

## Lesson 7

# Remedial Actions / Change in Use Rules

## Overview

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### Introduction

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

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

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## Overview, Continued

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### Objectives

After completing this lesson, you will be able to:

- Define and identify a deliberate action
  - Explain the effect of a deliberate action on the tax-advantaged status of bonds
  - Determine if proper remedial action has taken place
    - Determine if the §150(b) sanctions apply to a transaction
    - Explain how the sanctions affect the owner and user of the bond-financed property.
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### Typical Changes Which May Affect the Bond's Status

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

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

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### Effect of Change in Use

When a change in use occurs that causes the private business tests to be met, the bonds are considered to be taxable as **of the date of issuance**, unless an appropriate remedial action is taken. This is because the issuer took a deliberate action after the issue date which caused the bonds to be private activity bonds.

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### History

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

See Exhibit 7-1 for specific applications and exceptions.

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## Overview, Continued

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### Current Rules

This lesson will cover the current remedial action rules for governmental bonds and qualified 501(c)(3) bonds and the sanctions for private business use of qualified 501(c)(3) bonds that are generally effective for all such bonds issued on or after May 16, 1997. These rules are contained in Regulations §§ 1.141-12, 1.145-2, and 1.150-4.

Many of the rules may also be applied in whole, but not in part, to bonds that were issued before, but were still outstanding on May 16, 1997. Section 1.141-12 may be applied to any bonds (See Regulations §§ 1.141-15 and 1.141-16 for specific information.)

Revenue Procedure 2018-26 was released April 11, 2018. The Revenue Procedure provides remedial actions for certain longer term leases, and for other types of tax-advantaged bonds, including tax-credit and direct pay bonds.

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## Section 1

# Remedial Actions

## Overview

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### Introduction

The phrase “change in use” is not defined in the statute or the regulations relating to state or local bonds. Generally, the phrase “change in use” is most often used to describe a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used as of the date of issue to a different use (or user) that causes the bonds to meet the private business tests or the private loan financing test, or a use which is no longer a qualified purpose. That is how this chapter will use the phrase. Some practitioners, however, will use this phrase even when the transaction does not cause the tests to be met.

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

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

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## Overview, Continued

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## Concept of Use

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

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

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**Purpose** The private activity bond rules and the rules under § 150(b) work to limit the amount of tax-exempt subsidy being transferred to a nongovernmental person.

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

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

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

Rev. The IRS has provided safe harbors regarding management service contracts between a service provider and a qualified user (including a 501(c)(3) organization in its related activities) where the service is provided in connection with a bond-financed facility.

For management contracts executed, materially modified, or amended on or after May 16, 1997, and generally before August 22, 2016, the safe harbors are provided in Rev. Proc. 97-13, 1997-1 C.B. 632. Rev. Proc. 97-13 obsoleted Rev. Proc. 93-19, 1993-1 C.B. 526.

Rev. Proc. 2001-39, 2001-2 CB 38, modified the definitions of capitation fee and per unit fee in Rev. Proc. 97-13 to permit automatic increases of those fees to certain objective external standards.

Notice 2014-67, 2014-2 C.B. 822, amplified Rev. Proc. 97-13 by creating a new safe harbor for contracts with a term, including renewal options, of not more than five years which does not need to be terminable by the qualified user prior to the end of the term. Notice 2014-67 applies to bonds issued on or after January 22, 2015, and generally before August 22, 2016, but also may be applied to bonds issued before January 22, 2015.

Rev. Proc. 2016-44, 2016-44 I.R.B. 1, superseded Rev. Proc. 97-13, Rev. Proc. 2001-39, and the management contract safe harbor portion of Notice 2014-67. Rev. Proc. 2016-44 applies to management contracts entered into on or after August 22, 2016, and generally before January 17, 2017, and

may be applied to management contracts entered into before August 22, 2016. See section 7 of Rev. Proc. 2016-44 for permissive use of Rev. Proc. 97-13, as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67.

Rev. Proc. 2017-13, 2017-6 I.R.B. 787, then superseded Rev. Proc. 2016-44.

Revenue Procedure 2017-13 applies to management contracts entered into on or after January 17, 2017. An issuer may apply this revenue procedure to any management contract entered into before January 17, 2017. See

section 7 of Rev. Proc. 2017-13 for permissive use of Rev. Proc. 97-13 as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67.

Management contracts are discussed in detail in Phase I, Lesson 4, Private Activity Bonds met.



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**Research  
Agreements**

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

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## Reasonable Expectations and Deliberate Action

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### Section 141 Revisited

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

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

The term “issuer” includes the conduit borrower for this purpose . (See Regulations §§ 1.141-1(a) and 1.148-1(b) for definitions.)

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### Deliberate Action

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

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### Example 1

City X issues bonds and lends the proceeds to Hospital Q to renovate its main facility. Hospital Q reasonably expects that sometime in the future it will build an entirely new facility and sell the current one to a for-profit entity. But on the issue date, it does not know when this will happen.

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

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## Reasonable Expectations and Deliberate Action, Continued

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### Example 2

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

The organization has taken a deliberate action that affects the tax-exempt status of the bonds.

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### Safe Harbor Rules

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

- involuntary or compulsory conversions under § 1033, and
  - actions taken in response to a regulatory directive made by the Federal Government
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### Example 3

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

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

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## Reasonable Expectations and Deliberate Action, Continued

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### **Exception for Mandatory Redemption Provision**

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

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

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### **Example 4**

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

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## Reasonable Expectations and Deliberate Action, Continued

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

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# Remedial Actions

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## **Introduction**

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

Note: These actions do not remediate excess private security or payments, but since excess private business use will be cured, then the bonds will not be private activity bonds.

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

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## Remedial Actions, Continued

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### Required Conditions

With certain exceptions, the five conditions as provided by Regulations § 1.141-12(a) that are required to be met are:

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

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

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

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## Remedial Actions, Continued

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### **Condition # 2 Maturity**

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

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

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### **Condition # 3 Fair Market Value**

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

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

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### **Condition # 4 Disposition Proceeds**

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

This means that the disposition proceeds are subject to yield restrictions when necessary and the investment earnings are subject to the rebate provisions. The issuer may choose to treat the day that the disposition proceeds are received as the issue date of the bonds for the purpose of applying the temporary period rules and qualifying for a spending exception to rebate. Similarly, for the purpose of determining whether a spending exception is met, the issuer may disregard the disposition proceeds for expenditure exemptions met before receipt of the disposition proceeds.

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## Remedial Actions, Continued

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

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### **Remedial Actions**

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

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

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

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### **Redemption or Defeasance of Nonqualified Bonds**

Regulations § 1.141-12(d) provides that the requirements for this remedial action are met if all of the nonqualified bonds of the issue:

- are redeemed within 90 days of the deliberate action, or
  - if not redeemed, then a defeasance escrow is established within 90 days of the deliberate action. (**The first call date cannot be more than 10.5 years from the date of issue. See § 1.141-12(d)(5).**)
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## Remedial Actions, Continued

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### Example 5

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

The transaction does not cause the bonds to be private activity bonds (retroactively or prospectively) because C has taken a remedial action, which prevents C's lease to P from being treated as a deliberate action causing private business tests to be met, so P's use is ignored.

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### Special Rule for Cash Received

Regulations § 1.141-12(d)(2) provides that if the disposition proceeds are exclusively cash, only a pro rata portion of the bonds needs to be redeemed on the earliest call date or defeased, if the call date is not within 90 days of the deliberate action. This is helpful in situations where the cash received is less than the amount due on the outstanding bonds.

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### Example 6

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

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

None of the \$15M in bonds is treated as privately used if the requirements of § 1.141-12(d)(2) are met.

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**Anticipatory  
Remedial  
Action**

To encourage early redemption of tax-exempt bonds without imposing another set of rules for projects with unanticipated private business use, the regulations provide, in Regulations § 1.141-12(d)(3), an anticipatory remedial action which may be taken by the issuer prior to a deliberate action. Prior to redeeming or defeasing bonds, the issuer must declare its official intent to redeem or defease all of the bonds that would become nonqualified bonds in the event of a subsequent deliberate action. The declaration must identify the financed property with respect to which the anticipatory remedial action is being taken and describe the deliberate action that may result in the private business tests being met. The remedial action must also comply with the redemption and defeasance rules under § 1.141-12(d)(1) and the special rule for dispositions for cash under § 1.141-12(d)(2).

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## Remedial Actions, Continued

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### **Notice of Defeasance**

Regulations § 1.141-12(d)(4) requires that the issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

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

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### **Alternate Use of Disposition Proceeds**

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

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

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### **Example 7**

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

The bonds are not private activity bonds because B has taken appropriate remedial action. Note that the bonds are NOT redeemed. See Regulations § 1.141-12(k), Example 5.

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

In addition to the rule set forth above, if the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must be treated as reissued as of the date of the deliberate action for purposes of §§ 141, 145, 147, 149, and 150 and must satisfy all of the applicable requirements for qualified 501(c)(3) bonds. See Regulations § 1.141-12(e)(2).

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## Remedial Actions, Continued

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### Alternate Use of Facility

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

- The facility with respect to which the deliberate action occurs is used in an alternate manner (for example, used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization rather than a governmental person);
- The nonqualified bonds:
  - are treated as reissued for purposes of §§ 55 through 59, 141, 142, 144 through 147, 149, and 150, AND
  - the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds,
- The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds of another issue of tax-exempt bonds, AND
- Any disposition proceeds (other than those arising from an agreement to provide services) resulting from the deliberate action are:
  - used to pay debt service on the bonds on the next payment date, OR
  - are deposited (within 90 days of **receipt**) into an escrow that is yield restricted AND used to pay debt service on the bonds on the next available payment date.

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## Remedial Actions, Continued

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### **Example 8**

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

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

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### **Additional Remedial Actions Provided by Publication**

Regulations § 1.141-12(h) provides that the Commissioner may provide for additional remedial actions through publication. Pursuant to this authority, the Internal Revenue Service released Rev. Proc. 97-15, 1997-1 C.B. 635, on February 3, 1997. However, Rev. Proc. 97-15 was obsoleted effective July 18, 2016.

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## Remedial Actions, Continued

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### Revenue Procedure 2018-26

#### Remedial Actions for Longer Term Leases and Direct Pay Bonds

Revenue Procedure 2018-26 provides an additional remedial action for tax-exempt governmental bonds to address nonqualified uses that generally result from longer-term leases of bond financed property to private businesses. Among other things, the revenue procedure also provides a remedial action that an issuer of direct pay bonds may take to cure private business use, if the requirements of section 141 apply, or other nonqualified use.

#### Tax-Exempt Bonds – Longer term leases

Revenue Procedure 2018-26 adds a remedial action for tax-exempt governmental bonds that allows curing nonqualified use that results from a longer term lease of bond financed property. For eligible leases, the issuer may cure the nonqualified use by applying the alternative use of disposition proceeds remedial action under § 1.141-12(e) in the same manner as to a disposition with certain modifications as described in the Revenue Procedure. Leases are eligible for consideration if they consist of exclusively cash payments and the term is at least equal to the lesser of 20 years or 75 percent of the expected economic life of the property as of the start of the lease or runs through the end of the measurement period under § 1.141-3(g)(2).

#### Direct pay bonds

Revenue Procedure 2018-26 provides a mechanism to enable an issuer to cure a nonqualified use by reducing the amount of the refundable federal tax credit to eliminate the amount allocable to the nonqualified bonds. This is accomplished by providing certain additional information on the Form 8038-CPs filed after the nonqualified use occurs, as more specifically described in the Revenue Procedure.

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# Nonqualified Bonds

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

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**Definition** Section 1.141-12(j) states the percentage of outstanding bonds that are nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business use test or private loan financing test, as applicable. For this purpose, the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the one-year period in which the deliberate action occurs.

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## Nonqualified Bonds, Continued

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### Example 11

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

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

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

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

$$100\% - 55.56\% = 44.44\% \text{ non qualified bonds.}$$

See Regulations § 1.141-12(k), Example 8.

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## Nonqualified Bonds, Continued

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### **Allocation of Nonqualified Bonds**

Allocations of nonqualified bonds must be made on a *pro rata* basis, except that an issuer redeeming or defeasing nonqualified bonds may treat any bonds of an issue as the nonqualified bonds so long as

- (i) the remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (the determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer, is not greater than
  - (ii) the remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.
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## Exhibit 7-1 Applicability

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

<b>SUBJECT</b>	<b>REGULATIONS §</b>	<b>GOVT</b>	<b>QUALIFIED 501(c)(3)*</b>
<b>Deliberate action</b>	<b>1.141-2(d)(3)</b>	YES	YES
<b>Failure to properly use proceeds</b>	<b>1.142-2(a)</b>	NO	NO
<b>Special rules</b>	<b>1.141-2 (d)(4) and (d)(5)</b>	YES	NO
<b>Conditions for Remedial Action</b>	<b>1.141-12(a)</b>	YES	YES
<b>Redemption</b>	<b>1.141-12(d)</b>	YES	YES
<b>Redemption</b>	<b>1.142-2(c)</b>	NO	NO
<b>Dispositions of personal property</b>	<b>1.142-2(c)(4)</b>	NO	NO
<b>Dispositions for cash</b>	<b>1.141-12(d)(2)</b>	YES	YES
<b>Alt use-proceeds</b>	<b>1.141-12(e)</b>	YES	YES
<b>Special rule for 501(c)(3) orgs</b>	<b>1.141-12(e)(2)</b>	NO	YES
<b>Alt use-facility</b>	<b>1.141-12(f)</b>	YES	YES
<b>Nonqualified bonds</b>	<b>1.141-12(j)(1)</b>	YES	YES
<b>Nonqualified bonds</b>	<b>1.142-2(e)</b>	NO	NO
<b>Rev Proc 97-15</b>	<b>1.141-12(h)</b>	YES	YES
NOTES:	Rev. Proc. 2018-26 provides additional remedial actions for longer term leases, tax-credit and direct pay bonds		<b>*See modifications in § 1.145-2(b) and (c)(2).</b>  <b>N/A to § 145(b), (c), (d).</b>

## Section 2

# Change-in-Use Sanctions

## Overview

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### **Introduction**

As stated above, we generally use the phrase “change in use” to mean a change in the use of proceeds of an issue of State or local bonds from the use for which those proceeds were used, or expected to be used as of the date of issue, to a use that causes the private business tests or private loan financing test to be met. Section § 150(b) provides sanctions where proceeds of certain qualified private activity bonds are used for a non-qualified use. So, if there is a change to a nonqualifying use, these sanctions may apply.

The sanctions result in the characterization of the use of the facility as unrelated trade or business of a 501(c)(3) borrower and the disallowance of a deduction for the interest paid by the borrower of the bond proceeds to finance the facility.

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## Overview, Continued

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### Example 12

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

Absent appropriate remedial action under § 1.150-4, these bonds would become nonqualified private activity bonds on the date the hospital enters into an agreement with the partnership. The interest on the bonds would be taxable back to the issue date and § 150(b)(3) would apply, triggering the disallowance of the interest deduction to the 501(c)(3) borrower for the period beginning on the date the agreement was entered into and ending on the date such that the facility is not used in a nonqualified manner.

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### Contents

This section contains the following topics:

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Facilities Required to be Owned by Governmental Units or 501(c)(3) Organizations	37
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*Continued on next page*

## Overview, Continued

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

The sanctions were enacted in response to the concern that the proper use of bond-financed facilities was generally under the control of the users of such facilities and that such users should bear responsibility for improper use of bond proceeds.

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

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

- qualified 501(c)(3) bonds (§ 145)
- certain qualified private activity bonds, which will be covered in Phase II
- bonds financing facilities required to be owned by governmental units or 501(c)(3) organizations (§§ 145(a) and 142(b)(1))

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

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## Qualified 501(c)(3) Bonds

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### General Rule

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

1. Section 150(b)(3) applies when any portion of a facility that is financed with the proceeds of a 501(c)(3) bond is used in a trade or business of any person other than a 501(c)(3) organization or a government unit, but continues to be owned by a 501(c)(3) organization.
  2. Section 150(b)(5) applies when facilities are required to be owned by a governmental unit or 501(c)(3) organization and is discussed later in the module.
- 

### Exception for *de minimis* nonqualified private use

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

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### Sanctions

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

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

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

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## Qualified 501(c)(3) Bonds, Continued

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### Example 13

Hospital Y enters into an agreement whereby approximately 15 percent of Hospital Y's facility will be leased to and managed by a for-profit corporation. The entire facility was financed with tax-exempt bonds. No proceeds were used for costs of issuance.

Section 145(a)(2)(B) provides that one of the requirements for qualified 501(c)(3) bonds is that no more than 5 percent of the net proceeds is used for private business use. The sanctions under § 150(b) will apply only when the private business use exceeds 5 percent (see 150(c)(1)). In this example, 15 percent of the facility (and the bond proceeds) are treated as being used by the for-profit corporation. That percentage is not reduced by the 5 percent that may be used for non-exempt purposes under § 145(a). If the private use amounted to less than 5 percent, then the 150(b) penalties would not apply.

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### Effect of Remedial Action

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

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## Qualified 501(c)(3) Bonds, Continued

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### Special Rules

Section 150(c) provides an exception and several special rules which relate to § 150(b). The special rules relate to:

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

### Exceptions

The sanctions have limited application if the remedial action taken is:

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

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

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## Qualified 501(c)(3) Bonds, Continued

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### Example 14

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

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

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

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**General Rule** Section 150(b)(5) provides for a denial of interest deduction when property financed by tax-exempt private activity bonds is required to be owned by a governmental unit or a 501(c)(3) organization, and the owner is not a governmental unit or a 501(c)(3) organization.

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

<b>Beginning on the date...</b>	<b>Ending on the date...</b>
the property is not owned as required	the property is owned as required.

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**Example 15** County H issued bonds and loaned the proceeds to a 501(c)(3) organization to construct a nursing home. Five years after the nursing home had begun operation, the organization discovered financial difficulties, which precluded it from meeting the financial obligations of the bonds. The nursing home was sold to a private, unrelated operator of nursing home facilities. Terms of the sale called for the new operator to assume the 501(c)(3) organization's note to the County. Within 90 days of the sale, a defeasance escrow was established to redeem the bonds. The first call date was one year after the sale.

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

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## Auditing Techniques

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### § 150(b)(3)

Use by other than a 501(c)(3) organization or governmental unit that causes the private business use of the issue to exceed 5 percent will result in gross income for purposes of Unrelated Business Taxable Income (“UBTI”) to the 501(c)(3) organization of at least the fair rental value of the use of bond-financed facility.

Interest deductions are denied on the portion of the bonds that will be used by a person other than a 501(c)(3) organization or governmental unit equal to the allocable amount of bond interest.

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### Audit Tips

During an examination, the agent should:

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

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## Auditing Techniques, Continued

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### **Example 16**

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

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

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

The next page illustrates the financial aspects of this situation.

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## Auditing Techniques, Continued

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### Example 17

Remember that this use by the parent's members in addition to any other private business use of the proceeds (including costs of issuance paid with proceeds) must exceed 5 percent in order to cause a private use problem. Also remember that the private payment test must be met. Assume the following:

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

Sub is not permitted to deduct the \$7,735 from gross income. Note that if parent were paying rent, it would not be allowed to deduct such rent from its UBTI gross income, if any.

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### § 150(b)(5)

Tax-exempt bond facilities owned or used by a § 501(c)(3) or governmental entity must be owned by such an entity or no interest deduction is allowed for the portion that is not so owned.

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## Auditing Techniques, Continued

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### **Audit Tips**

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

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

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## **Review of Lesson 7**

Lesson 7 discussed the remedial action rules included in Regulations §§ 1.141-12, 1.145-2, and Revenue Procedure 2018-26, and the sanctions provided by §§150(b) and (c) and Regulations § 1.150-4.

Note that the sanctions of § 150(b) and (c) and the accompanying regulations apply to qualified 501(c)(3) bonds, while the other remedial action regulations apply to governmental bonds and/or qualified 501(c)(3) bonds.

The § 1.141-2(d)(1) regulations clearly state that the private business tests and the private loan financing test consider both the issuer's:

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

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

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## Summary, Continued

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### **Review of Lesson 7** (continued)

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

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

Revenue Procedure 2018-26 provides an additional remedial action for tax-exempt governmental bonds to address nonqualified uses that generally result from longer-term leases of bonds financed property to private businesses and , among other things, the revenue procedure also provides a remedial action for direct pay bonds to cure nonqualified uses, including private business use.

The § 150(b) sanctions apply only to certain types of qualified private activity bonds. These sanctions apply whenever proceeds are used for a non-qualified use, but their effects can be limited by the remedial action that is taken.

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### **Preview of Lesson 8**

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

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

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## Exercises

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### Exercise 1

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

Does the sale of the property constitute a deliberate action?

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

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

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## Exercises, Continued

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### Exercise 2

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

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

Why or why not?

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## Exercises, Continued

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### Exercise 3

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

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

Is the county subject to the sanctions of § 150(b)? Why or why not?

Is the new owner subject to the sanctions of § 150(b)? Why or why not?

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## Exercises, Continued

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### Exercise 4

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

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

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

Do the sanctions of § 150(b) apply to the hospital and the lessees?

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

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