue in a consistent manner based on relative debt service. See paragraph (b)(2)(iii)(B) of this section for special rules relating to certain refundings of governmental bonds originally issued before May 16, 1997.

(3) Special rule for arrangements not entered into in contemplation of the refunding issue. In applying the private security or payment test to a refunding issue that refunds a prior issue of governmental bonds, the issuer may use the yield on the prior issue to determine the present value of private security and private payments under arrangements that were not entered into in contemplation of the refunding issue.

For this purpose, any arrangement that was entered into more than 1 year before the issue date of the refunding issue is treated as not entered into in contemplation of the refunding issue.

(d) Multipurpose issue allocations--(1) In general. For purposes of section 141, unless the context clearly requires otherwise, §1.148-9(h) applies to allocations of multipurpose issues (as defined in §1.148-1(b)), including allocations involving the refunding purposes of the issue. An allocation under this paragraph (d) may be made at any time, but once made may not be changed. An allocation is not reasonable under this paragraph (d) if it achieves more favorable results under section 141 than could be achieved with actual separate issues. The issue to be allocated and each of the separate issues under the allocation must consist of one or more tax-exempt bonds. Allocations made under this paragraph (d) and

§1.148-9(h) must be consistent for purposes of section 141 and section 148.

(2) Exceptions. This paragraph (d) does not apply for purposes of sections 141(c)(1) and 141(d)(1).

(e) Application of reasonable expectations test to certain refunding bonds. An action that would otherwise cause a refunding issue to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of §1.141-2(d) if--

(1) The action is not a deliberate action within the meaning of §1.141-2(d)(3); and

(2) The weighted average maturity of the refunding bonds is not greater than the weighted average reasonably expected economic life of the property financed by the prior bonds.

(f) Special rule for refundings of certain general obligation bonds. Notwithstanding any other provision of this section, a refunding issue does not consist of private activity bonds if--

(1) The prior issue meets the requirements of §1.141-2(d)(5) (relating to certain general obligation bond programs that finance a large number of separate purposes); or

(2) The refunded portion of the prior issue is part of a series of refundings of all or a portion of an issue that meets the requirements of §1.141-2(d)(5).

(g) Examples. The following examples illustrate the application of this section:

Example 1. Measuring private business use. In 2002, Authority A issues tax-exempt bonds that mature in 2032 to acquire an office building. The measurement period for the 2002 bonds under §1.141-3(g) is 30 years. At the time A acquires the building, it enters into a 10-year lease with a nongovernmental person under which the nongovernmental person will use 5 percent of the building in its trade or business during each year of the lease term. In 2007, A issues bonds to refund the 2002 bonds. The 2007 bonds mature on the same date as the 2002 bonds and have a measurement period of 25 years under §1.141-3(g). Under paragraph (b)(2)(ii)(A) of this section, the amount of private business use of the proceeds of the 2007 bonds is 1.67 percent, which equals the amount of private business use during the combined measurement period (5 percent of 1/3rd of the 30-year combined measurement period). In addition, the 2002 bonds do not satisfy the private business use test, based on a measurement period beginning on the first day of the measurement period for the 2002 bonds and ending on the issue date of the 2007 bonds, because only 5 percent of the proceeds of the 2002 bonds are used for a private business use during that period. Thus, under paragraph (b)(2)(ii)(B) of this section, A may treat the amount of private business use of the 2007 bonds as 1 percent (5 percent of 1/5th of the 25-year measurement period for the 2007 bonds). The 2007 bonds do not satisfy the private business use test.

Example 2. Combined issue yield computation. (i) On January 1, 2000, County B issues 20-year bonds to finance the acquisition of a municipal auditorium. The 2000 bonds have a yield of 7.7500 percent, compounded annually, and an issue price and par amount of \$100 million. The debt service payments on the 2000 bonds are as follows:

Date	Debt Service
1/1/01	\$9,996,470
1/1/02	9,996,470
1/1/03	9,996,470
1/1/04	9,996,470
1/1/05	9,996,470
1/1/06	9,996,470
1/1/07	9,996,470
1/1/08	9,996,470
1/1/09	9,996,470
1/1/10	9,996,470
1/1/11	9,996,470
1/1/12	9,996,470
1/1/13	9,996,470
1/1/14	9,996,470
1/1/15	9,996,470
1/1/16	9,996,470
1/1/17	9,996,470
1/1/18	9,996,470
1/1/19	9,996,470
1/1/20	9,996,470
	\$199,929,400

(ii) On January 1, 2005, B issues 15-year bonds to refund all of the outstanding 2000 bonds maturing after January 1, 2005 (in the aggregate principal amount of \$86,500,000). The 2005 bonds have a yield of 6.0000 percent, compounded annually, and an issue price and par amount of \$89,500,000. The debt service payments on the 2005 bonds are as follows:

Date	Debt Service
1/1/06	\$9,215,167
1/1/07	9,215,167
1/1/08	9,215,167
1/1/09	9,215,167
1/1/10	9,215,167
1/1/11	9,215,167
1/1/12	9,215,167
1/1/13	9,215,167
1/1/14	9,215,167
1/1/15	9,215,167
1/1/16	9,215,167
1/1/17	9,215,167
1/1/18	9,215,167
1/1/19	9,215,167
1/1/20	9,215,167
	\$138,227,511

(iii) In accordance with §1.141-15(h), B chooses to apply §1.141-13 (together with the other provisions set forth in §1.141-15(h)), to the 2005 bonds. For purposes of determining the amount of private security and private payments with respect to the 2005 bonds, the 2005 bonds and the refunded portion of the 2000 bonds are treated as a combined issue under paragraph (c)(2) of this section. The yield on the combined issue is determined in accordance with §§1.148-4, 1.141-4(b)(2)(iii) and 1.141-13(c)(2). Under this methodology, the yield on the combined issue is 7.1062 percent per year compounded annually, illustrated as follows:

Date	Previous Debt Service on Refunded Portion of Prior Issue	Refunding Debt Service	Total Debt Service	Present Value on 1/1/00
1/1/00				(\$86,500,000.00)
1/1/01	\$6,689,793		\$6,689,793	6,245,945.33
1/1/02	6,689,793		6,689,793	5,831,545.62
1/1/03	6,689,793		6,689,793	5,444,640.09
1/1/04	6,689,793		6,689,793	5,083,404.58
1/1/05	6,689,793		6,689,793	4,746,135.95
1/1/06		\$9,215,167	9,215,167	6,104,023.84
1/1/07		9,215,167	9,215,167	5,699,040.20
1/1/08		9,215,167	9,215,167	5,320,926.00
1/1/09		9,215,167	9,215,167	4,967,898.55
1/1/10		9,215,167	9,215,167	4,638,293.40
1/1/11		9,215,167	9,215,167	4,330,556.57
1/1/12		9,215,167	9,215,167	4,043,237.15
1/1/13		9,215,167	9,215,167	3,774,980.51
1/1/14		9,215,167	9,215,167	3,524,521.90
1/1/15		9,215,167	9,215,167	3,290,680.46
1/1/16		9,215,167	9,215,167	3,072,353.70
1/1/17		9,215,167	9,215,167	2,868,512.26
1/1/18		9,215,167	9,215,167	2,678,195.09
1/1/19		9,215,167	9,215,167	2,500,504.89
1/1/20		9,215,167	9,215,167	2,334,603.90
	\$33,448,965	\$138,227,511	\$171,676,476	0.00

Example 3. Determination of private payments allocable to combined issue. The facts are the same as in Example 2. In addition, on January 1, 2001, B enters into a contract with a nongovernmental person for the use of the auditorium. The contract results in a private payment in the amount of \$500,000 on each January 1 beginning on January 1, 2001, and

ending on January 1, 2020. Under paragraph (c)(2) of this section, the amount of the private payments allocable to the combined issue is determined by treating the refunded portion of the 2000 bonds (\$86,500,000 principal amount) as a separate issue, and by allocating the total private payments ratably between the combined issue and the unrefunded portion of the 2000 bonds (\$13,500,000 principal amount) based on relative debt service, as follows:

Date	Private Payments	Debt Service on Unrefunded Portion of Prior Issue	Debt Service on Combined Issue	Percentage of Private Payments Allocable to Combined Issue	Amount of Private Payments Allocable to Combined Issue
1/1/01	\$500,000	\$3,306,677	\$6,689,793	66.92%	\$334,608
1/1/02	500,000	3,306,677	6,689,793	66.92	334,608
1/1/03	500,000	3,306,677	6,689,793	66.92	334,608
1/1/04	500,000	3,306,677	6,689,793	66.92	334,608
1/1/05	500,000	3,306,677	6,689,793	66.92	334,608
1/1/06	500,000		9,215,167	100.00	500,000
1/1/07	500,000		9,215,167	100.00	500,000
1/1/08	500,000		9,215,167	100.00	500,000
1/1/09	500,000		9,215,167	100.00	500,000
1/1/10	500,000		9,215,167	100.00	500,000
1/1/11	500,000		9,215,167	100.00	500,000
1/1/12	500,000		9,215,167	100.00	500,000
1/1/13	500,000		9,215,167	100.00	500,000
1/1/14	500,000		9,215,167	100.00	500,000
1/1/15	500,000		9,215,167	100.00	500,000
1/1/16	500,000		9,215,167	100.00	500,000
1/1/17	500,000		9,215,167	100.00	500,000
1/1/18	500,000		9,215,167	100.00	500,000
1/1/19	500,000		9,215,167	100.00	500,000
1/1/20	500,000		9,215,167	100.00	500,000
	<u>\$10,000,000</u>	<u>\$16,533,385</u>	<u>\$171,676,476</u>		<u>\$9,173,039</u>

Example 4. Refunding taxable bonds and qualified bonds.

(i) In 1999, City C issues taxable bonds to finance the construction of a facility for the furnishing of water. The bonds are secured by revenues from the facility. The facility is managed pursuant to a management contract with a nongovernmental person that gives rise to private business use. In 2007, C terminates the management contract and takes over the operation of the facility. In 2009, C issues bonds to refund the 1999 bonds. On the issue date of the 2009 bonds, C reasonably expects that the facility will not be used

for a private business use during the term of the 2009 bonds.

In addition, during the term of the 2009 bonds, the facility is not used for a private business use. Under paragraph (b)(2)(i) of this section, the 2009 bonds do not satisfy the private business use test because the amount of private business use is based on the measurement period for those bonds and therefore does not take into account any private business use that occurred pursuant to the management contract.

(ii) The facts are the same as in paragraph (i) of this Example 4, except that the 1999 bonds are issued as exempt facility bonds under section 142(a)(4). The 2009 bonds do not satisfy the private business use test.

Example 5. Multipurpose issue. In 2001, State D issues bonds to finance the construction of two office buildings, Building 1 and Building 2. D expends an equal amount of the proceeds on each building. D enters into arrangements that result in 8 percent of Building 1 and 12 percent of Building 2 being used for a private business use during the measurement period under §1.141-3(g). These arrangements result in a total of 10 percent of the proceeds of the 2001 bonds being used for a private business use. In 2006, D purports to allocate, under paragraph (d) of this section, an equal amount of the outstanding 2001 bonds to Building 1 and Building 2. D also enters into another private business use arrangement with respect to Building 1 that results in an additional 2 percent (and a total of 10 percent) of Building 1 being used for a private business use during the measurement period. An allocation is not reasonable under paragraph (d) of this section if it achieves more favorable results under section 141 than could be achieved with actual separate issues. D's allocation is unreasonable because, if permitted, it would result in more than 10 percent of the proceeds of the 2001 bonds being used for a private business use.

Example 6. Non-deliberate action. In 1998, City E issues bonds to finance the purchase of land and construction of a building (the prior bonds). On the issue date of the prior bonds, E reasonably expects that it will be the sole user of the financed property for the entire term of the bonds. In 2003, the federal government acquires the financed property in a condemnation action. In 2006, E issues bonds to refund the prior bonds (the refunding bonds). The weighted

average maturity of the refunding bonds is not greater than the reasonably expected economic life of the financed property. In general, under §1.141-2(d) and this section, reasonable expectations must be separately tested on the issue date of a refunding issue. Under paragraph (e) of this section, however, the condemnation action is not taken into account in applying the reasonable expectations test to the refunding bonds because the condemnation action is not a deliberate action within the meaning of §1.141-2(d)(3) and the weighted average maturity of the refunding bonds is not greater than the weighted average reasonably expected economic life of the property financed by the prior bonds. Thus, the condemnation action does not cause the refunding bonds to be private activity bonds.

Example 7. Non-transitioned refunding of bonds subject to 1954 Code. In 1985, County F issues bonds to finance a court house. The 1985 bonds are subject to the provisions of the Internal Revenue Code of 1954. In 2006, F issues bonds to refund all of the outstanding 1985 bonds. The weighted average maturity of the 2006 bonds is longer than the remaining weighted average maturity of the 1985 bonds. In addition, the 2006 bonds do not satisfy any transitional rule for refundings in the Tax Reform Act of 1986, 100 Stat. 2085 (1986). Section 141 and this section apply to determine whether the 2006 bonds are private activity bonds including whether, for purposes of §1.141-13(b)(2)(ii)(B), the 1985 bonds satisfy the private business use test based on a measurement period that begins on the first day of the combined measurement period for the 2006 bonds and ends on the issue date of the 2006 bonds.

Par. 5. Section 1.141-15 is amended by revising paragraphs (b)(1), (c), (d) and (h) and adding paragraph (j) to read as follows:

§1.141-15 Effective dates.

* * * * *

(b) Effective dates--(1) In general. Except as otherwise provided in this section, §§1.141-0 through 1.141-6(a), 1.141-9 through 1.141-12, 1.141-14, 1.145-1 through 1.145-2(c), and the definition of bond documents contained in §1.150-1(b) (the 1997 regulations) apply to bonds issued on or after May 16, 1997, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

* * * * *

(c) Refunding bonds. Except as otherwise provided in this section, the 1997 regulations do not apply to any bonds issued on or after May 16, 1997, to refund a bond to which those regulations do not apply unless--

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than-

(A) The weighted average maturity of the refunded bonds;
or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(d) Permissive application of regulations. Except as provided in paragraph (e) of this section, the 1997 regulations may be applied in whole, but not in part, to actions taken before February 23, 1998, with respect to--

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997, that are subject to 141.

* * * * *

(h) Permissive retroactive application. Except as provided in paragraphs (d), (e) or (i) of this section, §§1.141-1 through 1.141-6(a), 1.141-7 through 1.141-14, 1.145-1 through 1.145-2, 1.149(d)-1(g), 1.150-1(a)(3), the definition of bond documents contained in §1.150-1(b) and §1.150-1(c)(3)(ii) may be applied by issuers in whole, but not in part, to--

(1) Outstanding bonds that are sold before February 17, 2006, and subject to section 141; or

(2) Refunding bonds that are sold on or after February 17, 2006, and subject to section 141.

* * * * *

(j) Effective dates for certain regulations relating to refundings. Except as otherwise provided in this section, §§1.141-13, 1.145-2(d), 1.149(d)-1(g), 1.150-1(a)(3) and 1.150-1(c)(3)(ii) apply to bonds that are sold on or after February 17, 2006, and that are subject to the 1997 regulations "(defined in paragraph (b)(1) of this section)".

Par. 6. Section 1.145-0 is amended by adding an entry to the table in numerical order for §1.145-2(d) to read as follows:

§1.145-0 Table of contents.

* * * * *

§1.145-2 Application of private activity bond regulations

* * * * *

(d) Issuance costs financed by prior issue.

Par. 7. In §1.145-2, paragraph (d) is added to read as follows:

§1.145-2 Application of private activity bond regulations

* * * * *

(d) Issuance costs financed by prior issue. Solely for purposes of applying the private business use test to a refunding issue under §1.141-13, the use of proceeds of the prior issue (or any earlier issue in a series of refundings)

to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

Par. 8. Section 1.149(d)-1 is amended by revising paragraph (g) and adding paragraph (h) to read as follows:

§1.149(d)-1 Limitations on advance refundings

* * * * *

(g) Limitation on advance refundings of private activity bonds. Under section 149(d)(2) and this section, interest on a bond is not excluded from gross income if any portion of the issue of which the bond is a part is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond). For this purpose, the term private activity bond--

(1) Includes a qualified bond described in section 141(e) (other than a qualified 501(c)(3) bond), regardless of whether the refunding issue consists of private activity bonds under §1.141-13; and

(2) Does not include a taxable bond.

(h) Effective dates--(1) In general. Except as provided in this paragraph (h), this section applies to bonds issued after June 30, 1993, to which §§1.148-1 through 1.148-11 apply, including conduit loans that are treated as issued after June 30, 1993, under paragraph (b)(4) of this section.

In addition, this section applies to any issue to which the election described in §1.148-11(b)(1) is made.

(2) Special effective date for paragraph (b)(3).

Paragraph (b)(3) of this section applies to any advance refunding issue issued after May 28, 1991.

(3) Special effective date for paragraph (f)(3).

Paragraph (f)(3) of this section applies to bonds sold on or after July 8, 1997 and to any issue to which the election described in §1.148-11(b)(1) is made. See §1.148-11A(i) for rules relating to certain bonds sold before July 8, 1997.

(4) Special effective date for paragraph (g). See §1.141-15 for the applicability date of paragraph (g) of this section.

Par 9. Section 1.150-1 is amended by revising paragraphs (a)(3) and (c)(3)(ii) to read as follows:

§1.150-1 Definitions.

(a) * * *

(3) Exceptions to general effective date. See §1.141-15 for the applicability date of the definition of bond documents contained in paragraph (b) of this section and the effective date of paragraph (c)(3)(ii) of this section.

* * * * *

(c) * * *

(3) * * *

(ii) Exceptions. This paragraph (c)(3) does not apply for purposes of sections 141, 144(a), 148, 149(d) and 149(g).

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: November 23, 2005

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.