

## Module D

# Governmental and Private Activity Bonds

## Overview

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

See Conference Report No. 99-841, 1986-3 C.B. Vol. 4, 683.

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**Introduction** Bond proceeds that are used by nongovernmental persons are private activity bonds. However, private activity bonds used to finance certain activities are considered by Congress to be qualified private activity bonds, thus permitting exclusion of the interest to holders of the bonds.

IRC section 141 outlines the tests that, if met, make a bond issue a private activity bond. All qualified private activity bonds have met one or more of these tests, and by issuing the bonds as qualified private activity bonds, the issuer is admitting that these tests are met. Therefore, the bonds do not have to be tested for compliance with section 141 provisions.

However, at times a bond is issued as a governmental bond, but analysis of the use of proceeds or of the facility shows that the bonds are really private activity bonds. If the bonds can meet the appropriate sections of the Code, they can still be considered to be qualified private activity bonds. Most, however, cannot. Therefore, any examination of a governmental bond must include a determination of whether or not the bonds meet the tests of IRC section 141.

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## Overview, Continued

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### Objectives

At the end of this module the student will be able to:

- Define a private activity bond.
  - Identify a private activity bond by determining if any of the following tests are met:
    - private business use test,
    - private security or payment test,
    - private loan financing test, OR
    - unrelated or disproportionate use test.
  - Explain the consequences for a bond that meets any of the above tests.
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# Section 1

## Private Activity Bonds

### Overview

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- Definition** "Private activity bond" means any bond issued as part of an issue which meets:
- the private business use test, and the private security or payment test, OR
  - the private loan financing test.
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**In This Section** This section contains the following topics:

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## Reasonable Expectations

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- Definition** A bond issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either:
- the private business tests (business use AND security or payment) OR
  - the private loan financing test.
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**Term of Issue** The reasonable expectations test must take into account reasonable expectations about events and actions over the entire stated term of an issue.

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## Deliberate Actions

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

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**Definition** A deliberate action is taken by the issuer that is within its control. An intent to violate the requirements of IRC § 141 is not necessary for an action to be deliberate. See Treas. Reg. 1.141-2(d)(3)(i).

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**Safe Harbor Exceptions** An action is not treated as deliberate if:

- it would be treated as an involuntary or compulsory conversion under IRC § 1033, OR
- it is taken in response to a regulatory directive made by the federal government. See Treas. Reg. § 1.141-2(d)(3)(ii).

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**Timing** A deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies. Treas. Reg. § 1.141-2(e) provides a definition of “deliberate action.”

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

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**Example 2** Same facts as Example 5 except that the purchase contract provides that the State’s department of health must approve the transaction and Corporation must obtain a Certificate of Need. The purchase contract has material contingencies and thus the deliberate action does not occur when the contract is executed. Deliberate action will occur when all material contingencies have been removed or satisfied.

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## **Deliberate Actions, Continued**

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### **Remedial Actions**

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

See also Module L of this text for a complete discussion of these rules.

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## Section 2

### The Private Business Use Test

#### Overview

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**General Rule** Interest on a private activity bond is not excludable from gross income under IRC § 103(a) if more than 10 percent of the proceeds of the issue are to be used for any private business use. The private payment test must also be met. This section discusses only the determination of private business use.

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**Business Test** The 10 percent private business use test is met if *more than* 10 percent of the proceeds of an issue are used in a trade or business of a nongovernmental person. Any activity carried on by a person other than a natural person is treated as a trade or business. See Treas. Reg. § 1.141-3(a)(1).

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**Use** The use of bond proceeds includes use of bond proceeds or use of the bond-financed property.

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## Overview, Continued

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### Indirect Use

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

For example, a facility is treated as being used for a private business use if it is:

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

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

See Treas. Reg. § 1.141-3(a)(2).

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### Example 3

City P issues bonds on behalf of Nonprofit Corporation to finance the construction of a hospital. R will own legal title to the hospital. In addition, R will operate the hospital, but R is not treated as an agent of P in its capacity as operator of the hospital. P has certain rights to the hospital that establish that it is properly treated as the owner of the property for federal income tax purposes. P does not have rights, however, to directly control operation of the hospital while R owns legal title to it and operates it. The issue meets the private business use test because the arrangement provides a nongovernmental person an interest in the financed facility that is comparable to a leasehold interest.

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### Aggregation

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

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## Types of Private Business Use Arrangements (Treas. Reg. Section 1.141-3(b))

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

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

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

The special rules for output contracts are in Treas. Reg. § 1.141-7T and 8T. These rules apply to bonds issued on or after February 23, 1998 that are subject to section 1301 of the Tax Reform Act of 1986.

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**Example 4** State A issues 20-year bonds to purchase land and equipment and construct a factory. A then enters into an arrangement with Corporation X to sell the factory to X on an installment basis while the bonds are outstanding. The issue meets the private business use test because a nongovernmental person owns the financed facility.

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

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**Example 5** State A issues 20-year bonds to purchase land and equipment and construct a factory. A then enters into an arrangement with Corporation X whereby A leases the factory to X for a 5-year term. The issue meets the private business use test because a nongovernmental person is using the financed facility.

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## Management Contracts Resulting in Private Business Use (Treas. Reg. § 1.141-3(b)(4))

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**General Rule** A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

See Rev. Proc. 97-13, 1997-1 C.B. 632, for contracts that do not result in private use. This Rev Proc is included in your Deskbook.

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

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**Example 6** County uses proceeds of tax-exempt bonds to finance a courthouse. County enters into a contract with Corporation pursuant to which Corporation is to manage the cafeteria located in the courthouse. The contract is a management contract and may result in private use if it does not meet the requirements under Rev. Proc. 97-13.

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**Compensation Based on Share of Net Profits** A management contract under which the compensation of the manager is based, in whole or in part, on a share of the net profits from the operation of the bond financed facility results in private business use. See section 5.02 of Rev. Proc. 97-13.

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**Example 7** County uses proceeds of tax-exempt bonds to finance a courthouse. County enters into a contract with Corporation pursuant to which Corporation is to manage the cafeteria located in the courthouse. The contract provides that Corporation's compensation will equal 5 percent of the net profits of the cafeteria. The management contract results in private use

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## Management Contracts Resulting in Private Business Use (Treas. Reg. § 1.141-3(b)(4)), Continued

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**Arrangements not Treated as Net Profit Arrangements** Generally, compensation under a management contract is not based on net profits if it is based on –

- (a) A percent of gross revenues (or adjusted gross revenues) of a facility or
- (b) A percentage of expenses from a facility, but not both;
- (c) A capitation fee; or
- (d) A per-unit fee.

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**Example 8** County uses proceeds of tax-exempt bonds to finance a courthouse. County enters into a contract with Corporation pursuant to which Corporation is to manage the cafeteria located in the courthouse. The contract provides that Corporation will receive 10 percent of the gross receipts of the cafeteria. The management contract does not result in private use because the compensation is based only on gross receipts not gross receipts and expenses from the facility.

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**Example 9** Assume the same facts as in Example 12 except that Corporation receives \$2 for each person eating at the cafeteria. The compensation under the management contract is based on a per-unit fee. See definition of per-unit fee under section 3.06 of Rev. Proc. 97-13.

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**Example 10** Hospital, a 501(c)(3) organization, uses proceeds of tax-exempt bonds to finance a hospital. Hospital enters into a contract with HMO pursuant to which HMO will send its patients to Hospital and Hospital will provide services to such patients. The contract provides that HMO will pay \$100 per patient to Hospital. The compensation under the management contract is based on a capitation fee. See definition of capitation fee under section 3.02 of Rev. Proc. 97-13.

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## Management Contracts Resulting in Private Business Use (Treas. Reg. § 1.141-3(b)(4)), Continued

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**Example 11** Hospital, a 501(c)(3) organization, uses proceeds of tax-exempt bonds to finance a hospital. Hospital enters into a contract with Corporation pursuant to which Corporation is to manage the radiology department located in the hospital. The contract provides that Corporation will receive \$100 at the end of Hospital's fiscal year if the gross receipts of the radiology department increase by 5 percent during Hospital's fiscal year. The management contract does not result in private use because the productivity reward is based on increase of gross receipts only. See section 5.03 of Rev. Proc. 97-13.

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**Example 12** Same facts as Example 4 except that Corporation will receive \$250 at the end of Hospital's fiscal year if the radiology department's gross receipts increase by 5 percent and its expenses decrease by 2 percent. The management contract results in private use because the productivity reward is based on increase of gross receipts and decrease in expenses. See section 5.03 of Rev. Proc. 97-13.

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**Permissible Arrangements** Section 5.03 of Rev. Proc. 97-13 provides permissible terms that do not cause the management contract to result in private business use. The following examples illustrate some (but not all) of the permissible arrangements provided in such section.

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**Example 13** County uses proceeds of tax-exempt bonds to finance a courthouse. County enters into a contract with Corporation pursuant to which Corporation is to manage the cafeteria located in the courthouse. The contract provides that the contract will be a term of 15 years (including renewal options) and Corporation's compensation will be (i) \$X per month and (ii) 1 percent of gross receipts of the cafeteria during such month. The contract provides that in no event will the amount received by Corporation under clause (ii) be more than 5 percent of Corporation total compensation each month. The management contract provides that 95 percent of the compensation is based on a period fixed fee. See section 5.03(1) of Rev. Proc. 97-13.

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## Management Contracts Resulting in Private Business Use (Treas. Reg. § 1.141-3(b)(4)), Continued

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**Example 14** County uses proceeds of tax-exempt bonds to finance a courthouse. County enters into a contract with Corporation pursuant to which Corporation is to manage the cafeteria located in the courthouse. The contract provides that the contract will be a term of 7 years (including renewal options) and Corporation's compensation will be (i) \$X per month and (ii) 5 percent of gross receipts of the cafeteria during such month. The contract provides that in no event will the amount received by Corporation under clause (ii) be more than 20 percent of Corporation total compensation each month. The management contract provides that 80 percent of the compensation is based on a period fixed fee. See section 5.03(2) of Rev. Proc. 97-13.

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**Example 15** County uses proceeds of tax-exempt bonds to finance a courthouse. County enters into a contract with Corporation pursuant to which Corporation is to manage the cafeteria located in the courthouse. The contract provides that the contract will be a term of 5 years (including all renewal options) and Corporation's compensation for each month will be \$2 for each person eating at the cafeteria during the month. The management contract meets the requirements of section 5.03(4) of Rev. Proc. 97-13.

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**Example 16** County issues bonds to finance a hospital and enters into a management contract with Corporation to manage its dialysis department. Corporation will receive \$10 from each payment that County receives from Medicare reimbursement for each patient using the dialysis department. The term of the contract (including renewal options) 3 years. The management contract meets the requirements of section 5.03(5) of Rev. Proc. 97-13.

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**Example 17** Same facts as Example 20 except that the dialysis department is a new facility and has never been in operation before. The management contract provides that Corporation will receive 25 percent of the gross revenues of the dialysis department for the first two years. In addition, the contract may be terminated by County by providing 60 days' notice at the end of the first year without payment of any penalty to Corporation. See section 5.03(6) of Rev. Proc. 97-13.

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## Management Contracts Resulting in Private Business Use (Treas. Reg. § 1.141-3(b)(4)), Continued

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**Treatment as Lessee** A management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal tax purposes.

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**Example 18** City uses proceeds of bonds to finance an office building. The office building includes a cafeteria that is open to the general public. City enters into a contract with Corporation to manage the cafeteria for a term of 10 years. Corporation receives all the receipts of the cafeteria and in turn gives \$X per month to City. Corporation has complete discretion to manage the cafeteria without any input from City. The contract is labeled “management contract.” Notwithstanding its title, the contract seems to be a lease and should not be analyzed under Rev. Proc. 97-13. See Treas. Reg. § 1.141-3(b)(3).

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**Renewal Option** If the service provider (manager) has a legally enforceable right to renew the contract, the contract has a renewal option.

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**Example 19** County uses proceeds of bonds to finance an office building. The office building includes a cafeteria that is open to the general public. County enters into a contract with Corporation to manage the cafeteria for a term of 10 years. The contract provides that unless cancelled by either party, at the end of 10 years, the contract will renew for an additional one-year period. The contract does not give Corporation a renewal option.

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## Management Contracts Resulting in Private Business Use (Treas. Reg. § 1.141-3(b)(4)), Continued

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### **Certain Relationships**

A management contract results in private use if the service provider has a role or relationship with the qualified user to the extent that the relationship limits the ability of the qualified user to exercise its rights, including the right to terminate the contract. Section 5.04(2) provides a safe harbor-

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

Hospital, a 501(c)(3) organization, uses proceeds of bonds to finance a radiology department. Hospital enters into a contract with Corporation to manage the department for a term of 10 years. There are 6 members on the Board of Directors of Hospital. Corporation is wholly owned by the chairperson of the board of Directors of Hospital and two doctors that serve on the Board. The contract does not meet the safe harbor under section 5.04(2) of Rev. Proc. 97-13.

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## Arrangements That Are Generally Not Treated as Management Contracts (Treas. Reg. § 1.141-3(b)(4)(iii))

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### **Incidental Contract**

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

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### **Hospital Admitting Privileges**

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

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### **Operation of Public Utilities**

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

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### **Service Providers**

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

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## Research Agreements Resulting in Private Business Use (Treas. Reg. Section 1.141-3(b)(6))

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**Generally** An agreement by a nongovernmental person to sponsor research with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes.

See Rev. Proc. 97-14, 1997-1 C.B. 634, for research agreements that do not result in private use. This Rev. Proc. is included in your Deskbook.

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**Basic Research** Investigation for the advancement of scientific knowledge not having a commercial objective is considered basic research. For example, testing of a product that supports the trade or business of a specific nongovernmental person is not basic research.

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**Corporate Sponsored Research** A research agreement with regard to basic research that is sponsored by a private party does not result in private use if

- (i) any license or other use of the resulting technology by the sponsor is permitted only on the same terms as the governmental owner would permit other unrelated, non-sponsoring parties; and
- (ii) the price paid for the use of the license or other resulting technology is determined when it becomes available for use.

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

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**Example 21** University, an organization described in section 501(c)(3), finances its life sciences department with proceeds of tax-exempt bonds. University and Corporation enter into a research agreement whereby Corporation sponsors research related into a particular bacteria and its effect on the human body. The agreement provides that the any resulting technology from the research may be acquired by Corporation at the end of the term of the research agreement at the fair market value when it s acquired. The research agreement does not result in private use of the bond-financed property by Corporation. See section 5.02 of Rev. Proc. 97-14.

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## Research Agreements Resulting in Private Business Use (Treas. Reg. Section 1.141-3(b)(6)), Continued

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### Cooperative Research Agreements

A research agreement relating to property used pursuant to a joint industry-governmental cooperative research arrangement does not result in private use if—

- (i) Multiple, unrelated sponsors agree to fund governmentally performed basic research;
  - (ii) The research to be performed and the manner in which it is to be performed (for example, selection of the personnel to perform the research) is determined by the qualified user;
  - (iii) Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user; and
  - (iv) Sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research.
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### Example 22

University, an organization described in section 501(c)(3), finances its life sciences department with proceeds of tax-exempt bonds. University and Association, a group of corporations that manufacture and sell drugs, enter into a research agreement whereby Association provides a grant to the University to sponsor research related into a particular bacteria and its effect on the human body. The agreement provides that University will have control over the specific research to be performed and the University's professors and students will do the research. Further, any resulting technology (patent, etc.) from the research will be owned by University. Association, or its members, will have a nonexclusive, royalty free license to use the resulting technology. The research agreement does not result in private use of the bond-financed property by Association

See section 4.03 of Rev. Proc. 97-14. See also, PLR 199914045.

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## Use by the General Public

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

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**Example 23** State issues bonds to purchase land and construct a hotel for use by the general public (that is, tourist, visitors, and business travelers). The bond documents provide that State will own and operate the project for the term of the bonds. State will not enter into a lease or license with any user for use of rooms for a period longer than 200 days (although users may actually use rooms for consecutive periods in excess of 200 days). Use of the hotel by hotel guests who are traveling in connection with trades or businesses of nongovernmental persons is not a private business use of the hotel by these persons because the hotel is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

See Example 12 under Treas. Reg. § 1.141-3(f).

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**Example 24** Assume the same facts as in Example 27 except that State enters into an agreement with Corporation having a term of 1 year that provides Corporation the use of 10 percent of rooms for its corporate clients and employees. The 10 percent of the property reserved for the Corporation is used in its trade or business and is therefore considered to be private business use.

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**Facilities Not Available for Use by the General Public** Private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons. This is true even if those nongovernmental persons have no special legal entitlement to use of the property in the case of financed property that is not available for use by the general public.

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**200 Day Use** Arrangements longer than 200 days are NOT treated as general public use. See Treas. Reg. § 1.141-3(c)(3).

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## Other Actual or Beneficial Use

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**Priority Rights** An arrangement that conveys priority rights to the use or capacity of a facility is NOT use on the same basis as the general public. This type of use generally results in private business use.

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**Example 25** Corporations C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory. Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest.

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

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## Other Actual or Beneficial Use, Continued

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### **Economic Benefits**

In the case of a tax-exempt financed facility that is NOT available for use by the general public, private use may be established solely on the basis of economic benefits to a nongovernmental person, even if the nongovernmental person has no special legal entitlement.

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### **Example 26**

J, a political subdivision, owns and operates a hydroelectric generation plant and related facilities. Pursuant to a take or pay contract, J sells 15 percent of the output of the plant to Corporation K, an investor-owned utility. K is treated as a private business user of the plant. Under the license issued to J for operation of the plant, J is required by federal regulations to construct and operate various facilities for the preservation of fish and for public recreation. J issues its obligations to finance the fish preservation and public recreation facilities. K has no special legal entitlements for beneficial use of the financed facilities. The fish preservation facilities are functionally related to the operation of the plant. The recreation facilities are available to natural persons on a short-term basis according to generally applicable and uniformly applied rates. The recreation facilities are treated as used by the general public. K's use is not treated as private business use of the recreation facilities because K has no special legal entitlements for beneficial use of the recreation facilities. The fish preservation facilities are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under all of the facts and circumstances (including the functional relationship of the fish preservation facilities to property used in K's trade or business), K derives a special economic benefit from the fish preservation facilities. Therefore, K's private business use may be established solely on the basis of that special economic benefit, and K's use of the fish preservation facilities is treated as private business use.

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

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## Other Actual or Beneficial Use, Continued

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**Special  
Economic  
Benefit Test**

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

- Whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person;
  - Whether only a small number of nongovernmental persons receive the special economic benefit; AND
  - Whether the cost of the financed property is treated as depreciable by any nongovernmental person.
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## Other Exceptions to the Private Use Rule (Treas. Reg. § 1.141-3(d))

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

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

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**Certain 100 Day Arrangements** Use by a nongovernmental person is not private business use if:

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

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**Example 27** Authority E uses all of the proceeds of its bonds to construct a prison. E contracts with Federal Agency F to house federal prisoners on a space-available, first-come, first-served basis, pursuant to which F will be charged approximately the same amount for each prisoner as other persons that enter into similar transfer agreements. It is reasonably expected that other persons will enter into similar agreements. The term of the use under the contract is not longer than 100 days, and F has no right to renew, although E reasonably expects to renew the contract indefinitely. The prison is not financed for a principal purpose of providing the prison for use by F. It is reasonably expected that during the term of the bonds, more than 10 percent of the prisoners at the prison will be federal prisoners. F's use of the facility is not general public use because this type of use (leasing space for prisoners) is not available for use on the same basis by natural persons not engaged in a trade or business. The issue does not meet the private business use test, however, because the lease is not longer than 100 days.

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

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## Other Exceptions to the Private Use Rule (Treas. Reg. § 1.141-3(d)), Continued

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### 50 Day Use

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

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

See Treas. Reg. § 1.141-3(d)(3)(ii) and Example 16 under section Treas. Reg. § 1.141-3(f).

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### Temporary Use by Developers

Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the issuer and the developer reasonably expect on the issue date:

- to proceed with all reasonable speed to develop the improvement and property benefited by that improvement, and
  - to transfer the improvement to a governmental person, if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.
- 

### Incidental Use

Incidental use of a financed facility, that does not exceed 2.5 percent of the proceeds of the issue, is disregarded if:

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



## Other Exceptions to the Private Use Rule (Treas. Reg. § 1.141-3(d)), Continued

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### **Qualified Improvements**

Proceeds that provide a governmental owned improvement to a governmental owned building are not used for a private business use if:

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

## Measurement of Private Business Use (Treas. Reg. § 1.141-3(g))

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**General Rule** The amount of private business use of property determined according to the average percentage of private business use of that property during the measurement period.

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**Measurement Period** The measurement period of property financed by an issue begins on the **later** of:

- the issue date of that issue, OR
- the date the property is placed in service.
- The measurement period ends on the **earlier** of:
- the last date of the reasonably expected economic life of the property, OR
- the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates).

See Treas. Reg. § 1.141-3(g)(2)(i).

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**Example 28** On June 1, 2000, County issues bonds to construct an office building for its own use. The construction is completed on August 15, 2003 and the building is placed in service on such date. The reasonably expected life of the building is 40 years and the latest maturity date of bond issue is June 1, 2030. The measurement period for the office building begins on August 15, 2003 and ends on June 1, 2030.

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

See Treas. Reg. § 1.141-3(g)(2)(ii).

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*Continued on next page*

## Measurement of Private Business Use (Treas. Reg. § 1.141-3(g)), Continued

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**Example 29** On June 1, 2000, County issues bond anticipation notes to finance the construction of an office building. The construction is completed on August 15, 2003 and the building is placed in service on such date. On September 1, 2003, County issues bonds to refund the BANs. The reasonably expected life of the building is 40 years and the latest maturity date of bond issue is June 1, 2030. The measurement period for the office building begins on August 15, 2003 and ends on June 1, 2030.

---

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

See Treas. Reg. § 1.141-3(g)(2)(iv).

---

**Anti-Abuse Rule** The Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any one-year period, if an issuer establishes the term of an issue:

- for a period that is longer than is reasonably necessary for the governmental purposes of the issue, or
- for a principal purpose of increasing the permitted amount of private business use,

See Treas. Reg. § 1.141-3(g)(2)(v).

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**Average Use** The average percentage of private business use is the average of the percentages of private business use during the one-year periods within the measurement period.

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*Continued on next page*

## Measurement of Private Business Use (Treas. Reg. § 1.141-3(g)), Continued

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### **Determining Average Use**

Average private business use during one-year is determined by comparing the amount of private business use during the year to the total amount of all use (private business use and government use) during the year. Periods of nonuse are disregarded when computing percentage use.

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

See Treas. Reg. § 1.141-3(g)(4)(ii).

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### **Simultaneous Use**

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

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

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

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### **Fair Market Value**

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

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*Continued on next page*

## Measurement of Private Business Use (Treas. Reg. § 1.141-3(g)), Continued

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### Example 30

City L issues bonds and uses all of the proceeds to construct a stadium. L enters into a long-term contract with a professional sports team T under which T will use the stadium 20 times during the year. This use will occur on nights and weekends. L reasonably expects that the stadium will be used more than 180 other days each year, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of T's uses when compared to the other uses that T is reasonably expected to make for its use. Assuming no other private business use, the issue does not meet the private business use test because not more than 10 percent of the use of the facility is for a private business use.

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

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### Example 31

City N issues bonds to finance the construction of an airport terminal. Eighty percent of the leasable space of the terminal will be leased to private air carriers. The remaining 20 percent of the leasable space will be used, for the term of the bonds, by N for its administrative purposes. The common areas of the terminal, including waiting areas, lobbies, and hallways are treated as 80 percent used by the air carriers for purposes of the private business use test.

See Example 3 under Treas. Reg. § 1.141-3(g)(8).

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## Section 3

### Private Security or Payment Test

#### Overview

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##### Introduction

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

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##### Private Security or Payment Test

Except as otherwise provided in Treas. Reg. § 1.141-4, an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement directly or indirectly) secured by an interest in:

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

This section contains the following topics:

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## Measurement of Private Payment and Security (Treas. Reg. § 1.141-4(b))

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

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**Example 32** City M issues general obligation bonds with proceeds of \$10 million to finance a 5-story office building. The bonds bear interest at a variable rate that is recomputed monthly according to an index that reflects current market yields. The yield that the interest index would produce on the issue date is 6 percent. M leases 1 floor of the office building to Corporation T, a nongovernmental person, for the term of the bonds. Under all of the facts and circumstances, T is treated as using more than 10 percent of the proceeds. Using the 6 percent yield as the discount rate, M reasonably expects on the issue date that the present value of lease payments to be made by T will be 8 percent of the present value of the total debt service on the bonds. After the issue date of the bonds, interest rates decline significantly, so that the yield on the bonds over their entire term is 4 percent. Using this actual 4 percent yield as the discount rate, the present value of lease payments made by T is 12 percent of the present value of the actual total debt service on the bonds. The bonds are not private activity bonds because M reasonably expected on the issue date that the bonds would not meet the private security or payment test and because M did not take any subsequent deliberate action to meet the private security or payment test.

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**Example 33** Assuming the same facts as Example 36, except that 5 years after the issue date M leases a second floor to Corporation S, a nongovernmental person, under a long-term lease. Because M has taken a deliberate action, the present value of the lease payments must be computed. On the date this lease is entered into, M reasonably expects that the yield on the bonds over their entire term will be 5.5 percent, based on actual interest rates to date and the then-current rate on the variable fixed bonds. M uses this 5.5 percent yield as the discount rate. Using this 5.5 percent yield as the discount rate, as a percentage of the present value of the debt service on the bonds, the present value of the lease payments made by S is 3 percent. The bonds are private activity bonds because the present value of the aggregate private payments is greater than 10 percent of the present value of debt service.

See Examples 3(i) and (ii) under Treas. Reg. § 1.41-4(g).

Module M of this text discusses the computation of present value.

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*Continued on next page*

## Measurement of Private Payment and Security (Treas. Reg. § 1.141-4(b)), Continued

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

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## Private Payments for Use

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### **Direct and Indirect**

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

See Treas. Reg. § 1.141-4(c)(2).

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### **Example 34**

J, a political subdivision of a state, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. Under all of the facts and circumstances, the private business use test will be met with respect to each issue that will be used for the rehabilitation and construction of buildings that will be leased or sold to nongovernmental persons for use in their trades or businesses. Nongovernmental persons will make payments for these sales and leases. There is no limitation either on the number of issues or the aggregate amount of bonds that may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal of, and the interest on, each issue. Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements. The payments relating to these leases and sales are taken into account as private payments to determine whether each issue of bonds meets the private security or payment test.

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

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

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

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

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

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## Private Payments for Use, Continued

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### Payments in Respect of Property

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

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### Example 35

In order to further public safety, City Y issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by City Y on the customers of the utility. Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Y by the utility company for the undergrounding are, however, taken into account as private payments.

See Example 4 of Treas. Reg. § 1.141-4(g).

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### Example 36

City P issues general obligation bonds to finance the renovation of a hospital that it owns. The hospital is operated for P by D, a nongovernmental person, under a management contract that results in private business use under Treas. Reg. 1.141-3. P will use the revenues from the hospital (after the required payments to D and the payment of operation and maintenance expenses) to pay the debt service on the bonds. The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

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

---

### Payments for Operating Expenses

Ordinary and necessary expenses properly allocable to the operation and maintenance of the financed property would not be considered a payment for the use of the proceeds allocable to that space.

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

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## Private Payments for Use, Continued

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**Payments for Overhead**

Payments attributable to general overhead and administrative expenses, not directly attributable to operations and maintenance, are payments for use.

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**Refinanced Debt Service**

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

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## Allocation of Payments

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### **Generally**

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

See Treas. Reg. § 1.141-4(c)(3)(i).

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### **Discrete Property**

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

See Treas. Reg. § 1.141-4(c)(3)(ii).

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## Allocation of Payments, Continued

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

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

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

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

See Treas. Reg. § 1.141-4(c)(3)(iii)

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## Allocation of Payments, Continued

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### Example 37

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

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

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### Example 38

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

See Example 8 of Treas. Reg. 1.141-4(g).

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## Allocation of Payments, Continued

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

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

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

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

See Treas. Reg. § 1.141-4(c)(3)(iv).

---

### **Payments Allocated to Equity**

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

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

See Treas. Reg. § 1.141-4(c)(3)(v).

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## Private Security Test (Treas. Reg. § 1.141-4(d))

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

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

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

See Treas. Reg. § 1.141-4(d)(2).

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**Example 39** County W issues certificates of participation in a lease of a building that W owns and covenants to appropriate annual payments for the lease. A portion of each payment is specified as interest. More than 10 percent of the building is used for private business use. None of the proceeds of the obligations are used with respect to the building. W uses the proceeds of the obligations to make a grant to Corporation Y for the construction of a factory that Y will own. Y makes no payments to W, directly or indirectly, for its use of proceeds, and Y has no relationship to the users of the leased building. If W defaults under the lease, the trustee for the holders of the certificates of participation has a limited right of repossession under which the trustee may not foreclose but may lease the property to a new tenant at fair market value. The obligations are secured by an interest in property used for a private business use. However, because the property is not provided by a private business user and is not financed property, the obligations do not meet the private security or payment test.

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

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## Private Security Test (Treas. Reg. § 1.141-4(d)), Continued

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### Secured by any Interest in Property or Payments

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

See Treas. Reg. § 1.141-4(d)(4).

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### Example 40

Hospital, an organization described in section 501(c)(3), uses proceeds of an issue to finance a new wing at its facilities. As security for the bonds, Hospital grants a mortgage on the bond-financed property to the trustee for the bondholders and a mortgage on its medical office building. The office building is used by physicians in their private practice. The mortgage on the office building is treated as private security.

---

### Payments in Respect of Property

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

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

See Treas. Reg. § 1.141-4(d)(5).

In PLR 199928036 the Service ruled that revenues received by universities from stadium are payments in respect of property. City C will construct a stadium through Authority. State S will provide grant to construct stadium. S will receive some weekday parking spaces. The sports team will have exclusive 30-year lease of stadium. Public university will use stadium for its home games. Another university will use stadium one game per year. The Service stated that Partnership P, that owns the team, has “special legal entitlement” to use the stadium as lessee and therefore P’s use of stadium is private business use. Additionally, since P manages stadium even when the universities use the stadium, revenues received by the universities are revenues in respect of stadium.

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## Private Security Test (Treas. Reg. § 1.141-4(d)), Continued

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### **Allocation of Security**

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

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## Generally Applicable Taxes (Treas. Reg. § 1.141-4(e))

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

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**Definition** A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes.

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

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**Special Charges** A tax or a payment in lieu of tax that is limited to the property or persons benefited by an improvement is not a generally applicable tax.

Rev. Rul. 77-29, 1977-1 C.E. 44, involved an annual fee imposed upon all residential and commercial real property situated in the county for the collection and disposal of refuse. The fees were specifically earmarked for the sanitation department, and were not levied at a like rate against all property in the county. The revenue ruling states that a tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes. A tax is not a payment for some special privilege granted or service rendered. Ordinarily, when an amount is paid into a specific fund or earmarked for a specific purpose, it is treated as imposed as a regulatory measure, or as a charge for a privilege or service rendered. See also Rev. Rul. 61-152, 1961-2 C.B. 42, and Rev. Rul. 71-49, 1971-1 C.E. 103.

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## Generally Applicable Taxes (Treas. Reg. § 1.141-4(e)), Continued

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### Special Charges (continued)

In TAM 9250005, the Service held that City's tax increment bond, issued as a financial incentive for manufacturer to make improvements to its industrial facility, is found to be a private activity bond. The private use test of section 141(b)(1) is met, as site improvements (soil stabilization) were on company's property. The tax increment revenues meet private payment or security of section 141(b)(2) as they are not "generally applicable taxes." "The agreements to raise the assessed market value of the property, to insure the property, and to not defer the payment of the property taxes were a plan to generate enough additional property tax from [company's] property alone to pay the debt service on the" bond. As proceeds were not used for an essential governmental function, bond also meets private loan financing test of section 141(c).

In PLR 9735018 the Service held that a passenger facilities charge ("PFC") authorized by the Federal Aviation Administration, was not a generally applicable tax. PFC is collected from essentially all passengers that enplaned at Airport. Air taxi passengers and frequent flyers were not charged the PFC. PFC was not exacted pursuant to legislative authority in the exercise of the taxing power of State or any of its political subdivisions. Moreover, it could only be used to finance the allowable costs of projects approved by the FAA. The ruling stated that, in substance, the PFC is a charge on limited members of the public for the privilege of using Project or a charge for services rendered to limited members of the public who use Project. Accordingly, the PFC is a payment in respect of project (i.e., the airport facilities) which was to be used or to be used for private business use.

In PLR 9534014 the Service held that bonds to be issued by state authority to pay owners and operators of underground storage tanks for corrective action will not, as the program (extensively described in the ruling) is designed, be private activity bonds. Bonds are to be paid from a petroleum products regulatory fee imposed on refiners and importers, rather than on owners and operators of the tanks; and amounts payable by the latter will not be available to pay bonds or for the corrective action towards which bond proceeds are to be applied. The regulatory fee is a tax of general application and not a payment for a special privilege granted or service rendered for purposes of section 141(b)(2). A registration fee is not a tax of general application since it is imposed on the owners and operators of underground storage tanks that are the beneficiaries of the fund; however such fee is not a payment in respect of bond-financed property under section 141.

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## Generally Applicable Taxes (Treas. Reg. § 1.141-4(e)), Continued

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### **Impermissible Agreements**

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

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

### **Permissible Agreements**

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

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

### **Payments in Lieu of Taxes**

A tax equivalency payment and any other payment in lieu of a tax is treated as a generally applicable tax if:

- The payment is commensurate with and not greater than the amounts imposed by a statute for a tax of general application, AND
  - The payment is designed for a public purpose and is not a special charge as described above.
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## Generally Applicable Taxes (Treas. Reg. § 1.141-4(e)), Continued

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### Example 41

Authority N issues bonds to finance the construction of a stadium. Under a long-term lease, Corporation X, a professional sports team, will use more than 10 percent of the stadium. X will not, however, make any payments for this private business use. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium. The portion of the ticket tax attributable to tickets purchased by persons attending X's events will, on a present value basis, exceed 10 percent of the present value of the debt service on N's bonds. The bonds meet the private security or payment test. The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to X's events, the taxes are payments in respect of property used for a private business use.

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### Example 42

The facts are the same as Example 45, except that the ticket tax is imposed by N on tickets purchased for events at a number of large entertainment facilities within the N's jurisdiction (for example, other stadiums, arenas, and concert halls), some of which were not financed with tax-exempt bonds. The ticket tax is a generally applicable tax and therefore the revenues from this tax are not payments in respect of property used for a private business use. The receipt of the ticket tax does not cause the bonds to meet the private security or payment test.

See Examples 11 (i) and (ii) of Treas. Reg. § 1.141-4(g).

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## Waste Remediation Bonds (Treas. Reg. § 1.141-4(f))

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**Purpose** This section applies to bonds issued to finance hazardous waste clean-up activities on privately owned land.

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

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**Generally Applicable Requirement** This provision applies only if the payments are made pursuant to either

- a generally applicable state or local taxing statute, or
- a state or local statute that regulates or restrains activities on an industrywide basis of persons who are engaged in generating or handling hazardous waste, or in refining, producing, or transporting petroleum, provided that those payments do not represent, in substance, payment for the use of proceeds.

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**Private Users** The payments are not taken into account as private payments if:

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

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

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## Section 4

### Private Loan Financing Test (Treas. Reg. § 1.141-5)

#### Overview

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

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

In *City of New York v. Commissioner*, 70 F.3d 142 (D.C. Cir. 1995), *aff'g* 103 T.C. No. 27 (1994), the United States Court of Appeals for the District of Columbia Circuit affirmed the holding of the United States Tax Court that bonds to be issued by the City of New York, more than 5% of the proceeds of which are to be used to refinance loans to private developers of low-income housing projects, would be taxable private activity bonds by virtue of satisfying the private loan financing test. Although the loans, originally financed with short-term taxable bonds, bore interest rates that were substantially below market and the cash flows payable on the loans would have a present value, when discounted at a market rate, of less than 5% of the proceeds of the bonds, the court rejected the City's arguments in support of applying time-value-of-money concepts and a bifurcation of the loans into loan and grant components. The court felt that the plain language of the statute (Section 141(c)) required the application of the private loan financing test to the face amount of the loan rather than to its present value.

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

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

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

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## Overview, Continued

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### Nonpurpose Loans

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

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

- during a temporary period,
- as part of a reasonably required reserve or replacement fund,
- as part of a refunding escrow, or
- as part of a minor portion (as each of those terms are defined in Treas. Reg. § 1.148-1 or 1.148-2)

are generally not treated as loans under the private loan financing test.

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### Prepayment Loans

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

See Treas. Reg. § 1.141-5(c)(2)(ii) for limited exceptions.

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### Tax Assessment Loans

A **tax assessment loan** is not a loan for purposes of Treas. Reg. § 1.141-5 (the private loan financing test) if certain requirements are met. A “tax assessment loan” arises when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies the following requirements:

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

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### **Example 43**

City D creates a special taxing district consisting of property owned by nongovernmental persons that requires environmental clean-up. D imposes a special tax on each parcel within the district in an amount that is related to the expected environmental clean-up costs of that parcel. The payment of the tax over a 20-year period is treated as a loan by the property owners for purposes of the private loan financing test. The special district issues bonds, acting on behalf of D, that are payable from the special tax levied within the district, and uses the proceeds to pay for the costs of environmental clean-up on the property within the district. The bonds meet the private loan financing test because more than 5 percent of the proceeds of the issue are loaned to nongovernmental persons. The issue does not meet the tax assessment loan exception because the improvements to property owned by a nongovernmental person are not an essential governmental function under section 141(c)(2).

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

In TAM 9250005, the Service held that City's tax increment bond, issued as a financial incentive for manufacturer to make improvements to its industrial facility, is found to be a private activity bond. Because the proceeds were not used for an essential governmental function, bond also meets private loan financing test of section 141(c).

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### **Turnkey Contracts**

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

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*Continued on next page*

## Overview, Continued

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### Example 44

State agency Z and federal agency H will each contribute to rehabilitate a project owned by Z. H can only provide its funds through a contribution to Z to be used to acquire the rehabilitated project on a turnkey basis from an approved developer. Under H's turnkey program, the developer must own the project while it is rehabilitated. Z issues its notes to provide funds for construction. A portion of the notes will be retired using the H contribution, and the balance of the notes will be retired through the issuance by Z of long-term bonds. Z lends the proceeds of its notes to Developer B as construction financing and transfers title to B for a nominal amount. The conveyance is made on condition that B rehabilitate the property and reconvey it upon completion, with Z retaining the right to force reconveyance if these conditions are not satisfied. B must name Z as an additional insured on all insurance. Upon completion, B must transfer title to the project back to Z at a set price, which price reflects B's costs and profit, not fair market value. Further, this price is adjusted downward to reflect any cost-underruns. For purposes of section 141(c), this transaction does not involve a private loan.

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## Section 5

### Unrelated or Disproportionate Use Test

(Treas. Reg. § 1.141-9)

#### Overview

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##### **General Rule**

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

- First, determine whether a private business use is related to a government use
  - Next, examine private business use that relates to the government to determine whether it is disproportionate to that government use.
  - Then, aggregate all the unrelated use and disproportionate use financed with the proceeds of an issue to determine compliance with the unrelated or disproportionate use test.
- 

##### **Unrelated Use**

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

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##### **Use for Some Purpose as Government Use**

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

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## Unrelated or Disproportionate Use Test, Continued

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

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**Example 45** County issues \$20 Million principal amount of bonds and uses \$18.1 million of the proceeds for construction of a new school building and \$1.9 million of the proceeds for construction of a privately operated cafeteria in its administrative office building, which is located at a remote site. The cafeteria secures the bonds, in part. The \$1.9 million of proceeds is unrelated to the government use (that is, school construction) financed with the bonds and exceeds five percent of \$20 million. Thus, the issue meets the private business tests.

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

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**Example 46** County issues \$20 Million principal amount of bonds for the construction of a hospital with no private business use (\$17 million); renovation of an office building with no private business use (\$1 million); and construction of a garage that is entirely used for private business use (\$2 million). The use of the garage is related to the use of the office building but not to the use of the hospital. The private business use of the garage results in \$1 million of disproportionate use because the proceeds used for the garage (\$2 million) exceed the proceeds used for the related government use (\$1 million). The bonds are not private activity bonds, however, because the disproportionate use does not exceed five percent of the proceeds of the issue.

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

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## Section 6

### Effective Dates

#### Overview

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##### **1997 Regulations**

The private activity bond regulations (Treas. Reg. §§ 1.141-0 through 1.141-16 and 1.145-0 through 1.145-2, along with others) apply to bonds issued on or after May 16, 1997. See Treas. Reg. § 1.141-15(b)(1).

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##### **Short-Term Arrangements**

The provisions of section 1.141-3 that refer to arrangements for 200 days, 100 days, or 50 days apply to any bond sold on or after November 20, 2001 and may be applied to any bond outstanding after such date to which section 1.141-3 applies. See Treas. Reg. § 1.141-15(b)(2).

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##### **Retroactive Application**

The 1997 regulations generally permit elective, retroactive application of the regulations in whole, **but not in part**, to

- (i) Outstanding bonds that are sold before November 22, 2002 and subject to section 141; or
- (ii) Refunding bonds that are sold on or after November 22, 2002, and are subject to section 141.

See Treas. Reg. § 1.141-15(h).

The 1997 regulations permit elective retroactive application of each of the following sections to any outstanding issues:

- Treas. Reg. § 1.141-12 (the remedial action rules),
- Treas. Reg. § 1.141-3(b)(4) (the management contract rules), AND
- Treas. Reg. § 1.141-3(b)(6) (the research agreement rules).

See Treas. Reg. § 1.141-15(e).

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##### **1986 Act**

See sections 1311 and 1312 of the Tax Reform Act of 1986 for effective dates and transition rules for the 1986 Act.

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# Summary

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## **Review of Module D**

A private activity bond is any bond which meets:

- the private business use test, AND
- the private security or payment test, OR
- the private loan financing test.

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

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

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## **Preview of Module E**

Module E introduces you to exempt facility bonds described in IRC § 142. These bonds are the first specific type of qualified private activity bonds to be discussed in the text. Other types will follow in Modules F through I.

There are many different kinds of exempt facility bonds, all of which are discussed in the module. Some rules in IRC § 142 apply to all types of exempt facility bonds while others apply only to a specific type of exempt facility bond.

The following sections also apply to exempt facility bonds:

- IRC § 141, AND
  - IRC §§ 146 through 150.
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## Student Exercises

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### Facts

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

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

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### Required:

1. Prepare the business use schedule using the following information and "Mod D-use(st)" on your floppy disk:  
 Economic life of stadium - 40 years  
 Maturity date of bonds - June 1, 2027
2. Prepare the payment schedule using the following information and "Mod-D-Payment(st)" on your floppy disk:

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

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