Locke Lord LLP

Locke Lord Edwards
111 Huntington Avenue
Boston, MA 02199
Telephone: 617-239-0100
Fax: 617-227-4420
www.lockelord.com

TO: Beth Pearce, Scott Baker, State of Vermont

FROM: Jennifer Mendonça, Walter St. Onge, Locke Lord LLP

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RE: A Brief Overview of Remedial Actions With Respect to Tax-Exempt Governmental Bonds; Treasury Regulations Section 1.141-12

A tax-exempt governmental bond is any obligation of a state or political subdivision that is not a "private activity bond." Bonds are private activity bonds if they meet the private business use and private security or payment tests. Generally, the private business tests are met if (1) more than 10% of the proceeds of an issue is used in a trade or business carried on by a nongovernmental person,[1] and (2) the payment of principal or interest on more than 10% of the issue is directly or indirectly secured by or derived from property used or to be used for a private business use or payment in respect of such property.[2]

A nongovernmental person will be treated as "using" (each use, a "Private Business Use") proceeds of tax exempt obligations to the extent the nongovernmental person:

- borrows proceeds of the tax exempt obligations,
- uses any portion of the projects financed with tax exempt obligations as owner, lessee, service provider, operator or manager,
- acquires the output of such projects, or
- enters into any other arrangement that provides a special legal entitlement or special economic benefit to a nongovernmental person.

The amount of Private Business Use of bond-financed property is generally determined according to the average percentage of Private Business Use during the measurement period. Typically, the measurement period begins on the later of the issue date of the bonds or the date the property is placed in service and ends on the earlier of the last day of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing (or refinancing) the property. The average percentage of Private Business Use is the average of the percentages of private business use during 1-year periods within the measurement period.

[1] Note that organizations described in Section 501(c)(3) of the Code and the federal government are considered nongovernmental persons.
[2] These 10% limitations are reduced to 5% for private business uses of bond proceeds that are unrelated or disproportionate to the governmental purposes of the issue.

Under the Code, a deliberate action that would cause an issue to be characterized as a private activity bond issue jeopardizes the tax-exempt status of such bonds (see "When a Deliberate Action Occurs" below) unless all of the following requirements are met and the issuer undertakes a timely remedial action:

(1) Reasonable Expectations. The issuer reasonably expected on the date of issue that the issue would not meet the private activity bond tests for the entire term of the bonds.[3]

(2) Maturity Not Unreasonably Long. The term of the issue must not be longer than reasonably necessary for the governmental purposes of the issue. This requirement will be met if the bonds satisfied the weighted average maturity limit based on project useful lives when the bonds were issued.

(3) Fair Market Value Consideration. Except with respect to the alternative use of facility remedial action described below, the terms of any agreements that result in satisfaction of the private activity bond tests are bona fide and arm's length and the new user/owner pays fair market value for its use.

(4) Disposition Proceeds. The issuer must treat any disposition proceeds as bond proceeds for the purposes of the arbitrage rules imposed by the Code.

(5) Proceeds Expended. Except with respect to the redemption or defeasance remedial action described below, the proceeds of the issue affected by the deliberate action must have been expended on a governmental purpose before the deliberate action.

Remedial Action Options

Treasury Regulations Section 1.141-12 (the "Remedial Action Regulations") describes procedures to remediate any use of bond proceeds that would cause the bond issue to meet the private business tests. The effect of the remedial action is to cure the deliberate action that causes the issue to meet the private business tests and thus to ensure that the tax-exempt status of the bonds is maintained.

(1) Redemption Or Defeasance Of Nonqualified Bonds.

(a) All of the nonqualified bonds (see "Definition of Nonqualified Bonds" below) must be redeemed within 90 days of the deliberate action or a defeasance escrow must be established within such period, using amounts other than proceeds of tax-exempt bonds. If there is a disposition of bond-financed property exclusively for cash in an amount less than the total amount of nonqualified bonds (e.g., as a result of a sale at a loss), the requirements are satisfied

[3] If the issuer reasonably expects to take a deliberate action during the term of the bonds but (a) the issuer reasonably expects as of the issue date that the financed property will be used for a qualified purpose for a substantial period before the action, (b) all nonqualified bonds are required to be redeemed within 6 months of the date of action, and (c) the issuer does not enter into any arrangement with a nongovernmental person as of the issue date with respect to the specific action, then the term of the bonds for this purpose may be determined taking into account mandatory redemption provisions.

if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds within 90 days of the deliberate action or to establish a yield-restricted defeasance escrow within such period.

(b) If a defeasance escrow is established, the issuer must notify the IRS of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

(c) Notwithstanding the foregoing, the establishment of a defeasance escrow will not be considered a remedial action if the period between the issue date and the first call date of the nonqualified bonds is more than 10.5 years.

(2) Alternative Use Of Disposition Proceeds. Use of disposition proceeds for an alternative use is a remedial action, if:

(a) The deliberate action involves a transfer exclusively for cash.

(b) The issuer reasonably expects to spend the disposition proceeds within 2 years of the deliberate action.

(c) The disposition proceeds are used in a manner that does not cause the issue to meet either the private activity bond tests or the private loan financing test.

(d) Any disposition proceeds not so used are used for another remedial action (such as redemption or defeasance of nonqualified bonds).

(3) Alternative Use Of Facility. Alternative use of a facility is treated as a remedial action if all of the following are met:

(a) The facility is used in an alternative manner (*i.e.*, used for a qualifying purpose by a nongovernmental person or a 501(c)(3) organization rather than a governmental person).

(b) The nonqualified bonds are treated as reissued as of the date of deliberate action for certain purposes of the Code pertaining to tax-exempt bonds, such as information reporting and public hearings and approvals.

(c) The deliberate action does not involve a transfer to a purchaser that finances the acquisition with proceeds of tax-exempt bonds.

(d) Any disposition proceeds other than those arising from an agreement to provide services are used to pay debt service on the bonds on the next debt service payment date or are deposited in a yield restricted escrow within 90 days of receipt to pay debt service on bonds on the next available debt service payment date.

Definition Of Nonqualified Bonds. The nonqualified bonds are the portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business tests. Allocations to nonqualified bonds (i) must be made on a pro-rata basis, or (ii) the issuer may treat bonds with longer maturities as the nonqualified bonds.

When a Deliberate Action Occurs. 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.

The preceding is a short overview of the federal tax law rules pertaining to remedial actions for maintaining the tax-exempt status of governmental bonds. Please call Jennifer C. Mendonça at (617) 239-0845 or Mark-David Adams at (561) 820-0281 if you have any questions about these rules or about how these rules would apply to the potential sale or lease or your bond-financed property.

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IRS

Tax Exempt Bond Topics

- Internal Revenue Manual (IRM)
- Voluntary Closing Agreement Program (VCAP)
- Published Guidance
- Forms & Publications
- Tax Statistics
- FAQs
- Taxpayer Bill of Rights
- **Tax Exempt Bonds Home**

Sale of Assets Financed with Tax-Exempt Bonds by State and Local Governments and 501(c)(3) Organizations

Governmental issuers and 501(c)(3) organizations may use this information to establish practices to monitor tax compliance throughout the period that their bonds are outstanding. This information is not intended to be cited as an authoritative source. TEB recommends that issuers and 501(c)(3) organizations review this basic information concerning remedial actions in consultation with their counsel.

For remedial action with respect to exempt facility bonds, see section 1.142-2 of the Income Tax Regulations (the "Regulations"), and for build America bonds, see IRM 7.2.3.1.2.3.

Generally

To raise needed funds, state and local governments and 501(c)(3) organizations may plan to sell property financed with tax-exempt bonds. The sale of such property could cause the bond issue to become taxable. A timely remedial action, if necessary, will help ensure that the interest on the bond issue remains tax-exempt.

There are three basic remedial action options as generally described below:

- Redemption or defeasance of nonqualified bonds
- Alternative use of disposition proceeds
- Alternative use of facility

Governmental Bonds Example

A governmental bond is one that is not a private activity bond. A bond is a private activity bond if both: (i) more than 10% of the proceeds of a bond issue are used for a private business use (the private business use test); and (ii) more than 10% of the debt service on the bonds is directly or indirectly secured by an interest in property or payments with respect to property used for a private business use or derived from payments in respect of property used for a private business use (the private security or payment test). The sale of bond-financed property, a "deliberate action," may cause the bond issue to meet both of these tests.

Private business use, generally, is use directly or indirectly in a trade or business carried on by any person other than a governmental unit. The result of meeting both the private business use test and the private security or payment test (together, the private business tests) is that the tax-exempt bond issue becomes a taxable private activity bond.

An example of when governmental bonds are likely to meet the private business tests is the sale of a tax-exempt bond financed facility to a corporation. The sale is a deliberate action because the sale was within the issuer's control. Depending on how much of the proceeds of the bond issue that the issuer used to construct or acquire the facility and how long after the bonds are issued that the sale occurs, the private business use test may be met since the purchaser is not a governmental entity. If the present value of the sales price is greater than 10% of the present value of the debt service on the bonds, the private security or payment test is met. If the revenues from the facility were pledged as security for the payment of debt service on the bonds and are expected to be more than 10% of the present value of the debt service, the private security or payment test is met (regardless of the sales price to the new purchaser). If the bond issue meets both the private business use test and the private security or payment test, the bonds are taxable unless remedial action is taken as described below.

Qualified 501(c)(3) Bonds Example

If the bonds financing the property are qualified 501(c)(3) bonds, the private business use test threshold of 10% is reduced to 5%. The 5% is further reduced by the percentage of proceeds of the bonds used to pay costs of issuance. (Up to 2% of the proceeds may be used for costs of issuance.) Additionally, use of tax-exempt bond financed property in an unrelated trade or business of any 501 (c)(3) organization, as described in section 513 of the Internal Revenue Code (the "Code"), is considered private business use and counts toward the 5% limit.

An example of qualified 501(c)(3) bonds likely to meet the private business tests is the sale of tax-exempt bond financed land to a taxable corporation. The sale is a deliberate action because the sale was within the issuer's (or 501(c)(3) borrower's) control. Depending on how much of the proceeds of the bond issue that the issuer or 501(c)(3) borrower used to construct or acquire the facility and how long after the bonds are issued that the sale occurs, the private business use test may be met since the purchaser is not a governmental entity or a 501(c)(3) organization. If the parcel of land sold was pledged as security for the payment of debt service on the bonds, the private security or payment test is met if the sales price is more than 5% of the present value of the debt service on the bonds. If the revenues from the facility were pledged as security for the payment of debt service on the bonds and are expected to be more than 5% of the present value of the debt service, the private security or payment test is met (regardless of the sales price to the new purchaser). If the bond issue meets both the private business use test and the private security or payment test, the bonds are taxable unless remedial action is taken as described below.

A qualified 501(c)(3) bond is one where, among other requirements, the tax-exempt bond financed property is owned by a 501(c)(3) organization or a governmental unit. An example of qualified 501(c)

(3) bonds failing to meet this requirement is the sale of the tax-exempt bond financed land to a taxable corporation. Accordingly, the bonds are taxable unless remedial action is taken as described below.

Remedial Action under the Treasury Regulations

The Regulations permit an issuer to take remedial action to preclude the sale of tax-exempt bond financed assets from causing the bonds to become taxable bonds. There are five basic conditions that an issuer must meet to qualify to take a remedial action. The conditions are:

- The issuer must have reasonably expected on the issue date that the bonds would not meet either the applicable private business tests (including the ownership test for qualified 501(c)(3) bonds) or the private loan financing test for the entire term of the bonds.
- The term of the bonds must not be longer than reasonably necessary for the qualified purposes of the issue (as a guideline, the term is not greater than 120% of the average reasonably expected economic life of the financed property).
- Generally, the terms of a sale must be a bona fide and arm's-length arrangement for fair market value.
- Disposition proceeds must be treated as gross proceeds for arbitrage and rebate purposes. Disposition proceeds are any amounts, including property, derived from the sale, exchange or other disposition of the tax-exempt bond financed property.
- Except for a remedial action involving the redemption or defeasance of nonqualified bonds, the proceeds must have been spent on a qualified purpose before the date of the deliberate action, that is, the sale of the bond-financed assets.

Redemption or Defeasance of Nonqualified Bonds

Generally, in the case of a sale of bond-financed property, the nonqualified bonds are the portion of the outstanding bonds equal to the percentage of the proceeds of the bond issue that financed that property. For example, if 50% of the proceeds of a bond issue financed the sold property, the nonqualified bonds equal 50% of the outstanding bonds of the issue at the time of the sale.

The first type of remedial action available is the redemption or defeasance of all of the nonqualified bonds within 90 days of the deliberate action. (Generally, proceeds of another issue of tax-exempt bonds may not be used for this redemption.) If the disposition proceeds are all cash, the issuer need not redeem or defease all of the nonqualified bonds, but must use all of the disposition proceeds to redeem a pro rata portion of nonqualified bonds. The redemption must be on the earliest call date after the deliberate action, or if the earliest call date is more than 90 days after the deliberate action, the issuer must establish a defeasance escrow within 90 days of the deliberate action. Defeasance is only permitted as a remedial action if the first call date is no more than 10 ½ years from the issue date of the bonds. The issuer must provide written notice to the Commissioner of the escrow within 90 days of its establishment.

Alternative Use of Disposition Proceeds

The second type of remedial action, available when the seller receives only cash, allows the issuer to spend the disposition proceeds within two years of the date of the sale for an alternative qualifying use. The issuer must treat the disposition proceeds as proceeds of the bonds, and must not take any action after the date of the sale to cause either the applicable private business use tests or the private loan financing test to be met. (If the bonds are qualified 501(c)(3) bonds, the disposition proceeds must be used for a qualified purpose under section 145 of the Code.) If the issuer does not expect the full amount of the disposition proceeds to be spent for a qualifying purpose within the two year period, it must use the balance of disposition proceeds to redeem (or defease) nonqualified bonds as allowed for the first type of remedial action described above.

Note: If the proceeds of a governmental bond issue are to be subsequently used by a 501(c)(3) organization, remediation by spending the disposition proceeds for an alternate use requires that the nonqualified bonds satisfy all the requirements for qualified 501(c)(3) bonds beginning on the date of the sale.

Alternative Use of Facility

The third type of remedial action available to the issuer is when the tax-exempt financed facility will be used after the sale for a purpose that is a qualifying purpose for another type of tax-exempt bonds (provided that the purchaser of the facility does not use tax-exempt bond proceeds for its purchase). The nonqualified bonds must satisfy all the requirements for the alternate type of tax-exempt bonds beginning on the date of the sale. The issuer must either apply any disposition proceeds resulting from the sale to pay the debt service on the bonds on the next available payment date or deposit the proceeds into an escrow within 90 days of their receipt. If the issuer must establish an escrow, the investment yield on the disposition proceeds must be restricted to the yield on the bonds and the escrow used to pay debt service on the next available payment date.

Allocation of Disposition Proceeds

For all three remedial actions, if the property was financed by different sources, the issuer must first allocate disposition proceeds to the outstanding bonds in proportion to the principal amounts of the outstanding bonds. If the disposition proceeds are not greater than the principal amount of outstanding bonds allocated to the sold property, the proceeds must first be allocated to the outstanding bonds before allocating to bonds no longer outstanding or to sources not derived from borrowing (such as revenues of the issuer).

Remedial Actions-Examples

The following examples assume that the above-described five conditions for remedial action are satisfied. Also, in these examples, no bond proceeds were used for costs of issuance or to fund a reserve fund.

Example 1. - Disposition proceeds are less than the principal amount of the outstanding bonds allocated to the sold property.

Issuer issues $10 million of bonds to finance the construction of a community center. Issuer later sells the center for $5 million, its fair market value. At this time, all $10 million of the bonds are still outstanding. The issuer may choose to remediate by using all $5 million of disposition proceeds to redeem within 90 days or establish a defeasance escrow for a pro rata portion of the $10 million of nonqualified bonds. The remaining outstanding $5 million of bonds would not be private activity bonds because the issuer has remediated as required by the Regulations.

Or, the issuer could remediate by using the alternative use of disposition proceeds option. Under this option, the issuer must apply the total amount of disposition proceeds, $5 million, to a qualifying alternative use within two years (or use a combination of the alternative use of disposition proceeds and redemption or defeasance options).

The disposition proceeds are considered gross proceeds of the bonds and as such are subject to the applicable yield restriction and arbitrage rebate rules pending their use as described above.

Example 2.- Disposition proceeds are greater than the principal amount of the outstanding bonds allocated to the sold property.

Issuer issues $10 million of bonds to finance a school and land. Issuer subsequently sells a portion of the land for $3 million. At this time, all $10 million of the bonds are still outstanding. The principal amount of outstanding bonds allocated to the sold property is $2 million. If the issuer chooses to remediate by redeeming bonds, it must redeem $2 million of outstanding bonds leaving the issuer with $1 million of gross proceeds.

Or, the issuer could remediate by using the alternative use of disposition proceeds option. If so, the Issuer must apply the total amount of the disposition proceeds, $3 million, to a qualifying use within two years (or use a combination of the alternative use of disposition proceeds and redemption or defeasance options).

The disposition proceeds are considered gross proceeds of the bonds and as such are subject to the applicable yield restriction and arbitrage rebate rules pending their use as described above.

Example 3. - Disposition proceeds are greater than the principal amount of the outstanding bonds allocated to the sold property and the conduit borrower finances the project in part with tax-exempt bond proceeds and in part with an equity contribution.

A 501(c)(3) conduit borrower contributed $4 million of cash from its revenues and used $6 million of tax-exempt bonds to finance a $10 million acquisition of a continuing care facility. Subsequently, the conduit borrower sells the facility for $12 million. At this time, all $6 million of the bonds are still outstanding. Thus the issuer has $6 million of nonqualified bonds. The issuer may remediate by either redeeming all of the $6 million nonqualified bonds or by requiring the conduit borrower to use $12 million of disposition proceeds for an alternative use within two years (provided all requirements of qualified 501(c)(3) bonds are met).

Of the $12 million of disposition proceeds, $6 million are considered gross proceeds of the bonds and as such are subject to the applicable yield restriction and arbitrage rebate rules pending their use as described above.

Gross Proceeds - Example 2 versus Example 3

When the tax-exempt bond financed property is sold for an amount in excess of the principal amount of the outstanding bonds allocated to that property, a different result occurs with respect to that excess amount depending on whether all the bonds of the issue have been redeemed. In Example 3, where the issuer redeemed all of the outstanding bonds, the remaining disposition proceeds are not gross proceeds of the bonds and, therefore, are no longer subject to the federal tax restrictions. This is because the amount of gross proceeds cannot exceed the amount of the outstanding bonds of the issue. Whereas in Example 2, although the issuer has redeemed the nonqualified bonds, the issuer still has bonds of the issue outstanding and thus the additional disposition proceeds are gross proceeds of the bonds and subject to the applicable yield restriction and arbitrage rebate rules pending their use.

Correction of Violations Using TEB Voluntary Closing Agreement Program (VCAP)
If an issuer or conduit borrower discovers that it has sold bond financed assets causing the applicable private business tests to be met but is ineligible to self-correct through a remedial action provision, we encourage the issuer to take advantage of the Voluntary Closing Agreement Program (TEB VCAP) to resolve federal tax violations relating to bonds as described in Notice 2008-31 and IRM section 7.2.3.

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