

# Lesson 4

## Governmental Bonds

### Overview

---

**Purpose** This lesson explains how to distinguish a governmental bond from a private activity bond.

---

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

- Distinguish a governmental bond from a private activity bond
- Apply the following tests
  - private business use test
  - private security or payment test
  - private loan financing test
  - unrelated or disproportionate use test
- Explain the consequences, if any, for a bond that meets one or more of these tests

---

**Contents** This lesson contains the following topics:

<b>Topic</b>	<b>See Page</b>
Overview	1
Introduction	2
Section I – Private Business Use Test	3
Section II – Private Security or Payment Test	36
Section III – Private Loan Financing Test	56
Section IV – Unrelated or Disproportionate Use Test	61
Section V – Effective Dates	66
Section VI – Student Exercise	67
Summary	68

---

# Introduction

---

**In General** Bonds issued by a State, territory, possession of the United States, the District of Columbia, or any political subdivision thereof (“State or local governments”) are classified generally as either governmental bonds or private activity bonds.

---

**Why is this important?** A bond may be issued by a State or local government as a governmental bond, but analysis of the use of proceeds or of the bond may reveal that the bond is actually a private activity bond. In addition, the State or local government may take a deliberate action after the issuance of the bond that may turn a governmental bond into a private activity bond. In either case, the issuer may lose all or a portion of the tax law benefits of the bond issue.

---

**Definition of Governmental Bond** A governmental bond is an obligation of a State or local government that is issued to finance governmental purposes, meets the eligibility requirements for interest on the obligation to be excludable from the gross income of the owner of the obligation and is not a private activity bond.

---

**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
- 

**Reasonable Expectations** The issuer’s reasonable expectations must take into account events and actions over the entire stated term of an issue.

See Regulations § 1.141-2(d)(2).

---

# Section I

## Private Business Use Test

### Overview

---

**Contents** This section contains the following topics:

Topic	See Page
Overview	3
Introduction	4
Basic Private Business Use Arrangements	7
Management Contracts	9
Arrangements That Are Not Management Contracts	16
Research Agreements	17
Comparable Use	21
Use by the General Public	23
Other Exceptions	26
Measurement of Private Business Use	30

---

## Introduction

---

### **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 in Section 3) is also met, the issue is an issue of private activity bonds. This section only discusses the private business use test.

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

---

### **Private Business Users**

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

See Regulations § 1.141-3(b).

---

*Continued on next page*

## Introduction, Continued

---

### **Indirect and Direct Uses**

In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of bond proceeds.

A facility is treated as being used for a private business use if it is:

- leased to a nongovernmental person and subleased to a governmental person, or
- leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business.

The issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met

See Regulations § 1.141-3(a)(2).

---

### **Leases**

A lease of financed property to a nongovernmental person for use in a trade or business is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease.

---

### **Actual and Beneficial Uses**

Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer.

See Regulations § 1.141-3(b)(1).

---

### **Proceeds and Property**

The use of bond proceeds includes the direct use of bond proceeds of the issue or use of the bond-financed property.

See Regulations § 1.141-3(a)(2).

---

*Continued on next page*

## Introduction, Continued

---

**Aggregate Use** The use of proceeds by **all** nongovernmental persons is aggregated to determine whether the private business use test is met.

See Regulations § 1.141-3(a)(3)

---

**Output Contracts** Special rules for output contracts are in Regulations §§ 1.141-7 through 1.141-8. These rules apply to bonds sold on or after November 22, 2002.

See Treasury Decisions (T.D.) 8941 for the special rules found in Regulations § 1.141-7T as in effect from January 19, 2001, to November 21, 2002. See T.D. 8757 for the special rules in effect prior to January 19, 2001.

---

## Basic Private Business Use Arrangements

---

**Recall –  
Transferring  
Ownership of  
or Leasing  
Financed  
Property May  
Be Private Uses**

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

See Regulations § 1.141-3(b).

---

**Example 1  
Ownership**

State Alpha issues 20-year bonds to purchase the site for and construct and equip a building. Alpha then enters into an arrangement with Corporation Beta to sell the building to Beta on an installment basis while the bonds are outstanding.

The issue meets the private business use test because a nongovernmental person owns the financed facility.

---

**Example 2  
Lease**

State Alpha issues 20-year bonds to purchase the site for and construct and equip a building. Alpha then enters into an arrangement with Corporation Beta whereby Alpha leases the factory to Beta for a 5-year term.

The issue meets the private business use test because a nongovernmental person is using the financed facility for more than 10 percent of the measurement period. (See section entitled “Measurement of Private Business Use” below.)

---

*Continued on next page*

## Basic Private Business Use Arrangements, Continued

---

### **Example 3 Lease**

City of Gamma issues bonds on behalf of Nonprofit Corporation Delta to finance the construction of a hospital. Delta will own legal title to the hospital. In addition, Delta will operate the hospital, but Delta is not treated as an agent of Gamma in its capacity as operator of the hospital. Gamma has certain rights to the hospital that establish that Gamma is properly treated as the owner of the property for federal income tax purposes. Gamma does not have rights, however, to directly control operation of the hospital while Delta owns legal title to it and operates it.

The issue meets the private business use test because the arrangement provides a nongovernmental person an interest in the financed facility that is comparable to a leasehold interest.

---

## Management Contracts

---

**Recall – A Management Contract of Financed Property May Be a Private Business Use**

In general, a nongovernmental person engaged in a trade or business is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- **a management or incentive payment contract;** or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract

See Regulations § 1.141-3(b).

---

**General Rule**

Generally, a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

See Regulations § 1.141-3(b)(4)(i); see also Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38 (Management Contract Guidelines). Rev. Proc. 97-13 can be found in Federal Taxation of Municipal Bonds.

---

**Definition**

A management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

See Regulations § 1.141-3(b)(4)(ii).

---

*Continued on next page*

## Management Contracts, Continued

---

### **Treatment as Lessee**

Further, a management contract with respect to financed property generally results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal tax purposes.

See § 1.141-3(b)(4)(iv).

---

### **Arrangements not Treated as Net Profit Arrangements**

(a) Generally, compensation under a management contract is not based on net profits if it is based on: (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee.

See Rev. Proc 97-13, § 4.02(2).

---

### **Permissible Arrangements**

Section 5.03 of Rev. Proc. 97-13 provides permissible terms (safe harbors) that do not cause the management contract to result in private business use.

---

### **Renewal Option**

Under Rev. Proc. 97-13, if the service provider (manager) has a legally enforceable right to renew the contract, the contract has a renewal option.

---

### **Certain Relationships**

A management contract is not within the safe harbors of Rev. Proc 97-13 if the service provider has a role or relationship with the qualified user (governmental person) to the extent that the relationship limits the ability of the qualified user to exercise its rights, including the right to terminate the contract. No such role or relationship is present if-

- (a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;
  - (b) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and
  - (c) The qualified user and the service provider under the contract are not related parties, as defined in Regulations § 1.150-1(b).
- 

*Continued on next page*

## Management Contracts, Continued

---

### Compensation Arrangements - Hypothetical Set #1

County of Alpha uses proceeds of tax-exempt bonds to finance the construction of a courthouse. Alpha enters into a contract with Corporation Beta pursuant to which Beta is to manage the cafeteria located in the courthouse.

- The contract is a management contract and may result in private use depending on all the facts and circumstances.
- 

### Compensation Terminology

What are the compensation terms of the management contract between Alpha and Beta?

*What if* the contract provides that Beta's compensation will equal 5 percent of the net profits of the cafeteria?

- The management contract is based on net profits.

*What if* the contract provides that Beta will receive 10 percent of the gross receipts of the cafeteria?

- The management contract is based only on gross receipts and not gross receipts and expenses from the facility.

*What if* Beta receives \$2 for each meal served at the cafeteria?

- The management contract is based on a per-unit fee. See definition of "per-unit fee" in section 3.06 of Rev. Proc. 97-13 as modified by section 4.02 of Rev. Proc. 2001-39.

*What if* Beta's compensation will be \$X per month?

- The management contract is based on a periodic fixed fee.
- 

*Continued on next page*

## Management Contracts, Continued

---

**Compensation Arrangements - Hypothetical Set #1**  
(continued)

*What if* the contract is for a term of 15 years (including renewal options) and Beta's compensation will be (i) \$X per month and (ii) 1 percent of gross receipts of the cafeteria during such month. The contract further provides that in no event will the amount received by Beta under clause (ii) be more than 5 percent of Beta's total compensation each month.

- The management contract does not result in private use because the management contract provides that 95 percent of Beta's compensation is a period fixed fee and the term of the agreement is 15 years. See section 5.03(1) of Rev. Proc. 97-13.

*What if* the contract is for a term of 7 years (including renewal options) and Beta's compensation will be (i) \$X per month and (ii) 5 percent of gross receipts of the cafeteria during such month. The contract provides that in no event will the amount received by Beta under clause (ii) be more than 20 percent of Beta's total compensation each month.

- The management contract does not result in private use because the management contract provides that 80 percent of Beta's compensation is a periodic fixed fee and the term of the agreement is for a term of less than 10 years. See section 5.03(2) of Rev. Proc. 97-13.

*What if* the contract is for a term of 5 years (including all renewal options) terminable by Alpha after three years without penalty after reasonable notice and Beta's compensation for each month will be (i) \$X per month and (ii) the lesser of 2 percent of gross revenues per month and \$X dollars?

- The management contract does not result in private use because at least 50% of Beta's compensation is based on a periodic fixed fee, and the term of the agreement is 5 years and terminable by Alpha after three years without penalty. See section 5.03(4) of Rev. Proc. 97-13.

---

*Continued on next page*

## Management Contracts, Continued

---

### Compensation Arrangements – Hypothetical Set #2

County of Gamma uses proceeds of tax-exempt bonds to finance the construction of a hospital.

*What if* Gamma enters into a management contract with Corporation Delta to manage its dialysis department for a term of 3 years, the contract is terminable by Gamma without penalty after 2 years and Delta will receive \$10 from each payment that County receives from Medicare reimbursement for each patient using the dialysis department?

- The management contract does not result in private use because Delta’s compensation is a per-unit fee and the term of the agreement (including renewal options) is 3 years and is terminable by Gamma without penalty after 2 years. The management contract meets the requirements of section 5.03(5) of Rev. Proc. 97-13.

*What if* the dialysis department is a new facility and the management contract provides that Delta will receive 25 percent of the gross revenues of the dialysis department for the first two years and Gamma may terminate the contract (after providing 60 days’ notice) at the end of the first year without payment of any penalty to Delta?.

- The management contract does not result in private use because the facility is in its “start up” phase, Delta’s compensation is based on a percentage of gross revenues, the term of the agreement (including renewal options) is 2 years and the contract is terminable by Gamma without penalty after 1 year after reasonable notice. The management contract meets the requirements of section 5.03(6) of Rev. Proc. 97-13.

---

*Continued on next page*

## Management Contracts, Continued

---

### Compensation Arrangements – Hypothetical Set #3

Epsilon Hospital, a 501(c)(3) organization, uses proceeds of tax-exempt bonds to finance the construction of a hospital.

*What if* Epsilon enters into a contract with HMO pursuant to which HMO will send its patients to Epsilon and Epsilon will provide services to such patients? The contract provides that HMO will pay \$100 per patient per month to Epsilon.

- The compensation is not considered to be based on a share of net profits because the compensation under the management contract is based on a capitation fee. See definition of capitation fee under section 3.02 of Rev. Proc. 97-13 as modified by section 4.01 of Rev. Proc. 2001-39.

*What if* Epsilon enters into a contract with Corporation Zeta pursuant to which Zeta is to manage the radiology department located in the hospital facility and the contract provides that Zeta will receive \$100 at the end of Epsilon's fiscal year if the gross receipts of the radiology department increase by 5 percent during Epsilon's fiscal year?

- The productivity reward does not cause the compensation to be based on a share of net profits because the productivity reward is based on increase of gross receipts only. See section 5.02(3) of Rev. Proc. 97-13.

*What if* Epsilon enters into a contract with Zeta to manage the department, there are 6 members on the Board of Directors of Epsilon and Zeta is wholly owned by the chairperson of the Board of Directors of Epsilon and two doctors that serve on the Board?

- The management contract does not meet the safe harbor under section 5.04(2) of Rev. Proc. 97-13 because more than 20% of the voting power of the Board of Directors of the Epsilon is vested in shareholders of the Zeta. Whether the management contract results in private use will depend on all the facts and circumstances.

---

*Continued on next page*

## Management Contracts, Continued

---

**Compensation  
Arrangements  
– Hypothetical  
#4**

City of Iota uses proceeds of bonds to finance an office building. The office building includes a cafeteria that is open to the general public.

*What if* Iota enters into a contract labeled “management contract” with Corporation Kappa to manage the cafeteria for a term of 10 years and Kappa receives all the receipts of the cafeteria and in turn gives \$X per month to Iota? Kappa has complete discretion to manage the cafeteria without any input from Iota.

- Notwithstanding the contract’s title, the contract is a lease and should not be analyzed under Rev. Proc. 97-13. See Regulations § 1.141-3(b)(3).
-

## Arrangements That Are Not Management Contracts

---

### **Incidental Contract**

A contact for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services) is **not** a management contact.

See Regulations § 1.141-3(b)(4)(iii)(A).

---

### **Hospital Admitting Privileges**

The mere granting of admitting privileges by a hospital to a doctor is **not** a management contract, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area consistent with the size and nature of its facilities.

See Regulations § 1.141-3(b)(4)(iii)(B).

---

### **Operation of Public Utilities**

A contract to provide for the operation of facilities that consists predominantly of public utility property is **not** a management contract if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

See Regulations § 1.141-3(b)(4)(iii)(C).

---

### **Service Providers**

A contract to provide for services is not a management contract if the only compensation is reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

See Regulations § 1.141-3(b)(4)(iii)(D).

---

## Research Agreements

---

**Recall –  
Research  
Agreements  
May Create  
Private Use**

In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- **research contract**

See Regulations § 1.141-3(b).

---

**Generally**

An agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research based on all the facts and circumstances. Regulations § 1.141-3(b)(6)(ii).

An agreement by a nongovernmental person to sponsor research with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes. See Regulations § 1.141-3(b)(6)(ii).

See Rev. Proc. 2007-47, 2007-2 C.B. 108 (Research Agreements and Private Business Use Test), which can be found in Federal Taxation of Municipal Bonds.

---

**Basic Research**

Any original investigation for the advancement of scientific knowledge not having a specific commercial objective is considered basic research. For example, product testing supporting the trade or business of a specific nongovernmental person is not treated as basic research.

See section 3.01 of Rev. Proc. 2007-47.

---

*Continued on next page*

## Research Agreements, Continued

---

### **Corporate Sponsored Research**

A research agreement relating to property used for basic research supported or sponsored by a sponsor does not result in private use if -

- (i) any license or other use of resulting technology by the sponsor is permitted only on the same terms as the recipient would permit that use by any unrelated, non-sponsoring party (that is, the sponsor must pay a competitive price for its use); and
- (ii) the price paid for that use must be determined at the time the license or other resulting technology is available for use

The government entity is not required to permit persons other than the sponsor to use any license or other resulting technology. However, the price paid by the sponsor must be no less than the price that would be paid by any non-sponsoring party for those same rights.

See section 6.02 of Rev. Proc. 2007-47.

---

*Continued on next page*

## Research Agreements, Continued

---

**Industry or  
Federally-  
Sponsored  
Research  
Agreements**

A research agreement relating to property used pursuant to an industry-Federal Government research arrangement does not result in private use if -

- (i) A single sponsor agrees, or multiple sponsors agree, to fund governmentally performed basic research;
- (ii) The qualified user determines the research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research);
- (iii) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and
- (iv) The sponsor or sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.

For purposes of (i) through (iv) above, the rights of the Federal Government and its agencies mandated by the Bayh-Dole Act does not result in private use if the license granted to any party other than the qualified user to use the product of the research is no more than a nonexclusive, royalty-free license.

See sections 6.03 and 6.04 of Rev. Proc. 2007-47.

---

*Continued on next page*

## Research Agreements, Continued

---

### Research Agreements – Hypothetical Set

University of Upsilon, a university established under state law, finances the building housing its life sciences department with proceeds of tax-exempt bonds.

*Assume that* Upsilon and Corporation Chi enter into a research agreement whereby Chi sponsors research related into a particular bacteria and its effect on the human body. The agreement provides that any resulting technology from the research may be acquired by Chi at the end of the term of the research agreement at the fair market value when it is acquired.

- The research agreement does not result in private use of the bond-financed property by Chi. See section 6.02 of Rev. Proc. 2007-47.

*Assume that* Upsilon and Xi Association, a group of corporations that manufacture and sell drugs, enter into a research agreement whereby Xi provides a grant to the Upsilon to sponsor research related to a particular bacteria and its effect on the human body. The agreement provides that Upsilon will have control over the specific research to be performed and the Upsilon's professors and students will do the research. Further, any resulting technology (patent, etc.) from the research will be owned by Upsilon. Xi, or its members, will have a nonexclusive, royalty free license to use the resulting technology.

- The research agreement does not result in private use of the bond-financed property by Xi. See section 4.03 of Rev. Proc. 97-14.

*Assume that* Upsilon and the National Institutes of Health (NIH), an agency of the U.S. Department of Health & Human Services, enter into a research agreement whereby NIH provides a grant to Upsilon to sponsor research related into a particular bacteria and its effect on the human body. The agreement provides that Upsilon will have control over the specific research to be performed and the Upsilon's professors and students will do the research. Further, any resulting technology (patent, etc.) from the research will be owned by Upsilon. NIH will have a nonexclusive, royalty free license to use the resulting technology. In addition, the agreement also provides that if Upsilon fails to make the product of the research available to the public on reasonable terms or if action is necessary to alleviate health or safety needs, NIH may grant a nonexclusive, royalty free license to a third party nongovernmental person to use the product of the research (march-in rights).

- The research agreement does not result in private use of the bond-financed property by NIH. See sections 6.03 and 6.04 of Rev. Proc. 2007-47.
-

## Comparable Use

---

### **General**

Any other arrangement that conveys special legal entitlements for beneficial use of the bond proceeds or financed property that are comparable to special legal entitlements of ownership, leases, management contracts, output contracts, or research agreements described above results in private business use.

See Regulations. § 1.141-3(b)(7)(i).

---

### **Priority Rights**

An arrangement that conveys priority rights to the use or capacity of a facility is private business use.

See Regulations. § 1.141-3(b)(7)(i).

---

### **Economic Benefit -- Facilities Not Available for Use by the General Public**

In the case of financed property that is not available for use by the general public, private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons. This is true even if those nongovernmental persons have no special legal entitlement to use of the property.

See Regulations § 1.141-3(b)(7)(ii).

---

*Continued on next page*

## Comparable Use, Continued

---

### **Special Economic Benefit Test**

In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including one or more of the following factors:

- Whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person
- Whether only a small number of nongovernmental persons receive the special economic benefit; AND
- Whether the cost of the financed property is treated as depreciable by any nongovernmental person

See Regulations § 1.141-3(b)(7)(ii).

---

## Use by the General Public

---

**Public Use** Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

See Regulations § 1.141-3(c).

---

**200 Day Use** Arrangements longer than 200 days are NOT treated as general public use.

See Regulations § 1.141-3(c)(3).

---

**Priority Rights** In general, an arrangement that conveys priority rights to the use or capacity of a facility is NOT use on the same basis as the general public. Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. This includes different rates for different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable.

See Regulations. § 1.141-3(c)

---

*Continued on next page*

## Use by the General Public, Continued

---

### General Public Use – Hypothetical Set #1

State of Psi issues bonds to purchase land and construct a hotel for use by the general public (that is, tourists, visitors, and business travelers). The bond documents provide that Psi will own and operate the project for the term of the bonds. Psi will not enter into a lease or license with any user for use of rooms for a period longer than 200 days (although users may actually use rooms for consecutive periods in excess of 200 days). Psi charges the same rates to business travelers as to other guests.

- Use of the hotel by hotel guests who are traveling in connection with trades or businesses of nongovernmental persons is not a private business use of the hotel by these persons, because the hotel is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

*Assume that* Psi enters into an agreement with Corporation Tau having a term of 5 years that provides Tau the use of 10 percent of rooms for its corporate clients and employees.

- The 10 percent of the property reserved for the Tau is used in its trade or business is therefore considered to be private business use.

See Regulations § 1.141-3(c)(3).

---

### Other Actual or Beneficial Use – Hypothetical #2

Corporation Lambda and City of Mu enter into a plan to finance the construction of a parking lot adjacent to Lambda's factory. Pursuant to the plan, Lambda conveys the site for the parking lot to Mu for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, Mu agrees that Lambda will have the right to approve rates charged by Mu for use of the parking lot. Mu issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied.

- There is private business use of the parking lot. A nongovernmental person has special legal entitlements for beneficial use of the parking lot that are comparable to an ownership interest.

See Regulations § 1.141-3(b)(7)(i) and Example 5 of Regulations § 1.141-3(f).

---

*Continued on next page*

## Use by the General Public, Continued

---

**Other Actual or  
Beneficial Use –  
Hypothetical #3**

Pi Authority, a political subdivision, owns and operates a hydroelectric generation plant and related facilities. Pursuant to a take or pay contract, Pi sells 15 percent of the output of the plant to Corporation Rho, an investor-owned utility. Rho is treated as a private business user of the plant. Under the license issued to Pi for operation of the plant, Pi is required by federal regulations to construct and operate various facilities for the preservation of fish and for public recreation. Pi issues its obligations to finance the fish preservation and public recreation facilities. Rho has no special legal entitlements for beneficial use of the financed facilities. The fish preservation facilities are functionally related to the operation of the plant. The recreation facilities are available to natural persons on a short-term basis according to generally applicable and uniformly applied rates. The recreation facilities are treated as used by the general public. Rho's use is not treated as private business use of the recreation facilities because Rho has no special legal entitlements for beneficial use of the recreation facilities. The fish preservation facilities are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business.

- Under all of the facts and circumstances (including the functional relationship of the fish preservation facilities to property used in Rho's trade or business), Rho derives a special economic benefit from the fish preservation facilities. Therefore, Rho's private business use may be established solely on the basis of that special economic benefit, and Rho's use of the fish preservation facilities is treated as private business use.

See Regulations § 1.141-3(b)(7)(ii) and Example 6 under Regulations § 1.141-3(f).

---

## Other Exceptions

---

### **Agents**

Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person is not private business use.

See Regulations § 1.141-3(d)(1).

---

### **Use Incidental to Financing**

Use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. For example, bond trustees, servicers, and guarantors are generally not treated as private business users.

See Regulations § 1.141-3(d)(2).

---

### **Certain 100 Day Arrangements**

Use by a nongovernmental person is not private business use if:

- The term of use under the arrangement, including all renewal options, is less than 100 days;
- The arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and
- The property is not financed for the principal purpose of providing that property for use by that nongovernmental person.

See Regulations § 1.141-3(d)(3)(i).

---

*Continued on next page*

## Other Exceptions, Continued

---

### **50 Day Use**

Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if:

- The term of use, including all renewal options, is not longer than 50 days;
- The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value; and
- The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

See Regulations § 1.141-3(d)(3)(ii) and Example 16 under Regulations § 1.141-3(f).

---

### **Temporary Use by Developers**

Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if --

- the issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and property benefited by that improvement, and to transfer the improvement to a governmental person, and
- the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed

See Regulations § 1.141-3(d)(4).

---

*Continued on next page*

## Other Exceptions, Continued

---

### Incidental Use

Incidental use of a financed facility is disregarded to the extent that such use does not exceed 2.5 percent of the proceeds of the issue. A use of a facility by a nongovernmental person is incidental if:

- **Except for vending machines, pay telephones, kiosks, and similar uses**, the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers
- The nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); AND
- All nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility

See Regulations § 1.141-3(d)(5).

---

### Qualified Improvements

Proceeds that provide a governmental owned improvement to a governmental owned building (including land functionally related and subordinate to the building) are not used for a private business use if:

- The building was placed in service more than one year before the construction or acquisition of the improvement is begun
- The improvement is not exclusively for any private business use
- No portion of the improved building or any payments in respect of the improved building are taken into account under § 141(b)(2)(A) (the private security test); AND
- No more than 15 percent of the improved building is used for a private business use

See Regulations § 1.141-3(d)(6).

---

*Continued on next page*

## Other Exceptions, Continued

---

**Exceptions to  
the Private  
Business Use  
Rule -  
Hypothetical**

Authority Eta, a political subdivision, uses all of the proceeds of its tax exempt bonds to construct a prison. Eta contracts with Federal Agency Theta to house federal prisoners on a space-available, first-come, first-served basis, pursuant to which Theta will be charged approximately the same amount for each prisoner as other persons that enter into similar transfer agreements. It is reasonably expected that other persons will enter into similar agreements. The term of the use under the contract is not longer than 100 days, and Theta has no right to renew, although Eta reasonably expects to renew the contract indefinitely. The prison is not financed for a principal purpose of providing the prison for use by Theta. It is reasonably expected that during the term of the bonds, more than 10 percent of the prisoners at the prison will be federal prisoners.

- Theta's use of the facility is not general public use because this type of use (leasing space for prisoners) is not available for use on the same basis by natural persons not engaged in a trade or business. The issue does not meet the private business use test, however, because the lease is not longer than 100 days.

See Regulations § 1.141-3(d)(3)(i) and Example 15 under Regulations § 1.141-3(f).

---

## Measurement of Private Business Use

---

**General Rule** In general, the private business use of proceeds is allocated to property under § 1.141-6. The amount of private business use of property is determined according to the average percentage of private business use of that property during the measurement period.

See Regulations § 1.141-3(g)(1). (Proposed regulations published September 26, 2006, address the allocation of proceeds to property, including mixed-use property. These rules are intended to be applied prospectively from a date after final regulations are published.)

---

**Measurement Period – General Rules** Generally, the measurement period of property financed by an issue begins on the **later** of:

- the issue date of that issue, OR
- the date the property is placed in service

The measurement period 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)

See Regulations § 1.141-3(g)(2)(i).

Example: On June 1, 2000, County issues bonds to construct an office building for its own use. The construction is completed on August 15, 2003, and the building is placed in service on such date. The reasonably expected life of the building is 40 years and the latest maturity date of any bond of the issue is June 1, 2030. The measurement period for the office building begins on August 15, 2003, and ends on June 1, 2030.

---

*Continued on next page*

## Measurement of Private Business Use, Continued

---

**Measurement  
Period When  
Refunding**

For short-term obligations that the issuer reasonably expects to refund (such as bond anticipation notes), the measurement period is based on the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates).

See Regulations § 1.141-3(g)(2)(ii).

Example: On June 1, 2000, County issues bond anticipation notes to finance the construction of an office building. The construction is completed on August 15, 2003, and the building is placed in service on such date. On September 1, 2003, County issues bonds to refund the BANs. The reasonably expected life of the building is 40 years and the latest maturity date of bond issue is June 1, 2030. The measurement period for the office building begins on August 15, 2003, and ends on June 1, 2030.

---

**Use Resulting  
from  
Ownership**

The amount of private business use resulting from ownership by a nongovernmental person is the greatest percentage of private business use in any one-year period.

See Regulations § 1.141-3(g)(2)(iv).

---

**Anti-Abuse  
Rule**

The Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any one-year period, if an issuer establishes the term of an issue for a period that is longer than is reasonably necessary for the governmental purposes of the issue for a principal purpose of increasing the permitted amount of private business use.

See Regulations § 1.141-3(g)(2)(v).

---

*Continued on next page*

## Measurement of Private Business Use, Continued

---

### **Determining Average Use**

The average percentage of private business use is the average of the percentages of private business use during the one-year periods within the measurement period. The percentage of private business use during any one-year period is determined by comparing the amount of private business use during the year to the total amount of all use (private business use and government use) during the year.

See Regulations § 1.141-3(g)(3) and (4)(i).

---

### **Use at Different Times**

For a facility in which actual governmental use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. Periods of nonuse are disregarded when computing percentage use.

For example, the average amount of private business use of a stadium generally is based on the total number of days the stadium is actually used for events.

See Regulations § 1.141-3(g)(4)(ii).

---

### **Simultaneous Use**

In general, for a facility in which governmental and private business use occur simultaneously, the facility is treated as having private business use. For example, a governmental owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use.

If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility.

For example, the average amount of private business use of a garage with unassigned spaces is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

See Regulations § 1.141-3(g)(4)(iii).

---

*Continued on next page*

## Measurement of Private Business Use, Continued

---

### **Discrete Portion**

Measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility. A discrete portion is a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls partitions, or other physical barriers are examples of a discrete portion.

See Regulations § 1.141-3(g)(4)(iv); § 1.141-1(b).

---

### **Fair Market Value**

If the private business use is reasonably expected to have a greater fair market value than the government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use.

See Regulations § 1.141-3(g)(4)(v).

---

### **Common Areas**

The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of a facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit. Common areas are portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

See Regulations § 1.141-3(g)(5) and § 1.141-1(b).

---

*Continued on next page*

## Measurement of Private Business Use, Continued

---

**Neutral Costs** Proceeds that are used to pay costs of issuance, invested in a reserve or replacement fund, or paid as fees for a qualified guarantee or a qualified hedge must be allocated ratably among the other purposes for which the proceeds are used.

See Regulations § 1.141-3(g)(6).

---

**Commencement of Measurement of Private Business Use** Generally, private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if the issuer enters into an arrangement for private business use a substantial period (at least 10% of the measurement period) before the right to actual private business use commences and the arrangement transfers ownership or is an arrangement for long-term use, private business use commences on the date the arrangement is entered into.

See Regulations § 1.141-3(g)(7).

---

*Continued on next page*

## Measurement of Private Business Use, Continued

---

**Private  
Business Use  
Allocations –  
Hypothetical #1**

City of Kappa issues bonds and uses all of the proceeds to construct a stadium. Kappa enters into a long-term contract with a professional sports team Lambda under which Lambda will use the stadium 20 times during the year. This use will occur on nights and weekends. Kappa reasonably expects that the stadium will be used more than 180 other days each year, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of Lambda's uses when compared to the other uses of the stadium, taking into account the payments that Lambda is reasonably expected to make for its use.

- Assuming no other private business use, the issue does not meet the private business use test because not more than 10 percent of the use of the facility is for a private business use.

See Example 2 under Regulations § 1.141-3(g)(8).

---

**Private  
Business Use  
Allocations –  
Hypothetical #2**

City of Heta issues bonds to finance the construction of an airport terminal. Eighty percent of the leasable space of the terminal will be leased to private air carriers. The remaining 20 percent of the leasable space will be used, for the term of the bonds, by Heta for its administrative purposes.

- The common areas of the terminal, including waiting areas, lobbies, and hallways are treated as 80 percent used by the air carriers for purposes of the private business use test.

See Regulations § 1.141-3(g)(5) and Example 3 under Regulations § 1.141-3(g)(8).

---

## Section II

### Private Security or Payment Test

#### Overview

---

The private security or payment test is the second of the private business tests. If the private security or payment test **and** the private business use test described in Section I above are satisfied, a bond will be a private activity bond.

---

#### Contents

This section contains the following topics:

Topic	See Page
Overview	36
Introduction	37
Measurement of Private Payment and Security	38
Private Payments for Use	40
Allocation of Payments	43
Private Security Test	47
Generally Applicable Taxes	50
Waste Remediation Bonds	55

---

## Introduction

---

**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.

---

## Measurement of Private Payment and Security

---

**Present Value** In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

See Regulations § 1.141-4(b)(2)(i).

---

**Debt Service** Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. Debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of § 148(f).

See Regulations § 1.141-4(b)(ii).

---

*Continued on next page*

## Measurement of Private Payment and Security, Continued

---

### Measurement of Private Payment and Security – Hypothetical Set #1

City Alpha issues general obligation bonds with proceeds of \$10 million to finance a 5-story office building. The bonds bear interest at a variable rate that is recomputed monthly according to an index that reflects current market yields. The yield that the interest index would produce on the issue date is 6 percent. Alpha leases 1 floor of the office building to Corporation Beta, a nongovernmental person, for the term of the bonds.

- Under all of the facts and circumstances, Beta is treated as using more than 10 percent of the proceeds. Using the 6 percent yield as the discount rate, Alpha reasonably expects on the issue date that the present value of lease payments to be made by Beta will be 8 percent of the present value of the total debt service on the bonds. After the issue date of the bonds, interest rates decline significantly, so that the yield on the bonds over their entire term is 4 percent. Using this actual 4 percent yield as the discount rate, the present value of lease payments made by Beta is 12 percent of the present value of the actual total debt service on the bonds. The bonds are not private activity bonds because Alpha reasonably expected on the issue date that the bonds would not meet the private security or payment test and because Alpha did not take any subsequent deliberate action to meet the private security or payment test.

See Example 3(i) under Regulations § 1.141-4(g).

*Assume that 5 years after the issue date Alpha leases a second floor to Corporation S, a nongovernmental person, under a long-term lease.*

- Because Alpha has taken a deliberate action, the present value of the lease payments must be computed. On the date this lease is entered into, Alpha reasonably expects that the yield on the bonds over their entire term will be 5.5 percent, based on actual interest rates to date and the then-current rate on the variable fixed bonds. Alpha uses this 5.5 percent yield as the discount rate. Using this 5.5 percent yield as the discount rate, as a percentage of the present value of the debt service on the bonds, the present value of the lease payments made by S is 3 percent. The bonds are private activity bonds because the present value of the aggregate private payments from Beta and S is greater than 10 percent of the present value of debt service.

See Example 3(ii) under Regulations § 1.141-4(g).

---

## Private Payments for Use

---

### **Direct and Indirect**

Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person.

See Regulations § 1.141-4(c)(2)(i)(A).

---

### **Not to Exceed Actual Use**

Payments are taken into account only to the extent that they are made for the period of time that proceeds are used for a private business use.

Payments cannot exceed the percentage of private use. Thus if 7 percent of the proceeds of an issue is used by a person over the measurement period, payments with respect to the property financed with those proceeds are taken into account as private payments only to the extent that the present value of those payments does not exceed the present value of 7 percent of the debt service on the issue.

See Regulations § 1.141-4(c)(2)(i)(B).

---

### **Payments in Respect of Property**

Private payments include payments made with respect to property financed with bond proceeds, even if such payments are not made by the private business user of bond proceeds. However, such payments are not taken into account if they are reasonably allocable to other property being used by the person making the payment.

See Regulations § 1.141-4(c)(2)(i)(A).

---

### **Payments for Operating Expenses**

Payments for a use of proceeds do not include the portion of any payment properly allocable to the payment of ordinary and necessary expenses directly attributable to the operation and maintenance of the financed property used by the payer.

See Regulations § 1.141-4(c)(2)(i)(C).

---

*Continued on next page*

## Private Payments for Use, Continued

---

### Payments for Overhead

General overhead and administrative expenses are not directly attributable to operations and maintenance, so payment attributable to these expenses are included as payments for use.

See Regulations § 1.141-4(c)(2)(i)(C).

---

### Refinanced Debt Service

If the debt service on a bond issue is paid with proceeds of a refunding issue, the bond issue meets the private security or payment test if (and to the same extent that) the refunding issue meets the private security or payment test.

See Regulations § 1.141-4(c)(2)(ii).

---

### Private Payments for Use – Hypothetical #1

Gamma Authority, a political subdivision of a state, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. Under all of the facts and circumstances, the private business use test will be met with respect to each issue that will be used for the rehabilitation and construction of buildings that will be leased or sold to nongovernmental persons for use in their trades or businesses. Nongovernmental persons will make payments for these sales and leases. There is no limitation either on the number of issues or the aggregate amount of bonds that may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of Gamma, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by Gamma to pay the principal of, and the interest on, each issue.

- Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements. The payments relating to these leases and sales are taken into account as private payments to determine whether each issue of bonds meets the private security or payment test.

See Example 2 of Regulations § 1.141-4(g).

---

*Continued on next page*

## Private Payments for Use, Continued

---

**Private  
Payments for  
Use –  
Hypothetical #2**

In order to further public safety, City of Epsilon issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by Epsilon on the customers of the utility.

- Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Epsilon by the utility company for the undergrounding are, however, taken into account as private payments.

See Example 4 of Regulations § 1.141-4(g).

---

**Private  
Payments for  
Use –  
Hypothetical #3**

City of Zeta issues general obligation bonds to finance the renovation of a hospital that it owns. The hospital is operated for Zeta by Eta, a nongovernmental person, under a management contract that results in private business use under Regulations § 1.141-3. Zeta will use the revenues from the hospital (after the required payments to Eta and the payment of operation and maintenance expenses) to pay the debt service on the bonds.

- The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

See Regulations § 1.141-4(c)(2)(i)(A) and Example 5 of Regulations § 1.141-4(g).

---

## Allocation of Payments

---

### **Generally**

Private payments for the use of property are allocated to the source or different sources of funding of property. The allocation to the source or different sources of funding is based on all of the facts and circumstances. In general, a private payment for the use of property is allocated to a source of funding based upon the nexus between the payment and both the financed property and the source of funding. For this purpose, different sources of funding may include different tax-exempt issues, taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

See Regulations § 1.141-4(c)(3)(i).

---

### **Discrete Property**

Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.

See Regulations § 1.141-4(c)(3)(ii).

---

*Continued on next page*

## Allocation of Payments, Continued

---

### **Allocation among Two or More Sources**

Generally, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property.

If an issuer has not retained records of amounts expended on the property (for example, records of costs of a building that was built 30 years before the allocation), an issuer may use reasonable estimates of those expenditures. For this purpose, costs of issuance and other similar neutral costs are allocated ratably among expenditures in the same manner as in Regulations § 1.141-3(g)(6).

A payment for the use of property may be allocated to two or more issues that finance property according to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if that allocation reasonably reflects the economic substance of the arrangement. In general, allocations of payments according to relative debt service reasonably reflect the economic substance of the arrangement if the maturity of the bonds reasonably corresponds to the reasonably expected economic life of the property and debt service payments on the bonds are approximately level from year to year.

See Regulations § 1.141-4(c)(3)(iii)

---

### **Payments Made in Connection with Issuance of Bonds**

A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue.

Whether an arrangement is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances. An arrangement is ordinarily treated as entered into in connection with the issuance of an issue if:

- (i) The issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and
- (ii) The amount of payments reflects all or a portion of debt service on the issue.

See Regulations § 1.141-4(c)(3)(iv).

---

*Continued on next page*

## Allocation of Payments, Continued

---

### **Allocation to Equity**

A private payment for the use of property may be allocated to equity before payments are allocated to an issue only if:

- (i) Not later than 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to Regulations § 1.150-2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and
- (ii) The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

See Regulations § 1.141-4(c)(3)(v).

---

### **Allocation of Payments – Hypothetical #1**

City Z purchases property for \$1,250,000 using \$1,000,000 of proceeds of its tax increment bonds and \$250,000 of other revenues that are in its redevelopment fund. Within 60 days of the date of purchase, Z declared its intent to sell the property pursuant to a redevelopment plan and to use that amount to reimburse its redevelopment fund. The bonds are secured only by the incremental property taxes attributable to the increase in value of the property from the planned redevelopment of the property. Within 18 months after the issue date, Z sells the financed property to Developer M for \$250,000, which Z uses to reimburse the redevelopment fund. The property that M uses is financed both with the proceeds of the bonds and Z's redevelopment fund. The payments by M are properly allocable to the costs of property financed with the amounts in Z's redevelopment fund.

See Example 7 of Regulations § 1.141-4(g).

---

*Continued on next page*

## Allocation of Payments, Continued

---

**Allocation of  
Payments –  
Hypothetical #2**

In 1997, City L issues bonds with proceeds of \$8 million to finance the acquisition of a building. In 2002, L spends \$2 million of its general revenues to improve the heating system and roof of the building. At that time, L enters into a 10-year lease with Corporation M for the building providing for annual payments of \$1 million to L. The lease payments are at fair market value, and the lease payments do not otherwise have a significant nexus to either the issue or to the expenditure of general revenues. Eighty percent of each lease payment is allocated to the issue and is taken into account under the private payment test because each lease payment is properly allocated to the sources of funding in a manner that reasonably corresponds to the relative amounts of the sources of funding that are expended on the building.

See Example 8 of Regulations § 1.141-4(g).

---

## Private Security Test

---

**General rule** Property used or to be used for a private business use and payments in respect of the property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds.

See Regulations § 1.141-4(d)(4).

---

**Security Taken into Account** The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with proceeds to the extent it is provided (directly or indirectly) by a user of proceeds of the issue.

See Regulations § 1.141-4(d)(2).

---

**Payments in Respect of Property** The payments taken into account as private security are payments in respect of property used or to be used for a private business use. To determine the amount of payments treated as payments in respect of property used or to be used for a private business use, generally, the same rules as for private payments apply.

Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

See Regulations § 1.141-4(d)(5).

---

**Allocation of Security** In general, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.

See Regulations § 1.141-3(d)(6).

---

*Continued on next page*

## Private Security Test, Continued

---

**Private  
Security Test –  
Hypothetical #1**

County of Theta issues certificates of participation in a lease of a building that Theta owns and covenants to appropriate annual payments for the lease. A portion of each payment is specified as interest. More than 10 percent of the building is used for private business use. None of the proceeds of the obligations are used with respect to the building. Theta uses the proceeds of the obligations to make a grant to Corporation Iota for the construction of a factory that Iota will own. Iota makes no payments to Theta, directly or indirectly, for its use of proceeds, and Iota has no relationship to the users of the leased building. If Theta defaults under the lease, the trustee for the holders of the certificates of participation has a limited right of repossession under which the trustee may not foreclose but may lease the property to a new tenant at fair market value.

- The obligations are secured by an interest in property used for a private business use. However, because the property is not provided by a private business user and is not financed property, the obligations do not meet the private security or payment test.

See Example 9 of Regulations § 1.141-4(g).

---

*Continued on next page*

## Private Security Test, Continued

---

**Private Security  
Test –  
Hypothetical #2**

Iota Park District issues \$10 million of bonds and uses proceeds of the issue to purchase a building to be used as a recreation center. As security for the bonds, Iota grants a mortgage on the recreation center financed with bond proceeds to the bond indenture trustee. Iota enters into a management contract with Corporation Kappa, a for-profit corporation, to operate the recreation facility. The management contract results in 100% private business use of the recreation center under Regulations § 1.141-3. The fair market value of the recreation center is \$10 million.

- The mortgage on the recreation center is treated as private security since a portion of the security for debt service on the bonds is property used (directly or indirectly) in a private business use by Kappa, a for-profit corporation..

See Regulations § 1.141-4(d)(4).

- The present value of the recreation center is compared to the present value of the debt service to be paid over the term of the issue in order to determine if there is private security. For purposes of determining the present value of debt service that is secured by property, the property is valued at the fair market value as of the first date on which the property secures bonds of the issue.

See Regulations § 1.141-4(b)(2).

- On the date of issuance, the present value of the fair market value of the recreation center is \$10 million. If the present value of debt service on the bonds is \$10 million, there is 100% private business use and 100% private security. The bonds are taxable private activity bonds.
-

## Generally Applicable Taxes

---

**General Rule** For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use).

See Regulations § 1.141-4(e)(1).

---

**Definition** With respect to bonds sold on or after October 24, 2008, unless the transition rule described below applies, a generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes or public purposes.

A transition rule applies to certain refunding bonds and projects substantially in progress as of October 19, 2006. Under the transition rule, a generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes.

See Regulations §§ 1.141-4(e)(2) and 1.141-15(k).

---

**Uniform Tax Rate** A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.

See Regulations § 1.141-4(e)(2).

---

*Continued on next page*

## Generally Applicable Taxes, Continued

---

**Special Charges** A special charge is not a generally applicable tax.

With respect to bonds sold on or after October 24, 2008, unless the transition rule described below applies, a special charge includes a payment for a special privilege granted or regulatory function (for example, a license fee), a service rendered (for example, a sanitation services fee), a use of property (for example, rent), or a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons based on benefits received from the capital improvements financed with the assessment.

A transition rule applies to certain refunding bonds and projects substantially in progress as of October 19, 2006. Under the transition rule a special charge is a payment for a special privilege granted or service rendered. Special assessments paid by property owners benefitting from financial improvements are not generally applicable taxes.

See Regulations §§ 1.141-4(e)(3) and 1.141-15(k).

---

**Impermissible Agreements**

The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection:

- an agreement to be personally liable on a tax that does not generally impose personal liability
- an agreement to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls
- an agreement regarding the minimum market value of property subject to property tax; AND
- an agreement not to challenge or seek deferral of the tax

See Regulations § 1.141-4(e)(4)(ii).

---

*Continued on next page*

## Generally Applicable Taxes, Continued

---

### Permissible Agreements

The following are examples of agreements that do not cause a tax to fail to have a generally applicable manner of determination and collection:

- an agreement to use a grant for specified purposes (whether or not that agreement is secured)
- a representation regarding the expected value of the property following the improvement
- an agreement to insure the property and, if damaged, to restore the property
- a right of a grantor to rescind the grant if property taxes are not paid;  
AND
- an agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose

See Regulations § 1.141-4(e)(4)(iii).

---

*Continued on next page*

## Generally Applicable Taxes, Continued

---

### Payments in Lieu of Taxes

With respect to bonds sold on or after October 24, 2008, unless the transition rule described below applies, a tax equivalency payment and any other payment in lieu of a tax (“PILOT”) is treated as a generally applicable tax if all of the following requirements are met:

- The PILOT is not greater than the amount imposed by statute for a generally applicable tax that would otherwise apply in each year.
- The PILOT is commensurate with the amount imposed by a statute for a generally applicable tax in each year. A PILOT generally is commensurate with a generally applicable tax only if it is equal to a fixed percentage of the generally applicable tax that would otherwise apply in each year or it reflects a fixed adjustment to the generally applicable tax that would otherwise apply in each year. A PILOT based on a property tax does not fail to be commensurate with the property tax as a result of changes in the level of the percentage of or adjustment to that property tax for a reasonable phase-in period ending when the subject property is placed in service (as defined in Regulations §1.150-2(c)). A PILOT based on a property tax must take into account the current assessed value of the property for property tax purposes for each year in which the PILOT is paid and that assessed value must be determined in the same manner and with the same frequency as property subject to the property tax. A PILOT is not commensurate with a generally applicable tax, however, if the PILOT is set at a fixed dollar amount (for example, fixed debt service on a bond issue) that cannot vary with changes in the level of the generally applicable tax on which it is based.
- The PILOT is to be used for governmental or public purposes for which the generally applicable tax on which it is based may be used.
- The PILOT is not a special charge.

A transition rule applies to certain refunding bonds and projects substantially in progress as of October 19, 2006. Under the transition rule, a PILOT is treated as a generally applicable tax if:

- The payment is commensurate with and not greater than the amounts imposed by a statute for a tax of general application, AND
- The payment is designed for a public purpose and is not a special charge under the transition rule described in the section “Special Charges” above.

See Regulations §§ 1.141-4(e)(5) and 1.141-15(k).

---

*Continued on next page*

## Generally Applicable Taxes, Continued

---

### Generally Applicable Taxes - Hypotheticals

Authority Lambda issues bonds to finance the construction of a stadium. Under a long-term lease, Corporation Mu, a professional sports team, will use more than 10 percent of the stadium. Mu will not, however, make any payments for this private business use. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium. The portion of the ticket tax attributable to tickets purchased by persons attending Mu's events will, on a present value basis, exceed 10 percent of the present value of the debt service on Lambda's bonds.

- The bonds meet the private security or payment test. The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to Mu's events, the taxes are payments in respect of property used for a private business use.

See Example 11(i) of Regulations § 1.141-4(g).

*Assume that* the ticket tax is imposed by Lambda on tickets purchased for events at a number of large entertainment facilities within Lambda's jurisdiction (for example, other stadiums, arenas, and concert halls), some of which were not financed with tax-exempt bonds.

- The ticket tax is a generally applicable tax and therefore the revenues from this tax are not payments in respect of property used for a private business use. The receipt of the ticket tax does not cause the bonds to meet the private security or payment test.

See Example 11 (ii) of Regulations § 1.141-4(g).

---

## Waste Remediation Bonds

---

**Purpose** Section 1.141-4(f) applies to bonds issued to finance hazardous waste clean-up activities on privately owned land.

---

**General Rule** Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated (cleaned up) or persons potentially responsible for disposing of hazardous waste on that site are not taken into account as private security. This provision applies only if the payments are made pursuant to either

- a generally applicable state or local taxing statute; or
- a state or local statute that regulates or restrains activities on an industry-wide basis of persons who are engaged in generating or handling hazardous waste or in refining, producing, or transporting petroleum,

provided that those payments do not represent, in substance, payment for the use of proceeds.

See Regulations § 1.141-4(f)(2)

---

**Persons that are Private Users**

The payments are not taken into account as private payments if payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds.

See Regulations § 1.141-4(f)(3) for additional requirements.

---

## Section III

### Private Loan Financing Test

---

**General Rule** 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 (with certain exceptions) to persons other than governmental persons.

See § 141(c) and Regulations § 1.141-5(a).

---

**Measurement Test** The amount actually loaned to a nongovernmental person is NOT discounted to reflect the present value of the loan repayments when determining whether the private loan financing test is met.

See Regulations § 1.141-5(b).

---

*Continued on next page*

## Private Loan Financing Test, Continued

---

### **Definition of Private Loan**

Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this section.

In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed.

The determination of whether a loan is made depends on the substance of a transaction rather than its form.

See Regulations § 1.141-5(c)(1).

---

### **Nonpurpose Loans**

A loan that is a nonpurpose investment does not cause the private loan-financing test to be met.

For example, proceeds invested in loans, such as obligations of the United States:

- during a temporary period,
- as part of a reasonably required reserve or replacement fund,
- as part of a refunding escrow, or
- as part of a minor portion

(as each of those terms are defined in Regulations § 1.148-1 or § 1.148-2) are generally not treated as loans under the private loan financing test.

See § 141(c) and Regulations § 1.141-5(c)(2)(i).

---

### **Prepayment Loans**

A prepayment for property or services is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller.

See § 141(c)(2)(C) and Regulations § 1.141-5(c)(2)(ii) for limited exceptions.

---

*Continued on next page*

## Private Loan Financing Test, Continued

---

**Tax Assessment Loans** A **tax assessment loan** is not a loan for purposes of the private loan financing test if certain requirements are met. A “tax assessment loan” arises when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies the following requirements:

- The tax or assessment must be an enforced contribution that is imposed and collected for the purpose of raising revenue to be used for a specific purpose (that is, to defray the capital cost of an improvement). The tax or assessment must be imposed pursuant to a state law of general application.
- The tax or assessment that must be imposed for one or more specific, essential governmental functions. See Regulations § 1.141-5(d)(4)(ii) for examples of essential governmental functions.
- Owners of both business and nonbusiness property benefiting from the financed improvements must be eligible, or required, to make deferred payments of the tax or assessment giving rise to tax assessment loan on an equal basis (the equal basis requirement).

See § 141(c)(2)(A) and Regulations § 1.141-5(d).

---

**Turnkey Contracts** Turnkey contracts where the proceeds of a bond issue are loaned to a developer to be used to construct or rehabilitate a facility and the facility is conveyed to the municipality upon completion do not cause the private loan financing test to be met.

See Regulations § 1.141-5(e) Example 1.

---

*Continued on next page*

## Private Loan Financing Test, Continued

---

**Private Loan  
Financing Test  
– Hypothetical  
#1**

City of Nu creates a special taxing district consisting of property owned by nongovernmental persons that requires environmental clean-up. Nu imposes a special tax on each parcel within the district in an amount that is related to the expected environmental clean-up costs of that parcel. The payment of the tax over a 20-year period is treated as a loan by the property owners for purposes of the private loan financing test. The special district issues bonds, acting on behalf of Nu, that are payable from the special tax levied within the district, and uses the proceeds to pay for the costs of environmental clean-up on the property within the district.

- The bonds meet the private loan financing test because more than 5 percent of the proceeds of the issue are loaned to nongovernmental persons. The issue does not meet the tax assessment loan exception because the improvements to property owned by a nongovernmental person are not an essential governmental function under § 141(c)(2).

See Example 2 of Regulations § 1.141-5(e).

In TAM 9250005, the Service held that City's tax increment bond, issued as a financial incentive for manufacturer to make improvements to its industrial facility, was a private activity bond. The tax was not a generally applicable tax because of impermissible agreements. Since the proceeds were not used for an essential governmental function, the bond also met the private loan financing test of § 141(c).

---

*Continued on next page*

## Private Loan Financing Test, Continued

---

**Private Loan  
Financing Test  
– Hypothetical  
#2**

State Agency Xi and federal agency Omicron will each contribute to rehabilitate a project owned by Xi. Omicron can only provide its funds through a contribution to Xi to be used to acquire the rehabilitated project on a turnkey basis from an approved developer. Under Omicron's turnkey program, the developer must own the project while it is rehabilitated. Xi issues its notes to provide funds for construction. A portion of the notes will be retired using the Omicron contribution, and the balance of the notes will be retired through the issuance by Xi of long-term bonds. Xi lends the proceeds of its notes to Developer B as construction financing and transfers title to B for a nominal amount. The conveyance is made on condition that B rehabilitate the property and reconvey it upon completion, with Xi retaining the right to force reconveyance if these conditions are not satisfied. B must name Xi as an additional insured on all insurance. Upon completion, B must transfer title to the project back to Xi at a set price, which price reflects B's costs and profit, not fair market value. Further, this price is adjusted downward to reflect any cost-underruns.

For purposes of § 141(c), this transaction does not involve a private loan.

See Example 1 of Regulations § 1.141-5(e).

---

# Section IV

## Unrelated or Disproportionate Use Test

### Overview

---

**Contents** This section contains the following topics:

<b>Topic</b>	<b>See Page</b>
Overview	61
In General	62
Deliberate Actions	64

---

## In General

---

### **General Rule**

Under § 141(b)(3) (the unrelated or disproportionate use test), an issue meets the private business tests if the amount of private business use and private security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue. The test is applied as follows:

- First, determine whether a private business use is related to a government use
- Next, examine private business use that relates to the government use to determine whether it is disproportionate to that government use
- Then, aggregate all the unrelated use and disproportionate use financed with the proceeds of an issue to determine compliance with the unrelated or disproportionate use test
- If such uses exceed 5 percent, apply the private security or payment test to the payments and security related to such uses.

---

### **Unrelated Use**

Whether a private business use is related to a government use financed with the proceeds of an issue is determined on a case-by-case basis, emphasizing the operational relationship between the government use and the private business use. In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.

See Regulations § 1.141-9(b)(1).

---

*Continued on next page*

## In General, Continued

---

**Use for Same Purpose as Government Use**

Use of a facility by a nongovernmental person for the same purpose as use by a governmental person is not treated as unrelated use if the government use is not insignificant. Similarly, a use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use does not result in unrelated use if the related use is not insignificant.

See Regulations § 1.141-9(b)(2).

---

**Disproportionate Use**

A private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use.

---

**Unrelated or Disproportionate Use – Hypothetical #1**

County of Pi issues \$20 million principal amount of bonds and uses \$18.1 million of the proceeds for construction of a new school building and \$1.9 million of the proceeds for construction of a privately operated cafeteria in its administrative office building, which is located at a remote site. The cafeteria secures the bonds, in part.

- The \$1.9 million of proceeds is unrelated to the government use (that is, school construction) financed with the bonds and exceeds five percent of \$20 million. Thus, the issue meets the private business tests.

See Example 1 of Regulations § 1.141-9(e).

---

**Unrelated or Disproportionate Use – Hypothetical #2**

County of Rho issues \$20 million principal amount of bonds for the construction of a hospital with no private business use (\$17 million); renovation of an office building with no private business use (\$1 million); and construction of a garage that is entirely used for private business use (\$2 million). The use of the garage is related to the use of the office building but not to the use of the hospital.

- The private business use of the garage results in \$1 million of disproportionate use because the proceeds used for the garage (\$2 million) exceed the proceeds used for the related government use (\$1 million). The bonds are not private activity bonds, however, because the disproportionate use does not exceed five percent of the proceeds of the issue.

See Example 4 of Regulations § 1.141-9(e).

---

## Deliberate Actions

---

### **Introduction**

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 conditions of either the private business tests (business use AND security or payment) or the private loan financing test to be met.

See Regulations § 1.141-2(d)(1).

---

### **Definition**

Generally, a deliberate action is any action taken by the issuer that is within its control. An intent to violate the requirements of § 141 is not necessary for an action to be deliberate.

See Regulations 1.141-2(d)(3)(i).

---

### **Safe Harbor Exceptions**

An action is not treated as deliberate if:

- It would be treated as an involuntary or compulsory conversion under § 1033, OR
- It is taken in response to a regulatory directive made by the federal government.

See Regulations § 1.141-2(d)(3)(ii).

---

### **Timing**

A deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

See Regulations. § 1.141-2(e).

---

### **Remedial Actions**

Regulations. § 1.141-12 provides certain remedial actions that an issuer can take to prevent a deliberate action with respect to property financed by an issue from causing that issue to meet the private business use test or the private loan financing test.

See Regulations § 1.141-2(f); see also Lesson 7 for a complete discussion of these rules.

---

*Continued on next page*

## Deliberate Actions, Continued

---

### Deliberate Actions – Hypotheticals

County owns and operates a hospital that was financed with proceeds of bonds the interest on which is excludable from gross income under § 103. On June 1, 2000, County enters into a purchase contract with Corporation, an organization described under § 501(c)(3) of the Code, to sell the hospital to Corporation. The purchase contract has no material contingencies. The settlement for the sale will not occur until October 1, 2000.

- The deliberate action occurred on June 1, 2000.

*Assume that* the purchase contract provides that the State's department of health must approve the transaction and Corporation must obtain a Certificate of Need. The purchase contract has material contingencies and thus the deliberate action does not occur when the contract is executed.

- Deliberate action will occur when all material contingencies have been removed or satisfied.

See Regulations § 1.141-2(e).

---

## Section V

### Effective Dates

---

<b>In General</b>	The effective dates of Regulations §§ 1.141-0 through 1.141-6(a), §§ 1.141-7 through 1.141-14 are more fully described in Regulations § 1.141-15.
<hr/>	
<b>Certain Short-Term Arrangements</b>	See Regulations § 1.141-15(b)(2).
<hr/>	
<b>Certain Prepayments</b>	See Regulations § 1.141-15(b)(3).
<hr/>	
<b>Refunding Bonds</b>	See Regulations §§ 1.141-15(c), (g), and (j).
<hr/>	
<b>Retroactive Application of 1997 Regulations</b>	See Regulations § 1.141-15(d), (e), (h), and (i).
<hr/>	
<b>Output Facilities</b>	See Regulations § 1.141-15(f)-(i).
<hr/>	
<b>Generally Applicable Taxes and PILOTs</b>	See Regulations § 1.141-15(k)(1) (in general). See Regulations § 1.141-15(k)(2)-(3) (transitional rules).
<hr/>	
<b>1986 Act</b>	See sections 1311 and 1312 of the Tax Reform Act of 1986 for effective dates and transition rules for the 1986 Act.
<hr/>	

## Section VI

### Student Exercise

---

**Basic Facts**

On June 1, 1997, City L issues revenue bonds using all of the proceeds to construct a stadium that it will own. The stadium is placed in service on June 1, 1999. L enters into a 20-year contract with a professional sports team, T, under which **T** will use the stadium **20 times** during the year. This use will occur on nights and weekends. L reasonably expects that the stadium will be used **not more than 80 other times each year**, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of T's use when compared to the other uses of the stadium.

T will not make any payments for its use of the stadium. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for T's events at the stadium. This ticket tax is unique to this stadium and is not imposed on other facilities in City L.

---

**Additional Information:**

Bond issue amount	\$100,000,000.
Fixed yield	5.348912 percent (30/360 basis)
Ticket tax	<ul style="list-style-type: none"><li>• \$3.00/ticket</li><li>• 50,000 attendees per event for T</li><li>• Payments are calculated annually on June 1</li></ul>
Total annual operating/maintenance costs for stadium. Costs are paid ratably throughout the year.	\$1,000,000
Total annual administrative costs for the stadium. Costs are paid ratably throughout the year.	\$400,000

---

# Summary

---

## Review of Lesson 4

A governmental bond is an obligation of a State or local government that is issued to finance governmental purposes, meets the eligibility requirements for interest on the obligation to be excludable from the gross income of the owner of the obligation, and is not a private activity bond.

In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of:

- ownership;
- actual or beneficial use of property, pursuant to a lease,
- a management or incentive payment contract; or
- certain other arrangements such as a take-or-pay or other output-type contract, or a
- research contract.

Except as otherwise provided in Regulations § 1.141-4, 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.

Property used or to be used for a private business use and payments in respect of the property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds.

The payments taken into account as private security are payments in respect of property used or to be used for a private business use. To determine the amount of payments treated as payments in respect of property used or to be used for a private business use, generally, the same rules as for private payments apply.

---