Lesson 4

General Rules for Private Activity Bonds

Overview

Introduction

Recall that under § 103(b), for the interest on a private activity bond to be tax-exempt, the bond must:

- be a qualified private activity bond,
- not be an arbitrage bond, AND
- meet the applicable requirements of § 149

To be a qualified private activity bond, § 141(e) provides that a bond must meet the:

- applicable requirements of § 142, 143, 144, OR 145, depending on the type of bond,
- volume cap requirements of § 146, AND
- applicable requirements of § 147

Lesson 4 discusses the rules set forth in §§ 146 and 147. These are general rules that apply mostly only to qualified private activity bonds and NOT to governmental bonds. Moreover, some of the rules do not apply to every type of qualified private activity bond. Failure to comply with these requirements precludes tax exemption for the interest on the bonds.

Lesson 4 also discusses the rules for depreciation of tax-exempt bond financed property set forth § 168 and the rule under § 57(a)(5) that requires individuals and corporations to include tax-exempt interest from "specified private activity bonds" in income for purposes of figuring the alternative minimum tax.

This lesson is divided into eleven sections, as indicated on page 3.

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Objectives

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

- Determine if the volume cap requirements have been met
- Identify a substantial user
- Explain the effect that a substantial user can have on the tax-exempt status of any bonds purchased and held by him/her
- Determine if the maturity limitation has been met
- Explain the limitations on use of proceeds for land acquisition
- Explain the limitations on acquisitions of existing property
- Identify the types of facilities that cannot be funded with tax-exempt bonds
- Explain the public approval requirements
- Explain the restrictions on use of proceeds for issuance costs
- Determine which depreciation rules apply to tax-exempt bond financed property placed in service after December 31, 1986
- Identify those bonds which are "specified private activity bonds," the interest on which is an item of tax preference for purposes of the Alternative Minimum Tax

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Overview, Continued

Contents

This lesson contains the following topics.

Section 1

Volume Cap

Overview

What is the Volume Cap?

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

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

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

Contents

This section contains the following topics.

General Rules

State Ceiling

The state ceiling limits the amount of tax-exempt private activity bonds that can be issued annually in each State. According to §§s 146(d)(1) and (2), for calendar years **after** 2001, this limit is equal to the greater of:

- $225 million, or
- $75 multiplied by the State's population

However, for bonds issued **after** calendar year 2002, the amounts are adjusted for a cost-of-living increase. These adjustments are published in a revenue procedure issued prior to the beginning of each year. For example, the adjustments for the calendar year 2011 are published in Rev. Proc. 2010-40, 2010-46 I.R.B. 663. These adjustments resulted in the following limits for 2011.

- $277,820,000, or
- $95 multiplied by the State's population.

For calendar year 2008, the Housing Assistance Tax Act of 2008, P.L. 110-289, provided an additional $11 billion to be apportioned among the States and added to the existing 2008 state ceiling for each State. This increase in a State's ceiling could be used solely for the purpose of issuing qualified mortgage bonds (single family bonds) and qualified residential rental projects (multifamily housing bonds). Single family bonds using this additional ceiling amount were only allowed a 12-month origination period, instead of the usual 42 month period. IRS Notice 2008-79 provides the additional amount of state ceiling that was allocated to each State. This additional amount could be carried forward for two years (solely for the purpose of issuing single family bonds and multifamily housing bonds in 2009 and 2010). A separate Form 8328 must have been used to make the carryforward election.

See § 146(d)(5), (f)(6), and (i)(6).

State population estimates

State population estimates used in the calculation of the State ceiling are published each year in a Notice. The Notice, entitled "20XX Calendar Year Resident Population Estimates" is usually published very early in the year.

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Allocation of State Ceiling

Except for States with constitutional home-rule cities, each state's ceiling is allocated among state issuers and local issuers as follows.

- 50 percent among the state and its agencies, AND
- 50 percent among local issuers and authorities within the state on the basis of relative populations.

Except with respect to constitutional home-rule cities, a state may provide a different formula for allocating the state ceiling among issuers in such state.

See § 146(b), (c), (d)(3), and (e).

Example 1

In 2011, State A's population consists of 10 million residents. The largest cities are City A with two million residents and City B with three million residents. The rest of the population resides in other, smaller cities.

State A's 2011 ceiling is equal to the greater of:

- $277,820,000, OR
- $95 multiplied by the total population (95 x 10,000,000=$950M)

Since $950M exceeds $277,820,000, State A's ceiling equals $950M

The state issuers are allocated a total of $475M, as are the local issuers. Since City A (population $2M) and City B (population $3M) are considered local issuers, they would compute their allocation as follows.

<u>CITY A:</u> 2M/10M= 20% x $475M = $95M
<u>CITY B:</u> 3M/10M= 30% x $475M = $142.5M

The $950M ceiling would be allocated as follows.

All State Issuers	$475M	50%	
City A	95.0	10%	
City B	142.5	15%	50%
Other local issuers	237.5	25%	
Total	$950M	100%	

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General Rules, Continued

Definition of the Volume Cap

The "volume cap" for any issuing authority is the maximum amount of tax-exempt private activity bonds that may be issued during the calendar year.

If the amount of the bonds of an issue added to the amount of tax-exempt private activity bonds previously issued in that calendar year exceeds that issuer's volume cap, that issue is taxable.

Location of Bond financed Facility

Generally, no portion of the state ceiling may be allocated to bonds the proceeds of which will be used to finance a facility located outside of the state.

See § 146(k) for specific exceptions.

Bonds Subject to the Volume Cap

Only Certain Private Activity Bonds are Subject to the Volume Cap

The volume cap under § 146 applies generally to all qualified private activity bonds issued after August 15, 1986, including qualified enterprise zone facility bonds, except for the following.

- Any qualified veterans' mortgage bond
- Any qualified 501(c)(3) bond
- Bonds used for airports, docks and wharves, environmental enhancements of hydroelectric generating facilities, qualified public educational facilities, qualified green building and sustainable design projects, and qualified highway or surface freight transfer facilities (§§ 142(a)(1),(2), (12), (13), (14) or (15))
- 100 percent of any high-speed intercity rail facility bond (§ 142(a)(11)), IF OWNED BY A GOVERNMENTAL UNIT, (beginning January 1, 1994), or 75 percent of any high-speed intercity rail facility bond (§ 142(a)(11), IF OWNED BY OTHER THAN A GOVERNMENTAL UNIT
- Any qualified New York Liberty Bond (§ 1400L(d)(5)(A)), however separate volume cap limits apply under § 1400L(d)(3)
- Any qualified GO Zone Bond (§ 1400N(a)(5)(D)), however separate volume cap limits apply under § 1400N(a)(3)
- Any qualified Midwestern disaster area bond (P.L. 110-343, Division C, § 702(a)(1)(A)), however separate volume cap limits apply under § 1400N(a)(3) as modified by P.L. 110-343, Division C, § 702(d)(1)(E)
- Any qualified Hurricane Ike disaster area bond (P.L. 110-343, Division C, § 704(a)), however separate volume cap limits apply under § 1400N(a)(3) as modified by P.L. 110-343, Division C, § 704(a)(5)

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Only Certain Private Activity Bonds are Subject to the Volume Cap, Continued

Section 146(h)(1) provides an additional exception for any qualified private activity bond used for solid waste disposal facilities (§ 142(a)(6), if all of the property to be financed is OWNED BY A GOVERNMENTAL UNIT. Section 146(h)(2) provides the rules for determination of government ownership for purposes of § 146(h)(1).

Section 146(f)(3)(A) provides that bonds issued pursuant to a valid carryforward election (discussed below) and within 3 years of the year in which the carry-forward arose shall not be taken into account as using the volume cap for the calendar year in which the bonds are issued. Section 146(f)(3)(B) provides that carryforwards elected with respect to any purpose shall be used in the order of the calendar years in which they arose.

Section 7871(c)(3)(A)(iii) provides an exception for bonds issued by Indian tribal governments if at least 95 percent of the net proceeds are used for a manufacturing facility and certain other requirements are met.

(Recall from Section 1 of Phase I, Lesson 6 that “Net Proceeds” includes Sale Proceeds and Investment Proceeds.)

Refunding Bonds

Generally, § 146(i) provides that current refundings are not subject to the volume cap, as long as the principal amount of the refunding bonds is not greater than the outstanding principal amount of the refunded bond. Additional rules apply for qualified mortgage and student loan bonds.

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2008 Housing Tax Act

The Housing Tax Act of 2008 added § 146(i)(6), which is a special refunding provision for bonds issued for qualified residential rental projects (multifamily housing bonds), effective with repayments of loans received after July 30, 2008. The provision provides that if the repayments of loans financed by multifamily housing bonds are recycled into new multifamily loans, any bond that refinances such issue will be treated as a refunding issue, that is, additional volume cap is not required to the extent that the principal amount of the refunding bonds does not exceed the principal amount of the refunded bonds.

The requirements are that:

- the new loan must be made within six months of the prior loan repayment;
- the refunding bonds must be issued within four years of the original bonds; the refunding bonds must receive public approval (§ 147(f)) prior to issuance; and
- the last maturity date of the refunding bonds cannot be more than 34 years after the issuance date of the refunded bonds

Mortgage Credit Certificates

Section 146(n) provides that the volume cap is reduced for certain mortgage credit certificates.

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Governmental Bonds subject to Volume Cap

An issuer's volume cap shall be reduced by the amount allocated by the issuer to an issue under § 146(m). Advance refundings of governmental bonds and qualified 501(c)(3) bonds are subject to the volume cap to the extent that the provisions of § 141(b)(5) apply or would have applied if the section applied to the issue. See § 146(i)(5) and 146(m)(2).

Section 1313(b)(5) of the Tax Reform Act of 1986 provides generally, that certain advance refundings of bonds issued before August 16, 1986 (or after August 15, 1986, if § 1312(a) of the 1986 Act applies) are subject to the provisions of § 146 to the extent of the nongovernmental use of the issue, if more than five percent of the net proceeds of the refunded bonds were used for output projects.

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Coordination with § 141(b)(5)

Section 141(b)(5) provides that a governmental bond will be treated as a private activity bond if:

- the "nonqualified amount" exceeds $15 million, but is less than the amount needed to meet any of the private activity bond tests, AND
- the issuer does not allocate a portion of its volume cap to the issue in an amount equal to the excess of such nonqualified amount over $15 million

Section 141(b)(8) provides that the "nonqualified amount" is equal to the LESSER OF:

- the proceeds of the issue to be used for ANY private business use, OR
- the proceeds of the issue with respect to which there are payments (or property or borrowed money) described in § 141(b)(2)

Note that this nonqualified amount must be less than the:

- 5 percent needed to satisfy the disproportionate use and/or payment tests, OR
- 10 percent needed to satisfy the private business tests

Example 2

County B issues governmental bonds in the principal amount of $300M on June 1, 2011. The bonds are used to construct an office building. A for-profit entity enters into a long-term lease for 7% ($21M) of the building. The lease payments accounted for 7% ($21M) of the debt service.

Section 141(b)(5) provides that $6M (only the EXCESS over $15M) of these bonds must be allocated to the volume cap. ($21M-15M)

If this $6M is not properly allocated, then the **entire** bond issue would be considered to be taxable private activity bonds. (The issue could NOT be qualified private activity bonds, because the § 146 requirements would not be met.)

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Example 3

County E issues bonds in the principal amount of $200M on June 1, 2011. On the issuance date, County E reasonably expects to use 100 percent of the bond-financed facility for its own use. In May 2012, County E leases 8.5 percent of the facility to Corporation X, a for-profit entity. The lease payments ($17M) will be used to pay 8.5 percent of the debt service on the bonds. There has been a deliberate action and change of use, but not enough to cause the bonds to meet the private business tests. However, $2M of the bond proceeds should have been allocated to the volume cap. Section 141(b)(5) requires that the bonds be treated as private activity bonds. However, Rev. Proc. 97-15 or the remedial action provisions of Regulations § 1.141-12 may be applied. (Note, however, that these provisions are not applicable to issues discovered during an examination.)

Exception for Use by a 501(c)(3) Organization

Section 141(b)(9) provides an exception for use by a 501(c)(3) organization if the portion of the proceeds of a governmental bond used by the 501(c)(3) organization would be treated as a qualified 501(c)(3) bond if the issuer elects to treat such portion as a qualified 501(c)(3) bond.

For example, if Corporation X in Example 3 was a 501(c)(3) organization, the amount of proceeds allocated to the use by the 501(c)(3) organization would not be considered private business use for purposes of § 141(b)(5) (or for any part of § 141(b) or (c)). This assumes that the use of proceeds would meet all of the requirements of a qualified 501(c)(3) bond, and the issuer elected to treat it as such.

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Bonds Subject to the Volume Cap, Continued

Applicability to Qualified 501(c)(3) Bonds

Section 141(b)(5) may also apply to qualified 501(c)(3) bonds.

Assume that County E issued § 145 bonds in the principal amount of $400M and paid costs of issuance with funds other than proceeds. The proceeds of the bonds are loaned to Hospital, a 501(c)(3) organization. Hospital leases 4.0 percent of the facility to Corporation X, a for profit entity. The lease payments ($16M) will be used to pay 4.0 percent of the debt service on the bonds. Although the private use is less than 5 percent of the net proceeds of the bonds, more than $15M of the proceeds are used in private use. Under § 141(b)(5), County E should have obtained volume cap for $1M ($16M-$15M) of the bonds.

Reporting Requirements

Issuers of qualified private activity bonds are required to indicate the amount of volume cap allocated to the issuer on Form 8038.

Issuers are required to indicate the amount of a governmental issue allocated to the volume cap on Form 8038-G.

Elective Carry-forward of Unused Volume Cap for Specified Purpose

General Rule

Section 146(f) permits an issuing authority to elect to carry forward any unused volume cap for three years, however only for certain purposes.

Specific Purposes Permitted

According to § 146(f)(5), any excess volume cap must be assigned to one of the following purposes:

- Qualified student loan bonds
- Qualified mortgage bonds (or mortgage credit certificates)
- Qualified redevelopment bonds
- Exempt facility bonds under § 142(a)
- Enterprise zone facility bonds (Regulations § 1.1394-1(m)(3))

Example 4

County B has been allocated $50M of the state's volume limitation for 2010. During 2010, County B issues $40M principal amount of bonds. County B has been contacted by Corporation X which plans to build a qualified residential rental project to be located in the County within the next 3 years. County B agrees that it will issue $10M principal amount of bonds to finance the project. County B can elect to carry forward $10M from 2010 for this purpose by timely filing Form 8328.

Making the Election

This election is made by filing Form 8328 by the earlier of:

- February 15 following the year in which the unused amount arises, OR
- the date of issue of the bonds issued pursuant to the carryforward election

See Rev. Proc 2005-30, which outlines the six requirements an issuer must meet to receive an automatic six-month extension to make a volume cap carryforward election.

Section 146(f)(4) provides that the carryforward election is irrevocable.

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Elective Carry-forward of Unused Volume Cap for Specified Purpose, Continued

Where to File Form 8328

Form 8328 is filed with the Internal Revenue Service Center in Ogden, Utah.

Transitional Rules

Section 1315 contains two exceptions under which bonds issued after August 16, 1986 are not subject to the provisions of § 146.

Generally, carryforward authority under § 146(f) does not apply to volume cap under § 103(n) of the 1954 Code and no carryforward under § 103(n) is recognized. See § 1315 of the 1986 Act for special rules.

Section 2

Substantial User Requirement

Overview

Introduction

Section 147(a) provides that, with certain exceptions, interest paid on any qualified private activity bond is **included in gross income of a substantial user (or a related person of a substantial user)** for any period during which such obligation is **held by a substantial user or related person.** Interest on the bonds held by other parties is not affected. The crux of this subsection is the identification of a "substantial user."

Statutory & Regulatory Provisions

Section 147(a) provides the rules regarding the substantial user requirement. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(13) of the 1954 Code.

Regulations § 1.103-11 provides rules applicable to the substantial user requirement. The examples, however, should not be relied upon to the extent that they reflect tax-exempt financing of facilities that is no longer authorized.

Applicability

Section 147(h) provides, among other things, that § 147(a) does not apply to the following types of bonds:

- Qualified mortgage bonds
- Qualified veterans' mortgage bonds
- Qualified student loan bonds
- Qualified 501(c)(3) bonds

Contents

This section contains the following topics.

Substantial User

General Definition

Regulations § 1.103-11(b) provides that a substantial user of a facility generally includes any nonexempt person who regularly uses a part of the facility in his trade or business. However, unless the facility (or a part of it) was constructed, reconstructed, or acquired specifically for a nonexempt person, a nonexempt person will be a substantial user of a facility only if:

- the gross revenue derived by such user with respect to the facility is more than five percent of the total revenue derived by all users of the facility, OR
- the amount of area of the facility occupied by the user is more than five percent of the entire usable area of the facility.

Definition of a Nonexempt Person

Regulations § 1.103-7(b)(2) defines "exempt person" as:

- a governmental unit, or
- a 501(c)(3) organization, but only with respect to its related activities

A nonexempt person is any entity other than those identified above.

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Other Arrangements

Regulations § 1.103-11(b) provides that a nonexempt person under certain facts and circumstances may be a substantial user, if the nonexempt person:

- has a contractual or preemptive right to the exclusive use of all or a portion of the property,
- is a lessee or sublessee of all or any portion of the facility, OR
- is a licensee whose use of the facility is regular and NOT merely casual, infrequent, or sporadic

Individuals who are physically present on or in the facility as employees of a substantial user are usually NOT substantial users.

Example 5

Corporation X, a nonexempt person, borrows the entire principal amount of $4M of County A's bonds. The bonds are qualified small issue bonds used to finance construction of a manufacturing facility, which will be leased to Corporation X for an annual rental of $500,000. Corporation X subleases space to a restaurant operator at an annual rental of $25,000. The restaurant is open five days a week from 8am until 5pm. The amount of revenue derived by the restaurant operator is more than five percent of the total revenue by all users of the facility. Both Corporation X and the restaurant operator are substantial users of the facility. Corporation X is a substantial user because the facility was constructed specifically for its use. The restaurant operator is a substantial user because the revenues earned by it exceed five percent of that of the entire facility. However, the employees of the restaurant as well as the manufacturers and distributors of the products sold at the restaurant are not substantial users.

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Substantial User, Continued

Definition of Related Person

Section 147(a)(2) provides that the following will be treated as related persons.

- Two or more persons if the relationship between such persons would result in a disallowance of losses under §§ 267 or 707(b)
- Two or more persons which are members of the same controlled group of corporations (as defined in § 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein)
- A partnership and each of its partners (and their spouses and minor children)
- An S corporation and each of its shareholders (and their spouses and minor children)

Section 3

Maturity Limitation

Overview

Introduction

To prevent bonds from remaining outstanding longer than necessary, § 147(b) limits the average length of maturity of certain qualified private activity bonds.

Statutory & Regulatory Provisions

Section 147(b) provides the rules regarding the maturity limitation. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(14) of the 1954 Code.

Regulations § 1.147(b)-1 provides rules applicable to the maturity limitation.

General Rule

Section 147(b)(1) provides that a private activity bond is not a qualified private activity bond if it is issued as part of an issue and the average maturity of the bonds issued as part of such issue EXCEEDS 120 percent of the average reasonably expected economic life of the facilities being financed with the net proceeds of such issue.

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Applicability

Section 147(h) provides that § 147(b) does NOT apply to the following types of bonds.

- Qualified mortgage bonds
- Qualified veterans' mortgage bonds
- Qualified student loan bonds

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

Exception for Working Capital Financings

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

(Remember that qualified 501(c)(3) bonds are the only qualified private activity bonds that can be used to finance more than a *de minimis* amount of working capital expenditures.)

Contents

This section contains the following topics.

Average Maturity of the Bonds

Determination of Average Maturity

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

Computation

The following example illustrates the computation of the average maturity of bonds.

Example 7

City K issues $5M principal amount of bonds, which are sold at par on January 1, 2010. The issue prices and maturity dates are shown below:

Maturity Date - January 1	Issue Price
2011	$1M
2012	$1M
2013	$1M
2015	$2M

There are three steps involved in the computation.

1. Multiply each issue price by the number of years remaining until maturity.
2. Add all of these products together.
3. Divide this sum by the principal amount of the bonds.

The computation below shows that the weighted average maturity of these bonds is 3.2 years.

Issue Price	Number of Years Until Maturity	Product
$1M	1	1M
$1M	2	2M
$1M	3	3M
$2M	5	10M
SUM OF PRODUCTS		16M
DIVIDED BY PRINCIPAL AMOUNT		16M/5M = 3.2

Economic Life

Determination of Average Reasonably Expected Economic Life

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

Determination Date

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

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

Determination of Economic Life

House Conference Report No. 97-760, at 519 (1982) provides that the economic life of assets is determined on a case-by-case basis. However, the conferees intend that guidelines established for useful lives used for depreciation prior to the ACRS (the midpoint lives under the ADR system or guidelines provided by Rev. Proc. 87-56, 1987-2 CB 674, where applicable, and Rev. Proc. 62-21, 1962-2 CB 418, in the case of structures, may be used. Further, the issuer can use longer lives when it can show that the economic life of the asset is expected to be longer than that established by the guidelines.

Rev. Proc. 88-22, 1988-1 CB 785, clarifies and modifies Rev. Proc. 87-56.

Treatment of Land

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

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

Be sure to read the part in **Section 4** of this lesson that discusses the relationship between §§ 147(b)(3)(B) and 147(c).

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Computation of Average Economic Life

The following example illustrates the computation of average economic life.

Example 7

Hospital System M borrows the proceeds of bonds issued by State B to build a parking garage. The building and its components along with their economic lives and respective costs are listed below:

ASSET	ECONOMIC LIFE	COST
Masonry multilevel parking structure	25	$2,000,000
Roof covering	10	$50,000
Electric lighting	15	$10,000
Passenger elevator	20	$5,000
Total cost		**$2,065,000**

Computation of the average economic life is similar to that of the average maturity and involves three steps.

1. Multiply the economic life by the cost of the asset.
2. Add together all of these products.
3. Divide this sum by the total cost of the assets.

The computation shown below shows that the average economic life is 24.58 years. Therefore, the average maturity of the bonds cannot be more than 29.5 years (120 percent of 24.58 years.)

Economic Life	Cost	Product
25	$2,000,000	50,000,000
10	$50,000	500,000
15	$10,000	150,000
20	$5,000	100,000
SUM OF PRODUCTS		**50,750,000**
DIVIDED BY TOTAL COST		50,750,000/2,065,000= 24.58 yrs

Special Rule for Pooled Financings of Qualified 501(c)(3) Bonds

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Special Rule

Section 147(b)(4) provides that for pooled issues where 95 percent or more of the net proceeds of the issue are used to make loans to 501(c)(3) organizations or governmental units for acquisition of property to be used by 501(c)(3) organizations, **the issuer can elect** to satisfy the general maturity limitation requirement by treating each loan as a separate issue.

Requirements

Section 147(b)(4)(B) provides that under this election, the bond will meet the maturity limitation if the following requirements are met:

- 95 percent or more of the net proceeds of the issue must be used to finance loans to 2 or more 501(c)(3) organizations or governmental units for acquisition of property to be used by such organizations
- The average maturity of each loan must not exceed 120 percent of the average reasonably expected economic life of the facilities financed by that loan
- Before the bonds are issued, a demand survey must be conducted which shows a demand for financing greater than an amount equal to 120 percent of the lendable proceeds of the issue
- 95 percent or more of the net proceeds of the issue are to be loaned to 501(c)(3) organizations or governmental units within 1 year of issuance
- Any unspent proceeds after 1 year are to be used to redeem the bonds as soon as possible, but not later than 18 months after issuance
- The maturity date of the bond must not exceed 30 years

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Special Rule for Pooled Financings of Qualified 501(c)(3) Bonds, Continued

Making the Election

Regulations § 301.9100-7T(g) provides that an election under § 147(b)(4)(A) must be made in the bond indenture or a related document on or before the date of issue.

Example 10

Charity Q and Charity R borrow proceeds from City A. The average economic life is computed for each charity's property separately. If Charity Q plans to acquire property having a 10-year ADR midpoint life, the maximum loan term permitted for Charity Q's loan is 12 years. If Charity R plans to acquire two properties, each with a different class life, then a weighted average economic life would be used as under the general 120 percent rule.

Section 4

Limitations on Land Acquisition

Overview

Statutory Provisions

Section 147(c) provides the general rules regarding limitations on use of proceeds for land acquisitions. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(16) of the 1954 Code.

General Rule

Section 147(c)(1) provides that, with certain exceptions, a private activity bond will not be a qualified bond if:

- 25 percent or more of the NET PROCEEDS are to be used (directly or indirectly) for the acquisition of land (or an interest in land), OR
- any portion of the PROCEEDS is to be used (directly or indirectly) for the acquisition of land (or an interest in land) to be used for **farming purposes**.

For this purpose, the NET PROCEEDS is defined in § 150(a)(3).

Applicability

Section 147(h) provides that § 147(c) does NOT apply to the following types of bonds.

- Qualified mortgage bonds
- Qualified veterans' mortgage bonds
- Qualified public educational facility bonds
- Qualified student loan bonds
- Qualified 501(c)(3) bonds

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Exception for First-time Farmers

Section 147(c)(2) provides an exception to the general rule for land to be acquired by first-time farmers, if the requirements of § 147(c)(2)(B) are met. Effective for bonds issued after May 22, 2008, a lifetime maximum of $450,000 is available for this purpose. Previously, a lifetime maximum of $250,000 applied. For calendar years **after** 2008, the lifetime maximum is adjusted for inflation. (For example, for calendar year 2011 the lifetime maximum is $477,000. See Rev. Proc. 2010-40, § 3.10, 2010-46 I.R.B. 663.) This limit does not include bond-financed land disposed of while the first-time farmer was insolvent if § 108 applied to indebtedness with respect to such farmland.

“Farm” is defined under § 6420(c)(2) as including stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards.

First-time farmers may also use up to $62,500 of the lifetime maximum to acquire used depreciable agricultural equipment under § 147(c)(2)(F).

Section 147(c)(2) also includes relevant definitions and rules regarding acquisitions from related persons and aggregation.

Exception for Land Purchased for Environmental Purposes

Section 147(c)(3) provides an exception to the general rule for any land acquired by a governmental unit (or issuing authority) in connection with an airport, mass commuting facility, high-speed intercity rail facility, dock, or wharf, IF:

- such land is acquired for noise abatement or wetland preservation, or for future use as any of the abovementioned facilities, AND
- there is not other significant use of such land

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Relationship With § 147(b)(3)(B)

Recall from **Section 3** of this lesson that § 147(b)(3)(B) provides that land is not taken into account when computing the average economic life of a facility UNLESS 25 percent or more of the net proceeds of any issue is used to finance land. Under § 147(c) if 25 percent or more of net proceeds are used for the acquisition of land, the bonds will not be qualified bonds. This restriction on the acquisition of land does not apply to qualified mortgage or veterans' mortgage bonds, qualified public educational facility bonds, qualified student loan bonds, qualified 501(c)(3) bonds, or when the exception for first-time farmers or for certain land acquired for environmental purposes applies.

Accordingly, § 147(b)(3)(B) would have significant repercussions only to those types of bonds to which the land restriction does not apply.

Section 5

Acquisition of Existing Property Not Permitted

Overview

Statutory Provisions

Section 147(d) provides the rules regarding the limitations on acquisitions of existing property. Prior to the Tax Reform Act of 1986, these rules were in § 103(b)(17) of the 1954 Code.

General Rule

Section 147(d)(1) provides generally that a private activity bond will not be a qualified bond if any portion of the NET PROCEEDS of the issue is to be used for the acquisition of any property, or an interest in property, unless the first use of such property is pursuant to such acquisition.

Applicability

Section 147(h) provides that § 147(d) does NOT apply to the following types of bonds.

- Qualified mortgage bonds
- Qualified veterans' mortgage bonds
- Qualified student loan bonds
- Qualified 501(c)(3) bonds

More Than One Building

If a project involves two or more buildings, § 147(d) is applied on a project, rather than on a building, basis.

See § 147(d)(4).

Used Property vs Property With Used Parts

In PLR 8929073, used rails were incorporated into the construction of a new railroad line. The used rails, representing only 8.7 percent of the cost of the project, were an integral part of the entire railroad track structure, which was treated as a single piece of property with component parts for purposes of § 38 as in effect at the time of the ruling. Therefore, utilization of the used rail as a building material in the construction of the track structure would not constitute the utilization of separate property the first use of which did not begin with the taxpayer.

Continued on next page

Exception for Certain Rehabilitations

Section 147(d)(2) provides an exception to the general rule for:

1. buildings (and equipment for the building), if rehabilitation expenditures equal or exceed **15 percent** of the cost of acquiring the building (and equipment for the building) financed with the net proceeds of the bonds, AND
2. structures other than buildings (e.g. dry docks), if rehabilitation expenditures equal or exceed **100 percent** of the cost of acquiring the structure financed with the net proceeds of the bonds.

For qualified New York Liberty Bonds; qualified GO Zone Bonds; qualified Midwestern disaster area bonds; and qualified Hurricane Ike disaster area bonds, § 147(d)(2) is applied by substituting “50 percent” for “15 percent’ in item 1 above.

Rehabilitation Expenditures

Section 147(d)(3) provides that rehabilitation expenditures are amounts:

- properly chargeable to capital account, AND
- incurred in connection with the rehabilitation of a building (including rehabilitating or replacing equipment existing in the building)

Any amount incurred by a successor to the purchaser or by the seller under a sales contract with the purchaser is treated as incurred by the purchaser.

See “Excluded Expenditures” below.

Time Period

Section 147(d)(3)(C) provides that qualifying rehabilitation expenditures must be made on or prior to the date which is two years after the later of:

- the date on which the building was acquired, OR
- the date on which the bond was issued.

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Excluded Expenditures

For certain expenditures which are not “rehabilitation expenditures,” § 147(d)(3)(B) refers to § 47(c)(2)(B) for property placed in service after December 31, 1990. The following expenditures described in § 47(c)(2)(B) are generally NOT rehabilitation expenditures:

- The cost of acquiring the building or interest therein
- Expenditures for the enlargement of an existing building
- Certain expenditures for the rehabilitation of historic structures
- Expenditures for rehabilitation of a building allocable to tax-exempt use property (within the meaning of § 168)
- Certain expenditures of lessees

See Regulations §§ 1.48-12(c)(7) through (10) and 1.48-12(d) for rules regarding the above expenditures. Note that due to the re-designation of §§ 48 to 47, effective December 31, 1990, the regulations accompanying current § 47 are in Regulations § 1.48.

In PLR 8831033, bond proceeds were used to acquire and rehabilitate a medical office building. Proposed improvements included construction of an elevated pedestrian walkway from the building to the garage to facilitate access for patients, including those with restricted mobility. Construction of the walkway was composed of two components: 1) minor demolition and interior modifications to create an entrance to the building; and 2) construction of the walkway from the exterior wall of the building to the garage. The walkway was found to result in an increase in the volume of the building and, therefore, constitute an enlargement under § 48(g)(2)(B). Thus, expenditures for the walkway component would not be rehabilitation expenditures. However, since construction of the entrance component would not be part of an enlargement, expenditures for the entrance could be rehabilitation expenditures.

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Exception for First-time Farmers

Section 147(c)(2)(A) provides that the first-time farmers exception to the limitation on use for land acquisition under § 147(c) (discussed earlier in **Section 4** of this lesson) also applies to § 147(d) for property to be used on such land for farming purposes.

Section 6

Prohibited Facilities

Overview

Statutory Provisions

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

There are no regulations applicable to this rule.

Rule

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

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

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

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Principal Business of Alcohol Sales

In PLR 8743008, a wholesaler leased a bond-financed warehouse and distribution facility for use in its business of buying alcoholic beverages from brewers and manufacturers for resale to retailers. Here, it was determined that § 147(e) did not apply to a wholesale warehouse and distribution facility since only retail facilities sell alcoholic beverages for consumption.

In PLR 8646014, applying § 103(b)(18) of the 1954 Code, a wholesaler in the business of selling food and grocery items to restaurants and small grocers expanded its inventory to include alcoholic beverages. Here, it was concluded that the sale of alcoholic beverages for consumption off premises was not a principal business since the gross revenues and total inventory space allocated to such sales were less than 10 percent of the total operation.

Section 7

Public Approval Requirement

Overview

Statutory & Regulatory Provisions

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

Regulations § 5f.103-2 also contains rules that pertain to the public approval requirement.

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

Introduction

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

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

Public approval by a governmental unit can be either by:

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

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

Continued on next page

Applicability

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

Contents

This section contains the following topics.

Obtaining Approval

Issuer Approval

Generally, approval must always be provided by the governmental issuer or governmental unit on whose behalf the bonds will be issued.

However, if a governmental unit issues bonds on behalf of more than one governmental unit (e.g. an authority issuing bonds on behalf of multiple counties), any of such units may satisfy the issuer approval requirement.

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

Host Approval

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

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

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

Definition of Governmental Unit

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

Example 10

State X proposes to issue private activity bonds to finance a facility located entirely within the geographic jurisdiction of City Y. State X must approve the issue because State X is the issuer and the facility is to be located entirely within the State's geographic jurisdiction.

Example 11

County M proposes to issue private activity bonds to finance a project located partly within the geographic jurisdictions of both County M and County R. Both counties are located in State X. The part of the project in County R is located partly within the geographic jurisdictions of Cities O and P. Issuer approval must be given by County M. Host approval must also be given by **either** State X, County R, or **both** Cities O and P.

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Definition of Applicable Elected Representative

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

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

If a governmental unit has no applicable elected representative, then approval must be by the applicable elected representative of the next higher governmental unit:

- which has an applicable elected representative, AND
- from which the authority of the governmental unit without an applicable elected representative is derived.

Example 12

In PLR 200126006, the governor of State Z left office mid-term, creating a vacancy. Per the State constitution, the president of the State senate, elected a senator by voters in a single district and voted president by a majority of the State senate, was sworn in as acting governor until an election to fill the office was held. The acting governor approved a proposed bond issue, to be issued by Authority Y on behalf of State Z, after a public hearing. Even though not elected at-large by the voters of State Z, the acting governor was treated as an applicable elected representative because the office was filled in accordance with State law and the acting governor was removable, with or without cause, by the State senate from the office of president.

Example 13

County M will issue bonds to finance a facility located in both County M and County R. Neither governmental unit has any officials who are elected at-large by the voters. Both units derive their authority from State X, the next higher governmental unit with an applicable elected representative. Thus, an applicable elected representative of State X must approve the issue for both Counties after the public notice and public hearing requirements are satisfied.

Reasonable Public Notice

What is "Reasonable Public Notice?"

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

The notice must state the time and place for the hearing.

The notice is presumed reasonably designed to inform residents if:

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

Notice Must Contain Certain Information

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

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

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Inadequate Notice

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

Example 14

In PLR 9622032, a state agency proposed to issue pool bonds and lend the proceeds to 501(c)(3) organizations. The specific organizations receiving the proceeds would not be known until after the issuance date. The state agency intended to elect to qualify for the special maturity rule for pooled financings under § 147(b)(4). The agency proposed to publish a public hearing notice containing a general, functional description of the type of facilities to be financed and the maximum aggregate amount of the obligations used to finance the facilities. Here, the notice was determined to be inadequate because it would not identify the initial owner, operator, or manager of the proposed facilities or the facilities' prospective locations.

Example 15

In PLR 9508029, Authority W issued qualified 501(c)(3) bonds and loaned the proceeds to Hospital B to finance the construction and renovation of capital facilities at the hospital as well as the acquisition of capital equipment. A notice of public hearing for the bonds described the project, listed its location, identified Hospital B as the initial owner, and provided the aggregate face amount of the bonds. Although many of the specific items included within the project had been completed, approximately 25 percent of the bond proceeds remained unspent prior to Hospital B's merger with Hospital A. Thereafter, management decided to use the remaining bond proceeds to finance capital renovations and capital equipment at Hospital A which was located approximately 1 mile away from Hospital B. Here, the deviation was determined to be insubstantial because the proceeds were to be used in a nearby facility in the same manner as originally approved and that the deviation would not impact the residents in the locality of the facilities.

PLRs 200049022 and 200050026 both reach the same result based upon similar facts where the alternate facility was approximately one-half mile away from the facility originally identified in the public hearing notice.

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Example 16

In PLR 9452021, Authority G issued qualified 501(c)(3) bonds and loaned the proceeds to Hospital Q to finance capital improvements to its facility. A notice of public hearing described the project, listed its location, identified Hospital Q as the initial owner, and provided the aggregate face amount of the bonds. Due to subsequent financial distress, Hospital Q proposed to expend a portion of the unspent proceeds on working capital and other ongoing operating expenses related to the facility. Here, the deviation was determined to be insubstantial because only a very small percentage of the gross proceeds were to be used for alternate purposes.

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Example 17

In PLR 200821031, the Notice stated that Bond proceeds would be spent on acquiring Parcel A, which was the location of the Parcel A Improvements. The Notice further provided a general description of the location where the Bond proceeds would be spent, stating that "all of the facilities and improvements to be financed with the proceeds of the Bonds are to be located in or near Authority's existing port facilities, including those located [in Area A] ..." This general description also included the location of the Parcel A Improvements, since Parcel A was located within Area A. The Parcel A Improvements would also be located across a river from the Coal Terminal where improvements identified in the Notice and financed with the proceeds of the Bonds were being made, and less than one-half mile from certain other improvements identified in the Notice and financed with the proceeds of the Bonds. The Parcel A Improvements were being made for the purpose of furthering Authority's maritime operations, which was in keeping with the nature, function, and character of the uses of the Bond proceeds described in the Notice.

While the use of Bond proceeds to make the Parcel A Improvements was not expected or foreseen at the time the Bonds were issued, the Notice did not fail to put the public in the affected area on notice as to Authority's intention to use the Bond proceeds to finance projects that would further its maritime operations at Port and in the vicinity of the location of the Parcel A Improvements. Thus, the Notice published originally in newspapers of general circulation covering State and the affected localities provided the general public in those localities with all of the pertinent information regarding the Parcel A Improvements as required by § 147(f) and § 5f.103-2(f).

The proposed use of Bond proceeds to further the Authority's maritime operations at Port by making the Parcel A Improvements constituted an insubstantial deviation from the uses of the Bond proceeds described in the Notice, and would not cause the Bonds to fail to meet the public notice and approval requirements of § 147(f) and § 5f.103-2(f).

See also PLR 200703017 (property will exceed the square footage described in the Notice and have a different street address than that published in the Notice; deviation insubstantial).

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Reasonable Public Notice, Continued

Public Hearing

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

Other Rules

Time Frame

Section 147(f)(2)(C) provides that once public approval has been obtained for a plan of financing a facility, that approval shall constitute approval for any issue:

- which is issued pursuant to such plan within 3 years after the date of the first issue pursuant to the approval, AND
- all or substantially all of the proceeds of which are to be used to finance such facility or to refund previous financing under the plan.

Regulations § 5f.103-2(f)(3) also provides that the first issue of the plan of financing satisfying the approval requirement must have been issued no later than 1 year after the date of approval.

Refunding Bonds

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

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

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

See § 147(f)(2)(D).

Special Rules for Approval of Certain Qualified Private Activity Bonds

Airports and High-Speed Intercity Rail Facilities

For the purposes of the public approval requirement, § 147(f)(3) provides that a governmental unit will be considered to be the only governmental unit having jurisdiction over an airport or high-speed intercity rail facility if:

- the proceeds of the bonds are to be used to finance a facility located at an airport or high-speed intercity rail facility, AND
- the governmental unit issuing the bonds is the owner or operator of the facility

Scholarship Funding Bonds

Section 147(f)(4)(A) provides that for purposes of the public approval requirement, any governmental unit which made a request described in § 150(d)(2)(B) with respect to the issuer of such bond shall be treated as the governmental unit on behalf of which the bond was issued.

When more than one governmental unit within a State has made such a request, the State may also be treated as the governmental unit on behalf of which such bond was issued.

Volunteer Fire Department Bonds

Section 147(f)(4)(B) provides that with respect to any volunteer fire department which meets the requirements of § 150(e), the political subdivision described in § 150(e)(2)(B) will be considered the governmental unit on behalf of which the bond was issued for purposes of the public approval requirement.

Section 8

Restriction on Issuance Costs

Overview

Statutory & Regulatory Provisions

Section 147(g) provides the rules regarding costs of issuance. These rules were added to the Code by the Tax Reform Act of 1986.

Regulations § 1.150-1(b) provides a definition of issuance costs.

General Rule

Section 147(g)(1) provides that a private activity bond shall not be a qualified bond if the issuance costs financed by the issue exceed 2 percent of the **proceeds** (NOT face amount) of the issue.

Applicability

Section 147(g) applies to all types of qualified private activity bonds.

Under Regulations § 1.141-3(g)(6), issuance costs are treated as neutral costs when applying the private business tests under § 141(b) to governmental bonds.

Relationship with "95 percent" Test

As was discussed in prior lessons, generally at least 95 percent of the net proceeds of qualified private activity bonds must be used for the qualified purposes of the issue. Amounts used to finance any costs of issuance are NOT treated as spent for the qualified purpose of the issue. Thus, the amount of proceeds allocated to issuance costs must also be allocated to the 5 percent permissible "bad use" portion of the net proceeds.

Continued on next page

Example 18

County E issues $1,000,000 bonds and loans the money to Corporation F, which will own and operate a solid waste disposal facility. Use of proceeds is shown below:

$1,000,000	Sale and investment proceeds
< 100,000>	Deposit to 4R Fund
900,000	Net Proceeds
x .95	
855,000	Min. amount required to be allocated to qualified purposes
900,000	
x .05	
45,000	Max. amount allowed for nonqualified purposes
< 20,000>	Max. amount allowed for issuance costs
25,000	Amount of proceeds available for nonqualified purposes other than issuance costs.

Introduction

What are Issuance Costs?

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

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

Special Rule for Small Mortgage Revenue Bonds

Section 147(g)(2) provides that in the case of qualified mortgage bonds or qualified veterans' mortgage bonds, the issuance cost limitation is increased to 3.5 percent if the bond proceeds do not exceed $20 million.

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Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds must satisfy the requirements under § 147(g). Recall from Phase I, Lesson 12, that, under § 145(a)(2)(B), qualified 501(c)(3) bonds must satisfy the private business tests of § 141(b) by treating 501(c)(3) organizations as governmental units and substituting “5 percent” for “10 percent” each place it appears and “net proceeds” for “proceeds” each place it appears.

In applying these tests to qualified 501(c)(3) bonds, Regulations § 1.145-2(c)(2) provides that issuance costs are to be treated as private business use. This differs from the general rule for governmental bonds under Regulations § 1.141-3(g)(6) which provides for the ratable allocation of issuance costs, as neutral costs, among the purposes for which the bonds were issued.

Additional Issuance Costs

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

Calculating the Two Percent Limit

Example 19

County H issues $12M principal amount of bonds on June 1, 2011, and loans the proceeds to Developer A to build a sewage facility. The bonds are sold at a premium, allowing County H to receive $12.5M in sale proceeds. Assume there were no investment proceeds. The county incurred the following expenses in connection with the bond issuance.

- Underwriter's discount $120,000
- Counsel fees 75,000
- Trustee fees 20,000
- Bond insurance premium 24,000

The 2% limit is calculated as follows:

Proceeds	$12,500,000
Investment Proceeds	0
Deposit to 4R Fund	< 1,250,000>
Net Proceeds	11,250,000
	x .95
Min. amount to be allocated to project	10,687,500
Net Proceeds	$11,250,000
	x .05
Max. amount allowed for bad use	562,500
Max. amount allowed for issuance costs	< 250,000>
Amount available for nonqualified purposes other than issuance costs	312,500

If County H uses more than $250,000 of the bond proceeds to pay issuance costs, the bonds violate § 147(g) and cannot be qualified private activity bonds. The underwriter's discount, counsel fees, and trustee fees all qualify as issuance costs paid by County H. Assuming the bond insurance premium is a qualified guarantee under Regulations § 1.148-4(f), it is properly treated as an interest expense and excluded from the 2 percent limitation on issuance costs. Accordingly, the total amount of proceeds allocated to issuance costs by County H is equal to $215,000 (1.7 percent of the proceeds), satisfying § 147(g).

Moreover, since the $215,000 in issuance costs is considered private business use, it is allocated to the $562,500 allowed for nonqualified purposes leaving only $347,500 (or 3.1 percent of net proceeds) available for other nonqualified expenditures.

Section 9

Remedial Actions

Overview

Regulatory Provisions

Regulations § 1.147-2 provides remedial actions to correct certain violations of the requirements of § 147.

General Rule

Regulations § 1.147-2 provides that the remedial action rules of Regulations § 1.142-2 (available to exempt facility bonds) apply to the rules in § 147 for qualified private activity bonds that:

- permit use of proceeds to acquire land for environmental purposes (see § 147(c)(3)),
- permit use of proceeds to finance certain rehabilitations (see § 147(d)(2) and (3)),
- prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (see § 147(e)), AND
- require public approval (see § 147(f))

Application of Rules

For purposes of applying the remedial action rules under Regulations § 1.142-2 to the instances described above, the qualified private activity bonds subject to the rules of § 147 are to be treated as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

Section 10

Depreciation Rules for Property Financed with Private Activity Bonds

Overview

Introduction

The depreciation deduction provided by § 167(a) for tangible property placed in service after December 31, 1986, generally is determined under § 168. Section 168 prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in § 168(a) and the other method is the alternative depreciation system in § 168(g).

Section 168(g)(1)(C) provides that in the case of any tax-exempt bond financed property (as defined in § 168(g)(5)), the depreciation deduction provided by § 167(a) is determined under the alternative depreciation system.

Statutory Provisions

Section 168(g) provides the rules for computing the depreciation deduction for tax-exempt bond financed property placed in service after December 31, 1986. These rules were added to the Code by the Tax Reform Act of 1986.

Alternative Depreciation System

General Rule

Section 168(g)(2) provides that the depreciation deduction under the alternative depreciation system is determined by using:

- the straight line method (without regard to salvage value),
- the applicable convention (determined under § 168(d)), and
- a recovery period determined under the following table

In the case of:	**The recovery period shall be:**
(i) Property not described in (ii) or (iii) below	The class life.
(ii) Personal property with no class life	12 years.
(iii) Nonresidential real and residential rental property	40 years.
(iv) Any railroad grading or tunnel bore or water utility property	50 years.

Section 168(g)(3) provides the rules for determining class life under the alternative depreciation system.

Applicability

Section 168(g)(5)(A) provides that, except as otherwise provided in this paragraph, the alternative depreciation system applies to any property to the extent such property is financed (directly or indirectly) by an obligation the interest on which is exempt from tax under § 103(a).

However, § 168(g)(5)(C) provides that the alternative depreciation system does not apply to any qualified residential rental project (within the meaning of § 142(a)(7)).

General Depreciation System

General Rule for Qualified Residential Rental Projects

In the case of any qualified residential rental project (within the meaning of § 142(a)(7)), the depreciation deduction provided by § 167(a) is determined under the general depreciation system in § 168(a).

The depreciation deduction for qualified residential rental property is determined by using:

- the straight line method (see § 168(b)(3)),
- the applicable convention (determined under § 168(d)), and
- a recovery period of 27.5 years (see § 168(c)).

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Election to Use Alternative Depreciation System

Section 168(g)(1)(E) allows a taxpayer to elect to apply the alternative depreciation system to property to which it otherwise would not apply. Section 168(g)(7) provides that if a taxpayer makes an election under this paragraph with respect to any class of property for any tax year, the alternative depreciation system under § 168(g) will apply to all property in such class placed in service during such year. Notwithstanding the preceding sentence, in the case of residential rental property, the election may be made separately with respect to each property. An election made under § 168(g)(7) is irrevocable.

Section 301.9100-7T(a)(2)(i) of the Procedure and Administration Regulations provides that the election under § 168(g)(7) must be made in the same tax year in which the property is placed in service. For example, if a calendar year taxpayer places residential rental property in service on July 1, 2012, in order to make a timely election under § 168(g)(7), the election must be made on the taxpayer's federal tax return for the tax year ending December 31, 2012.

Section 11

Alternative Minimum Tax

Overview

Introduction

Under § 55 an individual or corporate taxpayer must, in addition to determining its “regular” taxable income and corresponding “regular” tax, compute its “alternative minimum taxable income” (“AMTI”) and its corresponding “tentative minimum tax” (“TMT”). In general, AMTI is regular taxable income with certain adjustments provided in §§ 56 and 58, plus certain “items of tax preference” provided in § 57. The AMTI, reduced by an exemption amount, is then multiplied by the applicable percentage under § 55(b)(1) to arrive at the TMT. If the resulting TMT exceeds the regular tax liability, the excess amount (the Alternative Minimum Tax (“AMT”)) is imposed in addition to the regular tax.

Statutory Provisions

Section 57(a)(5)(A) provides that interest on “specified private activity bonds” is an “item of tax preference.” Therefore, this interest must be added to a taxpayer’s regular taxable income in order to compute the taxpayer’s AMTI.

Section 57(a)(5)(A) also provides that the amount of interest income that is includible in AMTI as an item of tax preference may also be reduced by any deduction that was not allowed in computing the regular tax, but which would have been allowable if such interest were includible in gross income.

Specified Private Activity Bonds

General Rule

Section 57(a)(5)(C)(i) provides that the term "specified private activity bond" means any private activity bond (as defined in § 141) which is issued **after** August 7, 1986, and the interest on which is not includible in gross income under § 103.

For purposes of the rule above, a bond issued **before** September 1, 1986 is treated as issued **before** August 8, 1986, unless such bond would be a private activity bond if:

- § 141(b)(1) and (2) were applied by substituting "25 percent" for "10 percent" each place it appears, AND
- §§ 141(b)(3), (4), and (5), and 141(c)(1)(B) did not apply

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Specified Private Activity Bonds

Applicability

The interest on any of the following types of bonds is not an "item of tax preference" for purposes of the AMT.

1. Qualified 501(c)(3) bonds (as defined in § 145).
2. Any refunding bonds (whether a current or advance refunding) if the refunded bond (or in the case of a series of refundings, the original bond) was issued before August 8, 1986.
3. Any qualified New York Liberty Bonds (as defined in § 1400L(d)(2)).
4. Any qualified Gulf Opportunity Zone Bonds (as defined in § 1400N(a)(2)).
5. Any qualified Midwestern disaster area bonds (as defined in § 1400N(a)(2) as modified by PL 110-343, Division C, § 702(d)(1)).
6. Any qualified Hurricane Ike disaster area bonds (as defined in § 1400N(a)(2) as modified by PL 110-343, Division C, § 704(a)).
7. (New money) qualified mortgage bonds (as defined in § 143(a)) issued after July 30, 2008, as well as any refunding bonds or series of refunding bonds which refund any such new money bonds that were issued after July 30, 2008.
8. (New money) qualified veterans' mortgage bonds (as defined in § 143(b)) issued after July 30, 2008, as well as any refunding bonds or series of refunding bonds which refund any such new money bonds that were issued after July 30, 2008.
9. (New money) exempt facility bonds issued after July 30, 2008, as part of an issue 95 percent or more of the net proceeds of which are to be used to provide qualified residential rental projects (as defined in § 142(d)), as well as any refunding bonds or series of refunding bonds which refund any such new money bonds that were issued after July 30, 2008.

See §§ 57(a)(5)(C) and 1400N(a)(5)(G).

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Specified Private Activity Bonds, Continued

Exception for Bonds Issued in 2009 and 2010

Section 57(a)(5)(C)(vi) provides that the term “private activity bond” does NOT include any bonds issued in calendar years 2009 and 2010, and therefore the interest on such bonds is not an “item of tax preference” for purposes of the AMT.

For purposes of determining whether a bond was issued during 2009 or 2010, refunding bonds (whether current or advance refunding) are treated as issued on the date of issuance of the refunded bond (or the original bond in a series of refundings), except for refunding bonds issued during 2004 through 2008.

Thus, the term “private activity bond” does NOT include any refunding bonds (whether current or advance refunding) issued in calendar years 2009 and 2010, and the interest on those bonds is not an “item of tax preference” for purposes of the AMT, **if** the refunded bond (or in the case of a series of refundings, the original bond) was issued on or after January 1, 2004. Further, interest on refunding bonds issued after 2010, to refund bonds originally issued in 2009 or 2010, will not be a preference item.

Adjusted Current Earnings

Introduction

Section 56(g) provides that the AMTI of a corporation is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceeds its AMTI (determined without regard to this increase and the alternative tax net operating loss deduction ("ATNOLD")).

Adjusted Current Earnings

A corporation's "adjusted current earnings" is its AMTI (not including the ATNOLD) plus the adjustments provided in § 56(g)(4).

General Rule

Section 56(g)(4)(B)(i) provides that any amount which is excluded from gross income for purposes of computing AMTI but is taken into account in determining the amount of a corporation's earnings and profits shall be included in income in the same manner as if such amount were includible in gross income for purposes of computing AMTI.

Because tax-exempt interest is included in a corporation's earnings and profits under § 312, a corporation's "adjusted current earnings" will include any tax-exempt interest. Potentially, a corporation's AMTI could be increased by up to 75 percent of any tax-exempt interest it receives.

This provision applies whether or not the tax-exempt interest is paid with respect to any "specified private activity bond" discussed earlier. However, to the extent the tax-exempt interest **is** paid with respect to any "specified private activity bond," this provision will not result in any additional AMTI.

Exceptions

A corporation's "adjusted current earnings" does not include tax-exempt interest on bonds described in items 7-9 in the section on "Applicability" or on bonds described in the section on "Exception for Bonds Issued in 2009 and 2010," both discussed earlier in this Section 11 under the discussion on "Specified Private Activity Bonds."

See § 56(g)(4)(B)(iii) and (iv).

Summary

Review of Lesson 4

Lesson 4 discussed the requirements of §§ 146 and 147 that must be met for a private activity bond to be a **qualified** private activity bond. Section 141(e), which defines qualified private activity bonds, explicitly provides that these requirements be satisfied. Qualified private activity bonds must also comply with all the requirements generally applicable to tax-exempt bonds (*e.g.*, § 148).

Computation of each state's volume cap limitation and allocation according to the provisions of § 146 are the responsibility of each state. Unused volume cap can be carried over for three years, as long as the carryover is for a specified purpose and the issuer is specified. It is the agent's responsibility to verify that volume cap has been allocated if required.

Most qualified private activity bonds are subject to the § 146 volume cap requirements, with some exceptions. Although governmental bonds and qualified 501(c)(3) bonds are not subject to the volume cap, if over $15M of the proceeds are used in private use or disproportionate use, any amount in excess of $15M will be subject to volume cap.

Generally, the provisions of § 147, as they apply to certain qualified private activity bonds, are as follows.

- Section 147(a) prohibits a substantial user of a facility that holds the bonds financing that facility from receiving tax-exempt interest paid thereon.
- Section 147(b) limits the length of maturity of bonds to 120 percent of the economic life of the bond-financed facility.
- Section 147(c) limits the amount of net proceeds of bonds that can be used for the acquisition of land.
- Section 147(d) generally prohibits any portion of the net proceeds of the bonds from being used to acquire existing property.
- Section 147(e) lists certain purposes that may NOT be financed with qualified private activity bonds.
- Section 147(f) requires that there be public approval of all qualified private activity bonds.
- Section 147(g) limits the amount of proceeds that may be used to pay for issuance costs.

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Summary, Continued

Review of Lesson 4 (continued)

With the exception of qualified residential rental projects, the alternative depreciation system under § 168(g) provides the general rules for computing the depreciation deduction for tax-exempt bond financed property placed in service after December 31, 1986. In almost all cases of property financed with tax-exempt bonds, the depreciation deduction will be determined using the straight line method.

Section 57(a)(5) provides that interest on "specified private activity bonds" is an item of tax preference for purposes of the Alternative Minimum Tax. With many exceptions, a "specified private activity bond" is generally any tax-exempt, qualified private activity bond which is issued **after** August 7, 1986.

Preview of Lesson 5

Lesson 5 discusses the requirements of qualified small issue bonds under § 144(a). Regulations § 1.103-10 provides rules that also may be applicable to qualified small issue bonds. Regulations § 1.144-2 provides that § 1.142-2 contains rules regarding remedial actions that are applicable to qualified small issue bonds.
